Twenty Years of Inflation Targeting by the Bank of England

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Abstract:

The Bank of England was only the fourth central bank in the world to adopt an inflation targeting regime but in some ways the British approach to IT represented an advance over what had been done by its predecessors, including the Bank of Canada.

The Bank of England was the first IT central bank not to use the official consumer price series as its target indicator, recognizing that a good inflation measure has somewhat different properties from a good cost-of-living index. More specifically it used the RPIX series (RPI excluding mortgage interest) as its target, rather than the Retail Price Index itself. The principle that an inflation measure should exclude interest rates was later adopted by Eurostat as one of the guiding principles for creating the Harmonized Indexes of Consumer Prices (HICPs). Later, the BoE would target the UK HICP as its own inflation indicator.

In 1989, the Treasury Department had considered excluding the community charge along with mortgage interest payments from the RPI series used as an inflation measure. Later, with the adoption of an HICP framework, the BoE excludes on principle not only property taxes but all indirect taxes that are not associated with a particular good or service. By contrast, the BoC does not even exclude property tax movements from its core CPI, which ostensibly excludes changes in indirect taxes.

Two years after adopting IT, the RPIX series was modified to include a house depreciation component. Its owner-occupied housing component then approximated a series based on the narrowly-defined net acquisitions approach, the best approach for a target inflation indicator. This approach was first adopted, a few years later, by the Reserve Bank of New Zealand, and will likely be adopted by the European Central Bank before the end of the decade.

The IT regime in Britain only ran into difficulties after housing prices were removed from the target inflation indicator, which was followed shortly by a massive housing bubble.

Keywords: CPI, inflation targeting, indirect taxes, owner-occupied housing, net acquisitions, RPIX
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The announcement that the Bank of England would adopt an inflation targeting regime was made on October 8, 1992, less than a month after the United Kingdom had withdrawn from the European Exchange Rate Mechanism. At the time it seemed like a short-term expedient until Britain could re-enter the ERM or a minor variation on the Conservative Government’s previous policy of targeting the money supply, but more than twenty years later the BoE is still an IT central bank. The 20th anniversary of this important change was duly commemorated in Britain but has attracted next to no notice here in Canada. This is a shame, because in many ways the implementation of IT in Britain improved on what had previously been done in Canada. Canadians have lessons to learn from the British experience that could help us improve both our official statistics and our monetary policy.

This paper does not provide a comprehensive analysis of the development of the IT regime in the UK, something which has been well covered in previous studies. It will concentrate primarily on the issue of the appropriate target inflation indicator for an IT central bank. Here the British approach was decidedly innovative. The Bank of England was the first IT central bank not to use the official consumer price series as its target indicator, recognizing that a good inflation measure has somewhat different properties from a good cost-of-living index. More specifically it used the RPIX series (RPI excluding mortgage interest) as its target, rather than the Retail Price Index itself. The principle that an inflation measure should exclude interest rates was later adopted by Eurostat as one of the guiding principles for creating the Harmonised Indexes of Consumer Prices (HICPs), one of which would serve as the inflation indicator for the European Central Bank. Later, the BoE itself would target the UK HICP as its own inflation indicator.

Two years after adopting IT, the RPIX series was modified to include a house depreciation component. Its owner-occupied housing component then approximated a series based on the narrowly-defined net acquisitions approach, the best approach for a target inflation indicator, and an approach that would be first adopted, a few years later, by the Reserve Bank of New Zealand.

The IT regime in Britain only ran into difficulties after housing prices were removed from the target inflation indicator, which was followed shortly by a massive housing bubble.

The first section of the paper discusses the properties of an inflation indicator appropriate to a central bank, which, except for the final one, are basically the principles to be found in the current Eurostat HICPs. The second section discusses monetary policy in the Conservative governments of Margaret Thatcher and John Major from May 1979 to October 1992, prior to the start of the IT regime. The third section looks at the central banks that adopted IT before the BoE, all of which targeted their official CPIs as inflation indicators. The fourth section considers a remarkable document from a December 1989 Chevening paper which outlined the options for an IT regime for the BoE almost three years beforehand. The fifth section asks whether an IT regime might not have been introduced earlier in Britain, in March 1987, in place of the shadowing of the Deutsche Mark, or sometime in 1990, before the decision to enter the ERM. The sixth section looks at the introduction of IT by the Chancellor of the Exchequer, Norman Lamont, and the seventh section at changes in the framework introduced by his successor, Kenneth Clarke. The eighth section looks at the constructive reforms introduced by Gordon Brown when he became the Chancellor of the Exchequer in the Blair government, and the ninth section examines his
foolish decision to take housing prices out of the target inflation indicator. The tenth section looks at the influence of IT in Britain on other countries and the final section considers the future of IT in Britain.

The Properties of an Inflation Indicator Appropriate to a Central Bank

In order to better appreciate the achievements of the IT regime in Britain, one should set out very roughly what an ideal inflation measure to be used by a central bank might look like.

First, it should be an index of market prices, as much as possible avoiding proxy series for items that cannot be priced, hypothetical prices in the absence of transactions and transaction prices where buyer and seller are not at an arm’s length from each other.

Second, the index should exclude interest payments, so the price of a good would relate to when the buyer took possession rather than when it was paid for or consumed.

Third, it should be an index of prices paid by households or with very slightly broader coverage (e.g. including residents of nursing homes) as any attempt to go to an index with broader scope, say final domestic demand, would hopelessly compromise the first objective.

Fourth, it should ignore indirect taxes that do not relate to consumption of a particular good or service, including property taxes and licence fees, such as those paid to operate a motor vehicle.

Fifth, the index should relate to expenditures of resident households and of non-resident households within the given country, ignoring the expenditures of resident households abroad. Thus, tourist expenditures and student expenditures by the resident population in other countries would be out of scope, while tourist expenditures of non-resident households and non-resident students in the country would be in scope.

Sixth, houses (or at least dwellings) should be treated as a household good like any other good, so both house purchases and alterations and improvements to existing dwellings would fall within the scope of the index.

Unfortunately, no central bank currently relies on such an inflation measure that has all six of these properties, but the first five describe the basic principles of Eurostat’s Harmonised Index of Consumer Prices, as it exists now, and the six taken together describe the HICP or its successor series as it will be when it incorporates a component for owner-occupied housing (OOH). Both the Bank of England and the European Central Bank currently target HICP series as their inflation indicators, and the ECB plans to move to an HICP that will incorporate OOH, and would satisfy all of the above criteria.

The Reserve Bank of Australia and the Reserve Bank of New Zealand both target CPIs that satisfy properties 1 to 3 and 6. Revising their CPI to satisfy all six properties would be problematic as neither Australia nor New Zealand currently has a distinct consumer price series that could serve as a cost-of-living index.
The second property recognizes that monetary policy in most countries operates in terms of a central bank’s control over interest rates. It would therefore be counterproductive for a central bank to include interest rates in an inflation measure. Hiking interest rates to fight inflation would then have the perverse effect of raising the measured rate of inflation the rate hike was intended to correct.

The fifth property, so contrary to the principles of a cost-of-living measure, recognizes the fact that the central bank has little or no influence on prices set abroad, so confines the scope of the index to domestic prices, on which it does have some control. This also has the additional advantage that these are prices which the official statistical agency has some authority to collect. Finally, in such a framework no important prices set domestically are likely to be ignored, as, for example, university tuition fees for foreigners are currently ignored in the Canadian consumer price series.

1. Monetary Policy in the United Kingdom before the IT Regime

Without trying to exaggerate them, there are striking similarities to the evolution of monetary policy in Canada and in the UK from the 1980’s forward. In each case, the central bank gave a higher priority to fighting inflation in the 1980’s, and embraced monetarism as the means of bringing inflation under control. In each case, there was disappointment with the monetary aggregates that were targeted, as the demand for money proved far more instable than had been expected. In Canada, it took years between the abandonment of targeting monetary aggregates in 1982 and the formal adoption of IT in February 1991, with no other policy regime occupying the interim. In the UK, the Thatcher government targeted the money supply for much longer, from 1979 to March 1987. Between March 1987 and February 1988 there was an informal targeting of the Deutsche Mark, i.e. an exchange rate policy, followed by a brief return to monetarism, followed by an exchange rate policy again from October 1990 to September 1992. When this collapsed Britain moved directly to an IT policy a few weeks later.

The United Kingdom did not immediately enter the European Exchange Rate Mechanism (ERM) in March 1979 when it was established as a precursor to a single European currency. The Labour government of James Callaghan was in power then and the Labour Party at that time was generally unenthusiastic about the project of European monetary integration. Ireland did do so, and this led almost immediately to an end of the peg between the Irish punt and the British pound, terminating a monetary union that had survived for centuries. The ERM was based on a parity grid of bilateral exchange rates between countries, and the actual exchange rate could only deviate from this rate by at most 6% up or down. For most countries a narrower range of 2½% above and below the parity rate applied.

Both Geoffrey Howe and Nigel Lawson had criticized Labour’s European policy in Opposition and called for Britain to join the ERM. However after Howe was sworn in as Chancellor of the Exchequer and Lawson in a Treasury portfolio, the government made no effort to bring the UK into the ERM. Margaret Thatcher had entered the House of Commons the year the Werner Report which laid out the first plan for European Monetary Union was produced. It led to the creation in April 1972 of “the snake in the tunnel”, an agreement to limit exchange movements between bilateral exchange rates of participating European countries to2¼%. Thus European currencies would snake up and down within the tunnel
agreed to in the Smithsonian Agreement of 1971, which limited currencies to exchange movements within a 4½% range against the dollar. Thatcher remembered well Britain’s disastrous experience with the snake. Her Prime Minister, Edward Heath, had signed on to the Basel Agreement in 1972, although the UK was then only a candidate country for membership in the EEC. Speculative attacks directed against the pound forced the UK out of the snake at the end of June after burning through about three billion dollars used to defend the currency.

Consequently the Conservative government adopted the control of inflation using monetarist policies as their first priority. The rate of inflation was 10.3% when they took office in May 1979. Even the Chancellor of the Exchequer Geoffrey Howe and others favourable to entering the EMS were agreeable to putting European monetary integration aside for the first term to concentrate on fighting inflation.

The Conservatives targeted sterling M3, which was one of the more broadly defined monetary aggregates. They found it difficult to forecast, a problem made more difficult by their own reforms, such as removing exchange controls, which altered the demand for money function. Nevertheless, they did succeed in bringing down inflation very substantially in the early 1980s.

When Nigel Lawson took over as Chancellor of the Exchequer in 1983, the issue of entering the ERM was revived. Monetary policy became somewhat less focussed on monetary aggregates and more attention was paid to exchange rates, and to changes in nominal GDP. From March 1987 to February 1988, Lawson adopted what Edmund Dell has called “exchange rate monetarism”, he concentrated on shadowing the Deutsche Mark, keeping the pound between £2.92 and £2.99 to the Deutsche Mark for this entire period. The rationale for this was that tying the pound to the currency of a low-inflation country was a means of guaranteeing a low inflation rate, and of course this also served as a test of the viability of entering the ERM.

This shadowing policy was conducted seemingly without the knowledge or approval of Margaret Thatcher, and when discovered was replaced by a brief return to monetary targeting. However, the new Chancellor of the Exchequer, John Major, finally brought sterling into the ERM on October 8, 1990 at a parity of £2.95, with exchange rate movements permitted within the relatively large range of 6% above and below parity (for most other currencies it was just 2½%).

This was another form of exchange rate monetarism, but now sterling was formally rather than informally linked to the Deutsche Mark and to the other currencies in the ERM. Reducing the inflation rate was the goal, and in this sense Britain’s membership in the ERM was remarkably successful. As Norman Lamont wrote:

> The speed of disinflation was remarkable. The headline rate came down from 10.9 per cent in October, to 4.5 per cent in December 1991 and to 1.7% in January 1993 an astonishing fall in just over two years... Without membership in the ERM it is highly unlikely that any UK government, let alone John Major’s, would have had the determination and consistency to pursue the anti-inflation policy necessary to deliver these results outside of the ERM. (See Lamont(1999, p.387)
Unfortunately, German reunification and high German interest rates put an enormous strain on British participation in the ERM. In Britain, the dominance of variable rate mortgages meant that high interest rates were almost immediately communicated to the mortgage market, which was not the case with any of the other countries in the ERM. Danes voted against the Maastricht Treaty in a referendum in June and the possibility that the French might also vote against the treaty on September 20 put a number of ERM currencies under heavy speculative pressure. On Black Wednesday, September 16, after intervention on the foreign exchange markets and raising the minimum lending rate had failed to keep sterling from falling below the floor rate, the Chancellor of the Exchequer Norman Lamont announced that Britain would withdraw from the ERM.

So prior to adopting an IT regime, the Conservative government had gone from targeting the money supply to shadowing the Deutsche Mark back to targeting monetary aggregates and then to membership of the ERM. There was never a long period when monetary policy was fumbling for a new objective as there was in Canada from 1982 to 1991.

However, it should be remembered that the period from 1982 to 1987 at the Bank of Canada, while it hardly could be described as exchange rate monetarism, did see more attention paid to the exchange rate than any other policy variable. John Crow has noted that during the great American disinflation that started in 1979 the Bank of Canada essentially had a de facto crawling peg for the Canadian dollar against its American counterpart. This was successful in bringing inflation down from double digits in 1982 to less than 4% by the third quarter of 1984. Also, arguably from February 1987, when John Crow became governor of the Bank of Canada, and certainly from Governor Crow’s “Edmonton Manifesto” speech in January 1988, the Bank of Canada was prioritizing reduction of inflation although it had not yet set up an inflation targeting regime. Between February 1987 and February 1991, the 12-month rate of change in the core CPI had already gone from 5.0% to 3.4%.

The most striking difference between Canada and the United Kingdom is the much stronger persistence of belief in targeting monetary aggregates. In fact, Tim Congdon, who was one of the seven economists appointed by Norman Lamont to the Panel of Independent Forecasters (see section 6) when it was established, has argued that there was never any need to adopt exchange rate monetarism and the Conservative Government would have done much better to go on targeting the money supply over the period from 1987 forward. (See Budd (2005), p. 47-54)

2. The Earlier Inflation Targeting Central Banks

On October 7, 1992 the Bank of England became the fourth central bank in the world with an IT regime, and the third IT central bank with a full IT regime. The United Kingdom was the first European country with an IT central bank, and as London is its capital it was also the first country to adopt IT that had a world-class financial centre.

New Zealand was the first country to adopt IT. The start of IT in that country should probably be dated from April Fool’s Day (I know, I know), 1988, when the Minister of Finance, Roger Douglas announced in a TV interview that New Zealand should reduce inflation within the next two years to the 0% to 2% range, and keep it there. It should certainly be dated no later than 2 March, 1990, when the first Policy
20 years

Targets Agreement was signed between the new Minister of Finance, David Caygill, and the governor of the Reserve Bank of New Zealand (RBNZ), Donald Brash, which confirmed the objective of reducing the inflation rate to 0% to 2%. Although the policy parameters of IT in New Zealand have gone through many changes since then, the inflation target has always been expressed as a range; the RBNZ has never had a point target for the inflation rate.

The inflation indicator adopted was the All-Groups CPI. This was in some ways a dubious indicator for a central bank to monitor as the New Zealand CPI adopted a broadly-defined net acquisitions approach to owner-occupied housing (OOH), similar to the approach used in the US CPI between 1953 and 1982. This meant that the All-Groups CPI included changes in mortgage interest rates, and these reflected changes in newly contracted mortgages. Any change in the bank rate would quickly be communicated to the inflation indicator.

This weakness was evident to the people at the RBNZ, so for practical purposes they relied more on a Housing-Adjusted Price Index (HAPI) with an OOH component based on rental equivalence.

Contrary to a frequently repeated assertion, the Bank of Canada was not the second central bank in the world to adopt an IT framework. This distinction belongs to the Banco Central de Chile, the Central Bank of Chile. The first inflation target was announced in September 1990, pertaining to the 12-month rate of change for the CPI in December 1991, and the Central Bank of Chile has continued to follow the same pattern. Until 1999, the Chilean central bank had a dual anchor system, since it continued to target its exchange rate against the US dollar. This did not, however, pose the problems one might expect it would, as whenever the exchange rate objective came in conflict with the inflation objective, the inflation objective was favoured.

The Central Bank of Chile began with inflation range targets, but began to specify point targets starting in 1995. The Chilean CPI excluded OOH in September 1990 and continues to do so.¹ Mortgage interest rates have never been a problem for the Chilean inflation indicator; on the other hand, it is completely insensitive to changes in current house prices.

The Bank of Canada was the third central bank in the world to adopt any IT regime, and the second to adopt a full one. This was announced jointly by the Minister of Finance, Michael Wilson, and the governor of the BoC, John Crow, on February 26, 1991. In contrast to the RBNZ and the Central Bank of Chile, the BoC had point targets for the inflation rate. Inflation was to drop to 3% by the end of 1992, to 2½% by the middle of 1994 and to 2% by the end of 1995, with further reductions in inflation to follow.

The target inflation indicator adopted was the CPI All-items. Like the New Zealand CPI, the Canadian CPI included a component for OOH, and one which incorporated mortgage interest costs. However, the

¹ The frequently repeated factoid that most countries in the OECD adopt the rental equivalence approach to OOH in their CPIs, if it is still true, contains an element of special pleading, suggesting that this is the dominant approach in the world, without actually saying so. In fact, the exclusion approach adopted by Chile is the most common one, adopted by most of most Latin America, most of Eastern Europe including Russia, by China and by many other countries, including France. France does also calculate a consumer price series with a rental equivalence approach to OOH, but it is not the official French CPI. It shows that on conceptual issues, there is seldom safety in numbers, as it is hard to justify the exclusion approach in principle.
Canadian index was not based on the net acquisitions approach, but on the landlord’s deductible cost variant of the user cost approach. All costs including depreciation, that would be treated as legitimate costs for tax purposes were included in the index, while the opportunity cost of owner’s equity was excluded as out-of-scope. (The belief of Gregor Smith, expressed in a highly publicized C.D. Howe Institute monograph, that this imputed cost was omitted from the index simply because it is difficult to calculate, is quite unfounded.) The mortgage interest cost index of the Canadian series reflected costs paid on the stock of mortgage debt, not newly initiated mortgages, so the series was not so sensitive to changes in the bank rate as its New Zealand counterpart. Nevertheless, it seems strange that there was no attempt at the time to remove mortgage interest costs at the outset from the core CPI, which initially only excluded food and energy prices and the impact of changes in indirect taxes.

3. The December 1989 Chevening Paper: Outlining the Options for British Inflation Targeting

An IT regime could not have been implemented so quickly following Black Wednesday if a lot of thought had not already been devoted to its mechanics. In this respect, a remarkable note prepared in December 1989 stands out as the blueprint for what was announced not quite three years later by the Chancellor of the Exchequer.

This was a section of the December 1989 Chevening paper prepared by an anonymous civil servant for a January 1990 meeting at Chevening House, the official residence of the Foreign Secretary. The Treasury ministers and their officials met here once a year in advance of the budget. Neither John Major, who was then the Chancellor of the Exchequer, nor Norman Lamont, who was then the Chief Secretary to the Treasury, mention this document in their memoirs. John Major thought it worthy of note that he and Norman Lamont lost to Terry Burns and Peter Middleton in the annual Ministers versus Mandarins snooker game, but not that a proposal was made to introduce an IT regime almost three years in advance of one being implemented.

In any case, although it was prepared before either the Central Bank of Chile or the BoC had committed to IT, and before the first Policy Target Agreement had been signed in New Zealand, the Chevening paper provides a detailed analysis of how IT might be implemented in Britain.

It actually outlines three different alternative policy regimes:

(i) Inflation targeting,
(ii) A price/output framework,
(iii) A money output framework (i.e. nominal GDP targeting).

The discussion of the money output framework is quite terse and it is unclear if its author had in mind targeting of the level or the growth rate of nominal GDP. However, it seems likely that the author wished to target the rate of nominal GDP growth. There is no mention of refusing to let bygones be bygones and no discussion of the presentation difficulties of constantly changing the goal for nominal GDP growth, which makes one think that the level is being targeted.

In the price/output framework the idea is that if the non-inflationary sustainable rate of growth of the economy is 3% and the target inflation rate is 2%, then an inflation rate of 4% would require that a more restrictive monetary policy be adopted, targeting a lower growth rate than 2% until the inflation rate was satisfactorily lower. Then the economy could be allowed to grow again at a normal rate. The bare bones of the description make it sound more like a different way of looking at inflation targeting rather
than a different way of looking at nominal GDP targeting. Possibly, the author thought that in the price/output framework, the inflation measure would necessarily be the GDP deflator. In a sense, it doesn’t matter, as this approach seems to have sunk without a trace.

The discussion of inflation targeting discusses the relative merits of a point target versus a target range. The author clearly doesn’t favour a point target as “even a very slight overshoot could be presented as a ‘failure’... this could be bad for both credibility and for maintaining the government’s interest in hitting targets.” Whether it was due to the influence of this paper or not, IT was introduced with a target range and not a point target. In fact, there was only a target range for inflation for the duration of the John Major government; a point target was only introduced after the Labour Party took office.

The Chevening paper also considered a third option, “to confine the inflation objective to, say, 1996 (the year when a first decision may be made on preceding to stage 3 of EMU)”. Stage 3 was the stage at which the European currency unit would come into being. In the preceding years there would be no inflation targets, only “illustrative paths” for how to arrive at the terminal year target.

This actually seems to have been the option that most interested the Treasury Department prior to Black Wednesday. The December Chevening paper for the following year, 1990, stated:

We might give an inflation objective for the final year of the MTFS [Medium Term Financial Strategy], together with illustrative paths for both output and prices over the medium term. The inflation objective for the final year would need to be in line with our assessment of the likely inflation rate in Germany, but this approach would enable the Government to signal its commitment to low inflation irrespective of developments in other ERM countries. However there would be a risk of undermining our commitment to the ERM if we sought to adopt an independent inflation objective...It is not clear that this approach would enhance credibility in practice, and the practical options we identified when looking at this last year [i.e. in the December 1989 Chevening paper] remain.

It is hardly surprising that there was no move to inflation targets while the UK was in the ERM. Keeping sterling within its bilateral parity limits was a difficult enough task without adding inflation targets to the mix.

The December 1989 Chevening paper considers two possible target inflation indicators:

(i) The Retail Price Index,  
(ii) The GDP deflator.

The paper gives no consideration to the Tax and Price Index (TPI), an alternative to the RPI that the Thatcher government had introduced in 1979. The Consumer Price Indices Technical Manual – 2012 (p.91-92) notes that: “The TPI measures how much the average person’s gross income needs to change to purchase the basket, allowing for the average amount of income tax and national insurance paid on earnings... The TPI is almost unaffected by a shift between direct and indirect taxation, which can distort the RPI.” This was why the index was introduced in 1979: there was a big increase in the RPI due to the tax changes but not in the TPI. This provided some cover for the government when it was accused of stoking inflation. However it was always a muddled concept, neither a true price index nor an index of tax rates. An equivalent to the CPI-CT for the RPI where tax rates on goods and services were kept constant at their base period levels would have been a better alternative to the TPI, but alas, was not
calculated then and has never been calculated since. The TPI continues to be published but should probably be replaced by an RPI-CT. The author of the Chevening paper was beyond any question familiar with the TPI, but obviously didn’t think it even bore mention as a target inflation indicator.

The paper seems somewhat naïve in its discussion of the GDP deflator, noting that it is a broader measure than the RPI, and less influenced by oil price shocks. The lack of arms-length transaction prices for much of GDP outside of personal expenditures, and also for important components of personal expenditures, isn’t even hinted at. Instead the GDP deflator is criticized for being quarterly not monthly, published with a considerable lag and subject to revision.

The paper notes that the RPI has “problems with respect to interest rates”, hinting at the use of RPIX instead of RPI as the target inflation indicator. It also speaks of “RPI ex-MIPs [mortgage interest payments] and similar measures ex-community charge etc.”. The community charge was the official name for what was more generally referred to as the poll tax, later replaced by the council tax, the British equivalent of our own property taxes. It is unclear what was implied by “etc.” Perhaps the author thinking also of excluding vehicle excise duty and similar taxes, consistent with the fourth principle of an inflation indicator (see section 1).²

In any case, when IT was implemented, the target inflation indicator was an RPI series that excluded mortgage interest payments but not council tax. The Office of National Statistics has now been calculating an RPI series that excludes both mortgage interest payments and council tax for some time now. It is a pity that it was not implemented as the target inflation indicator, as it would have been a more appropriate indicator for a central bank. If property taxes are raised this is an indicator of fiscal retrenchment, and it would be perverse for a central bank to treat such an increase as an upswing in inflation to which it must react by raising interest rates.

Oddly enough, the BoC includes property taxes not only in its target indicator, the CPI All-items, but also in its core CPI, an index which ostensibly excludes changes in indirect taxes. The index is included without adjustment so the full impact of property tax increases, registered only in October in the Canadian CPI, is included in the core CPI. The same is true of drivers’ licence premiums and motor vehicle registration fees, which the Canadian System of National Accounts also considers to be indirect taxes. When the present author asked the BoC’s Sharon Kozicki about this she maintained that it was not necessary to adjust for municipal taxes like property taxes. However, the core CPI does adjust for much less important room rate taxes assessed by municipalities on hotel and motel rooms. And any provincial or municipal taxes can take on a national dimension if the federal government downloads a fiscal burden to the provinces or the provinces download a fiscal burden to the municipalities.

4. Could an Inflation Targeting Regime Have Been Implemented Earlier?

² Starting with its February 2013 update, the UK CPI includes vehicle excise duty and television licence fees, which were part of the RPI, but were previously excluded from the UK HICP. This was done with Eurostat’s blessing. Both inclusions, especially that of the vehicle excise duty, seem to undermine the HICP commitment to the fourth principle. Revenues from the vehicle excise duty are not dedicated to road maintenance but are part of the government revenues. In any case, even if they were, it is hard to see how they are consistent with the HICP framework. In a cost-of-living framework, the vehicle excise duty is considered part of the cost of operating a vehicle. In a net acquisitions framework, since the vehicle excise duty does not relate to the purchase of the vehicle itself, if it has to be considered as a payment for road maintenance. This would seem to require some kind of adjustment for the quality of the public road network. This seems to depart from what one would expect of an inflation indicator designed for central bank use.
The existence of the Chevening paper from December 1989 raises the question of whether Britain might not have adopted an IT regime earlier, starting in March 1987, when the policy of targeting the Deutsche Mark was introduced instead, or early in 1990, rather than joining the ERM later in the year.

Samuel Brittan had written a column in the *Financial Times* much before the shadowing of the Deutsche Mark, in September 1985, advising the Chancellor of the Exchequer, Nigel Lawson to forget about targeting the money supply, and instead start targeting either the inflation rate or nominal GDP. He also allowed for the possibility of targeting an exchange rate as a proxy for targeting one of the first two variables. So IT was already being discussed in Britain, prior to being adopted anywhere in the world.

Under any regime there necessarily would have been a loosening of monetary policy following the September 1987 stock market crash, monetary policy works with a long lag, and until 1995 the target inflation indicator did not incorporate housing prices. All these considerations suggest that if Nigel Lawson had moved to an IT regime in March 1987 instead of shadowing the Deutsche Mark, there would have been no avoiding the severe housing bubble that burst in 1989 and plunged the UK into recession the following year. However, an IT regime might well have limited the damage.

An IT regime adopted in 1990 could also have successfully brought down the inflation rate. In January 1990 the RPIX showed a 12-month rate of change of 8.1%, so any caveat about the target inflation indicator not reflecting house price movements wasn’t that important then. Any kind of IT regime would necessarily be hiking interest rates and dampening growth to bring inflation under control. However, it is likely true that an IT regime would not have had the same credibility with the markets as Britain’s membership in the ERM and the process of wringing inflation out of the economy over the period that Britain was in the ERM might have been at a higher cost in output and in jobs.

If the BoE had moved to an IT regime in March 1987 it would have been the first central bank in the world to do so. If it had changed regime in the first half of 1990, it would not have had that honour, but the case for regime change would have been strengthened by being able to cite the RBNZ as a precedent.

In his memoirs Norman Lamont writes (p.323):

> I first raised the issue of independence [of the BoE] in September 1991, when I put forward a scheme based on the model of New Zealand, with the Governor of the central bank being given an inflation target. Failure to meet it could result in his dismissal.

This shows that an IT regime was in Mr. Lamont’s mind for at least a year before he actually introduced it. However, it would be difficult to see how, less than a year after Britain had entered the ERM, such a move could be squared with the country’s participation in the project of European monetary integration.

Unfortunately, while the economic case for the BoE adopting an IT regime earlier than it did is solid, politically it would likely have been quite impossible. While the British public did not have much interest in European Monetary Union, among the top decision makers there was a strong consensus in favour of entering the ERM for years before it happened. By November 1985, it included Geoffrey Howe, Nigel

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Lawson, Leon Brittan, the Minister of Industry, Norman Tebbit, the president of the Conservative Party, John Wakeham, the Party Whip, as well as the Governor of the Bank of England Robin Leigh-Pemberton. (Norman Lamont, the Chancellor of the Exchequer for virtually the entire period of Britain’s participation in the ERM, was, ironically, always opposed.) If there was going to be a major regime change from targeting of monetary aggregates, it could only be a move to join the ERM. Ignoring such a consensus to move to an IT regime instead would have been too much even for Margaret Thatcher to have contemplated.

In a sense, the British participation in the ERM was beneficial to the new IT regime. In Canada, the painful process of wringing out inflation was the main task of IT, and made it a political target. The Liberal Party attacked the new monetary policy in the 1993 election when it was still the Opposition, did not renew John Crow as Governor of the Bank of Canada when it became the Government, and while it did not finally replace the IT regime, it did cancel the planned reduction of the target rate of inflation to something less than 2%.

In Britain, by contrast, winning the war on inflation was mostly done while Britain was part of the ERM, and the IT regime was left with a mopping-up operation. Opposition attacks were directed at the Conservative government’s alleged bungling of ERM membership, and not at the IT regime that replaced it. And when a Labour Party was elected to office in 1997, it reformed the IT regime rather than emasculating it (see section 9).

5. The Inflation Targeting Framework Established after Black Wednesday

John Major gives a more detailed account in his memoirs of how the IT framework was decided on than his Chancellor of the Exchequer does (see p. 667):

After Black Wednesday we could not return to the pre-ERM strategy of monetary targets and ‘taking account’ of the exchange rate; it was vital to develop a new strategy. I had a meeting with Sarah Hogg [the Head of the Policy Unit for John Major], Norman Lamont and Terry Burns from the Treasury on 22 September at which we discussed the options. Our objective was a low-inflation economy. Norman developed the theme in meetings at the Treasury, while Sarah fed in more ideas from Number 10 and liaised closely with Terry Burns and Treasury officials. Eddie George, the Governor of the Bank of England, which would have a more prominent role, was closely involved throughout. We agreed to set a target for the rate of inflation.

Mr. Major errs slightly in his recollection. Robin Leigh-Pemberton was still the Governor of the BoE at this time; Eddie George, then Deputy Governor, was only appointed Governor in 1993. The Russian speaking Mr. George, who went by the nickname “Steady Eddie”, was quite comfortable with the new regime: when a Labour backbencher dismissed him as “an inflation nutter”, he took it as a compliment.

Mr. Major continues (see p. 667-68):

The target _ an ambitious one _ was not easily arrived at, and until it was completed the void was impossible to hide. In early October, on the first day of the Conservative Party Conference in Brighton I had a further meeting with Norman, Terry Burns, Alan Budd (an economic adviser), Sarah Hogg and Alex Allan [Principal Private Secretary to the Prime Minister] to finalise the
strategy…. As we talked, our conversation was punctuated by competing demonstrations from
the street outside _ a kind of duet for trumpet and megaphone, with a Scottish orator bellowing
a distinctly anti-government message at us...As I spoke of options to encourage enterprise, cries
of “End the recession; restore growth” cut into our debate. The demonstrators didn’t know it,
but we were on the same wavelength, and the package we agreed proved hugely successful.

This meeting was held on October 6, the first day of a Conference that lasted until October 9. Norman
Lamont did not announce the change in regime in his own speech to the Conference, as “it would not be
a suitable vehicle for a mass of detail mainly designed for the financial markets”. Instead it was
announced on October 8 in a letter to John Watts, the Chairman (iof the House of Commons Treasury
and Select Committee. The letter reads, in part:

I believe we should set ourselves the specific aim of bringing underlying inflation in the
UK, measured by the change in retail prices excluding mortgage interest payments, down
to levels that match the best in Europe. To achieve this, I believe we need to aim at a rate
of inflation in the long term of 2% or less.

For the remainder of this Parliament, I propose to set ourselves the objective of keeping
underlying inflation within a range of 1%-4%, and I believe by the end of the Parliament
we need to be in the lower part of the range.

This use of the expression “underlying inflation” to reference the RPIX series, the RPI excluding
mortgage interest, was used by others as well as Mr. Lamont, although it suggests something
more like a core measure of inflation. Contrary to Canada, which had a core CPI measure from
the start of its IT regime, the UK did not construct a core RPI series as an operational guide, nor
have core measures subsequently played as an important a role in monetary policy in the UK as
the core CPI has in Canada.

The initial targets can be summarized as follows:

(i) Until spring 1997 between 1% and 4%,
(ii) From spring 1997 forward between 1% and 2.5%,
(iii) In the long term, between 0% and 2%.

It didn’t take long to drop the long term target, which Mr. Lamont does not even mention in his
memoirs, nor does Mr. Major.

There were a number of additional reforms that were made to implement this new framework:

(i) There had always been meetings between the Treasury and the BoE but now the
Chancellor of the Exchequer would meet every month with the Governor of the BoE,
with the Treasury summarizing the decisions taken at these meetings,
(ii) An Inflation Report would be prepared each quarter summarizing the state of the
economy and the Bank’s success in meeting its targets,
(iii) In his Mansion House Speech on October 29, 1992, the Chancellor of the Exchequer
announced that he would establish a Treasury Panel of Independent Forecasts, a
group of seven economists outside of government who would meet three times a year with Allan Budd, the Government’s chief economic adviser as chair. This innovation was retained by Kenneth Clarke when he took over as Chancellor of the Exchequer but was scrapped when the Labour Party took office in 1997.

The quarterly Inflation Report is very similar to the BoC’s Monetary Policy Review. Since August 2003 the press conference that accompanies its presentation has been webcast. It is somewhat different from the webcast of the BoC’s press conference following the MPR. The camera follows the journalists who are asking the questions, and they are all identified by name and affiliation. Shortly after the press conference a transcript of it is available on line and all journalists asking questions are again identified by name and affiliation. They are not treated like nobodies.

Both Nigel Lawson and Norman Lamont had been in favour of the independence of the Bank of England, but neither Margaret Thatcher nor John Major was agreeable to their proposals. This was in spite of the fact that the Maastricht Treaty required that any central bank participating in the European System of Central Banks satisfy a defined standard of independence. Mr. Lamont quite rightly regarded the IT regime as providing a framework that could lead to an independent Bank of England, as the technicians in the central bank could be better trusted to keep inflation under control than the politicians at the Treasury. As it happened the independence of the BoE did not follow immediately on the introduction of an IT regime, but would have to wait on the election of a Labour government.

The importance of the regime change at the Bank of England has not been sufficiently appreciated, either now, or, even more so, then. There are several reasons that account for this:

(i) Occurring in the wake of Black Wednesday, the Conservative Government was not inclined to brag too much about a policy that was only introduced because of the failure of British membership in the ERM. Also, the public mind was more interested in knowing why the previous regime had failed than in what would replace it. When Norman Lamont appeared as a witness before the House of Commons Treasury Select Committee he expected to be grilled on his letter to its Chairman, but instead found, in his words, that the Committee “only wanted to hold another post-mortem on the ERM” (see p.293).

(ii) In the five and a half years since March 1987, this was the fourth big change in monetary policy, as Britain moved from shadowing the Deutsche Mark back to monetary targets to ERM membership and finally to IT. At the time observers had little reason to believe that this change in regime would be any more lasting than the previous ones.

(iii) In his March 1993 Budget, the Chancellor of the Exchequer set “monitoring ranges” of 0%-4% growth for M0 and 3%-9% growth for M4. (In his autobiography, only M4 was said to have had a monitoring range, while M0 had a target (See Lamont, p.276.) This made the switch to an IT regime look to some people like it was more of a switch back to targeting the money supply, with a new twist. The 1993 Budget speech was the last Budget speech that provided specific numeric goals for money supply
growth. When Kenneth Clarke took over as Chancellor of the Exchequer he only promised to pay close attention to the growth in the monetary aggregates.

(iv) It was never clear that the switch to IT would be a long-term change, and not just a transitory policy before the UK re-entered the ERM. Italy dropped out of the ERM the day after Britain, but re-entered it and was one of the original members of the euro area. The central banks of Spain and Finland adopted IT regimes, following the British example, but these folded when their countries joined the euro area. Mr. Lamont has criticized PM Major for not making it clear that this was a definitive change but with a caucus containing a strong bloc favourable to European monetary integration this was probably not politically expedient.

6. A Change in the Target Indicator and a Change in the Target Range

Norman Lamont was a Treasury Minister during the housing boom and bust in Britain in the late 1980s, and so was acutely aware of the problems that volatile housing prices can create for an economy. In his 1992 Mansion House Speech, he notes that in deciding whether the inflation objective has been met “we will take account of asset prices, particularly house prices...”

The RPI took a payments approach to OOH: the only series that included house prices was the mortgage interest component, which was excluded from RPIX. Therefore the target indicator itself provided no feedback about house price movements, and required the independent monitoring of house price indexes.

Incidentally, it is quite remarkable that the first four countries to adopt IT regimes for their central banks monitored inflation indexes that illustrate all of the basic approaches to OOH in a consumer price series: net acquisitions (New Zealand), rental equivalence (New Zealand again, with its HAPI), exclusion (Chile), user cost (Canada) and payments (the UK).

This unhappy state of affairs ended in March 1993, when the February 1993 update of the RPI introduced a house depreciation component into the RPI. The treatment of OOH in the RPI then became comparable to the landlords’ deductible cost variant of the user cost approach used in the Canadian CPI.4

The major distinction between the two series is that the Canadian index relates to unobserved dwelling prices while the British index relates to observed prices for house and lot combined. Conceptually the depreciation series should relate to dwellings, since dwellings deteriorate rather than lots, or at least lots don’t deteriorate very much. In the Canadian CPI, this is handled by calculating a new housing price index for dwellings as well as for total house prices. The house price index is based, as much as possible, on actual transaction prices, and if not then on list prices, but the dwelling price index is based on

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4 It was therefore quite astounding that Mark Carney, in his written remarks to the UK Treasury Select Committee in January regarding UK inflation measures, would have ignored the RPI, which resembles the Canadian CPI more than any other official consumer price series of a foreign country, and praised the CPI, which is, as discussed, an HICP series based on quite different principles. Mr. Carney never once suggested that Canada should calculate its own HICP series while he was Governor of the BoC, although Canada is the only country in the G-7 that does not publish an HICP on a monthly basis.
20 years

Notional prices obtained from residential contractors of what they believe their lots can sell for. In the UK RPI, the depreciation index is cobbled together from two different house price indexes, neither of which breaks down house prices between dwelling and lot components.

This is not altogether a bad thing for the British series. It satisfies the first test of a central bank inflation indicator, that it include only actual prices rather than notional prices, which its Canadian counterpart conspicuously fails.

It also means that the OOH series for RPIX approximates an OOH series based on a narrowly-defined net acquisitions approach. Since 2001, when mortgage interest costs are excluded from its core CPI, the OOH series for the Canadian core index also approximates an OOH series based on a net acquisitions approach, and this is without question one factor that accounts for the superior performance of the Canadian economy in the global financial crisis compared to the other countries in the G-7. However, the RPIX series is better in the sense that it provides a better approximation to the ideal net acquisitions series than its Canadian counterpart. (This is discussed in more detail in the Appendix.)

The addition of the depreciation component was a recommendation of the 1994 Report of the RPI Advisory Committee. This was, as it turned out, the final report of this Committee, as it was replaced, more than a decade later, by a Consumer Prices Advisory Committee. The RPI and all other series produced by the Office of National Statistics were the responsibility of the new Chancellor of the Exchequer, Kenneth Clarke. In fact, Mr. Clarke was responsible for creating the ONS from a merger of the old Central Statistical Office with the Office of Population Censuses and Surveys.

While the addition of a depreciation component made the RPIX more sensitive to house price movements, and thereby provided more protection against housing bubbles, it also made it a more volatile series. This likely played a part in Kenneth Clarke announcing a change in the target range in his Mansion House Speech in his 1995 Mansion House Speech. From spring 1997 forward the goal was to have inflation as defined by the RPIX at 2.5% or less. This was later defined by the BoE’s Mervyn King as meaning that most of the time inflation should be between 1% and 4%, the previous range, with the possibility of overshooting and undershooting. The target would be satisfied if the inflation rate was 2.5% or less over a long period. Gone was the idea that the BoE would react strongly if the inflation rate exceeded 2.5%, envisaged by Norman Lamont for the period from spring 1997 forward. The inflation objectives had become somewhat fuzzy.

Kenneth Clarke was also responsible for the publication of the minutes of the monthly meetings between the Chancellor of the Exchequer and the Governor of the BoE, which added to the transparency of monetary policy.

7. The Changes Under Gordon Brown

When the Labour Party took office in May 1997 under Tony Blair, the new Chancellor of the Exchequer, Gordon Brown, was quick in making changes in the IT regime:

(i) For the first time, a point target was established at 2.5%,
(ii) It had an upper bound of 3.5% and a lower bound of 1.5%.
(iii) If the inflation rate was below its lower bound or above its upper bound the Governor of the Bank of England would be required to write an open letter to the Chancellor of the Exchequer explaining the reason for the deviation, and outlining what would be done to get inflation back on the right track.

At first glance, the new target range, from 1.5% to 3.5%, might seem less restrictive than the old one, but as explained in the last section, Kenneth Clarke’s target range was more than a little vague, and actually seemed to be based on a 4% upper bound rather than a 3.5% upper bound. (That being said, RPI inflation was never higher than 3.3% at any time when Mr. Clarke was Chancellor.)

The symmetric upper and lower bounds one percentage point above and below the point target were similar to what already existed at the BoC. It is logical, since too low inflation, especially deflation, can have adverse consequences as much as too high inflation.

There is, of course, no similar requirement in IT in Canada that requires the Governor of the Bank of Canada to write an open letter to the Minister of Finance if the inflation rate exceeds the upper bound, but it might be a good idea to introduce one. Mark Carney would have had to write many such letters and he might not have kept the overnight rate unchanged after September 2010.

Gordon Brown also made the BoE an independent central bank, giving it the freedom to set interest rates in May 1997, almost immediately on taking office, confirmed in legislation in June of the following year with the Bank of England Act 1998, amending an earlier 1946 Act. The Chancellor of the Exchequer was greatly influenced by the example of the RBNZ in establishing the independence of the central bank. Ed Balls, the present shadow chancellor in the UK, was then an adviser to Mr. Brown and examined the RBNZ’s operational autonomy framework in great detail, consulting, among others, the Governor of the RBNZ at the time, Donald Brash.

A Monetary Policy Committee was set up to take interest rate decisions, usually meeting every month for a couple of days. Five of the members are senior members of the BoE, while four are outsiders. The Governor only has one vote like the other eight members but he does get to cast the deciding vote in the event of a tie.

The remit of the BoE still comes from the Chancellor of Exchequer, who sets the target rate and target range for inflation once a year.

The Chancellor of the Exchequer also chose to relieve the BoE of most of its former regulatory responsibilities, which were assigned to a separate body, the Financial Services Authority. Whether this was a sensible decision or not is outside of the scope of this paper. It does seem strange though, for a writer like Dambisa Moyo (2011, p.65-66) to somehow conflate any errors in financial regulation under the Labour government with a fundamental flaw in the IT regime, which had been around for four and a half years before Labour took office. It is hard to understand why she would pillory the IT monetary policy because of an unconnected regulatory failure. Ms. Moyo ignores completely the role of a poor choice of inflation indicator in bringing on the financial crisis, the subject to which we will now turn.
8. The Move to the UK HICP as the Target Indicator

The HICP for the United Kingdom started in 1996, while the Major government was still in office, prior to the initial publication by Eurostat in 1997. HICPs were required by the price stability criterion for convergence in the Maastricht Treaty, since it was necessary that all European countries that sought to enter the monetary union should have their inflation rates measured on a comparable basis.

One HICP series, the Monetary Union Index of Consumer Prices, was established for the euro area and became the target inflation indicator for the European Central Bank. As outlined in section 1, the HICP principles are actually very well suited to calculating an inflation indicator for a central bank, the main problem being that the HICPs currently adopt an exclusion approach to OOH.

This was done as a temporary expedient rather than in the belief it was appropriate. As early as 1999, a few months following the start of the euro, John Astin wrote a paper that already pointed to the net acquisitions approach as the only conceivable one if an OOH component was going to be incorporated in the HICP. Why the progress has been quite so slow in moving towards this approach then, is an intriguing question. The English economist, Andrew Lydon has suggested it may have something to do with the fact that HICPs including OOH series would make the price stability criterion harder to satisfy for countries still outside the euro area. The Netherlands itself, one of the original members of the euro area, might not have satisfied the price stability criterion if it had been based on HICPs that included housing costs.

Be that as it may, on 9 June 2003, Mr. Brown announced in the House of Commons that he intended to make the UK HICP the new target inflation indicator for the BoE. This was mainly to try to help satisfy one of the five economic tests that he had stipulated in July 2007 that Britain must pass in order to join the euro area, the test of economic convergence. Moving to the HICP as the target indicator would give Britain the same kind of inflation measure as the euro zone. On December 16, 2003 it was announced that the UK HICP, renamed the Consumer Price Index, would be the new inflation indicator. Oddly, the 1994 Budget speech made only a tangential reference to this important change: “And I can confirm that under our new target, inflation is expected to be just 1.75 per cent this year, and 2 per cent next year and the years after.”

With the new target indicator, the target inflation rate was dropped to 2% and the upper and lower bounds were set at 1% and 3%. This actually amounted to a looser monetary policy remit, since the CPI ran quite a bit lower than the RPIX. An ONS document noted at the time of the change that: “Since January 1989, RPIX inflation has exceeded CPI inflation by an average of 0.7 percentage points and, at 1.3 percentage points in October 2003, the difference is currently quite wide.”

Some of this difference was due to the omission of the volatile OOH component from the CPI series. However, almost as much was due to different formulas used to calculate elementary aggregates in the two indexes. The RPI made heavy use of the Carli formula (arithmetic mean of price relatives) which was banned by Eurostat for use in HICPs. This draconian measure may have been an overreach, since in certain quite restrictive conditions, the Carli formula can be a reasonable choice, but there is little question that the British RPI, with its annual links, was subject to substantial upward bias due to its use of the Carli formula. Starting with the February 2013 update of the RPI, the UK Office of National
20 years

Statistics has started publishing a new RPIJ series, which is the RPI with its Carli indexes replaced by Jevons indexes (i.e. unweighted geometric mean indexes). Since there is still a huge volume of gilts on the market that are linked to the RPI it will probably be sometime before the RPI is permanently replaced by the RPIJ.

In any case, it was irresponsible on the part of Mr. Brown to replace the RPIX with the CPI while that series had no OOH component. The United Kingdom participated in the first pilot calculation of OOH series based on the net acquisitions approach organized by Eurostat in 2000. It might well have been possible to switch to a CPI series including an OOH component as early as December 2003. In any case, the switch should only have been made when an OOH(NA) series could be incorporated in the new target indicator. For a country like the UK, which had already had two housing bubbles in the last thirty years, it made no sense to provoke a third one.

A Treasury document released to announce the change said that there was no need to worry because the new inflation indicator did not contain house prices as they would be closely monitoring house price movements. Less than four years later, the house price boom in Britain went bust and there was the run on Northern Rock.

Table: 12-Month Percent Changes of Alternative Target Inflation Indicators

<table>
<thead>
<tr>
<th>Month</th>
<th>CPI</th>
<th>RPIX</th>
<th>RPIX ex CT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oct-06</td>
<td>2.5</td>
<td>3.2</td>
<td>3.1</td>
</tr>
<tr>
<td>Nov-06</td>
<td>2.7</td>
<td>3.4</td>
<td>3.4</td>
</tr>
<tr>
<td>Dec-06</td>
<td>3.0</td>
<td><strong>3.8</strong></td>
<td>3.7</td>
</tr>
<tr>
<td>Jan-07</td>
<td>2.7</td>
<td>3.5</td>
<td>3.5</td>
</tr>
<tr>
<td>Feb-07</td>
<td>2.8</td>
<td><strong>3.7</strong></td>
<td>3.6</td>
</tr>
<tr>
<td>Mar-07</td>
<td><strong>3.1</strong></td>
<td>3.9</td>
<td><strong>3.9</strong></td>
</tr>
<tr>
<td>Apr-07</td>
<td>2.8</td>
<td><strong>3.6</strong></td>
<td><strong>3.6</strong></td>
</tr>
<tr>
<td>May-07</td>
<td>2.5</td>
<td>3.3</td>
<td>3.3</td>
</tr>
<tr>
<td>Jun-07</td>
<td>2.4</td>
<td>3.3</td>
<td>3.3</td>
</tr>
<tr>
<td>Jul-07</td>
<td>1.9</td>
<td>2.7</td>
<td>2.6</td>
</tr>
<tr>
<td>Aug-07</td>
<td>1.7</td>
<td>2.7</td>
<td>2.6</td>
</tr>
<tr>
<td>Sep-07</td>
<td>1.7</td>
<td>2.8</td>
<td>2.8</td>
</tr>
</tbody>
</table>

The table above shows the 12-month percent changes for the CPI, the RPIX and the RPI ex mortgage interest payments and council tax series over the 12-month period ending in September 2007. This was the month of the bank run on Northern Rock in the United Kingdom that marked the start of the financial crisis there. Inflation rates above 3.0% for the CPI and above 3½% for RPIX are shown in boldface. The Governor of the Bank of England had to write a letter to the Chancellor of the Exchequer if the CPI inflation rate was greater than 3.0%. The only such occurrence over this period was in March 2007. Also shown in bold-face are the four months when a letter would have been written had RPIX been retained as the target inflation indicator, with a higher 3½% upper bound. The other RPI special aggregate was never actually targeted; it is assumed that had it been the Chancellor of the Exchequer
would have maintained the same 3½% upper bound. It differs from RPIX by as much as 0.1 percentage point, but leads to the Governor of the Bank of England writing a letter to the Chancellor of the Exchequer in exactly the same months.

If the RPIX series had been retained as the target inflation indicator, Bank of England monetary policy might have been more restrictive in the period leading up to the housing bust and the financial crisis. It would certainly not have been looser.

The Governor of the Bank of England at the time of the change, Mervyn King, was opposed to taking house prices out of the target inflation indicator. On the other hand, he was unenthusiastic about Eurostat’s proposed net acquisitions approach to OOH. Since the financial crisis, progress towards incorporating an OOH series based on net acquisitions in the UK CPI, initially favoured by the Office of National Statistics, has stalled badly. Now it seems only too possible that the Bank of England, when it next changes its target inflation indicator, will switch to the new CPIH series, a CPI including an OOH series based on the rental equivalence approach. If this transpires it would mark a return to an approach that failed Britain very badly forty years ago in 1973, when Britain had one of its recurrent housing bubbles. (This issue is explored in more detail in my forthcoming paper “Why England Slipped”.)

9. The UK as a Trailblazer for Other Countries

In 1997, the new Policy Target Agreement for the RBNZ led to the adoption of CPIX, the CPI excluding credit services, as its new target indicator. This was in anticipation of Statistics New Zealand removing credit services (i.e. mortgage interest and related costs) from the All Groups CPI in 1999. The naming of the new target series would appear to be inspired by the British RPIX, although the methodology change itself was not. In fact, the December 1992 PTA had already stipulated that the RBNZ focus on differences between the CPI and a CPI excluding interest rather than on differences between the CPI and the HAPI for the conduct of monetary policy.

Nevertheless, the 1997 PTA was an important event, marking the first time that a central bank had ever targeted a consumer price series with a narrowly-defined net acquisitions approach to OOH. It can be fairly said that the British had anticipated this move when they added a depreciation component to their RPI, which made the OOH component of the RPIX closely approximate such an aggregate.

When the Reserve Bank of South Africa adopted an IT regime in February 2000, the target indicator adopted was also called CPIX, “defined as the consumer price index for metropolitan and other urban areas, excluding the interest cost on mortgage bonds”. Here both the concept and the name of the target inflation indicator was likely inspired by the practice of the UK.

The BoC has never removed mortgage interest from its target indicator, but starting in 2001 it at least removed mortgage interest from its operational guide, the core CPI. The document released at that time, written by the current Deputy Governor of the BoC, Tiff Macklem, contained a perfect statement of the rationale for removing mortgage interest from the target indicator of a central bank:

...the Bank’s policy instrument—the target overnight rate of interest—has a very direct effect on mortgage rates at shorter maturities, and this gives a misleading signal of the future trend in
inflation. For example, a rise in the target for the overnight rate will tend to boost mortgage-interest costs, resulting in a rise in inflation in the very short run. But looking beyond this horizon, the higher interest rates will dampen spending and thus reduce inflationary pressures. (See Macklem (2009; p.9))

Given such an admission it is hard to see at first why the BoC would retain the mortgage interest component in their target inflation indicator. There is, after all, a published CPI ex mortgage interest series that they might use. The answer lies in their one-size-fits-all philosophy that the ideal cost-of-living index must also be the ideal inflation indicator. Unfortunately, it is not even clear that mortgage interest was removed from the core CPI for any other reason than that it is one of the most volatile components of the CPI.

The RPIX stopped people from thinking that a consumer price series used as a central bank inflation indicator necessarily had to be the same as the official consumer price series used for escalation purposes. This led quite directly to the far more radical rethinking of such a series implied by the HICP, whose principles are enumerated in section 1 of this paper. In fact, the HICP was, to a great degree, a British creation, developed by people familiar with the RPIX. Peter Hill was responsible for developing the concept of household final monetary expenditure, the National Accounts aggregate that gave it a conceptual base. Two other Britishers, John Astin and Don Sellwood, wrote the initial papers describing the properties of the HICP.

The first two G-20 countries to have IT regimes, Canada and the UK, have quite different attitudes towards the appropriate inflation indicator for a central bank. It would appear from Chuck Freedman’s account that the CPI All-items was chosen as the target inflation indicator largely on pragmatic grounds: it was well-known, it was timely and it wasn’t revised. Since then, however, the BoC has come to see the control of inflation in terms of a cost-of-living measure as the touchstone of monetary policy. Any consumer price series that cannot make this claim does not make the grade. By contrast the British were aware from the start of the perils for monetary policy of targeting a cost-of-living index as their inflation indicator. They started with an index that was at some remove from a cost-of-living measure and subsequently switched to an index that was much further removed from one.

This likely accounts for the quite different attitudes of the BoC and the BoE to price-level targeting, a proposed alternative to inflation targeting. The intuitive appeal of price level targeting is clear. If one sets a price level target, ideally the same price level every month, and tries to maintain it, the cost of living of the population will never show a permanent increase. It will only fluctuate slightly up and down around a steady price level. This is much to be preferred to messy inflation targeting, where the cost-of-living is usually going to go up, the only question being by how much.

The disadvantages of a price level targeting regime are fairly obvious whatever kind of indicator is targeted:
Whereas in inflation targeting, the target rate of inflation is always the same, the let’s-NOT-let-bygones-be-bygones philosophy of price level targeting means that the implied target inflation rate is often changing, which can be confusing to the public.

Where inflation has been low for a long time, price level targeting implies that one can have much higher inflation rates for a considerable time to achieve a higher price level target, but it is questionable if the public will wish to go back to much lower inflation rates once the price level target is achieved.

There is also a real risk of encouraging asset bubbles, and especially housing bubbles, during such periods of higher inflation.

To this list of disadvantages one must add that if the target inflation indicator is not a cost-of-living measure, one doesn’t obviously gain from a price level targeting approach in any case. One can keep the price level constant over time without necessarily keeping the cost of living constant.

This is perhaps why, while the BoE has shown some interest in price level targeting, it has never been preoccupied with it in the way that the BoC has. An inordinate amount of resources were thrown into studies of price level targeting between 2006 and the renewal of the inflation-control target in November 2011. In the end it led to no constructive changes at all, as the BoC remained an inflation targeting central bank, but it soaked up resources that might have been much better devoted to solving other problems, still unaddressed. (For example, it is surely unconscionable that tax rates are not maintained constant over the basket reference period in calculating the BoC’s core CPI series and its CPI adjusted for changes in indirect taxes.) Nor has the renewal of the inflation-control target put a stop to the BoC’s research on price level targeting, while deficiencies in the core CPI continue to be ignored.

What of the Future?

Although the BoE currently seems poised to change its target inflation indicator to the new CPIH series with an equivalent rent measure of OOH, a reactionary change if there ever was one, this is far from inevitable. The UK, like all other countries in the European Economic Area, must calculate quarterly OOH series based on the net acquisitions approach by September 2014, so there is still hope that the BoE will switch to a more appropriate target indicator sometime before the end of the series. Beyond the issue of the treatment of OOH, there are also some problems with the HICPs as they are currently constituted.

Although Britain now has an index it calls the CPI, it is identical with the UK HICP, and doesn’t depart from concepts laid down by Eurostat in any way, even when these are problematic. For example, the treatment of seasonal goods in the HICPs is quite inconsistent with their principle of avoiding imputations where unnecessary. Eurostat does not require the use of monthly baskets for seasonal goods but makes it optional, and the version of monthly baskets that they permit is far too crude, providing weighting structures that are not properly representative of the months in question. The HICPs also do not do as good a job of removing upward substitution bias from indexes as they could be if they were calculated as chain Walsh or chain Edgeworth indexes. Moving to such an index formula would have special benefits for the IT framework, as it might be possible to reduce the target inflation
rate, which has stayed at 2% for almost a decade now. The appendix provides a way in which the Eurostat proposal for an OOH component can be improved on.

It is probably time for the UK to calculate an inflation measure that it feels is appropriate to its own needs. It is not much extra work to calculate a separate HICP series to meet the requirements of Eurostat.

Any such reform would not only improve the IT regime; it might also likely outlast. Although much of the criticism of IT in Britain has been very unfair, it may be replaced by something else. Whatever replaces it, a central bank will always require an inflation measure that satisfies its own requirements, not those of a cost-of-living index.

This is a lesson that, unfortunately, the Bank of Canada has yet to learn. That is the main reason for this brief survey of the first two decades of inflation targeting in the United Kingdom. Although in some respects it is a cautionary tale, on balance it is still, despite the global financial crisis, a brilliant success story. Moreover, those Canadians who take an interest in monetary policy issues would be well advised to keep an eye on what the British will do in the future.
Appendix: The Three Different Variants for an OOH Series Based on a Narrowly-Defined Net Acquisitions Approach

In this paper, a broadly-defined net acquisitions approach implies that mortgage interest payments (or the discounted value of mortgage payments) are included in the index. A narrowly defined approach implies that mortgage interest payments (or the discounted value of mortgage payments) are excluded, and the OOH series is dominated by a house price index with a net acquisitions expenditure weight. It should not be confused with the issue of the inclusion or not of expenditures on alterations and improvements to owner-occupied homes.

The broadly-defined net acquisitions series included in the US CPI from 1953 to 1982 excluded alterations and improvements. So, regrettably, does the narrowly-defined net acquisitions series published for Canada starting in 1985, which is currently available from January 1982 to August 2000. The narrowly-defined net acquisitions series used in the official CPIs for Australia and New Zealand both include alterations and improvements, as do the narrowly-defined series that must be calculated for Eurostat by all countries in the EEA, the United Kingdom included, as of September 2014.

A narrowly-defined net acquisitions series for home purchase can have three different variants:

(i) A gross weight, gross price variant, where both the expenditure weight reflects net acquisitions of houses, and so does the price index,
(ii) A net weight, gross price variant, where the expenditure weight reflects net acquisitions of dwellings only, but the price index relates to houses,
(iii) A net weight, net price variant, where the expenditure weight reflects net acquisitions of dwellings, as does the price index.

The first variant has been used in the Canadian analytical indexes for owned accommodation and is the best. In the Australian housing market, it seems that a lot of new dwellings are purchased independently of the lots that they sit on, but in most countries dwelling and lot are purchased together. The third variant, which requires a price index for dwellings only, thus violates the first principle of an inflation indicator, that it be based only on transaction prices. As far as the expenditure weight is concerned, given that the target population of a consumer price series is the household sector, it hardly matters that land, for the most part, is neither produced nor consumed. The household sector is a net purchaser of residential lots from the other sectors of the economy, so there is simply no basis for confining the expenditure weight to dwellings only.

The third variant is what is prescribed by Eurostat for the proposed OOH series to be added to its HICPs. It is also what is done in the Australian and New Zealand CPIs. It would be appropriate if only dwellings were purchased and sold by the household sector while residential lots were rented. This is true of some transactions, including many mobile home purchases. These kind of transactions can easily be accommodated within a gross weight, gross price framework.

The second variant is basically a compromise on the part of statistical agencies that would like to calculate the net weight, gross price variant, but find it infeasible to calculate an index for dwellings.
only. This is the situation of the UK Statistical Authority, which so far has calculated pilot indexes for OOH based on net acquisitions using house price indexes rather than dwelling price indexes. It is also likely to be the case with most other EEA countries, so the quarterly OOH series published in September 2014 are likely to be based on house price indexes even though dwelling price indexes are required. (As far as I know, the only country that has already calculated a net weight-net price series is Norway, which isn’t even part of the EU.

If one considers the first variant as the ideal, the second variant is second best, since it only has a weighting problem and it uses the correct prices. In a housing boom lot prices tend to move up much more strongly than dwelling prices so the second variant would offer better protection against a housing bubble, though not as good as the first.

It can be readily seen that the house depreciation component in the RPI approximates the second variant of a limited net acquisitions home purchase index, while the same component in the Canadian CPI approximates the third variant, so in that sense the RPI series can be considered as superior for use in an inflation indicator as compared to its Canadian counterpart, even though the Canadian index is obviously more consistent conceptually with the landlord’s deductible cost approach.
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Mr. Baldwin was the author of the 1985 article “Analytical Consumer Price Index Series for Owned Accommodation”; the NP1 series introduced in that publication was the first official consumer price series for owner-occupied housing based on the narrowly-defined net acquisitions approach to be published anywhere in the world. He has also published several updates to that article and was responsible for the analytical series shown in the recent C.D. Howe Institute monograph *Housing Bubbles and the Consumer Price Index*.}