

## Why deflation matters

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UK inflation has fallen to 1.2%, as measured by the consumer prices index (CPI), which is the government's preferred measure. The retail prices index measure of inflation is, admittedly, higher at 2.3%. Either way, these are exceptionally low figures. But does this fall matter? I was a question I was asked on Twitter, yesterday.

The answer is that it matters, a lot. Deflation is pretty disastrous for an economy for two fundamental reasons. The first is that investment spending can grind to a halt when deflation occurs. The reason is obvious: if you expect something to be cheaper soon you may defer buying it. If that becomes habitual money suddenly stops flowing into the economy. And given that we're already in a pretty marginal economic situation where growth is having no real impact on the well-being of most people, withdrawing money from the economy is the last thing we need. So, let's be blunt, deflation removes any prospect of any form of growth in the economy - sustainable or otherwise. Human nature and the desire for a 'bargain' guarantees that.

Then there's the second problem. This is if anything more serious for anyone who owes money (and most households in the UK do). Deflation increases the value of that debt. It actually increases the real amount that has to be paid. This has the effect of taking yet ore money out of the economy - because it increases the cost of loan repayment which has the economic impact of increasing savings, and more savings are the last thing we need right now when the economy is short of spending.

There are two further impacts of this increasing cost of existing loans. The first is that this increases the risk of loan defaults - and that could create another banking crisis.

And if the value of loans goes up inequality increases because those to whom the money is owed see the value of what they will be repaid increase. And since loans are taken out, pretty much by definition, by the have nots and are repaid to the haves (and yes I am allowing in saying that for the fact that loans are created by banks) then inequality will inevitably rise, which is bad for the economy because those with wealth do not spend all their income, almost by definition, because that is how they became wealthy in the first place.

Deflation does then have no real advantages at all. Thankfully it can be easily addressed. Simply having the government invest significantly more to boost economic activity solves the problem whilst creating wealth and long term assets of value. When interest rates are also very low - as they are - the cost is virtually negligible as well in real terms, which makes ignoring this option something akin to economic madness.

The only problem is that economic madness has gripped the upper echelons of the UK political classes. So don't expect action to prevent deflation any time soon.