Article:

UK inflation falls sharply on back of 'eat out to help out' scheme

Restaurant subsidy strategy introduced because of Covid-19 crisis has dramatic effect

UK inflation dropped sharply to 0.2% in August after the government's "eat out to help out" scheme pushed down restaurant and cafe prices.

The fall in the annual consumer prices index (CPI) last month followed a rise of 1% in July, illustrating the dramatic influence on prices of the restaurant subsidy scheme that operated for a month to the end of August.

Eat out to help out was hugely popular, with at least 100m subsidised meals eaten by diners in the UK during the month. With prices cut by 50% on eating out from Monday to Wednesday up to a maximum of £10 per head, the lower average price dragged down the overall inflation rate.

The Office for National Statistics said the downward pressure on prices also came from falling air fares and clothing prices rising by less between July and August 2020 than between the same two months a year ago.

UK inflation dropped sharply to 0.2% in August

Guardian graphic | Source: ONS

However, the temporary drop is unlikely to influence Bank of England officials when they meet on Thursday to discuss the economy. Members of the central bank's monetary policy committee, who have the task of maintaining inflation at about 2%, are expected to maintain the base rate at its all-time low of 0.1% and the quantitative easing stimulus programme at £745bn.

They are expected to be influenced by figures for core year-on-year CPI, which was up 0.9% against expectations among City economists for a rise of only 0.5%.

Thomas Pugh, a UK economist at Capital Economics, said the fall in inflation to 0.2% probably represented the low point. "But a sustained rise to 2.0% seems unlikely within the next few years," he said.

Neil Birrell, the chief investment officer at the asset manager Premier Miton, said the rise in core inflation was more indicative of the bounceback in economic activity during the summer months as the lockdown eased and more people went back to work from being on furlough.

"Rising inflation has been much discussed as the inevitable consequence of all the stimulus being injected into the economy. Policymakers won't be worried about this number; they are more likely to be pleased there is activity in the economy," he said.

The ONS said the largest upward pressure on average prices came from games, toys and hobbies, accommodation services, road transport services and secondhand cars, where there was a rise in sales and prices in August.

Prices rose unexpectedly in July after the largest monthly increase in petrol prices for almost a decade and a lack of summer sales on the high street as non-essential shops reopened.

Commentary:
Word count: 739

The article states that the subsidy granted to diners in the UK led to an increase in the supply of meals (as the costs of production decreased due to the subsidy), bringing the prices of meals down by approximately 50%. The decrease in average price had the effect of dragging down the overall inflation rate from 1% to 0.2%, causing disinflation. Disinflation is defined as a decrease in the rate of inflation. This situation is illustrated below:

<u>Figure 1: Present Situation: Decrease in price to due "eat out to help" subsidy implemented by UK government</u>

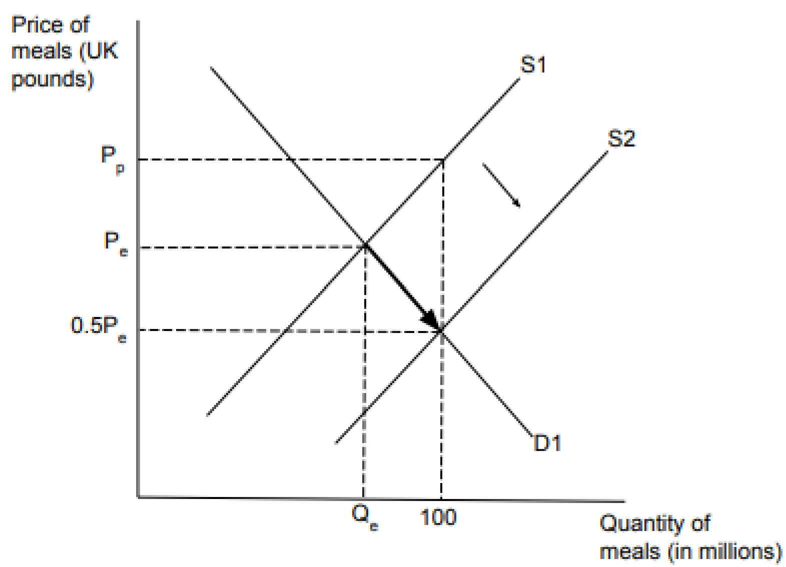
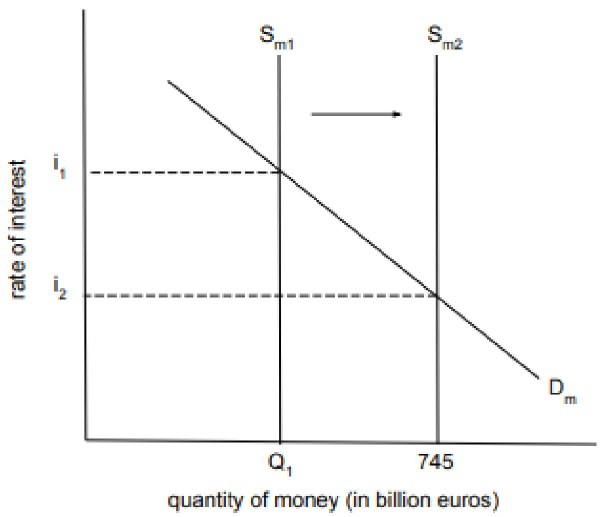


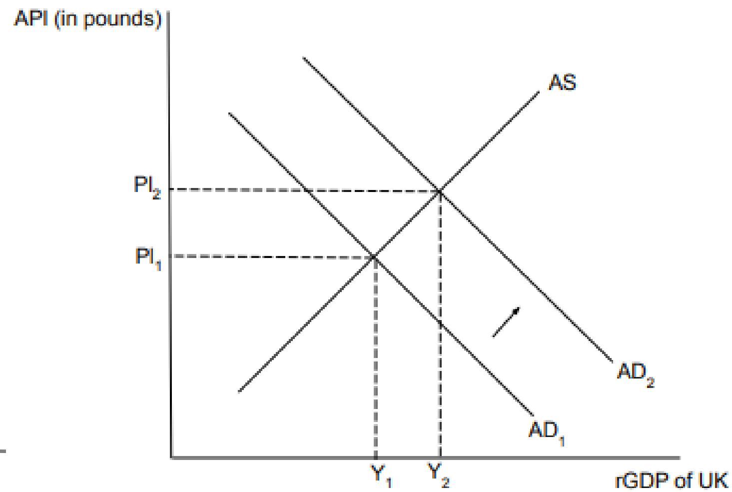
Figure 1 depicts the impact of the "eat out to help" subsidy. The subsidy granted resulted in an increase in supply as shown through the shift in supply curve from S1 to S2, creating a new equilibrium point. The consumer price decreased from P_e to $0.5P_e$ (as mentioned in the article). The decrease in price resulted in an increase in demand for restaurant meals(movement along demand curve). Finally, the price level fell from P_e to $0.5P_e$, resulting in disinflation.

An inflation rate of 0.2% is dangerously close to deflation. If the economy were to go into deflation, the value of money would begin to rise, decreasing consumption spending and increasing unemployment. Borrowers of money and payers of fixed income would be worse off as they now have to borrow and pay(respectively) finances of higher value. Hence, the Central Bank's monetary policy committee conventionally targets an inflation rate of 2%.

Since the committee aims to increase the inflation rate from 0.2% to 2%, they would implement an expansionary monetary policy. As the article states, the Central bank of the UK increased money supply to 745 billion euros through the quantitative easing stimulus programme.

Figure 2: Expansionary monetary policy as a solution to disinflation





As can be seen in *Figure 2*(left), the supply of money was increased to 745 billion euros from Q_1, consequently decreasing the interest rate(cost of borrowing) from i_1 to i_2. As the cost of borrowing would decrease, the consumer spending and investments financed by borrowing would increase.

Investments(I) and consumer spending(C) are components of AD, as shown in the formula below:

$$AD = C + I + G + X - M$$

Hence, due to the increase in *'C'* and *'I'*, AD would shift from AD_1 to AD_2(right), increasing the inflation rate to 2%.

Implementing a monetary policy has multiple advantages. The first is lack of government intervention, due to which, the Central Bank would be able to focus on achieving an inflation rate of 2% without any political constraints. Another significant advantage is that of inflation targeting. By aiming for a specific inflation rate, the Central Bank would reduce uncertainty for consumers and firms regarding future rates, allowing them to make decisions pertaining to investment and consumption. In addition, the government would be able to plan a fiscal policy that complements the monetary policy effectively.

An expansionary monetary policy also lacks extensive time lags. This advantage is especially significant for the UK because its economy is close to becoming deflationary(0.2% inflation rate). Hence, a monetary policy will lower the risk of the economy becoming deflationary before the policy takes effect.

A possible con that the UK may have to face upon implementing an expansionary monetary policy would be depreciation of the pound. As interest rates would decrease, investments in the UK by foreign countries would result in lower returns relative to other countries. This would lead to a fall in foreign demand for the UK pound, depreciating the value of the pound.

An alternative policy that would solve this problem is an expansionary fiscal policy. Through an expansionary fiscal policy, the government could cut personal income and business taxes, consequently increasing consumption and investment spending. The government could also increase its spending(G), in turn, increasing AD (G is a component of AD). Hence, through the upward pressure on AD through both strategies, the inflation rate would increase to 2%,

However, a fiscal policy has significant time lags and would create a budget deficit. The major advantage of the fiscal policy over the monetary policy is that it could aim government spending at the diner market, removing the downward pressure on price caused by the subsidized meals.

Comparing the pros and cons, the optimal solution would be an expansionary monetary policy supported by an expansionary fiscal policy. The former would enable the committee to target the specific inflation rate of 2% with minimal time lags (preventing a recession). And the latter would enable the committee to specifically target the fast food sector, reducing the downward pressure on price caused by the subsidy, hence aiding in solving the issue of disinflation.