Discuss the idea that if the economy is to prosper in the long run, the control of inflation should be the main objective of Government.

Since Edward Heath spoke about inflation in 1973 it has been a generally held view that the conquest of inflation is the most important task for government economic policy. Whilst this view is beginning to be challenged in all political parties, the public universally regard inflation as having a detrimental affect on the economy.

The problems caused by inflation can depend on whether the inflation is anticipated or not. If everybody knows that inflation is going to be 10% this year, and it is, then firms and consumers can plan for this. Although such planning does not eliminate the costs of inflation completely, it does mean that the rates may be more moderate.

The result of a higher rate if inflation, which is fully anticipated, is to raise the nominal (or market) rate of interest by the increase in the rate of inflation. In the long run this implies that the nominal rate of interest will be equal to the real rate of interest plus the rate of inflation. Thus, if inflation is higher in the UK than it is abroad, the nominal rate of interest will be higher in the UK. This is likely to attract mobile capital funds into the UK. With a floating exchange rate, the inflow of funds will lead to an appreciation of the sterling exchange rate, which may have adverse consequences for the balance of payments.

Even if inflation is perfectly anticipated, people will still be encouraged to reduce their holdings of cash and to keep as much of their wealth as possible in the form of assets whose value rises at least as rapidly as the general price level and which therefore do not decline in real terms. The reduction in the holding of cash balances imposes costs on individuals and firms that they would not have to face if prices were stable. Economising on cash balances requires time and effort. For example, individuals have to make more visits to the bank and other financial institutions to withdraw money. This has been termed the 'shoe leather' effect of inflation. In general, there is also a loss of convenience associated with the holding of a liquid asset. These costs could, of course, be avoided if interest were paid on cash balances at the same rate as the rate of inflation.

An economy facing inflation, even if it is fully anticipated, will be required to frequently change nominal values in order to keep the structure of relative values unchanged over time. For example, it is necessary to change the nominal value of prices, wages and tax benefits. These transaction costs may be significant. It is necessary to change the price tags, for instance. It is also necessary to disseminate information of wage and price changes to interested parties. Both of these examples take time, effort and money. The effects of this will be hugely significant to a large supermarket chain that would have to alter their prices in order to accommodate the cost increase incurred by inflation.

The costs of anticipated inflation do not appear to warrant the importance that Governments have attached to the reduction of inflation. Indeed there are no major problems associated with inflation once it is assumed that it is perfectly anticipated and that all groups can take action to protect themselves from its effects. This suggests that the costs Governments seek to avoid by reducing inflation must be those caused by unanticipated inflation.

If inflation is unanticipated, the actual rate if inflation is different from the expected rate. Unanticipated inflation, and the associated uncertainty about the future level of prices, has effects that are of an entirely different kind and are almost always much greater than those of anticipated inflation.

The effect of inflation on unemployment is relatively strong. If inflation in the UK is greater than it is abroad, then domestic producers will lose price competitiveness at home and abroad if the exchange rate does not adjust sufficiently to correct the inflation differential. The profitability of domestic will be impaired which will result in lower levels of output and employment. However, if the exchange rate is adjusted to the excess of domestic inflation over inflation abroad there would be no competitive deterioration in the UK.

Inflation may have an adverse effect on investment and thus, via the multiplier process, can cause a contraction in output and unemployment. Inflation, in causing nominal interest rates to rise, may increase the costs of borrowing so much that new investment by firms is not worthwhile. Also, a high level of inflation may increase the variability in investment which makes long-term investment uncertain as firms will not be sure of expected returns from new investment. Investment may also be affected if the

inflationary process redistributes income away from profits and towards wage incomes and thereby reduces the funds available for investment.

The uncertainty caused by volatile inflation means that some people who feel that they have planned their lives carefully, saved, invested in pension schemes and generally acted responsibly only to find that the value of their hard-earned savings and pensions has been eroded by unforeseen increases in the price level. If price level doubles their pensions and savings lose half their value. However, if the price mechanism is working properly, there should be no loss of value of savings from this source.

A strong argument for controlling inflation lies not within the economy, but outside it. As the price level in the UK rises, UK goods become more and more expensive. In other countries, too, prices may be increasing, but if the UK inflation rate exceeds the rates elsewhere then the UK goods will become progressively less and less competitive. This loss of competitiveness leads to a loss of export sales and an increase in imports. The demand for UK goods declines both at home and abroad, so UK workers are laid off and factories close.

This loss of competitiveness may be offset by a change in the exchange rate. If the UK exchange rate devalues at the same rate as our price levels rise, then our goods will keep constant export prices and leave foreign demand for our goods unchanged.

It is possible that if the price mechanism is working well enough it can maintain relative prices at their 'correct' levels, revise interest rates so that there is no tendency to penalize lenders over borrowers, and correct exchange rates so that there is no loss of international price competitiveness. This is placing a huge burden on the price mechanism, and many would argue that it is far too heavy. The price mechanism simply cannot keep up with anymore than the moderate rates of inflation.

Similarly, exchange rates, even when they are free to float, are influenced by capital flows and expected capital gains as well price level, and simply do not change to maintain a countries international competitiveness. UK exporters complain that inflation therefore leads to their losing sales and/or profits to countries with a lower rate of inflation.

One particular argument for the control of inflation in the UK economy is that our system of income tax is not designed for an inflationary economy. Typically, the amount of

income tax we pay depends on our nominal (money) incomes, and the amount of capital gains depends on the increase in the nominal value of our assets. As a result of this type of tax system the tax to pay increases simply as a result of inflation, with no change in the structure of neither tax rates nor our real pre-tax income. The effect of this is most significant on the lower income groups. If we consider the effect of inflation halving the value of money, and so what previously could have been bought with £4000 pounds now needs £8000 pounds, then it is clear that someone earning £4000 a year before inflation will have no tax, however after inflation they earn £8000, but the purchasing power of their income has remained unchanged, meaning that they are now taxed £1000, 25% of their income without earning anymore or the tax structure changing.

Probably the most common danger associated with rising inflation is that it turns into hyperinflation. During times of hyperinflation money loses its value so quickly that no one wishes to keep it for a moment longer than necessary and there may be such a flight from money that the velocity of circulation approaches infinity. If this occurs, exchange of goods will no longer be carried on with money but will be made on a purely barter basis. The economy would thus lose the advantages of monetary exchange and therefore operate less efficiently.

It is possible to identify a number of costs that might be incurred by society as a result of the inflationary process. However, it is far from easy to be precise about the order and magnitude of such costs and as yet there are no well-accepted studies that have measured the costs of inflation. It is also important to distinguish between anticipated and unanticipated inflation; in that the costs of unanticipated inflation are likely to be far less severe than the costs of anticipated inflation.

It may be argued that there is a good case for trying to cope with inflation by improving the degree to which inflation is correctly anticipated and ensuring that all sectors of the economy are allowed to adjust to it. In this way the costs of inflation may be avoidable. The discussion outlined here strongly indicates, therefore, that the objectives of policy might not simply be to lower inflation, but to stabilise the rate of inflation so that it is more likely to be anticipated. Finally, it should not be forgotten that the opportunity cost to society of policies designed to reduce inflation may actually have a worse effect on society than the initial inflation.

How might supply-side policies be used to reduce:

- **The natural rate of unemployment?**
- **Structural unemployment?**

The natural rate of unemployment is the rate of unemployment consistent with equilibrium in the labour market; that is, with the supply of labour equal to the demand for labour. Many have queried how there can be any unemployment if demand equals supply. In the real world, of course, the answer depends upon the way government chooses to record unemployment. When the labour market is in equilibrium, there are millions of adults who, for whatever reason, choose not to seek work at the equilibrium wage rate. Are these people unemployed? For example, is a trained solicitor who looks after her children at home unemployed? Is a male accountant who takes early retirement unemployed? In principle, although neither wants a job at the going wage rate, each may begin looking if wages were higher.

The natural rate of unemployment is therefore those people, who are able to work, but for whatever reason, they are not willing, in other words they are voluntarily unemployed. The government must therefore aim to reduce the amount of people who voluntarily do not seek a job.

Structural unemployment is a demand-side phenomenon. It changes as demand for the final product changes, as labour's productivity changes relative to the productivity of capital, and as labour costs in a region change relative to those in other areas. First, as individuals' tastes and preferences change and buyers switch from one product to another, the demand for labour to produce some goods increases, while the demand for labour to produce other goods falls. Second, as technology changes, and capital becomes relatively more productive and less expensive, businesses tend to substitute capital for labour. This "automation" of the production process reduces the demand for certain types of labour. Finally, in a large country like the United Kingdom, regional wage differentials may make skills obsolete in some areas, while the demand is high in other areas. Most often, this change in relative competitiveness crosses country boundaries changing international competitiveness and relative job opportunities. Geographic immobilities - the inability or unwillingness of workers to migrate - aggravate this condition. Unemployment in various

parts of the UK can remain high as jobs go begging in other parts of the country because the cost of living prevents the jobless from migrating to where the jobs are.

Given that relative demands for products are continuously changing, given that new technologies make capital more productive than labour in certain occupations, and given that relative competitiveness is changed through technological transfers and wage differentials, some element of structural unemployment is always evident in the unemployment statistics.

Structural unemployment is generally long-term, with much hardship, as workers either need to relocate and uproot families or need to acquire new skills to re-enter the job market. Some quit looking for new jobs and are dropped from the labour force and the unemployment statistics. These unemployed are the discouraged workers.

The solutions to reducing structural unemployment are policies such as improved job-search techniques; outplacement counselling; retraining programs; tuition grants; low-cost education loans; subsidies or tax credits to businesses for retraining; relocation subsidies and loans or venture capital funds to help workers start new business.

All policy however is problematic, and there are common problems that the government must face when any policy is made or considered. Economic complementarities arise when the effectiveness of one policy depends on the implementation of other policies. For example, since it is impossible for people to find more work when firms provide no new jobs, and since it is impossible for firms to fill their vacancies when there is no one looking for them, supply-side labour market policies – such as job counselling to promote job search – are complementary with demand-side policies – such as measures to stimulate investment demand.

Similarly, tax breaks for hiring the long-term unemployed – as in France or Germany – may be ineffective in the presence of generous unemployment benefits, since the latter discourage the unemployed from taking advantage of the former. Giving employers greater latitude in negotiating fixed-term contracts – as in Spain – may do little to stimulate employment unless the job security provisions associated with the incumbent employees are relaxed. And reducing the magnitude and duration of unemployment benefits may have only a limited effect on the employment rate when there are large incapacity benefits – as in the Netherlands – or high minimum wages – as in France.

In the presence of economic complementarities, individual unemployment policy measures might appear ineffective, but they would not be if they were implemented as part of a broad-based reform package. What is more, the exploitation of complementarities would address the apparent trade-off between unemployment and inequality by giving the unemployed greater incentives to work.

Unemployment policies are also characterized by political complementarities, when the ability to gain political consent for one policy depends on the implementation of other policies. For example, the political feasibility of unemployment benefit reform – such as reducing the magnitude and duration of benefits – depends on tax reform – such as reducing payroll and income taxes – and employment promotion policies – such as hiring subsidies.

The reason is that 'single-handed reforms' – such as reducing unemployment benefits without changing any other policy instrument – may improve economic efficiency, but they often pit the interests of the employed against those of the unemployed, creating political deadlock. In contrast, 'broad (many-handed) reforms' enable the government to use the efficiency gains from one reform to compensate the losers from another reform – and vice versa – thereby breaking the political deadlock.

Complementary policies call for a distinctive approach to policy-making. When only a small number of unemployment policies are under consideration, it may be politically impossible to implement them and their impact on unemployment would be small. It is only when a broader range of policies are implemented simultaneously that they become politically feasible and economically effective.

In conclusion, there are long-term policies, which the government tends to favour, to increase the productive potential of our economy and attempt to reach that potential, however, due to the many inconveniences and obstacles to the effective implementation of these policies, they rarely are as successful as they hope to be.