

Have Central Banks lost the plot on inflation?

In recent months a number of commentators have suggested that central banks in the US and elsewhere have been neglecting their primary duty, which is to keep inflation under control. It is irrelevant, these critics suggest, that recent increases in inflation are in large part due to increases in commodity prices. They claim that the source of inflation is unimportant, and argue central banks should have been ensuring that other prices have been flat or falling to offset these commodity price increases. I believe this criticism is too simplistic, because it neglects to ask a fundamental question, which is why we worry about inflation in the first place.

To many, inflation is a problem because it is a shorthand for a decline in their real income, and to the extent that they buy petrol and food, then commodity price increases reduce real incomes. But this is not what economists mean by the costs of inflation. Declines in real incomes reflect changes in *relative* prices, whereas inflation describes changes in the general price level. To the extent that rising oil and food prices reflect shortages in supply, then declines in the real incomes of consumers of commodities are inevitable. We may want to protect the poor and vulnerable, but to attempt to offset these relative price changes for the population as a whole would be both futile and dangerous.

For economists, inflation is the phenomenon where, over some period, all nominal magnitudes are rising together, without any particular implications for real incomes. There are a number of reasons why inflation so defined may be costly. One is that holding money becomes more expensive, because its purchasing power decreases with inflation. In this case the critics are probably correct: inflation due to commodity price increases is no different from inflation from any other source, as long as it involves goods that require money to buy, sell or produce. But there is another cost of inflation where the source of inflation does matter.

It has been known for some time that inflation goes hand in hand with greater variability in relative prices. To the extent that inflation causes this relative price variability, it is costly, because relative price changes caused by inflation alone distort the market mechanism. One clear reason why this might happen is that many prices are changed infrequently at different times. If the price of good X is changed each April, and the price of good Y is changed each October, then inflation will cause good Y to be too cheap relative to good X in the Summer and too expensive in the Winter. There are no reason in terms of supply or demand for this pattern in the relative price of X in terms of Y, so if it leads to changes in consumption or production it misallocates resources.

Is this cost of inflation important? Keynesians certainly believe that slow or 'sticky' price adjustment is pervasive, and is largely responsible for generating persistence in business cycles. The reasons why many prices are sticky appear diverse and complex, but imperfectly competitive markets do seem to be important. In recent years a number of Keynesian economists (following pioneering work by Michael Woodford in particular) have attempted to quantify the costs of the relative price movements generated by inflation and sticky prices, and these calculations suggest that changes in inflation generate significant changes in social welfare through this route. If they are right, then the source of inflation is important. If inflation occurs in commodities where prices are changed on a day to

day basis, then it is less costly than if inflation occurs in prices that are sticky. In other words, some types of inflation are more costly than others.

This focus on inflation in goods where prices are sticky bears some relation to the idea of focusing on 'core' inflation, although the association may be incidental. It also suggests that central banks should be concerned with wage inflation as well as price inflation, not just because the former leads to the latter, but because wages are themselves 'sticky', and so wage inflation will generate costs by changing relative wages in a distortionary manner just as price inflation causes distortionary relative price changes.

In these circumstances, it makes sense for central banks to allow some rise in average inflation as a result of the commodity price boom, as long as they judge that weak activity will prevent higher commodity prices leading to higher inflation in wages and non-commodity prices. So far the data on wage inflation suggests this judgement is correct. To attempt to offset commodity price inflation by reducing inflation in non-commodities may produce costs that exceed benefits. Far from losing the plot, recent actions by central banks suggest they are using their discretion wisely.

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