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Policy Brief #6

Price Stability

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Policy Issue

For four decades British governments have placed priority on maintaining low inflation. Under conservative governments this functioned as the central macroeconomic policy goal. A Labour government will come under strong pressure to maintain this priority, though it is frequently in conflict with other objectives such as economic growth and full employment.

What is the appropriate inflation guideline for a Labour government?

Analysis

Private sector price increases are simultaneously increases in private sector incomes (price = intermediate costs + value added, value added = wages + profits + other incomes). Price increases do not erode real wages. Real wages and more generally household real incomes fall as a result of distributional effects of price increases on incomes (wages and profits) and expenditures (spending patterns across the income distribution).

The standard definition of inflation is, "a general and continuous increase in prices implying a fall in the purchasing power of money". There exist several empirical yardsticks to assess the degree of inflation, prices paid by households on final goods and services ("consumer" price indices), prices paid by producers, wholesale indices, and aggregate output (GDP) deflators. Each of these measures can serve a different purpose. All have the same failing of treating an increase in the index as indicating inflation.

"A general increase in prices" need not imply "a fall in the purchasing power of money". A price increase may indicate an improvement in the quality of a good or service. For example, from 2000 to 2016 in Britain the price of new motor vehicles rose by 20%. Part of this increase represented quality change, not inflation. A closely related source of non-inflationary price increase is the introduction of new products, such as computer-regulated fuel injection in motor vehicles.

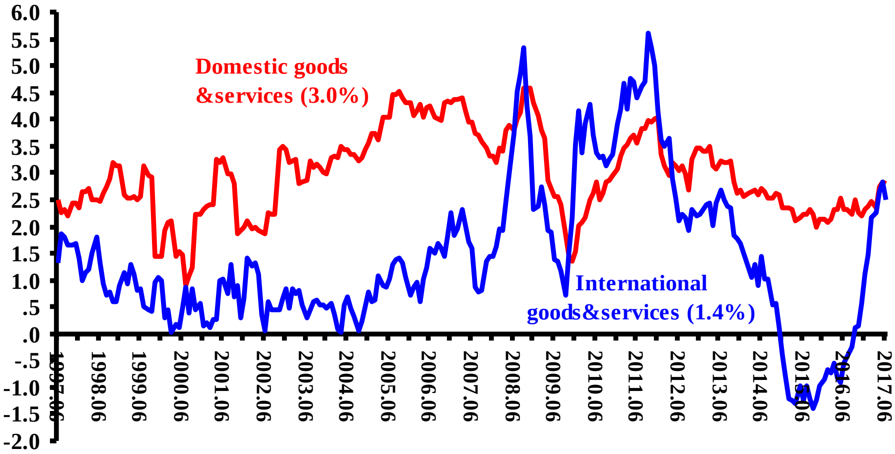
A 1995 study for the US Congress, the Boskin Report, concluded that quality change and new products accounted for 1.1 to 1.3 percentage points in the consumer price index. Less detailed work by the Bank of England and the European Central Bank reached the same conclusion, that an increase in composite price indices does not necessarily imply general price inflation (though there is no consensus on the degree of overestimation).

Every index includes many prices and their average increase is a statistical outcome affected by method of calculation. By definition inflation is a "general rise in prices". This phrase abstracts from the different ways in which prices are determined. Except in rare circumstances, all prices do not rise and if they do it is not in the same proportion across goods and services. The heterogeneous behaviour of prices should guide policy makers, not the changes in the composite index.

All goods and services fall into one of two categories, those whose price is strongly influenced by international trade and those determined primarily in UK domestic exchange. Following international guidelines for assigning goods and services to each category, detailed price data from the Office of National Statistics indicate that 56% of consumer expenditure goes to international goods and services and 44% on domestic. The former category contains most of the goods (commodities) covered by the index; the latter is overwhelmingly services.

These two categories of goods and services behaved quite differently over the 21 years 1997-2017, as the chart shows. During 2008-2012 the two take a similar pattern, but for most years the correspondence is weak. For the entire period the annualized rate of change of domestic prices was more than double the rate for the international category (3.0% and 1.4%, respectively, and 1.9% for the CPI as a whole). Prices of domestic goods and services were the more stable, reflecting the volatility of primary products, most obviously petroleum.

Annualized* rate of monthly price changes for domestic & international goods & services, Consumer Price Index, June 1997-June 2017



*Each month compared to same month of previous year. Most of "domestic" category is services, accounting for 43.5% of total (see sources at end of this brief). Twenty-one year averages are in legend. The two time series have a simple correlation of .15 (F statistic significant at .001).

The distinction between international and domestic goods and services in the measures of inflation used by UK policy makers (CPI) has major policy importance, and should guide the inflation policy for the Labour government.

1. The potential for British government and the Bank of England to influence the prices of international goods & services is limited.
2. The domestic category consists overwhelmingly of services, public (14% of the consumer price index) and private (30%).
3. With few exceptions the prices of public sector services are not determined through markets.
4. Trade unions are weak or absent in private sector services, and the sector has the highest incidence of poverty of any in the economy (e.g. domestic service).

In practice anti-inflationary monetary policies achieve their purpose largely through restraining the growth of wages in private services. Private sector services account for about 30% of the consumer price index, and for the economy as a whole the share of wages in national income is about 55%. If this share applies to private services it implies that a one percentage point fall in the overall CPI would require a 6% fall for wages in private services.

Policy Framework

A general and continuous increase in prices is simultaneously a general and continuous increase in incomes and cannot in itself reduce purchasing power. This implies that a policy of low inflation will not protect the purchasing power of the working class or that of households in the lower income groups.

Mainstream anti-inflation policies such as raising interest rates work through demand reduction. This approach tends to undermine the incomes of the non-rich. The following guidelines for price stability would serve the interests of the majority of the population.

1. **End Bank of England inflation targets** so that these no longer function as a policy constraint. Inflation targeting places the burden of price stability on the working class and especially low paid workers in private services.
2. **Abandon composite price indices as guides to price stability.** These are misleading and carry a deflationary bias.
3. **Correctly define inflation** (better incorporating quality effects).
4. **Make price stability policy derivative from overall macroeconomic management** (objectives for employment, economic growth and external balance).

The formal statement of government policy might be:

This government seeks to maintain a high level of employment with rising incomes accompanied with a degree of price stability consistent with financial stability and sustainable external balances.

Other policy briefs further develop this approach to macroeconomic management.

Sources

1. Price indices explained
https://www.ons.gov.uk/economy/inflationandpriceindices/articles/consumerpriceindicesabriefguide/2016
2, Price statistics (see Table 57)
https://www.ons.gov.uk/economy/inflationandpriceindices/datasets/consumerpriceinflation
3. International & domestic goods & services ("tradables" & "non-tradables")
http://www.bankofengland.co.uk/archive/Documents/historicpubs/qb/1993/qb93q18091.pdf
4. Analysis of the Report of the Boskin Commission
http://www.nber.org/papers/w12311
5. Bank of England inflation policy
http://www.bankofengland.co.uk/monetarypolicy/Pages/framework/framework.aspx
6. Labour's share in value added
http://www.bankofengland.co.uk/publications/Documents/speeches/2015/speech864.pdf

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