Why Should Governments Be Concerned About Inflation?

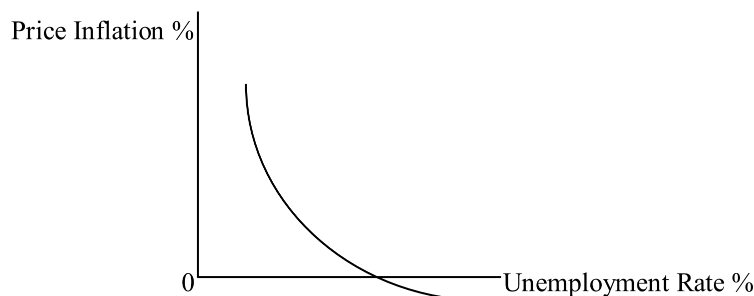
Inflation can be defined as the persistent tendency for prices and money wages to increase.[1] Inflation is usually measured with reference to its rate in terms of a percentage, rather than a cumulative figure. Inflation in the UK is calculated with reference to various different measures, the most important of these being the Retail Price Index (RPI). In fact this was the only major measure of inflation in the UK until 1979. However, since then, other prices and measures have been brought into consideration in order to gain a wider, more accurate overall picture.

The modern RPI was first compiled in 1947 and is a measure of the month to month change in the cost of a representative 'basket' of goods and services of the type bought by a typical household, and is compiled by the Office for National Statistics.[2] The RPI is used by the government businesses and society in general. It is an important indicator of the UK economy and shows the impact of inflation on the family budget. The Index covers a very large amount of goods and services in order to try to get the best representation of prices possible. It covers everything from basic food commodities to holiday prices.

In addition to RPI the government uses several different price indexes to calculate inflation. The latest of these being the Harmonised Index of Consumer Prices (HCIP), which was launched in 1997 in response to the need for a Europe wide comparable measure of inflation, a requirement of the Maastricht Treaty.

Inflation is generally seen as bad in economic terms and is the cause of much concern for the government, especially when there is an unexpected or rapid rise in the rate of inflation. This is because amongst other things, it gives a distorted view of the price system, promotes speculative investments and is usually costly to eliminate. However, the single largest negative product of inflation is the very close link to unemployment levels. A.W. Phillips' was the first to show this trend with his study of UK wage inflation over the period 1861-1957. He found that there was a stable, inverse relationship between UK wage inflation and unemployment.

The Phillips Curve[2]



[1] John Black (1997) - Oxford Dictionary of Economics, Oxford Paperback Reference
[2] Griffiths & Wall (1999) - Applied Economics, Pearson Education Ltd

This relationship can be explained in terms of supply and demand. When unemployment is low, demand for labour exceeds supply and leads to an increase in wages and prices. Similarly, when unemployment is high supply of labour exceeds the demand, hence a decrease in wages and prices. This shows inflation as a product of employment levels, but it is also possible to show that employment levels change as a result of inflation. If cost push inflation takes place, whereby an increase in production costs causes an overall rise in prices, this will affect employment levels as this creates a temporary decrease in real wages, resulting in lower unemployment.

It is this strong link between inflation and unemployment that causes the government most concern. The public always sees high unemployment as very bad, as obviously they are concerned for the safety of their jobs. Also high unemployment is seen as sign of a general slowing down of economic growth and hence bad for the country as a whole. For these reasons the government are keen to keep unemployment to a minimum but at the same time must keep inflation under control, which often causes many problems for the policy makes within the government.

The government uses two main economic techniques to manipulate inflation and unemployment to what they see to be the optimum levels: Firstly, the Keynesian approach would be to attempt to reduce aggregate demand, which is defined as the total of intended attempts to spend on final goods and services in a country.[3] They would attempt this through a combination of monetary and fiscal policies. A range of credit control measures could be used as part of monetary policy to increase the cost and reduce the availability of credit for consumer purchases. Personal taxation may also be increased along with a possible cut in government spending.

Secondly, a Monetarist approach would be more directed towards a reduction in the growth of money supply by reducing government spending and hence how much the public sector need borrow. Lower government spending would reduce aggregate demand. Another approach by the Monetarianist would be to raise interest rates hence deterring borrowing in the private sector and preventing devaluation of the currency. However conversely, interest rates have generally been shown to rise and fall together.

In summary, the government should be concerned with inflation as it is a major factor in the UK economy. The state see it as their role to attempt to control this and use a number of techniques to accomplish this.

[3] John Black (1997) - Oxford Dictionary of Economics, Oxford Paperback Reference

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