Getting inflation down and growth up

The inflation was brought on as a result of excessive money creation, bond buying and ultra low rates. It was compounded by shortages of energy, food and other basics. The inflation will now come down as money and credit are much tighter. Inflation is however proving obstinate because there remain some difficult supply shortages, price controls have delayed energy falls in the UK and public sector productivity has fallen a lot leading to too high a level of public spending.

The Bank's policy is to squeeze demand by raising the price of borrowings. This will put off investment, cutting demand for investment goods and construction. The main impact is on mortgages, narrowly targeting the worst hits on the 2 million or so who will need to renew their mortgage loans before the election, and on potential first time buyers who will be excluded from the market. It will take time to hit overall demand as the hit to incomes only occurs at the maturity date of the old lower rate mortgage. Meanwhile the millions of savers with money on deposit will enjoy an increase in income facilitating more demand from them. The Bank is hitting mortgages especially hard by selling £80bn of bonds a year, given the way the price and rate on the bonds of the right maturity is directly relevant to fixing commercial mortgage rates.

To get inflation down the government needs to undertake a series of supply side boosting measures. The UK can extract more of its own oil and gas with a big boost to its revenues and reduction in the balance of trade deficit. Grants to farmers not to farm should be replaced with grants and loans to encourage a big increase in domestic outputs, especially of fruit and vegetables where we have lost a lot of market share this century.

Reform of IR 35 allowing more people to work for themselves and to attract contracts from companies could lead to a reversal of the big decline in self employment and greatly add to capacity and flexibility in a range of markets. Raising the VAT threshold from £85,000 to £250,000 would lead to a same year boost to output by many small companies that decline business or have a temporary shut down to avoid going through the threshold.

These two tax measures will be costed as losing revenue, which is debatable. To cover estimated Treasury costs of say £4bn the government could rephase and reduce the £20bn carbon expenditures, suspend the free smart meter programme to save £1bn a year and transfer more of the costs of housing new migrant arrivals to the Overseas Aid budget.

There are many other ways of creating some fiscal space. It would be good to immediately cut inflation by temporarily taking VAT off vehicle and domestic heating fuels. There will be savings on the interest rate programme for a lower inflation rate, given the way the Treasury accounts for the non cash item of indexation costs on Index linked gilts. The government should press on with asset and property sales to release cash and lower spending.

Expanding supply with selective tax cuts paid for by spending controls is the best way to cut inflation whilst allowing some growth. Growth is the best way to get the deficit down.