[youtube:http://www.youtube.com/watch?v=jysFhfKY-S8 w auto]While governments talk of their fear of deflation, pouring trillions of dollars into the global economy, there is another reason why governments may want to encourage slightly higher inflation. An example may be the UK government where much most government debt is funded until around 2014 on fixed terms.

Yes it is true that deflation can cause people to stop spending, because they think that prices will be better tomorrow, and that can cause the economy to seize up. But it is also true that inflation is a very convenient tool to deal with massive government debt, that will otherwise burden tax-payers for more than a decade.

Government debt is sold in bonds which promise a fixed rate of interest for a long period. Those that buy bonds are therefore taking a view about what the future inflation rate is likely to be. High inflation wipes out government debt. For example, if future inflation stabilises at 5% above the interest rate payable to the bond owner, the value of the debt will halve over 15 years.

While higher inflation is unlikely to last that long, the example shows the power of higher inflation to erode government liabilities. Owners of such government bonds make huge losses.

And of course, talk of imminent deflation also helps governments to sell billions of dollars of bonds with long term interest rates close to zero - very convenient if they actually expect inflation to pick up in 2-3 years time.

For more discussion on these important issues, and other reasons why high inflation is almost inevitable following huge fiscal stimulus, see Deflation and Inflation - Winners and Losers.