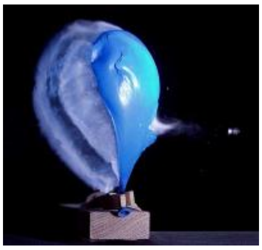
A little bit of inflation is still too much [1]

Written by **Dr Eamonn Butler** [2] | Wednesday 19 September 2012



Headline inflation in the UK has fallen to 2.5% (from a peak of 5.2% a year ago), so there is great rejoicing. The monetary hawks (such as Liam Halligan) have been proved wrong, we are told ? all the Quantitative Easing didn't actually fuel inflation. Meanwhile, the Governor of the Bank of England, Mervyn King, is relieved that he doesn't have to keep writing to the Chancellor, as the law requires when the inflation target is widely missed.

But is everything so hunky-dory in reality? At the most basic level, there are some price-raising pressures in the pipeline. Oil keeps going up, the utility companies are raising their prices, and poor harvests around the world this year cannot help. But as every good monetarist knows, rises in some prices, however important, cannot raise prices overall. If there is a fixed amount of cash around, people can only spend more on one sector (like food and energy) if they cut back on others (luxury goods, say, or housing).

And the fact that prices are rising only moderately suggests that all the Bank's quantitative easing is not actually having much effect on the real economy. It certainly seems to be keeping up asset prices, which is why the stock market is looking so healthy. But maybe it is not seeping into the everyday economy. Maybe it just replaced the collapse in the money supply when the banks found themselves caught in the headlights and stopped giving out loans any more. Still, the monetary hawks would say that as and when the economy recovers, the Bank of England needs to be able to rein things in again or all this new money really will have an effect on prices ? and reining people in is a lot harder than engineering a boom.

But as the deepest level, I still wonder why we should regard inflation of 2.5%, or the Bank's central inflation target of 2%, should be remotely acceptable. At that rate, the value of our money halves in 30 years. Which is great if you are a big creditor, like the government, because you are repaying your debts in devalued money. And indeed the government is charging us tax on the interest we get on our savings, even though these are negative in real terms. And as incomes struggle to keep pace with the inflation, more of us find ourselves drawn into the higher-rate income-tax brackets. And so on. It all favours the spendthrifts and punishes the savers.

Keynes figured that inflation is useful because of the downward inflexibility of wages. People don't like pay cuts, but pay in declining industries can be cut in real terms simply if it does not rise as much as prices. So people are gradually eased into more productive jobs without any nastiness. Keynes, though, did not realise just how damaging inflation is to signals in the economy. When all prices are rising, it is hard to separate the 'noise' of generally rising prices from the 'signal' of prices that rise because demand is not being met. For years, people invested in houses because they saw house prices going up and up, without realising that, after inflation, the rise was much less. So you get bubbles in some places, and underinvestment in others. None of which helps competitiveness and employment.

There is also an argument that a bit of inflation is fine because of the seignorage in the system. Put simply, as people get wealthier they keep more cash to hand, in their pockets, wallets and current accounts, without worrying about it so much. So you can have more money in circulation without it driving up prices, because there is more money lying dormant round the place. Maybe. But I still don't see why that is a reason to create so much money that prices, driven by the non-dormant bulk of the cash, rise beyond zero.

There is also an argument that it is wise to allow a bit of inflation because if by mistake we tipped into deflation things would be really terrible. With falling prices, why should anyone buy today what they could buy cheaper tomorrow? So business would grind to a halt, we're told. But in fact, inflation is equally destructive ? killing the incentives for saving and investment, encouraging false booms, diverting resources into the wrong places. Should it not be a key duty of the government to preserve the value of our money ? not to let it lose its value at 2.5% or indeed on any scale at all?

Source URL: http://www.adamsmith.org/blog/money-banking/a-little-bit-of-inflation-is-still-too-much

Links:
[1] http://www.adamsmith.org/blog/money-banking/a-little-bit-of-inflation-is-still-too-much
[2] http://www.adamsmith.org/authors/dr-eamonn-butler
[3] http://disqus.com/?ref_noscript
[4] http://disqus.com