UK INFLATION TARGETING UNDERPINNED BY AN EARLIER ‘OVERHAUL OF DOCTRINE’

The better economic performance of the UK economy in the 15 years before the recession reflects improved understanding by policy-makers of the economy’s structure rather than changes in the priority given by policy-makers to price stability. That is the conclusion of research by **Edward Nelson**, published in the June 2009 *Economic Journal*.

But according to Nelson, the significant break was not the introduction of inflation targeting in 1992 but what he calls the ‘overhaul of doctrine’ dating from 1979. That was when policy-makers came to accept that the UK monetary authority could essentially determine the UK inflation rate over the medium and long run.

The regime of inflation targeting in the UK that began in 1992 was associated with 15 years of continuous economic growth, low inflation and more stable behaviour of both inflation and output. And while the country is now undergoing a major recession, this development should not be regarded as discrediting the inflation-targeting framework.

Recent years of data will need to be taken into perspective and to be considered together with prior and subsequent periods of economic expansion. Once this perspective is available, the recent data will likely be treated as some of the more turbulent observations in what is nevertheless a more stable economic era than that observed in prior decades.

The reason for this conclusion is twofold:

- First, fluctuations in inflation continue to be relatively minor compared with those in the 1970s and early 1980s.

- Second, the inflation-targeting framework gives policy-makers a clear foundation on which to pursue large-scale monetary actions that will speed up the elimination of the current negative output gap, without being perceived as abandoning their goal of price stability.

Since the inflation-targeting regime has made an enduring contribution to economic stability in the UK, it is of great interest how the UK came to embrace this regime. The approach in this research is to answer this question by studying the ‘doctrine’ or conceptual framework driving UK policy-makers’ decisions in the past five decades.

Nelson finds that the doctrine driving UK policy took two forms: an ‘old doctrine’ prevailing before 1979; and a ‘modern doctrine’ since 1979. The adoption of inflation targeting in 1992 did not constitute a break in doctrine, but instead a formalisation and improvement of the implementation of the policy measures implied by the modern doctrine prevailing since 1979.

The overhaul of doctrine meant breaking with the ‘old doctrine’ driving UK policy-making in the post-war period until 1979. The ‘old doctrine’ viewed inflation as a non-monetary phenomenon. That is, inflation was believed to be insensitive to policy actions that restrained the volume of aggregate nominal spending in the economy; rather, it was believed to be driven by factors that monetary policy could not affect. Old doctrine also viewed UK aggregate demand as essentially insensitive to interest rate policy.

The new doctrine instead viewed both demand and inflation as very responsive to monetary policy. In particular, policy-makers came to accept that the UK monetary authority could essentially determine the UK inflation rate over the medium and long run. Nelson says:

> 'The crucial underpinning of UK inflation targeting is therefore an overhaul of doctrine – a changed view of the transmission mechanism.'

The emphasis on doctrine in this study contrasts with explanations that attribute changes in UK economic behaviour to changes in policy-makers' objectives. Nelson demonstrates that UK policy-makers' objectives have been essentially unchanged over the past five decades. Even in the 1950s, 1960s and 1970s, the objective of price stability was given high priority and was given a numerical definition comparable to that it has had under inflation targeting.

ENDS

Notes for editors: 'An Overhaul of Doctrine: The Underpinning of UK Inflation Targeting' by Edward Nelson is published in the June 2009 issue of the *Economic Journal*.

Edward Nelson is at the Federal Reserve Board, Washington DC.

For further information: contact Romesh Vaitilingam on 07768-661095 (email: romesh@vaitilingam.com) or Edward Nelson via email: edward.nelson@frb.gov