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Undercover Economist: Price Fighters

By Tim Harford

What is the perfect rate of inflation? It is the kind of odd question that economists like to ask each other for fun, but which central bankers have to decide for real.

You might think that the answer was, obviously, zero, but nobody has told the central banks. The Bank of England has an inflation target of 2 per cent, the European Central Bank aims to keep inflation below, but close to, 2 per cent, and the Federal Reserve has a "comfort zone" of between 1 and 2 per cent. Japan's inflation rate is about zero – but when I visited Tokyo in May, one senior official told me: "We envy you your inflation."

These are only targets: most would concede that inflation is impossible to control perfectly. But why do central bankers aim to keep it above zero, rather than trying to eradicate it?

One reason is that relative prices need to change frequently to reflect changes in the economy: this year, British peas will be expensive because the crop was ruined by floods. But clothes have been getting cheaper for years, thanks to low-cost manufacturers in China. And yet the evidence suggests that it is usually easier to raise nominal prices than to lower them. So a little bit of inflation, which ensures the typical price change is up rather than down, means that those relative price adjustments can happen more quickly and easily. This can have a substantial effect on the real economy.

Professor Peter Sinclair of Birmingham University, when a research fellow at the Bank of England, concluded that moderate inflation could have other benefits: creating more room for policymakers to stimulate the economy if necessary, a steadier banking system and slightly lower average unemployment.

Of course, you can have too much of a good thing. While some inflation may help relative prices to adjust, too much requires such frequent price changes as to become a real burden. According to a credible 1990s estimate from the economist Daniel Levy, the typical American supermarket spent $100,000 a year changing the labels on its products: at high inflation rates it would have spent much more.

At a certain point – which Zimbabwe is well past – hyperinflation renders all prices meaningless. When Robert Mugabe ordered shopkeepers to halve prices in June, one of the most remarkable features of the pointless edict was that it would only have reduced them to their level less than a fortnight earlier.

In such circumstances, it is all but impossible to get a sense of the price of a beer versus a meal versus a shirt. The whole purpose of the price system – to convey information about the relative cost of different items – is lost.

One often hears that during periods of hyperinflation, people switch to barter, trading cigarettes or coffee for other products. That is not quite correct. Instead, during hyperinflations people look for alternative currencies. Cigarettes and coffee are portable and standardised, and so are decent candidates. So while the price of a shirt in terms of Zimbabwean dollars may be hopelessly volatile; the price of a shirt in packets of cigarettes or pounds of coffee is more stable.

Meanwhile, Japan is still trying to work out how to reach the "enviable" inflation the UK enjoys. Another economists' conversation piece is the helicopter drop: the Bank of Japan could produce inflation by printing billions of yen and showering them over Tokyo.

Self-respecting central bankers try to expand the money supply using more sober methods.

Or do they? Japan has recently been gripped by an epidemic of mysterious cash gifts – bundles of yen left in mailboxes, public lavatories and even raining from the roof of a convenience store in Tokyo. Could the Bank of Japan finally be calling in the helicopters?

Tim Harford is author of "The Undercover Economist."

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