

Inflation and debts

The recent decision by the Bank to raise interest rates by another 0.5% to 2.25% has done enough to slow the inflation the Bank had allowed to build over the last year. According to the Bank's own forecasts inflation will now subside to the 2% target over the next two years as the economy slows and as world commodity prices and energy prices come under control, whether from market forces or government intervention. The danger is the Bank will do too much by way of rate rises, withdrawing too much money and credit from the system, creating a nasty recession. Their own estimates already show the UK in recession as we enter next year on their current policy.

The Bank of England carried on creating money and buying up bonds for too long and on too vast a scale last year. An inflation was well set by early 2022 when the Russian invasion of Ukraine disrupted energy markets and added to the inflationary pressures with a surge in gas and electricity prices. Whilst this energy price shock had as its first impact a boost to inflation, if left untreated it would also bring about a recession. Large sums are removed from people and companies to pay the sky high bills, with much of that money sent abroad to pay foreign suppliers and pay the elevated energy supply tax bills of foreign governments. None of this money remains in the UK to pay wages and buy goods. It created a nasty double problem for both the Bank and the government.

The Bank was right to correct its past monetary excesses. It had bought too many bonds to keep the longer term interest rates too low for too long. In the process it allowed a bubble in the money supply to develop. At first the excess money simply created an inflation in the prices of the bonds the Bank bought and in shares and properties which the sellers of those bonds bought with the proceeds. It then started to seep out into the world of consumption, bidding up the costs and prices of a wider range of goods and services. This is now being adjusted sharply by a major change of money policy and by the inflation robber coming in the night to depress the real incomes of all energy buyers.

The Bank needs to be careful from here. The government is providing considerable assistance to people and companies through the energy support measures and through reversing or cancelling inherited and future tax increases. These are needed and are not in themselves inflationary if borrowed through issuing new debt to savers. The much tighter money will slow the economy, and as the Fed brakes the US economy violently so there will be reduced price pressures from global commodity prices, from international transport rates and from internationally traded goods. Nor need we worry unduly about the level of UK debt. At an official 96% of our national income it is way below Japan, and below Italy, the USA and various other advanced countries. As a substantial proportion of the debt is owned by the Bank of England and all is repayable in local currency the state should be able to roll over the bonds as they fall due without too much problem. The official figures and commentary spreads alarm about the current high level of debt interest. This is a distortion of the position. The cash sums the state has

to pay to cover the interest bill on the debt are at quite modest levels because so much of the debt has been financed at the very low interest rates of recent years. Of the £8.2bn of stated interest in August only £3.5bn were cash payments. The rest is the increased eventual repayment cost of the indexed debt, which will simply be refinanced when it falls due.

Of course I would like borrowing to fall and the budget to move closer to balance. The truth is there are no options to let that happen easily. Were the government to refuse to offset some of the energy damage we would have a deeper and longer recession. That would mean much less revenue and more costs from higher levels of benefit expenditure to compensate people for loss of some or all of their work incomes. If the government seeks to stop the recession then that entails in the first instance borrowing more to allow the tax cuts and subsidies to sustain more activity. The second round effects should mean the state borrows less if it stops a recession now than if it opted for austerity and a longer recession. The government needs to get more people off benefit into work, find ways of working smarter in crucial public services, and cutting out things the state does not need to do in order to control public spending. Getting a better grip on numbers of illegal and low paid economic migrants would also make a welcome saving.

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