Inflation, what it is and why there's no reason that we...

Published: January 13, 2026, 12:00 pm

I have just posted this Twitter thread tackling the issue of inflation...

People are really worried about inflation. The right-wing media is fuelling that concern by saying government money creation is bound to lead to it increasing. And so people are also worried about interest rate rises. None of this is necessary. A thread....

First, let's deal with that money creation issue. The UK government has created about £900 billion of money in the last 12 years. No inflation in everyday prices has resulted. So for those making the claim that it will do so now have to prove why things have changed.

As a matter of fact they have not. The government has had to create money because all the time money is destroyed in our economy. That's the result of the way money works. Paying tax destroys government created money. Paying back loans destroys bank-created money.

These are facts. So if money is being destroyed all the time then new money is needed to keep the economy going. Government spending creates some of that new money. But so too would more borrowing if people were doing it. But there are good reasons to think they won't be.

The boom in house buying has come to an end. The number of new mortgages - and they create new money - will be falling now. So money creation from that source is slowing.

And because the Covid pandemic has not ended there are many signs that people are not now rushing out to spend in the way many economists predicted. It seems at least as likely that they are going to carry on saving right now. And that means they won't be borrowing either.

Nor will many businesses be borrowing. They've borrowed to the limit under government-backed schemes in the last year - and bankers aren't keen to lend more to them now as a result. So, it's pretty clear that new bank lending is not going to increase any time soon.

Put that altogether and it's likely there is going to be a shortage of money in the economy over the next year or more - so the government will still need to inject cash into it through quantitative easing, whatever the economists who are predicting gloom and doom say.

Remember, this is what the intention of QE is: ultimately it provides cash within the economy when the banks won't create it by lending. That's how it aims to keep the economy going. And whether the Bank of England admit it or not, it does so by funding government spending.

I won't pretend that QE is perfect. It's far from that. It has created asset price booms and massively increased inequality. It's in effect boosted savings, making the whole crisis worse in some ways. These are issues to address with better forms of QE.

But to pretend that right now government cash injection into the economy is going to create a boost in inflation is wrong: there are no signs that this is likely at present.

But just suppose it did? Presume I am wrong (and I could be - nothing is certain in economics), what would the right policy be? Would it be an interest rate rise or to stop QE? It is to stop QE. And given that can be done there is no reason to increase rates for this reason.

In other words, at this moment there is no reason to think there is excessive money creation in the UK causing inflation that might justify an interest rate rise. Anyone saying there is has to counter the evidence, and it does not exist at present.

So, what else might cause inflation in a way that might require an increase in interest rates? There are essentially three ways we get inflation.

One is excess demand, so too much new money chasing too few goods.

Then there are supply shortages, meaning there are too few goods for existing money to buy.

And last there are political shocks which change the relative value of UK money compared to other countries, importing inflation as a result through changes in the exchange rate.

Let's deal with these in turn. The first, which is too much new money chasing too few goods, is the situation I have already described. It could happen if the government kept creating money, or people started spending their savings and banks increased their lending.

But as I have noted those things aren’t happening.

It might also happen if there were some significant pay rises in excess of inflation really happening on the ground. But that’s not happening either.

The data that suggests there might be pay increases right now are largely related to the impact of furlough, and the reduced pay linked to it, unwinding and not to any real increases.

But why would you want to crush real pay increases anyway when it is so clear many of our economic problems are down to low pay? That is why we really have an HGV driver shortage, after all.

And that shortage of real pay rises feeds into another reason why people are not going to be going wild with their spending. There’s a fear factor to take into account when forecasting spending.

That fear factor partly relates to Covid and partly to government policy. When the government is reducing the social safety net - as it is - people save to provide for a rainy day. When they know the risk from Covid is still real of course they will save if they can.

So, as I have already concluded, the chance that inflation because of excess money in the economy is low. And in any event, the right response would be to cut or end QE, and not increase interest rates until it was shown that did not work. All round, this risk is low.

Then there’s supply shortages pushing up prices, as may happen. If we continue to see lorry driver shortages and Brexit food chain disruption then it is very likely we will see food and maybe some other price increases over the next few months.

So the question is, are interest rate rises the way to tackle supply chain shortage induced inflation? To put it another way, would they increase the number of lorry drivers? Clearly not. And can increasing mortgage rates control the demand for food? Again, obviously not: people have to eat.

So what would increasing rates for this reason do? It would push people already on tight household budgets because of food price increases into even harder economic scenarios, and may lead to mortgage and debt defaults, with all their consequences.

So what an interest rate rise to tackle inflation resulting from supply shortage issues will not do is change the demand for food or make lorries move. So a rate rise will not solve any problem, but it will increase the financial stress in the economy, considerably.

The real way to tackle supply chain problems is to fix them. In other words, training, investment and a more flexible migration policy are required. That's down to fiscal policy (or government spending) and politics then. Monetary policy can do nothing about these issues.

So what about the third type of inflation - which is the politically created sort where a fundamental change in the circumstance of the country makes our currency decline in value and brings temporary price increases as the economy adjusts to new exchange rates?

An example of such a shock was the oil crisis of the 1970s. More recently, of course, we have, and are still seeing, the impacts of Brexit. This impact is unlikely to end any time soon. Can an interest rate rise really solve the inflation that such events cause?

The answer is that they can't. They might temporarily attract a little money into London from overseas when rates are higher here than elsewhere. But, first of all, those attractions rarely last long. Rates elsewhere soon change to neuter such moves in reality.

And second, a bit of 'hot money' only really worked to address this issue when we were trying for fixed exchange rates, and those have long gone. With floating rates the exchange rate is really determined by what's happening in the underlying economy.

If our underlying economy is harmed by Brexit - and it clearly is - the way to solve that problem is not to raise interest rates to tackle any resulting inflation but is to instead deal with the underlying issues by, for example, rejoining the single market and customs union.

And remember, this type of inflation is always temporary: once the shock's worked through the system it's stable at the new price level. That's the way inflation like this works, especially when we've weak trade unions unable to demand pay rises in response to the economic shock.

Also remember too that given that changing interest rates always takes some time to have an impact on inflation the new stable price point might have been reached before interest rate changes have any impact in politically induced inflation cases like this.

So is changing interest rates likely to be an appropriate response to this type of inflation? Clearly not.

So, let's summarise. If there three types of inflation (too much new money for available goods, too few goods for existing money and political shocks) interest rate rises can only deal with one at most, which is the first.

The second and third types of inflation have to be dealt with using fiscal policy (i.e. by changing government spending) for the second type and political measures for the third, which alternatively just has to be lived with.

And the chance of the first type of inflation, which is where too much new money - from savings being spent, or real pay rises or from excessive QE or from a rash of new bank lending - pushes up prices looks to be really remote right now.

Why is that? I've already noted that people aren't spending their savings. Nor are banks lending excessively. And QE is not creating inflation. And meanwhile significant pay rises are also a dream for most. And of these points the last may be the most important.

Whilst labour shortages are being reported in the UK, and there are for some for types of work which have be come horribly undervalued, the reality is that we are a long way from full employment in the UK. What is more, around 7% of the UK workforce is still on furlough.

So, the truth is that there couldn’t be a shortage of goods for new money in the UK if only we got people to work. And right now there are people to do that work. What we have to do to meet demand is to adapt the UK economy to meet need with our own labour.

In other words, before we worry about inflation we should instead be investing to make sure that the UK economy can deliver what people want to buy. And that requires fiscal policy, or more government spending, and not an interest rate rise.

In fact, an interest rate rise would make that process of change much harder by increasing the cost of investment, meaning it would be counter-productive, and harm job prospects at the same time.

So, what should the Bank of England Monetary Policy Committee be doing in response to supposed inflation risk? Precisely nothing, I suggest. That's because there is no inflation risk that there is anything they can do to address at present? And that is why action is not needed.

All they should do is make clear that the inflation risks that do exist have to be solved by fiscal policy and by politics. And they should say that’s not their job.

They should also say that when it comes to the one type of inflation risk that they can address, the right response would be to reduce QE money creation in the first instance and to wait and see what happened after that before changing rates.

That’s because the evidence is that systemic inflation is simply not an issue in the economy now. That’s why inaction is required in response to it.

And when might action be required? Only when the evidence supports it, and it is clear that an interest rate rise is in the genuine interest of most people in this country. We are nowhere near that now. And I stress, we have no idea when we might be.

So, a last question, which is why are so many economists calling for interest rate rises when they aren’t needed, and in the case of the only inflation risks that we face they are not the right tool to use to tackle the issues that we face, and could make matters worse?

This is a question that @d_blanchflower and I have been asking. There are at least five possible answers.

First, it’s possible that those economists don't know how to appraise the risk of inflation.

Second, it’s also possible that they don't know that there are a number of very different types of inflation, with differing causes.

Third, maybe they don't realise that much inflation is temporary anyway - and inevitably goes away a year or so after the shock that created it has passed, because that’s the inevitable consequence of the way we measure inflation on the basis of annual comparison.

Fourth, perhaps they don't realise that in most cases fiscal or political initiatives are required to tackle inflation, and monetary policy can never address it.

Fifth, maybe they really do know all this but have another agenda. That agenda might be fourfold.

The first option is that they don’t really care about inflation risks and just want to increase interest rates to appease banks and savers. They want to serve the interests of the wealthy and don’t care about the cost to others from doing so. They’re doing class war then.

Or they want to stop the Bank of England funding the government, which is what it is doing with QE right now, because they want to shrink the size of the state and create a new era of austerity, including by cutting the NHS and benefits. They're doing politics, in other words.

Or, they want to pretend that their theories are right even though all the evidence suggests otherwise and they really don't mind imposing harm on the world to ensure that their own beliefs on how the world should be can be put into action. Call that dogmatic malice, if you like.

And last there is the chance that they are so out of touch with reality that they can't think through the consequence of what they are suggesting. They're living in a bubble of privilege in other words - call it City induced ignorance, if you like.

Whatever the cause I have three conclusions.

The first is that inflation may well happen soon, but for reasons that the Bank of England can't tackle and which the government deliberately created, mainly through Brexit. Only solving the problem created by Brexit can address that.

The second is that inflation from excess demand is very unlikely right now, and no action is required until it is apparent that it exists - which may never happen. So glorious inaction is all that is demanded from the Bank of England now.

And third, there are economists who're seeking to cause harm to the world by creating household poverty, austerity, a debt crisis, mortgage failures, homelessness, bank failures and recession, and all because they want an interest rate increase for reasons they won't explain.

And that's a good reason to be pretty annoyed with them and to continue to call them out, which @d_blanchflower and I plan to do, as the #MileEndRoadEconomists - taking the view from outside the City of London in the interests of the real people of this country.