Inflation drivel [1]

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Labour's economic team?led by Ed Balls?is either confused and economically ignorant, or deliberately misleading and opportunistic. After Tuesday's inflation release [3], they hit out at the government for the continued above-target rate (2.7% over the year to September, the same as over the year to August), as part of their new "cost of living" strategy. Spokesperson Catherine McKinnell said: [4]

> This is yet more evidence of the cost-of-living crisis facing families across Britain after three years of this Government's failing policies. Prices have now risen faster than wages in 39 out of 40 months under David Cameron and now we learn that we have the highest rate of inflation of any EU country.

At the same time, shadow chancellor Ed Balls has repeatedly attacked the Tories' fiscal austerity policies, blaming them for the extremely lacklustre recovery from the recession and even suggesting they may have been self-defeating. But at the same time he has also blamed above-target inflation for squeezing living standards. [5]

But which is it? If the Tories were wrong to cut spending, it's because the recession was driven by nominal factors, and cutting spending will further cut aggregate demand, only worsening the pricing mismatch that is leaving resources unemployed and output below potential. [6] But we also knowfrom our basic AD/AS model [7], the same one that we use to generate the result that falling aggregate demand is bad for output and employment, that higher AD means higher inflation. So if Ed Balls really wants more government spending, any of the models he's relying on would also tell him he'd have to have higher inflation as well. You can't criticise austerity and inflation.

But it goes deeper than this. What Ed Balls is missing is that actually the UK's overall economic policy wasn't particularly austere at all. Certainly at points it could have standed to be a bit easier [8], especially in the crucial 2008-2009 crash. But basically Ed Balls completely ignores monetary policy, which, in the final analysis, determines demand. The monetary policy committee, which sets rates and quantitative easing (QE) can choose whatever it wants demand in the economy to be. They use a faulty indicator, the consumer prices index [9]. But they interact with the economy by constricting or expanding demand based on their policy goals (inflation close to 2%, stable output and employment).

Imagine the government decided to cut spending by £100bn (an illustrative number). If this was going to bring inflation down to 0%, from 2%, then the Bank of England would be changing its monetary policy if it allowed inflation to fall there. The Bank, knowing this, will manipulate interest rates and asset buying policy (QE) to make sure their goals are met. This is true even though the Bank's current framework leaves so much to be desired [10]. In 2010 and 2011 the Bank allowed inflation to go all the way up to 5.2%, meaning that they more than counteracted the effect of austerity on overall aggregate demand.

What this means is that Ed Balls, were he to slow down the pace of fiscal contraction and nevertheless bring inflation down to 2% now, would worsen the nominal recession, and yet redistribute yet more resources to state control. He may not know this?despite his economic education?or he may be staking out a deliberately misleading and opportunistic set of policies, playing on the public's ignorance of economics.

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