Government Policies to Achieve the Inflationary Target

The aim of this essay is to explain to the reader what is meant by the term 'inflation' and to outline the policies used by the government to achieve its inflationary target. To help me achieve my aim I am going to use various resources throughout the essay, this includes slides provided during lectures, materials received in tutorials and internet sites with the relevant information for me to complete my aim.

Inflation is the increase in the costs to produce a product. When these costs rise, the value of money falls, meaning that when there is inflation our money buys us less. There are many different types of inflation and examples of these are demand pull inflation and cost push inflation.

The control over inflation has become one of the government's main objectives. There can be lots of different reasons for inflation such as excess demand for goods and service or cost-push inflation, etc. To help control this, different policies have been set to help the government achieve the inflationary target. However it is not that easy to predict inflation. Many different decisions are made by large or small businesses every day that could affect inflation such as an increase in selling price or a change in import or export of goods. Also a change in inflation abroad can affect the UK if goods are being imported from that country, often a higher payment will be needed to pay for the import and this raises production costs for the UK.

Inflation measures the annual rate of change of the general price level in the economy. One way of measuring inflation is RPI, retail price index. This measures how the price of household goods has changed over a certain period. Each item is given a 'weight' to calculate the percentage of RPI. I have taken the table from the lecture slides to give an example of goods RPI weights.

(1) RPI WEIGHTS

	1987	**1998**
Food	16.7%	13.0%
Alcoholic drink	7.6%	7.1%
Tobacco	3.8%	3.4%
Housing	15.7%	19.7%
Motoring	12.7%	13.6%
Leisure goods	3.0%	6.1%

There are also other methods that the government uses to measure inflation, these are:

- RPIX, which measures changes in RPI but it excludes mortgage interest payments.
- RPIY, this is changes in RPI but it excludes mortgage interest payments, indirect taxes and local taxes.
- CPI, consumer price index, this measure excludes costs whereas the RPI measure did not.

The British government has pursued an explicit inflationary target since 1992. There are advantages and disadvantages of having an inflationary target. Several economic benefits can be achieved by having an effective target, such as, if there is a low economic target then there will be a low inflationary expectation from workers and thus may encourage them to accept a slower pay rise. Also a constant low inflation can encourage more capital investment. In August 1999, a Bank of England report said that (2) “inflation targets have been successful in reducing inflation expectations and improving people's understanding of the inflation process.”

A disadvantage of the inflation target is that constant fluctuations in the exchange rate and increases in inflation rates in other countries can put the domestic inflation rate higher, this can mean higher interest rates and thus damaging economic growth.

Over the last few years the UK inflation has been well below the target expectation, giving low, stable inflation. We are now going to look at the policies that the government have been using to help them control the levels of inflation. The first policy we are going to look at is the Fiscal Policy.

The fiscal policy includes three main parts. Lower government spending, reduction in the amount the government borrows every year and higher direct taxes. This policy try’s to reduce the outgoings and in goings to the circular flow of income, reducing demand pull inflation.

Another policy used by the government is the Monetary Policy. In May 1997 the Bank of England was given the independence to set interest rates in the UK. They had to set these rates with the aim of keeping inflation under control for the next two years to control the growth of demand. For example, (3) the interest rates went up to 15% in the late 1980s. By raising the interest rates the demand fell and receeded again in the 1990s. By having high interest rates, the demand is reduced because it discourages people from borrowing money and increases the rate of saving. Also by raising the mortgage interest rates it discourages disposal income spending and reduces the demand in the housing market. If the interest rates rise 1% above or below the target the Bank of England has to write to the government explaining why this is.

Long term polices such as Labour market reforms and supply-side reforms. Labour market reform aims to increase flexibility by weakening the trade union power and having more flexible working hours. Supply side reform aims to produce a greater number of goods at a smaller cost per unit.

Another policy that was used but has not been used since the late 1970s is the income policy. This is direct wage control. Although the policy is no longer used the government still try’s to influence wage growth by restricting pay rises.

The key to controlling inflation is to keep control of aggregate demand but at the same time increase supply. I mentioned that there has been low, stable inflation over the past few years. Reasons for this are low wage growth, success of the Bank of England, increased efficiency, cuts in prices of utilities and lower inflationary expectations. This shows us that the government’s policies are working well and the low, stable inflation is expected to continue.

I received my statistical evidence from:

(1) Table taken from lecture slides, The Robert Gordon University, Topic4_2004_S1_Inflation_intranet.

(2) Quote taken from internet site on January 5th 2005, http://www.tutor2u.net/economics/content/topics/inflation/inflation_targets.htm

(3) Example taken from internet page on January 5th 2005, http://www.tutor2u.net/economics/content/topics/inflation/controlling_inflation.htm