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Subject Area - Economics
UK Inflation Rates

The past one hundred years has resulted in many changes for the UK economy.

Industrialisation and the labor movement modernized the way the country undertook manufacturing. Globalisation stretched the reach of the UK's economy from their concentrated sector to every populated place on earth. Within these changes external and internal forces affected their inflation rates. Economists have always argued about what causes inflation and what measures are needed to be taken to protect an economy from a volatile rate. By looking at the largest inflationary changes since 1900 you test the economist's theories and judge the current system on its ability to maintain stability.

Importance of Inflation Prediction

The inflation rate responds to cycles in the economy. Recessions will cause the inflation rate to drop, as noted by the drop in the price level during WWI and pre-depression era. There are costs to inflation. However, it's a different matter entirely when the inflation is perfectly anticipated, and can be taken into account in economic transactions. When the inflation rate is known, all contracts would build in the expected inflation. Loans, labor contracts, and tax brackets would all be able to take the inflation into account, because it is certain. In this case, inflation has no real costs. But, in the real world, inflation has imperfect anticipation. That is, it is extremely difficult, if not impossible to exactly predict the rate of inflation.

There is a component that is unanticipated. There are costs to imperfectly anticipated inflation. When inflation is not anticipated, those who hold money, bonds, savings accounts, insurance, contracts, etc. have their purchase power transferred to those who issue those financial assets. One line of argument is that inflation benefits capitalists or those who receive profit. However, this is at the cost of wage earners. Unanticipated inflation also has the cost of moving the public into higher tax brackets. This raises real value of tax payments and thus decreases real disposable income. Clearly, this unanticipated inflation can have some negative repercussions through redistribution of wealth which is why it's important to understand the inflation rate and its causes. Inflation becomes even more uncertain when the interest rate is high and therefore, more volatile.

Analysis of inflation in the UK

As noted above, Inflation is neither good nor bad as long as the governing body can predict what it will be. In judging the performance of the UK's current inflation rates you need to compare them to past increases. When graphed, if the inflation gradually increases from period to period then this is assumed to be the norm for the economy. Dramatic spikes or drops are where economic policy needs to be reassessed and measures need to be implemented to stabilize business.

The government can control inflation through monetary policy as depicted by the quantity theory of money. As pointed out by the Phillips Curve, monetary policy can have a profound effect on real variables. But, this is only a short-run phenomenon. Continuous stimulations of the economy, through increases in the money stock, would result in inflation in the long run. This assists in explaining the cyclical movement of inflation.

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The following graph represents the trends in the UK inflation rates since 1900. Using standardized economic factors to describe the performance during the spikes we can see how effective the accepted theories are in determining the rate changes.

Figure 1-A

Primary Dates for analysis-

1914-1923- WW1 and Pre Depression Era

1939-1943- WW2

1973-1981- OPEC Oil price increase

Secondary Datas for analysis-

1923- 1936- Depression

1950's- Post WW2 labor movements

Early 1990's- Gulf War

Classical Model, Inflation, and Money Supply

Before carrying on, the following theory is based on a number of assumptions. These assumptions are made under the basis of the Classical Model. Aggregate supply is assumed perfectly inelastic. Under this model, Y is the level of full employment where the aggregate supply curve will be vertical. It is assumed that wages and prices are fully flexible. The production function Y* = F(K, N*) tells us Y* is only dependant on N*. Through the classical model, the labor market depicts that N* depends on the real wage. So, supply in the long run is independent of the price level.

We will now examine the quantity equation to explain the relation between the money stock, the price level and the inflation rate. The quantity equation is defined as:

PY=VM

Where M is the size of the money stock (or money supply) in an economy. V is the velocity of money which is the measure of the speed with which money circulates in an economy. V will be held constant for the use of explanation. P is the price level or average price of goods. Y is goods in the economy. Therefore Y (or aggregate demand) must be equal to:

YD = VMo

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P

This is the economy's total spending (ie: Aggregate Demand). By this model we can see, that as the price level increases, YD will decrease. As the money stock increases, aggregate demand will increase. So, inherent in the formula PY = VM (as velocity and aggregate supply are constant), we find that P will increase in proportion to M.

$\Delta P\% = \Delta M\%$

Conclusion: Money Supply effects the rate of inflation. The practice of controlling inflation through money stock is called monetary policy. Monetary policy is the tool used by government to control inflation. Up until the 1970s, inflation was controlled in the UK controlling the amount of money banks could spend. In the 1980s, economists decided to take on a more active approach. Since then monetary policy has been exercised by setting interest rates. Interest rates are increased to stabilise money demand and inflation. On the other hand, interest rates are reduced to stimulate money demand. This explains the UK's fluctuations in accordance with interest rates since the 1970s due to conducting policy according to an interest rate rule, and not a money supply rule.

Purchasing Power ParityTheory

The purchasing power parity (PPP) theory says that in the long run, the nominal exchange rate moves primarily as a result of difference in the price level and its movement between two different countries. It is thought of as a general level of prices in two countries. The PPP level of the exchange rate is the one that would equate price level in two countries. Its defined as:

R = ePf

P

P is the the domestic price level and Pf is the foreign price level. If the real exchange rate (R) is greater than 1, the relative demand for domestically produced goods should rise. Therefore, This should drive up domestic prices (inflation). However, let's say the exchange rate drops. This could create inflationary pressures in the UK economy. Since the UK imports a lot of goods, inflation would thus increase in response to a decrease in the exchange rate. Since imports are now relatively cheaper with the lower exchange rate, the net exports component (X-M) of the GDP equation, AD = C+I+G+(X-M) will increase. If the economy is close to its capacity, this could lead to a further increase in inflation. Market forces keep the exchange rate relatively close to PPP. A government can choose to adopt a monetary policy based on exchange rate targets and the PPP. That is interest rates are set in order to hold the exchange rate at a certain level.

Conclusion: Changes in the nominal exchange rate will come about because of differences in inflations between two countries. A decrease in the exchange rate will result in increased inflation, and vice-versa. Government can adopt a strategy of exchange rate targeting for monetary policy. This explains the European Exchange Rate Mechanism installed in the early 1990s in the UK. It was put in place to ensure that the pound didn't decrease or increase in value in relation to other currencies by more than a certain amount. The interest rates set out to control the exchange rate, which has an impact on the inflation of that period.

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The Phillips Curve

When examining the Phillips curve, it is the consideration of the transition period between the very short run and the long run. Under this assumption, wage and price is adjustment are not fully flexible. Wages and prices move somewhat slowly. Under this assumption, there can be some unemployment. This adjustment is described as:

gw = -E(ut - u*)

gw is the wage inflation.. E is the adjustment for non-fully flexible prices. u* is the full employment level, and u t is the employment rate at that period of time. This equation is a simple Phillips curve. It is the curve relating to the unemployment rate. It shows a policy trade-off. Low unemployment could be traded off for high inflation or low inflation for higher unemployment. The Phillips curve is shown in Figure

1-B.:

Figure 1-B

The graph in Figure 1-C depicts the UK unemployment rate through the 1900s. There is a clear relationship between the unemployment rate of figure 1-C. and the inflation rate shown in figure 1-A. The increases in the unemployment rate are inversely correlated to the changes in the inflation rates.

Figure 1-C

Conclusion: In the short-run, the unemployment rate and inflation are inversely related. This explains the high levels of unemployment that have accompanied high inflation throughout the 1900s in the UK.

Current Techniques

Demand Pull Inflation

The concept of demand pull inflation is that you are not producing or importing enough product to keep satisfy the populations demand. What this results in is a lot of money fighting over few products which allows for companies to boost prices. This can be caused by a variety of situations.

1. Increase in money supply through wage increases, government spending or business expansion

2. Increase of local currency values resulting in an increased cost for imports and a higher demand for exports resulting

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in a lower supply of products within the UK

3. Large foreign market growth resulting in increased demand for exports which lower the supply for UK consumers

4. Lowering of taxes resulting in a larger disposable income for consumers and therefore an increase of buying and increase of prices.

Analysis- During the world wars government spending increases a massive amount due to the production engine required to supply the troops. The result of this is an increase in wages within the country but a large amount of exportation outside of the country with limited imports. Prices are forced to sky rocket as current residents compete for limited goods. On the reversed side, when analyzing the deflationary times during the recession it can be seen that the money supply was at an all time low with the market crash and inadvertently the government was forced to combat it with large government spending to boost production to place money back in the economy. On the short time span the supply was far too high for the demand and prices plummeted but as people started to earn money again, deflation started to plateau and the economy became stabilised again.

Conclusion: This theory for determining inflation seems to be at least partially relevant to key historical times within the last 100 years.

Cost Push Inflation

Cost push inflation occurs when the economy's firms are required to spend more on production. This results in and increase of prices in order to maintain current profit margins. Several factors can contribute to this force.

1. Increase in government taxation increases the cost of revenue for a firm and requires an increase in price to maintain margins

2. Wage increase from increased living cost or union power will result in a price increase. Normal wage increase can be expected from predicted inflation rates but a jump in worker power from labor unions can result in an increase in inflation over the standardized value.

3. External factors from other countries can also force up inflation. This can include an increase in commodity price such as oil, a loss of exchange value which result in more expensive importation of raw materials or an increased difficulty in finding resources from political problems or lack of known resources

Analysis: The major proof for this theory is during the 1973 where OPEC decided to increase their oil prices by which initially went from 3.00 USD to 12.00USD within the year and peaked in 1981 at 35.00USD. Petroleum is a major import for all developed countries including the UK. The result of the increased oil prices forced businesses to increase prices to maintain profit and therefore drove inflation rates through the roof. Such a dramatic increase in oil prices resulted in a recession within all the oil dependent countries including the UK. To a minor extent this happened again in the 1989 with the invasion of Kuwait by Iraq which resulted in Iraq's controlling share in OPEC. Thus remained high until the US invaded and recovered Kuwait.

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On a secondary extent it can be seen during the late 1940's through the 1950's that inflation rates were higher then wanted. During this time many labor movements including women rights movements resulted in employers spending more on their employees and required them to increase prices. This inflationary period was not necessarily bad as it was occurring within the majority of the first world nations and resulted in an increased production capacity with the larger work force of women and men.

Conclusion: Increase of commodity prices have proven to directly affect inflation in any developed nation. This leads to the belief that the cost push inflation theory is correct. On the other end, wage increases and labor movements may result in short term inflationary changes but governments watch this closely to ensure a wage spiral does not occur. A wage spiral is where employees demand a raise at which point employers are required to increase prices which again results in employees demanding increased wages. The end result of this is a cycle of inflation which is hard to control once it starts.

Inflation rate performance in the 1990's

The majority of the UK's inflationary trends have been caused by healthy economic growth with some external stresses. Over the last one hundred years the UK has been involved in two world wars, two oil crisis's and a multitude of political policy changes. From this they have been able to institute many monetary policies which will defend the country against volatile inflation rates in the future. Although many have been issued in the past, the most effective notion was instituting a target rate in 1992. The target rate was set at 2.5% based on the Retail Price Index (RPI) which is used to maintain a close proximity to annual growth of the UK economy. Since then the UK has hovered near their goal of 2.5% making them a bench mark for the developed nations.

How does the UK control inflation rates

The UK's MPC (monetary policy committee) controls the price of money which in turn controls the demand. What this means is they set an interest rate which they believe will encourage the public to spend or save as much as they want to control inflation. A higher interest rate would mean that the public would rather save their money to gain from interest then invest in a home or other asset which would not be as profitable. This affects firms in a similar manner. Increased interest rates also encourage foreign investors to produce an inflow of cash into the country in order to capitalise on the current trends. This inflow increases the currency exchange for the UK and will help defend against a low supply of goods as importing will be encouraged. The only issue that arises is that once policy-makers intervene, we don't know what the reaction of the economy would have been in the absence of this intervention. We can never know if we've actually benefited from the policy intervention.

Conclusion

This paper first explained costs of unanticipated inflation in terms of the issues involving wealth redistribution. The money stock was then proven to be a clear factor in determining the inflation rate, thus explaining the monetary policy effecting inflation according to the money supply rule. Then, post-1970s, the interest rate rule was the basis for monetary policy decisions effecting interest rates. The purchase power parity is used to explain UK's policies of the early 1990s,

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using an exchange rate target. The Phillips Curve sets out to explain the relationship of high unemployment rates and high inflation throughout the 1900s. The Demand Pull Model accurately accounts for key historical times in for inflation throughout the 1900s. The Cost Push Model explains inflation in terms of changes in commodity prices, specifically oil.

These models and theories have been proven and give accurate explanations of UK trends and phenomenon of inflation in the 1900s.

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