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Inflation continues to rise

Increased inflation makes survival tougher

The UK has traditionally been characterised as a country with a wholly strong and stable economy, with an equally impressive inflation rate. With inflation rates staying historically low for the 10 years under the Labour party from 1997 - 2007 under the supervision of then – Chancellor Gordon Brown, it seems as though inflation has now been allowed to get out of control; and many families are struggling to survive and can't afford their basic necessities; which is pushing many more families below the poverty line.

With rising prices occurring in many industries throughout the economy including key industries such as food, energy and services; times are getting tougher for all of the British public. Also, it doesn't seem as things are going to get any better before they get worse. With reputed economic analysts from Capital Economics forecasting inflation to rise above 4% by the end of this year from the current rate of 3.3%, news of this has shaken the country.

This report has been written with the intention of informing you more about inflation, types of inflation, and remedies that can be utilised to soften or reduce the effects of inflation.

Money losing value as a result of hyperinflation in Germany 1923-1924

What is inflation and how is it measured?

Inflation is an increase in the price of a basket of goods and services that is representative of the economy as a whole; it is an upward movement in the average level of prices. This definition refers to the fact that it is impossible to value each and every good in an economy; therefore a representative sample must be used. In the UK, the measure used is the Consumer Price Index, often referred to as the CPI for short. A CPI is an index number measuring the average price of consumer goods and services purchased by households, it is used for macroeconomic issues and is made most use of by the government. Components of the CPI include food and energy, but it does not include housing.

Alternatively, the Retail Price Index (RPI) can be used to see how the cost of living has changed, which can be utilised by firms to determine whether wage rates should be changed to compensate for an upward or downward movement from the original trend. RPI is also used by the government to determine pension schemes and is often used to set benefits and issues to do with welfare. The RPI measures the change in prices of goods and services such as food, health, transport and communication.

There are differences between RPI and CPI, despite them both being consumer price indices; I have stated these differences below:

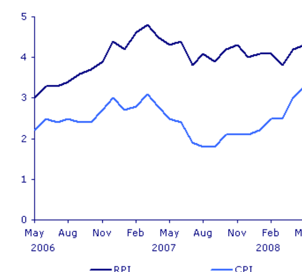
In the CPI, the geometric mean is used to combine the individual prices at the most basic level whereas the RPI uses arithmetic means.

- The CPI excludes a number of RPI series mainly relating to housing costs (for example, council tax), and in particular to owner occupiers' housing costs (including mortgage interest payments, house depreciation, and buildings insurance).

- The CPI includes series for university accommodation fees, foreign students' university tuition fees, and unit trust and stockbrokers charges, none of which are included in the RPI.

As you can see these are very helpful indices, and it is for that reason that the government and firms regulalry use them to measure the cost of living among its citizens, or in the firms' case its employees.

The graph below sows RPI and CPI fluctuations in the last 2 years up to last month (May 2008).



Annual inflation rates – 12-month % change Source: ONS

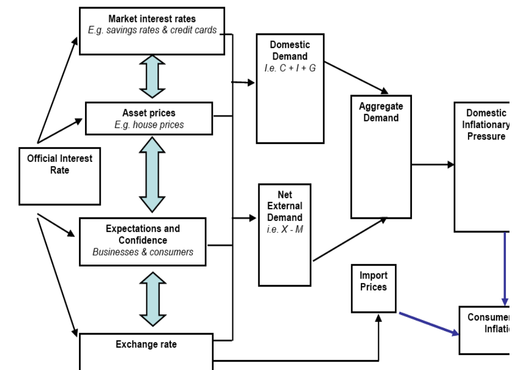
Types of Inflation

In an open economy such as the UK, there are many potential sources of inflationary pressure. Some come direct from the domestic economy, for example the decisions of the major utility companies on their prices for the year ahead, or the pricing strategies of the leading food retailers based on the strength of demand and competitive pressure in their markets.

The rising cost of raw materials forces suppliers to pass these costs on to the consumer

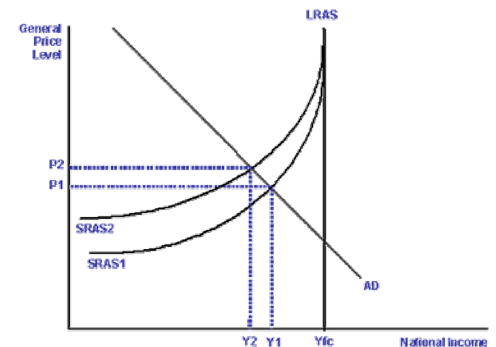
But inflation can also come from external sources, for example a sudden rise in the cost of crude oil or other imported commodities, foodstuffs and beverages. Fluctuations in the exchange rate can also have a powerful effect on inflation in the short and medium term. It is for this reason that I have chosen to focus on the two main and most common types of inflation: cost – push and demand – pull.

The diagram below shows how inflation is vulnerable to external factors; source - www.treasury.govt.nz/publications/ briefings/1990/big90-5.pdf



Cost – push inflation

Cost - push inflation occurs when firms increase prices to maintain or protect profit margins after experiencing a rise in their costs of production. This can be shown by an inward shift of the short run aggregate supply curve which leads to a contraction in aggregate demand and a fall in real output, but an increase in the general price level. (shown opposite, source ONS).



The main causes of cost - push inflation are: Rising imported raw materials costs perhaps caused by inflation in other countries or by a fall in the value of the pound in the foreign exchange markets, rising labour costs in the form of wages, higher indirect taxes, amongst others.

Cost inflation is more likely when unemployment is falling to low levels. In these circumstances there will be shortages of skilled labour. This means that businesses may have to offer higher pay to attract and retain their best workers when they are looking to expand their output.

Demand - pull inflation "too much money chasing too few goods".

Demand – pull inflation

Demand Pull inflation occurs when total demand for goods and services exceeds total supply. This type of inflation happens when there has been excessive growth in aggregate demand and there is an inflationary gap. Demand-pull inflation is often monetary in origin - because the authorities allow the money supply to grow faster than the ability of the economy to supply goods and services. The phrase that is often used is that there is "too much money chasing too few goods".

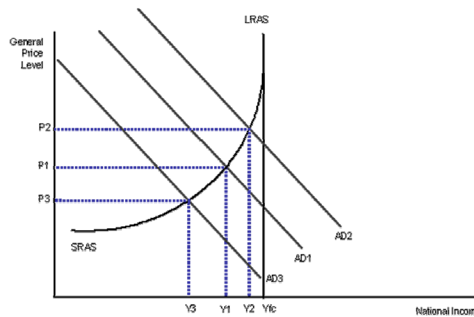
An example of this was during the late 1980s with the so-called "Lawson Boom". There was a sharp rise in the demand for credit and a sharp rise in house prices. The amount of money in circulation grew at alarming rates and caused excess demand in the economy. By the autumn of 1990, retail price inflation had climbed to 10.9%. A recession was needed to bring it back down again.

Demand - pull inflation can be illustrated graphically using aggregate demand and aggregate supply analysis.

As the economy approaches full employment (or full capacity), labour and raw material shortages mean that it becomes more difficult for firms to expand

production to meet rising demand. As a result, the AS curve becomes more inelastic. When aggregate demand (AD) increases from AD to AD1 the economy is still operating at relatively low levels of capacity. Output can expand relatively easily so firms will only implement small increases in prices from P to P1.

When aggregate demand increases from AD1 to AD2 the economy is moving towards the full employment of factors of production. Many firms choose to increase price to widen profit margins. Shortages of factor inputs mean that the firms' costs of production start to rise. Furthermore, it is likely that, as employment in the economy grows, demand for goods and services will become more inelastic. This will allow firms to pass on large price increases (P1 - P2) without any significant fall in demand.



Reasons for increased aggregate demand include: A depreciation of the exchange rate increases the price of imports and reduces the foreign price of UK exports, a reduction in direct or indirect taxation, Rapid growth of the money supply as a consequence of increased bank and building society borrowing if interest rates are low and consumer confidence is high.

The more produce that is supplied, the more elastic price becomes

Monetary Inflation

The Monetarist explanation of inflation operates through the Fisher equation.

M.V=P.T, where M=Money Supply, V= Velocity of Circulation, P = Price level and T = Transactions or Output.

As Monetarists assume that V and T are fixed, there is a direct relationship between the growth of the money supply and inflation. The mechanisms by which excess money might be translated into inflation are examined below.

Individuals can also spend their excess money balances directly on goods and services. This has a direct impact on inflation by raising aggregate demand. The more inelastic aggregate supply is in the economy, the greater the impact on inflation.

The increase in demand for goods and services may cause a rise in imports. Although this leakage from the domestic economy reduces the money supply, it also increases the supply of pounds on the foreign exchange market thus applying downward pressure on the exchange rate. This may cause imported inflation.

If excess money balances are spent on goods and services, the increase in the demand for labour will cause a rise in money wages and unit labour costs. This may cause cost-push inflation.

Monetarists believe that the control of the supply and flow of money is the answer to any economic problem

The benefits of inflation

“Overall, it is clear that there are many benefits from the successful achievement of low and stable inflation, especially in terms of greater macroeconomic stability and improved efficiency”

“ In addition, firms and households are able to plan with greater confidence, and there are efficiency gains fro the greater transparency of relative prices”

Kate Barker (MPC Member) Speech to the Manchester Statistical Society, February 2003.

In terms of high inflation, the only benefit is that it prevents consumers making rash decisions on buying items that aren’t necessarily needed. Other than this, there are no real benefits of high inflation.

The costs of inflation

UK CPI from 1930 to 2005.

High Inflation:

Effect on UK competitiveness - if the UK has higher inflation than the rest of the world it will lose price competitiveness in international markets. This assumes a given exchange rate. If the exchange rate depreciates, this may help to restore some of the lost competitiveness.

This rise in relative inflation leads to a fall in the world share of UK exports and a rise in import penetration. Ultimately, this will lead to a fall in the rate of economic growth and the level of employment.

Higher inflation causes an upward spike in inflationary expectations that are then incorporated into wage bargaining. It can take some time for these expectations to be controlled. Higher inflation expectations can cause an outward shift in the Phillips Curve.

The problems of a wage-price spiral – price rises can lead to higher wage demands as workers try to maintain their real standard of living. Higher wages over and above any gains in labour productivity causes an increase in unit labour costs. To maintain their profit margins they increase prices. The process could start all over again and inflation may get out of control.

It can reduce the value of savings, as well as creating menu costs and shoe leather costs.

Low inflation:

There is a risk of a general deflation that may affect the manufacturing sector if there is prolonged deflation; a restricted ability of relative wages to adjust; lower profitability as lower inflation improves price transparency and increases competitive pressures.

The remedies for inflation

The remedies for inflation depend on the type of inflation is in operation

1. To reduce demand pressures:

* Raise interest rates to reduce consumers disposable incomes

* Raise interest rates to discourage borrowing and demand

* Raise taxes to reduce disposable income and spending

2. To reduce cost - push pressures:

• Limit wage increases if possible e.g. public sector workers

• Force electricity and gas companies to hold their prices of

• Increase the value of £ in order to reduce the cost.

3. To reduce money supply pressures: If inflation is caused by too much money in the economy

• Print less money

• Withdraw some money from circulation.

Each policy idea has its weakness though:
- Number 1 is effective but will be unpopular with consumers and may cause a minor recession.
- Number 2 could be effective but it is very difficult for the government to tell private firms how much to charge for inputs and also how much to pay their workers.