Covid-19 has exposed weakness in our favoured measures of inflation

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Just as gross domestic product has been hit by Covid-19, so too has inflation. The latest figures for May show that the UK consumer price index (CPI) rose by only 0.5 per cent, way below the Bank of England's target of 2 per cent. Prices have actually fallen month-on-month in two of the five months since the beginning of the year. Does this foretell a slide into deflation? Should it prompt quick action by the Bank of England to try to return to target? Or is it time to change to a more robust inflation-targeting regime?

Inflation targeting has been largely successful in controlling and stabilising inflation since it was formally introduced in New Zealand in 1990, followed by Canada in 1991, the UK in 1992, the European Central Bank in 2002 and the US in 2012. Although their definitions of inflation differ somewhat, most countries have set their inflation target at or near 2 per cent. Having a specific, easily observed and well-understood target holds central banks to account and has helped to anchor inflation expectations by the public.

Covid-19, however, has brought new challenges and exposed old weaknesses. First, the data used to calculate inflation has become less reliable and more volatile. With many shops and restaurants closed and flights cancelled, many common goods and services are unavailable at any price. The UK Office for National Statistics (ONS) estimates that about 15 per cent of its typical household basket was simply unavailable in April and May. This means that the month-to-month measure of CPI is not comparing apples with apples. Volatility will also be increased by the changes to VAT rates introduced by the chancellor this week.

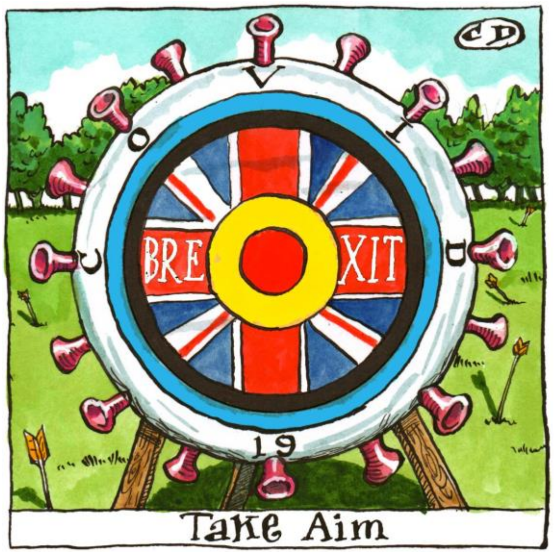
Second, there has been a shift in the pattern of household expenditures during lockdown. Categories such as "games, toys and hobbies", as well as "alcoholic beverages and tobacco" have surged. As the lockdown restrictions are removed some such shifts will be reversed and others will take place. This will add another distortion to the aggregated CPI measure, which uses fixed weights to construct its basket of expenditures.

Third, a well-recognised problem with the CPI is that it does not include housing costs, which are the biggest outlays for many households. Indeed the frustrations of millennials paying high rents and unable to afford access to the housing ladder is a significant social and political concern. A solution is available for incorporating these costs into the inflation target and it might help indirectly with the housing problem as it would make clear the importance of housing-related costs in consumer budgets.

The ONS publishes a separate consumer price index, the CPIH, which includes a "rental equivalent" measure of housing costs. Those costs account for nearly 30 per cent of an average household's expenditures; why are they not included in the Bank of England's inflation target?

The CPIH has a bit of a history. It was created in 2013, examined and recommended by the Johnson Report in 2015, supported by the National Statistician, revised slightly, back-casted to 2005 to facilitate comparisons over time and has languished, unloved, ever since. Its key fault is that it deviates from the EU statistical convention to which the UK committed as an EU member. Brexit provides a convenient escape.

A shift from CPI to CPIH would improve the relevance of the inflation target but more change is necessary to navigate the uncertain and turbulent economic recovery phase from Covid-19. Some sectors of the economy will bounce back quickly but others, such as airlines, may take many months or possibly years to recover. There will be huge uncertainties about both supply and demand in different sectors and therefore about the underlying path of inflation in the economy as a whole.



If consumers remain cautious while the supply chains of production recover then prices may fall, at least for a time. But if pent-up demand rebounds as people go back to work and out to eat with the chancellor's restaurant vouchers, then inflation could be ignited quite quickly by the large monetary and fiscal stimulus already supporting the economy.

Volatility in the data is also aggravated by the growing problem of adjusting the prices of high-tech goods for quality improvements. The ONS has just concluded a three-year study of its adjustments in the telecoms and internet sector. It found that the quality component of prices in that sector was eight times as large as previously estimated. This implies that the inflation component was correspondingly smaller. The new estimates by the ONS showed that prices in that sector fell by 95 per cent between 1997 and 2016 whereas the CPI measure showed only a 5 per cent fall.

There is no perfect measure of inflation that satisfies all users. The US Federal Reserve board targets the personal consumption deflator from its national accounts, but that suffers from the same mismeasurement and revision problems. Another idea popular with some economists is to target nominal GDP growth rather than the inflation component but this would create additional volatility in the target, which would be especially pronounced during sharp economic contractions and recoveries such as the current period.

The combination of Brexit and the post-Covid-19 recovery presents new challenges and a good opportunity to adjust the Bank's inflation-targeting regime. A strict adherence to the 2 per cent CPI target could generate unnecessary and counterproductive swings in monetary policy trying to drive the measured inflation rate back towards target.

The government could mitigate this risk and also broaden the target to include housing expenditures by replacing the point CPI target of 2 per cent with a range for CPIH of 0 per cent to 4 per cent. Such a range would recognise the new limitations and volatility of the data, while keeping the focus on the Bank's core function of inflation control. It would also recognise that during periods of strong changes in technology and consumption patterns, moderate and temporary deflation is not a disaster, as experience in Japan and Switzerland has shown.

Other options, such as targeting nominal GDP growth or a cyclically adjusted price level, lack the transparency and timeliness of the CPIH, as well as introducing new definitional issues. As our economy sputters and surges back to growth, it is time to update our inflation-targeting regime for the future.

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