Inflation in an economy is defined as the sustained increase in the general price level, resulting in a decrease in purchasing power of consumers and a fall in the value of money. Some inflation is vital for the macro economy in order to maintain adequate levels of economic growth, and since 1997, the UK government has recognised this fact by allowing The Bank of England Monetary Policy Committee to target a rate of 2.0% over the past fifteen years or so. The measure currently used by EU countries, including Britain, is that of the CPI (Consumer Price Index). This takes a weighted, indexed mean of a basket of goods deemed to be most influential in current household spending across the country. Other measures include the RPI and RPIX (the RPI, excluding mortgage interest repayments, as these fluctuate too readily). The UK has preserved one of the lowest inflation rates among EU countries in recent years, due to a thorough understanding of the causes of inflation and the policies necessary to manage it.

On a microeconomic level, inflation can arise from the domestic economy. For example, major energy providers may decide to put up prices in line with projections for the year ahead, or monopolistic supermarket chains could engage in pricing wars, often to the detriment of the consumer and the pocket inflation they experience. Government VAT increases to fund its budget deficit would eventually feed through to inflation. On an international level, various commodity shortages or scarcity power from giant oil companies undoubtedly forces inflation further upwards. Frequently, however, the causes of inflation are split into two areas: demand-pull and cost-push.

Demand-pull inflation is likely to occur when an economy is working at or close to full employment of resources. In the short run, aggregate supply is inelastic and any increases in demand will only be met with price rises, due to upward pressure on material and wage costs. This is as opposed to more resources available as an alternative to fuel the demand. With spare capacity, this will still take place, but to a much lesser extent as firms are confident they can compete in the market without being stretched for resources in the short run. In this state, the economy is growing, but the growth is unsustainable, leading to inflation.

Aggregate demand is clearly being allowed to grow to fast relative to supply capacity. The result is excess demand for goods and services, with firms raising their prices to cover costs of those in the present and of those for future investment. Demand-pull inflation can either be as a result of external factors or variable ones the government wishes to implement. The former includes things like the depreciation of the exchange rate (whereby a fall in the value of the sterling reduces demand for imports and raises demand for exports, culminating in inflation) and the improving economic positions of other countries (naturally forcing them to buy overseas UK exports to fund their growth in the short-run due to capacity constraints). The latter includes things like fiscal stimulus (cutting taxes to give consumers more disposable income or government spending on projects, infrastructure and initiatives) and monetary policy (adjusting interest rates to reduce borrowing costs and mortgage repayments, or increasing the money supply). Careful consideration of the long-run effects must be taken into account, which emphasised by cost-push inflation – a drop in the base rate, for example, can affect spending by as much as two years in advance.

Cost-push inflation is when firms respond directly to cost increases by raising their prices. This is done to protect profit margins, though in certain circumstances (such as

the financial crisis of 2008), firms in oligopolies and monopolies with lots of market power may decide to absorb some or all of their profit losses. In this situation, both prices and economic growth are affected, which is what governments are not looking to happen.

Reasons for cost rises comprise a range of areas. For example, an increase in component costs, such as those of the raw materials oil, copper and agricultural products essential for production processes. These are almost impossible to influence using any direct action, yet can affect many manufacturing industries to a large degree. Rising wage costs above the improvements that result from the productivity of the workforce. Particularly when unemployment is low, skilled workers become scarce and drive up wages in a bid for competition. According to the short-run Phillip's Curve, unemployment should constantly be deviating towards the natural rate as firms demand less labour when inflation is high and unemployment is low. This does not mean that inflation does not rise, however. The wage-price spiral effect also plays the part – an increase in wages in these conditions, or conversely expectations of higher inflation, can inevitably lead to workers demanding pay rises, which puts pressure on firms costs so that they must increase prices, which leads to high inflation and the process continues indefinitely. Governments must ensure wages do not get embedded into inflation in this way, because rational expectations can be damaging and are ever present according to the monetarist view of inflation. Finally, higher taxes in the form of corporation tax or fuel duty, as examples, can mean these extra costs are passed onto consumers in the form of inflation too.

The oldest theory for inflation, however, dates to the eighteenth century or earlier. The quantity theory demonstrates how the excess supply of money in the financial system, in relation to the number of goods and services available, causes households to quickly spend this money and allow inflation to occur. The following equation illustrates this:

Money Supply x Velocity of circulation = Price Level x Total Transactions

There are several assumptions in this model, but it is effectively saying more money leads to more spending, which leads to higher prices in accordance with demand-pull inflation. Money supply is dangerous in that if not regulated properly, it can cause hyperinflation. However, most governments have this under control.

In conclusion, inflation is caused by a combination of demand and supply side factors, and controlling it must take into account effective demand-side regulation in line with productive capacity in the short-run, along with a steady growth in the supply side using supply-side policies so that growth does not result in accelerating prices. Tight monetary policy, increases in technology and innovation, low global inflation from increased competition and a strong exchange rate, among other things, have all contributed to low UK inflation over the past 15 years. These are evidently both demand *and* supply related reasons.