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Course: International Foundation Year

Subject: International Foundation Year Macroeconomics

Question: 2

Question 2a) Explain the meaning of the term 'inflation'.

Along with the development of society more and more problems are brought to our attention, one of which is that 'inflation'. Nevertheless, with the advance of the human civilization, the living standard increases gradually so the price index and Retail Price Index (RPI) rise gradually as well.

Deep down, 'inflation' means a persistent increase in all money prices over a period of time which is generally considered to bring costs to society is the form of material, political and psychological costs. Also, the increase must be sustained at some rate before there is inflation and when the price level increases steadily over time. 'Inflation' that is to say, it is decrease in the purchasing power and all money prices to the same extent. In economic, inflation is measured as a percentage change in the PRI over a given period of time, for example, if the RPI increases from 100 to 200 in a year, then inflation is said to have increased by 20% that year.

In the UK, the Retail Prices Index is most commonly used measure of inflation. Because RPI is measure the cost of living index, it can reflex the money price level such as through the changes in the prices of goods in the shops by households. From the figure 1 illustrate, which show the inflation from 1.9 per cent in 2001 to 3.2 per

cent in 2003. Obviously, the inflation rate in UK has increased 1.3 per cent from 2001 to 2003 under the RPI. Nevertheless, in the USA, the Consumer Prices Index (CPI) is usually used to measure of inflation. In addition, GDP deflator can measure the average level of prices as well.

Definitely, inflation is either great or slight fluctuation in each year. In economic, creeping inflation and hyperinflation are represent inflation as well. Actually, hyperinflation similarly as inflation but the meaning is quiet difference. Hyperinflation means extremely rapid inflation and the price increase so fast that money largely loses its convenience as a medium of exchange. However, creeping inflation is at moderate rates but persevering over long period.

Annual Inflation Rates in UK – 12 month % change

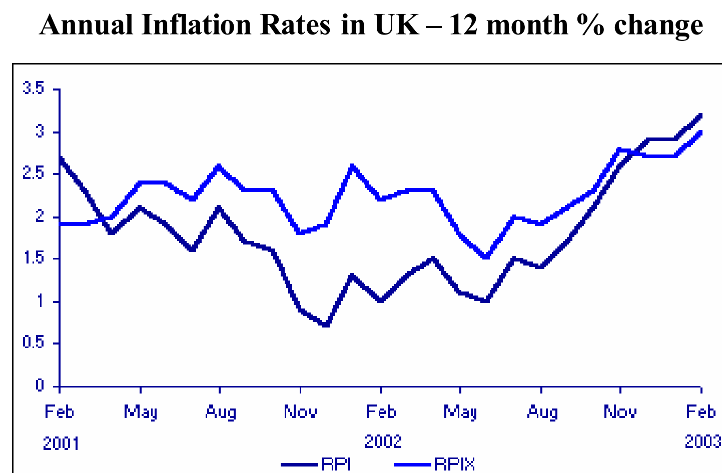

Figure 1: Source: Office for National Statistics

To avoid inflation and low inflation, this is a Macroeconomic Policy's objective for a long time. This policy tries to affect the overall performance of the economy. In fact, people have an aversion to inflation. Due to inflation would cause costs of inflation and a number of influences, for instance, redistributions effects, uncertainty possible harming for long-term investment reduces the welfare of people, inflation tax, Balance of Payment, unemployment, damage a country's competitiveness and create menu costs. Inflation indeed is a positive rate of growth of the general level and it is closely related to the unemployment.

Question 2b) Distinguish between demand-pull and cost-push inflation.

In economics, demand-pull and cost-push inflation are completely difference. Moreover, they are played a principal role in each nation economic as well. Demand-pull inflation is contrasted with cost-push inflation. Demand-pull inflation means the price increase is transmitted from one sector to another but cost-push inflation means the wage increase is transmitted from one sector to another. Actually, demand-pull inflation describes how inflation starts and cost-push inflation describes why inflation once begun is so difficult to stop.

Fist of all, demand-pull inflation is also call demand inflation. It exist is due to excess demand. It means that the resources are not completely sufficient the different regions and sectors of the economy. Demand inflation means the higher aggregate level of activity, the large proportion of areas and industries which experience excess demand for goods and labors of various sorts. Generally, we can know that increase in aggregate demand will cause higher prices and it bring to the society of cost inflation as well.

However, cost-push inflation is reverse of demand-pull inflation. Cost inflation is due to increase the factor input cost such as imported goods and raw materials so that

cause to raise the prices or wage rates round the economy. Basically, the costs increase would cause the manufacturer to raise prices, soon afterwards, increases in prices cause workers to demand higher wages as well. So the cumulative effect of all these processes cause of passed on in higher prices to consumers and the cost-push inflation is extremely difficult to stop finally.

Question 2c) Suggest how a government might tackle inflation.

In economics, there are four ways of dealing with inflation. Fist, government can adopt tough incomes policies to keep inflation under control. Second, government can through institutional and constitutional reform to tackle inflation like as fiscal and monetary policies. Third, government can adopt indexing deal with inflation as well.

One of the suggestion might tackle inflation is incomes policies. The aim of incomes policy is the attempt to influence wages and other incomes directly. The methods included jawboning, wage-price guideposts, wage-price controls and tax-based incomes policy. Generally, jawboning means the government uses verbal admonitions against those who want to raise the prices of their products. For example, the supermarket in UK cannot increase the prices for all of goods under the government use verbal admonitions against. In addition, wage-price guideposts can restrain the inflation similarly, the government may set up standards for permissible wage and price increase for the private sector to follow. For example, the government may intentionally reduce the wage increase for civil servants so that encourage other employers to control wage increase as well. It can curb inflation efficiently. Moreover, the government can use tax-based incomes policy such as allow the private sector lower taxes for who follow the guideposts and rise taxes for those who violate them.

Furthermore, the government may use wage-price controls or freezes may lead to non–price competition. Basically, the government use of wage and price controls can keep prices and wages below their equilibrium levels. From the above, there are a number of goods suggestions for tackle inflation in income policies for the government.

On the other hand, the government may change laws and institutions to make it hard for inflation to emerge. Actually, this way takes a long run view because it is not to concern with the temporary costs of first getting inflation down. Nevertheless, the objective is control how to keep inflation down. So the government can through controlling the Central Bank to pass a law permanently restricting the rate of nominal money growth to. Obviously, once the Central Bank going to rise in interest rates, the aggregate demand going to down naturally. After that, the inflation rate can be controlled finally. In addition, unemployment get a closely relationship with inflation, government can adopt the fiscal and monetary policies to curb inflation at the cost of higher unemployment. As we know, once the country have a higher inflation rate so that lower unemployment rate will be accompanied. Conversely, once the country have higher unemployment rate, the lower inflation will be emerged. But this trade-off focuses attention on aggregate demand and disregards aggregate supply.

From figure 2c, which express the price level decrease from P1 to P2 due to the Central Bank increase in interest rates, there is evidence that once increase in interest rates would cause to decrease the aggregate demand as well. To put it more simply, there is also indication that rise in interest rates may exert a downward pressure on prices.

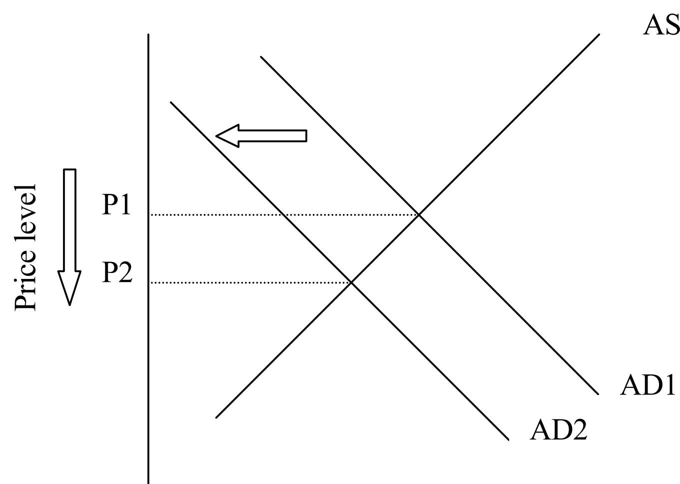

Figure 2c: A rise in the rate of interest effect.

Third, the government can adopt indexing to tackle inflation. Whereas indexation might automatically adjusts nominal contracts for the effects of inflation, any unanticipated inflation and inflation effect can be tackled. For instance, wage rates, pensions, interest payments on bonds, income taxes and many other things can be indexed in this way. Indeed, the purpose of indexing is to reduce the social cost of inflation. However, everything has a good side and a bad side, and indexing is no exception. Some economists worry about that people would diminish the confidence

combating inflation even all prices and terms in contracts will be adjusted according to the price index. Historically, indexation has already been introduced in countries that have had to live with inflation rates of 30 or 40 per cent for years.

Finally, there are many ways might tackle inflation for government. Income policies, institutional and constitutional reform with fiscal and monetary policies and indexing are the process to tackle inflation efficiently.