Article:

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

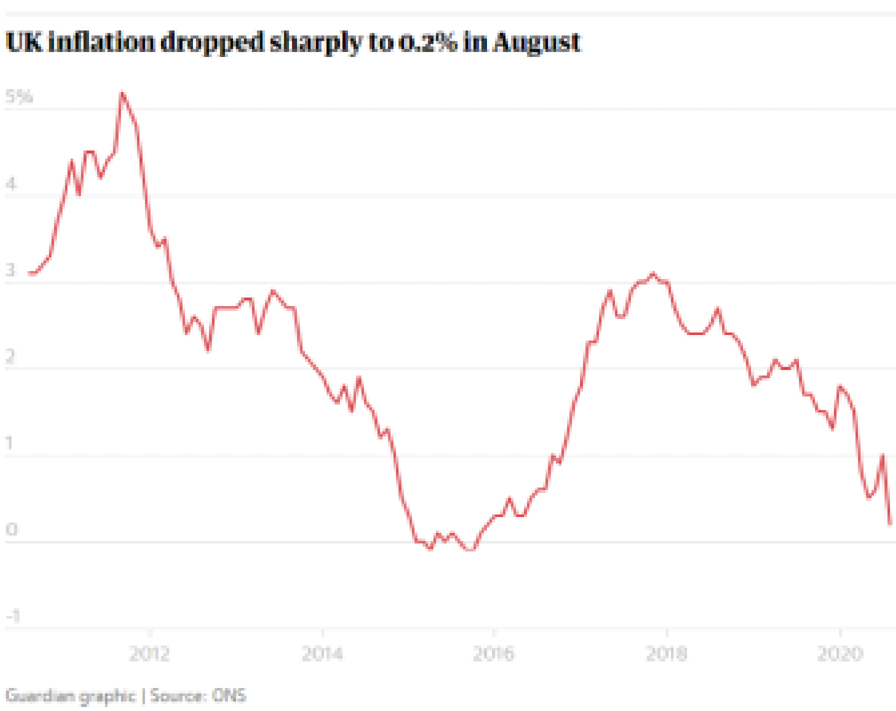
Restaurant subsidy strategy introduced because of Covid-19 crisis has dramatic effect

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.



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:

The article explains that the subsidy provided to UK diners contributed to an increase in meal supply, as production costs were lowered by the subsidy. This resulted in meal prices dropping by about 50%. This significant reduction in the average price of meals contributed to a decrease in the overall inflation rate, from 1% to 0.2%, causing disinflation—a reduction in the rate of inflation. The impact of this subsidy on economic indicators is illustrated in the following section:

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

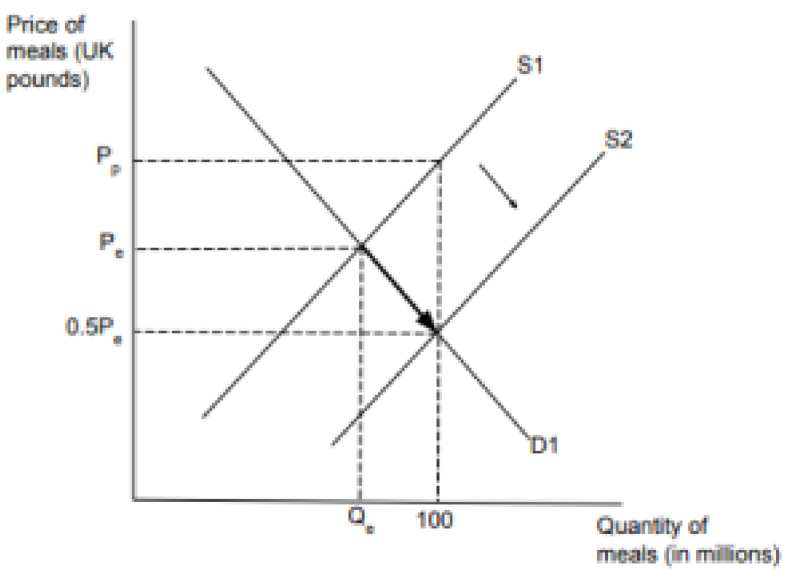
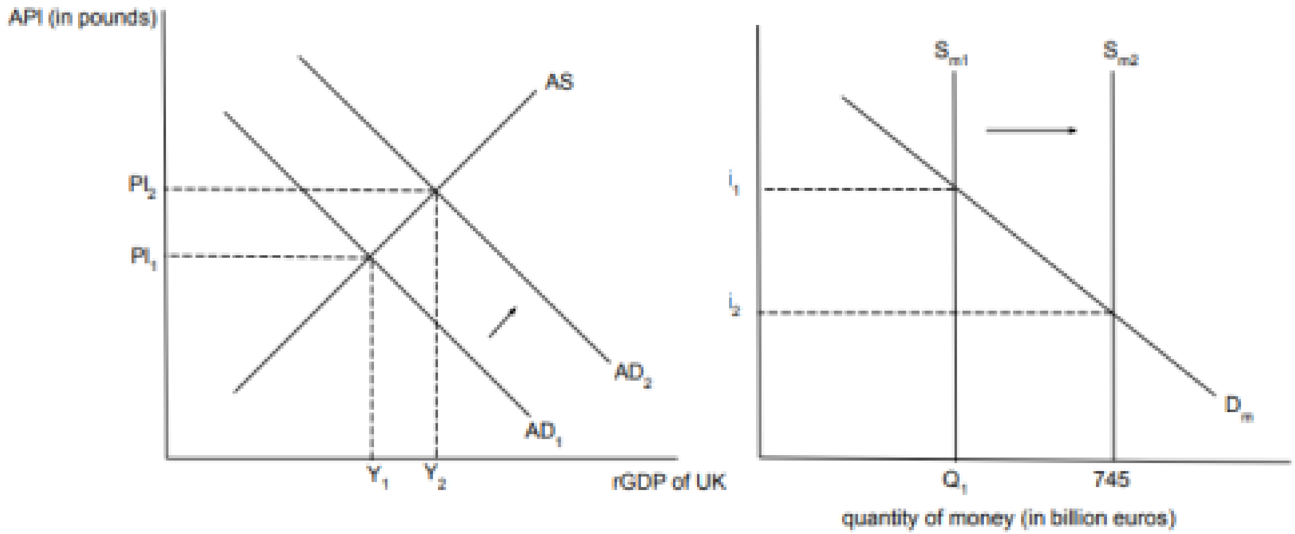


Figure 1 illustrates the economic effects of the "Eat Out to Help Out" subsidy. The subsidy led to a rightward shift in the supply curve from S1 to S2, establishing a new equilibrium point. As the article notes, consumer prices decreased from P to 0.5P, leading to increased demand for restaurant meals as evidenced by movement along the demand curve. Consequently, the overall price level dropped to 0.5P, contributing to disinflation.

An inflation rate of 0.2% is dangerously close to deflation. In a deflationary scenario, the value of money increases, which typically reduces consumer spending and elevates unemployment rates. Additionally, individuals with debts or fixed income payments find themselves effectively paying more in real terms, as the value of money they handle increases. Therefore, central banks, including the UK's, typically target an inflation rate around 2% to ensure economic stability.

According to this aim, the Central Bank of the UK would need to enact an expansionary monetary policy to increase inflation rate from 0.2 to 2%. Specifically - as evidenced in the article - the bank achieved this by increasing the money supply to 745 billion euros through a quantitative easing program.

Figure 2: Expansionary monetary policy as a solution to disinflation



As illustrated in Figure 2 (left), the money supply was increased to 745 billion euros from an initial quantity of Q1. This increase in money supply led to a reduction in the interest rate, lowering the cost of borrowing from i1 to i2. With the decrease in borrowing costs, consumer spending and investment activities that rely on borrowed funds would rise, consequently stimulating economic activity by encouraging more purchases and investments.

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 offers several distinct advantages. A key benefit is the autonomy of the Central Bank, which can pursue its target inflation rate of 2% free from political interference. This independence allows for more consistent and focused economic management. Another benefit is that of inflation targeting. By targeting a specific inflation rate, the Central Bank can mitigate uncertainty for consumers and businesses about future economic conditions, thereby facilitating more informed decisions regarding investments and consumption. This could allow the government to plan an effective complementary fiscal policy as well.

Another significant advantage of expansionary monetary policy is its relatively short implementation lag. This is particularly crucial for the UK, given its current near-deflationary inflation rate of 0.2%. The prompt effect of monetary policy helps mitigate the risk of the economy slipping into deflation before the policy can exert its influence.

A potential downside of implementing an expansionary monetary policy in the UK could be the depreciation of the pound. Lower interest rates might reduce the attractiveness of UK investments to foreign investors, yielding lower returns compared to other countries. This could decrease foreign demand for the pound, leading to its depreciation.

An alternative approach to address this issue is through expansionary fiscal policy. By reducing personal income and business taxes, the government could boost consumer spending and business investment. Additionally, increasing government spending (G), a key component of aggregate demand (AD), would further elevate AD. These measures would collectively exert upward pressure on AD, helping to raise the inflation rate toward the target of 2%.

However, fiscal policies often come with significant time lags and could result in a budget deficit. A major advantage of fiscal policy over monetary policy is its ability to target specific sectors. In this scenario, the policy could aim government spending at the dining market, counteracting the downward pressure on prices caused by meal subsidies, and stabilizing the market.

Weighing the advantages and disadvantages, the most effective approach would be a combination of expansionary monetary and fiscal policies. The former allows the committee to target and achieve the inflation rate of 2%, minimizing the risk of recession due to its quick implementation. Meanwhile, the latter provides the flexibility to focus specifically on sectors (like the dining sector), counteracting the downward price pressures introduced by subsidies and thus addressing the issue of disinflation effectively. This dual strategy ensures a balanced approach, leveraging the strengths of both monetary and fiscal measures to stabilize the economy.