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Economics Revision Focus: 2004

AS Economics

Inflation

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Revision Focus on Inflation

AS Syllabus Requirements

Candidates should understand that inflation can be caused by **excessive aggregate demand** and **sustained increases in costs**. They should also understand that the Bank of England attempts to control inflation by using interest rates to try to prevent aggregate demand increasing more rapidly than the underlying **trend rate of growth of output.**

What is inflation?

Inflation is a **sustained increase in the general price level** leading to a fall in the **value of money**.

The rate of inflation is measured by the annual percentage change in the level of consumer prices. The British Government has an inflation target of 2% using the consumer price index (CPI).

It is the job of the Bank of England to set interest rates so that AD is controlled and the inflation target is reached. Since the Bank of England was made independent, inflation has stayed comfortably within target range. Britain has one of the lowest rates of inflation inside the EU.

There has been a fall in average inflation rates in most of the world's developed countries over the last fifteen years. Indeed lower inflation seems to have become a global phenomenon. Japan has experienced negative inflation (deflation) over the last four years.

Deflation

Price deflation is when the **rate of inflation becomes negative**. I.e. the general price level is falling and the value of money is increasing. Some countries have experienced deflation in recent years – good examples include Japan and China. In Japan, the root cause of deflation was very slow economic growth and a high level of spare (excess) capacity in many industries that was driving prices lower. In China,

economic growth has been rapid – but the huge amount of capital investment and rising productivity has led to economies of scale being exploited and a fall in production costs.
There has been some price deflation in the UK economy – not for the whole economy – but for items such as clothing (prices have been driven lower by cheaper imports); audio-visual equipment, computers and many other household goods. The effects of technological change in increasing supply are important when explaining deflation in some UK markets

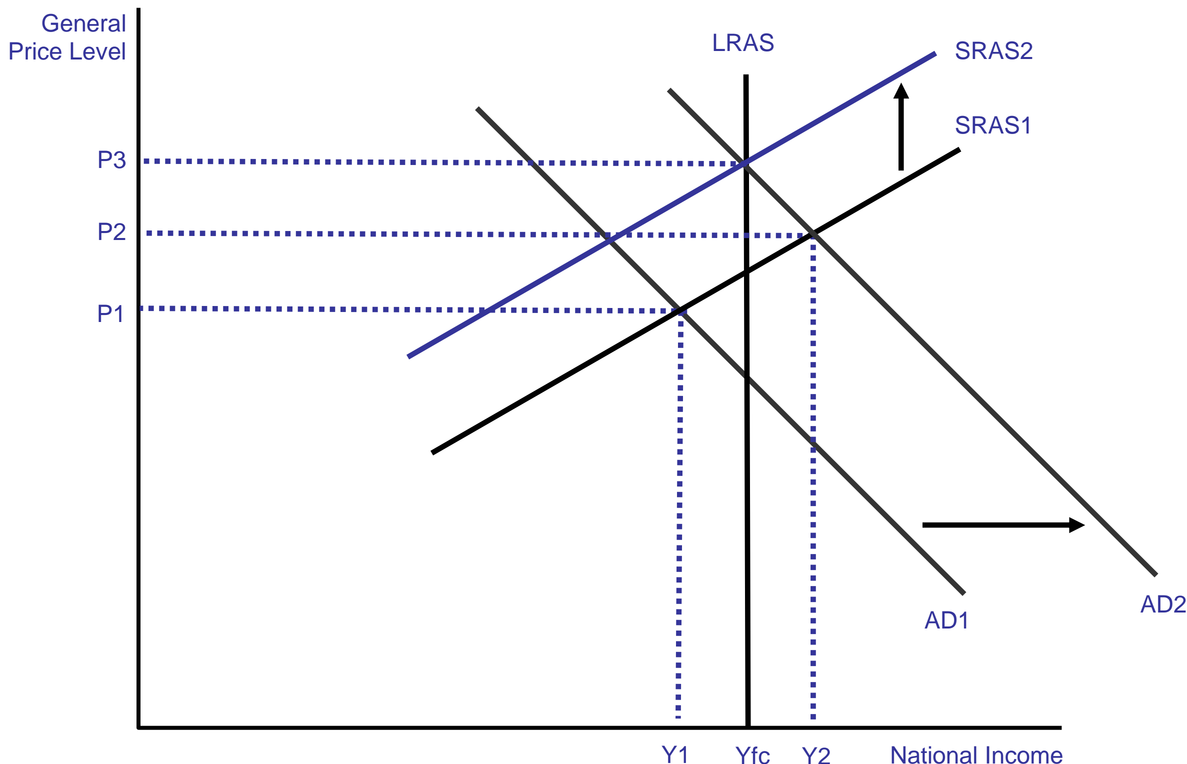
The main causes of inflation

Inflation can come from several sources: Some come direct from the **domestic economy,** for example the decisions of the major utility companies on their prices for the year ahead, or the pricing strategies of the leading food retailers based on the strength of demand and competitive pressure in their markets. A rise in VAT would also be a cause of increased domestic inflation because it increases a firm's production costs.

Inflation can also come from **external sources,** for example an unexpected rise in the price of crude oil or other imported commodities, foodstuffs and beverages. **Fluctuations in the exchange rate** can also affect inflation – for example a fall in the value of sterling might cause higher import prices – which feeds through directly into the consumer price index.

Demand-pull inflation

Demand-pull inflation is likely when there is **full employment of resources** and aggregate demand is increasing at a time when SRAS is inelastic. This is shown in the next diagram:



In the diagram above we see a large outward shift in AD. This takes the equilibrium level of national output beyond full-capacity national income (Yfc) creating a **positive output gap**. This would then put upward pressure on wage and raw material costs – leading the SRAS curve to shift inward and causing

real output and incomes to contract back towards Yfc (the long run equilibrium for the economy) but now with a higher general price level (i.e. there has been some inflation).

The main causes of demand-pull inflation

Demand pull inflation is largely the result of AD being allowed to grow too fast compared to what the supply-side capacity can meet. The result is **excess demand for goods and services** and pressure on businesses to raise prices in order to increase their profit margins. Possible causes of demand-pull inflation include:

1. A **depreciation of the exchange rate** which increases the price of imports and reduces the foreign price of UK exports. If consumers buy fewer imports, while exports grow, AD in will rise – and there may be a multiplier effect on the level of demand and output

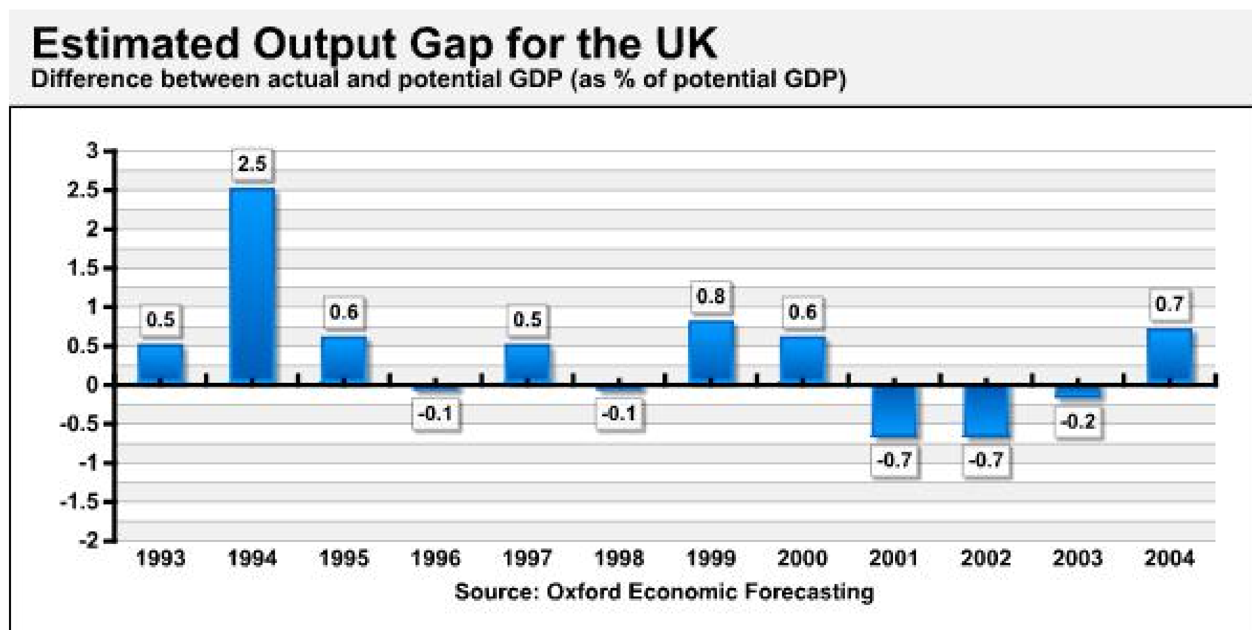
2. **Higher demand from a fiscal stimulus** e.g. via a reduction in direct or indirect taxation or higher government spending. If direct taxes are reduced, consumers will have more disposable income causing demand to rise. Higher government spending and increased government borrowing feeds through directly into extra demand in the circular flow

3. **Monetary stimulus to the economy:** A fall in interest rates may stimulate too much demand – for example in raising demand for loans or in causing a sharp rise in house price inflation

4. **Faster economic growth in other countries** – providing a boost to UK exports overseas. Export sales provide an extra flow of income and spending into the UK circular flow – so what is happening to the economic cycles of other countries definitely affects the UK

The importance of the output gap

The output gap is a measure of how close the economy is to its long-run equilibrium. We need firstly to estimate what the country's trend rate of growth is and then measure the strength of demand and output relative to that. If the output gap is small (say less than 1% either side of potential GDP) then the economy is successfully growing close to its trend rate and there is neither too much demand (creating inflationary pressure) nor too little demand/output (creating lower inflation and rising unemployment).



Over the last ten years according to the data in the chart above from Oxford Economic Forecasting, the British economy has managed to maintain a very low output gap. Partly this is due to the effectiveness of the Bank of England in keeping interest rates at an appropriate level. In 2001-03 the output gap was negative (real GDP was a little below potential) but this was mainly due to the weakness of the global economy which had a negative effect on our exports and business capital investment spending. The output gap is expected to become positive again in 2004 – as the UK economy experiences a pick-up in growth. Will this lead to higher inflation? Probably not because other factors are helping to keep inflation low and, because a positive output gap of 0.7% of GDP is not particularly high.

Cost-push inflation

Cost-push inflation occurs when firms respond to rising costs, by increasing prices to protect their profit margins. There are many reasons why costs might rise:

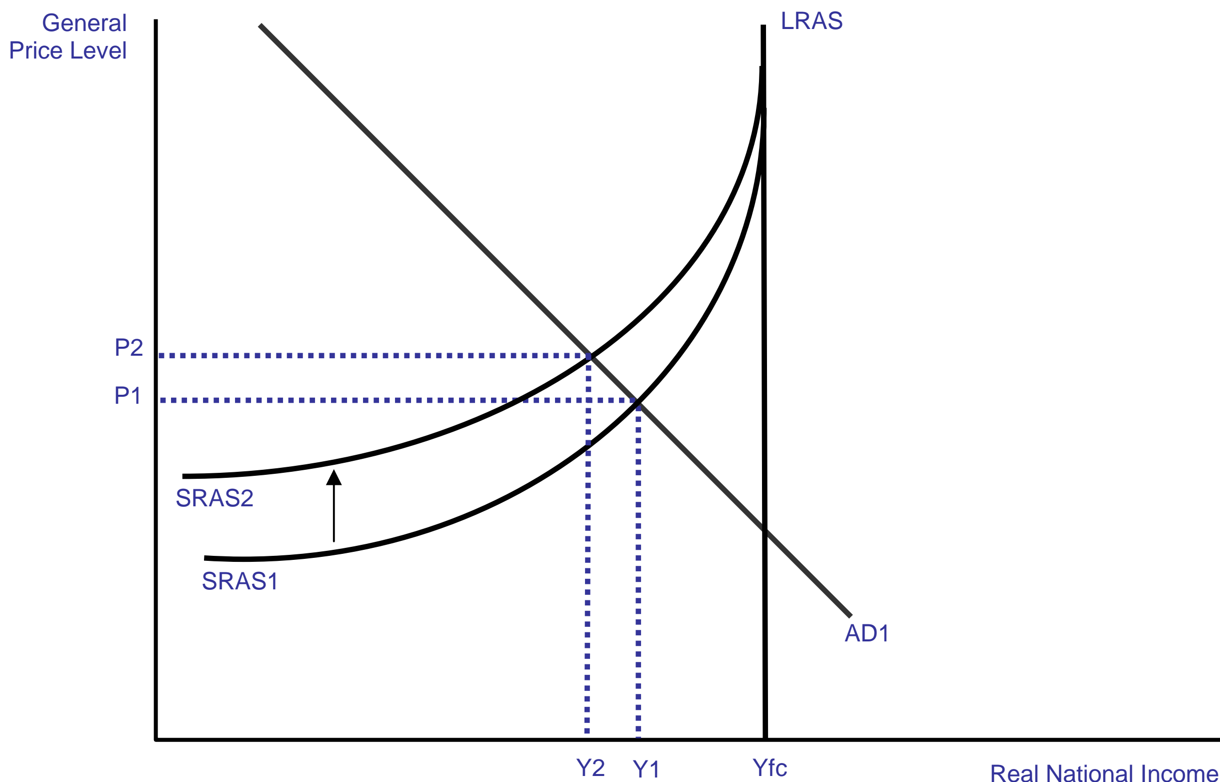
1. **Component costs:** e.g. an increase in the prices of raw materials and other components used in the production processes of different industries. This might be because of a rise in world commodity prices such as oil, copper and agricultural products used in food processing

2. **Rising labour costs** - caused by wage increases, which are greater than improvements in productivity. Wage costs often rise when unemployment is low (skilled workers become scarce and this can drive pay levels higher) and also when people expect higher inflation so they bid for higher pay claims in order to protect their real incomes. **Expectations of inflation** are important in shaping what actually happens to inflation!

3. **Higher indirect taxes imposed by the government** – for example a rise in the specific duty on alcohol and cigarettes, an increase in fuel duties or a rise in the standard rate of Value Added Tax. Depending on the price elasticity of demand and supply for their products, suppliers may choose to pass on the burden of the tax onto consumers

Cost-push inflation can be illustrated by an **inward shift of the short run aggregate supply curve**. The fall in SRAS causes a contraction of real national output together with a rise in the general level of prices. In the next diagram we are showing cost-push inflation using a non-linear AS curve. If you were drawing

a linear AS curve, cost-push inflation would again come from an inward shift causing a contraction along the AD curve.



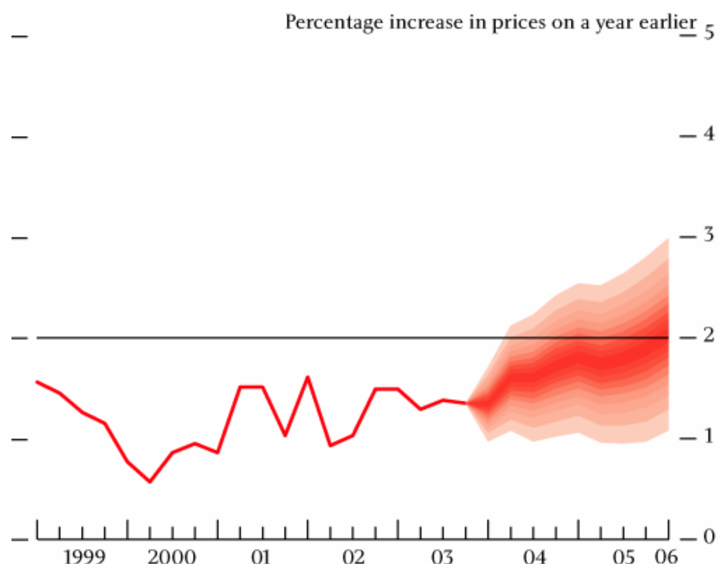
Which government policies are most effective in reducing inflation?

Inflation can be reduced by policies that (i) slow down the growth of AD or (ii) boost the rate of growth of aggregate supply (AS). The main anti-inflation controls available to a government are:

1. **Fiscal Policy**: Fiscal policy involves changing levels of government expenditure, taxation and borrowing. If the government believes that AD is too high, it may reduce its own spending on public and merit goods or welfare payments. Or it can choose to raise direct taxes, leading to a reduction in disposable income. Normally when the government wants to **"tighten fiscal policy"** to control inflation, it will seek to cut spending or raise tax revenues so that government borrowing (the budget deficit) is reduced. This helps to take money out of the circular flow of income and spending

2. **Monetary Policy**: Monetary policy now involves changes in interest rates to influence the rate of growth of AD. A **tightening of monetary policy** involves higher interest rates to reduce consumer and investment spending. Monetary Policy is now in the hand of the Bank of England –it decides on interest rates each month. Interest rates have been very low in recent years but inflation has remained low too. The Bank of England is likely to raise interest rates during the second half of 2004 from their current level of 4.0% because it believes that inflationary pressures may build in the short term. The chart below shows their latest inflation projections for the next two years

Inflation is currently below target but is forecast to edge up towards the 2% level. The darker the shading on this projection, the higher the probability that the Bank of England attaches to a given rate of inflation. The projection shows that the Bank is not concerned that inflation will shoot above the target level – but that there are a few more inflation risks around and that a gentle rise in interest rates is needed at this stage of the economic cycle to keep demand growing in line with the country's productive potential.

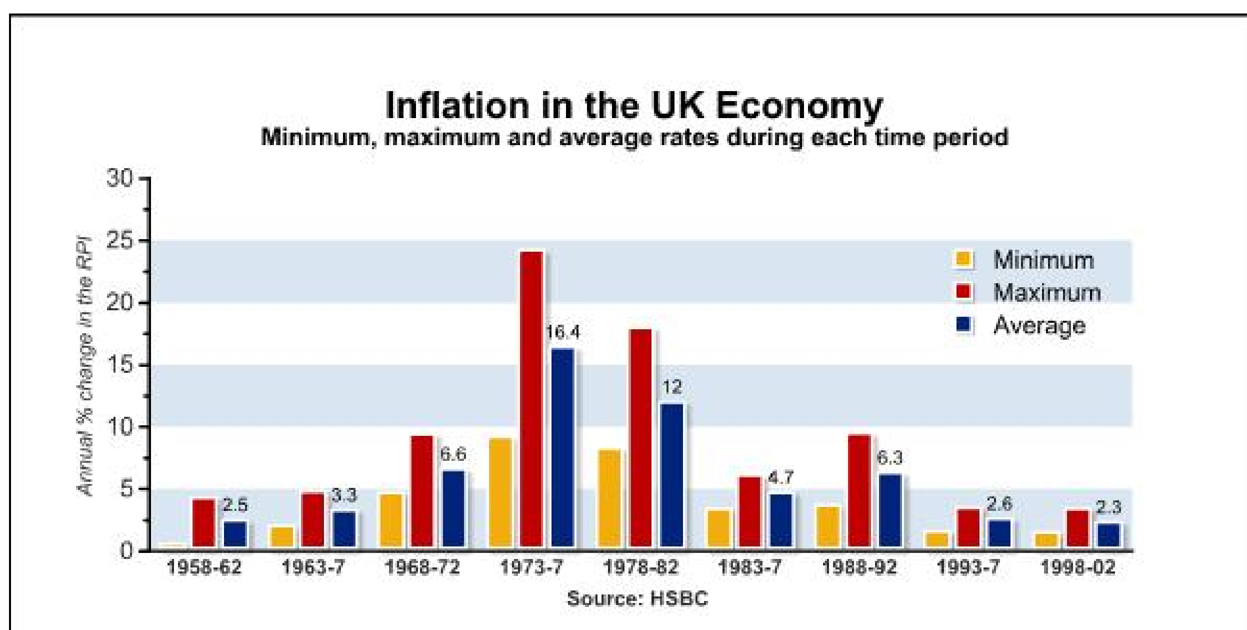


3. **Supply side economic policies:**
   Supply side economic policies are designed to increase total supply of goods and services in the economy – i.e. raise the level of **LRAS**. Supply side policies include those that seek to increase **productivity, competition and innovation** in markets – all of which can maintain lower prices. See the separate revision note on **supply-side economics**.

The most appropriate way to control inflation in the short term is for the Government and the Bank of England to keep control of aggregate demand to a level consistent with our productive capacity

The current consensus among economists is that AD is probably better controlled through the use of monetary policy rather than an over-reliance on using fiscal policy as an instrument of demand-management. But in the long run, it is the growth of a country's supply-side productive potential that gives an economy the flexibility to grow without suffering from acceleration in cost and price inflation.

Why has inflation remained low in the UK over recent years?



The last twelve years has been a period of very low and stable inflation. No one factor explains this – but among them we can highlight the following:

1. **Low wage inflation from the labour market**: Wages have been growing at a fairly modest rate in recent years despite a large fall in unemployment. This has been helped by a fall in expectations of inflation
2. **Low global inflation and deflation in some countries**: There has been a clear fall in the average rate of inflation among leading economies, and this decline in global inflation has filtered through to the UK. Falling inflation in emerging market economies such as China is also affecting the UK (e.g. because of cheaper imports)
3. **The effectiveness of monetary policy in the UK**: The success of the Bank of England through monetary policy in keeping aggregate demand under control through interest rate changes
4. **Increased competition**: Many markets have become more contestable in the last decade and this extra competition has placed a discipline on businesses to control their costs, reduce profit margins and seek improvements in efficiency. Many UK businesses face severe pressure from foreign competition as the process of globalisation continues
5. **The strength of the exchange rate**: The recent strength of the pound has lowered the cost of imported products and also squeezes demand for UK exporters
6. **Information technology effects**: The rapid expansion of information and communication technology has helped to reduce costs and has made prices more transparent for consumers – e-commerce has contributed to falling prices in many markets

In short, low inflation is the result of a combination of demand and supply-side factors. The UK economy has enjoyed the benefits of cheaper imports, rising productivity and lower costs arising from improvements in technology. But it has also managed to control inflation by preventing demand for goods and services rising too quickly.

The Governor of the Bank of England, Mervyn King has coined the 1990s as the "nice decade" – a period of time when a combination of favourable factors has kept inflation in check allowing continued economic growth and a fall in unemployment.

"In the 1990s, the UK experienced a non-inflationary consistently expansionary - or "nice" - decade; a decade in which growth was a little above trend, unemployment fell steadily, and cheaper imports allowed consumers to enjoy rising living standards without the need to ask for inflationary pay claims"

Will low inflation last? Or are there some nasty inflation surprises around the corner?