Macroeconomics Revision Essay Plan (2): Inflation and Unemployment and Economic Policy

(a) Explain why it is considered important to control inflation (20 marks)

(b) Discuss how a government’s commitment to achieve stable prices is likely to affect the level of unemployment (30 marks)

Note: This question is focusing on the consequences of inflation rather than the causes

Part (a) focuses on the economic and social costs of inflation that have persuaded governments to make inflation control one of the top objectives of macroeconomic policy-making over the last twenty years.

The current government is committed to the control of inflation (it has an explicit inflation target for RPIX of 2.5% +/- 1% as a pre-condition for macroeconomic stability and sustained economic growth

Briefly define inflation - a sustained rise in the general level of prices as measured by the RPI

Develop the case for the need for economic policy to control inflation by looking at the economic and social costs of inflation (not all of the following need to be covered except those marked important!)

In explaining and assessing the costs of inflation, we often distinguish between different degrees of inflation, since low stable inflation has less of a damaging effect on the macro-economy in the short and the long run than hyperinflation where prices are out of control

Impact on Savers and Debtors - An Arbitrary Redistribution of Income
Inflation leads to a rise in the general price level so that money loses its value. People may lose confidence in money as the real value of savings is reduced. This is the case with rapid inflation. Savers will lose out if nominal interest rates are lower than inflation - leading to negative real interest rates.

Inflation can also favour borrowers at the expense of savers as inflation erodes the real value of existing debts. And the rate of interest on loans may not cover the rate of inflation. When the real rate of interest is negative, savers lose out at the expense of borrowers

Employees in jobs with poor bargaining positions lose out - for example people in low paid jobs with little or no trade union protection may see the real value of their pay fall when inflation is high

Inflation Expectations and Wage Demands (important)
Price increases lead to higher wage demands as workers seek to maintain their real living standards. Businesses may then pass on these higher costs in higher prices to protect their profit margins. Higher prices then put further upward pressure on wages. This process is known as a wage-price spiral. Rising inflation leads to a build-up of inflation expectations that can worsen the trade-off between unemployment and inflation.

Business Planning and Capital Investment (important)
Inflation can disrupt business planning. Budgeting becomes difficult and this may reduce planned capital investment spending. Lower investment has a detrimental effect on the economy’s long run growth potential (i.e. it limits the growth of long run aggregate supply)

International Competitiveness and Unemployment (very important!)
Inflation is a possible cause of higher unemployment - particularly if a country experiences a much higher rate of inflation than another, leading to a loss of international competitiveness and a worsening of their trade performance. If inflation in Britain is significantly above that of our major trading partners, for a given exchange rate, British exporters may struggle to maintain their share in overseas markets and import penetration will grow. Both could lead to a worsening balance of payments.

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Inflation and Interest Rates (important)
Rising inflation is associated with higher nominal interest rates because the independent Bank of England seeks to control inflationary pressure by raising base interest rates – this reduces economic growth through its impact on AD and can lead either to a slowdown or (worse) a full-blown recession.

Many answers will also mention the shoe-leather and menu costs arising from inflation (and perhaps the distortions that inflation can cause to the working of the price mechanism)

Evaluation:

Anticipated and unanticipated inflation
The costs of inflation on individuals and businesses depend in part on whether inflation is anticipated or unanticipated:

When inflation is volatile, it is difficult for individuals and businesses to correctly predict the rate of price inflation in the near future. Unanticipated inflation occurs when economic agents (people, businesses and governments) make errors in their inflation forecasts. Actual inflation may end up well below, or significantly above expectations. This impose extra costs on individuals (whose real incomes and savings may decline) and businesses (who misjudge the real return on capital investment projects and who find it difficult to predict what is likely to happen to their costs)

Short and Long Run Consequences
In part (a) it is good idea to differentiate between short run costs (i.e. higher interest rates and a fall in real wages from an unexpected rise in inflation) and longer term consequences (e.g. on the competitiveness of industries facing severe competition from overseas). High relative inflation can be quite damaging to the macroeconomic performance of a country over a number of years

Discuss how a government’s commitment to achieve stable prices is likely to affect the level of unemployment (30 marks)

Your answer might start with a definition of price stability. The Chairman of the US Federal Reserve, Alan Greenspan has defined price stability as follows:

CLAIMANT COUNT UNEMPLOYMENT AND RPIX INFLATION

Your answer might start with a definition of price stability. The Chairman of the US Federal Reserve, Alan Greenspan has defined price stability as follows:
“We will be at price stability when households and businesses need not factor expectations of changes in the average level of prices into their decisions”

“Price stability” implies that business and household decision-making should be able to proceed on the basis that “real” and “nominal” values are substantially the same over the planning horizon.

Steady inflation of 1-3% must come close to meeting the requirements. Britain has enjoyed low and stable inflation now for a decade. The objective of price stability has been met in recent years - the question posed in part (B) is whether a commitment to price stability might be at the expense of unemployment.

The key to answering the second part is

(a) Firstly to explain why inflation control might lead to rising unemployment (at least in the short run) - based on the concept of a short-run trade off between unemployment and inflation presupposed by the Phillips Curve

(b) To challenge the validity of this argument (as part of your evaluation) in effect to argue that there is no long run trade off between unemployment and inflation and that the experience of the British economy in the last decade shows that inflation control and rising unemployment can be achieved simultaneously if there is a sufficient improved performance from the labour market.

The Basic Phillips Curve Trade Off

The standard Phillips Curve suggests a short run trade-off between the rate of unemployment and wage inflation. A fall in unemployment may lead to acceleration in wage inflation as the labour market tightens. As unemployment falls, so the pool of surplus labour available to employers is diminishing and we see the emergence of labour shortages in some industries (particularly skilled workers) and an increase in the bargaining power of workers.

If wage and price inflation picks up, deflationary macroeconomic policies may be required to control excess demand and reduce the inflationary pressure from factor markets. Higher interest rates (a tightening of monetary policy) and/or an increase in the burden of taxation (fiscal squeeze) will reduce AD and cause an economic slowdown/recession. This will reduce the demand for labour and potentially lead to rising unemployment. (Much depends on whether workers are prepared to accept cuts in their real wages when inflation rises). So - a commitment to price stability might be at the expense of rising unemployment if the original Phillips Curve relationship holds.
Friedman and the Monetarists criticized the concept of the Phillips Curve and argued that the long run Phillips Curve was vertical at the natural (equilibrium) rate of unemployment. They argued that there was no long run trade-off between unemployment and inflation. Eventually unemployment returns to its natural rate - and that the main role of economic policy-makers was to improve the functioning of the labour market to reduce equilibrium unemployment (by measures designed to reduce structural and frictional unemployment) and thereby improve the rate of unemployment consistent with any given rate of inflation. Monetary policy should be used to control inflation and supply-side and fiscal policy measures should be used to improve incentives and mobility within the labour market.

In the diagram above, each short run Phillips Curve is drawn on the assumption of a given expected rate of inflation - if inflationary expectations increase, then the short run Phillips Curve shifts outwards.

**Evaluation:**

**What has happened in the last decade?**

- Inflation has remained low - comfortably within the target ranges set by successive governments since targets were introduced in October 1992
- Unemployment has fallen on a sustained basis since the summer of 1993 (claimant count unemployment fell to below one million in the autumn of 2001 and the labour force survey measure has declined to just over 1.5 million
- Employment in the British economy is now at a record high
- The growth of wages and average earnings has remained relatively stable - certainly well within the margin of tolerance set by the Bank of England when it deliberates over interest rates

<table>
<thead>
<tr>
<th>Year</th>
<th>RPIX Inflation % y-o-y</th>
<th>Claimant Unemployment Rate %</th>
<th>Average Earnings % y-o-y</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996</td>
<td>3.0</td>
<td>7.2</td>
<td>3.6</td>
</tr>
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</table>
1997 2.8 5.5 4.2  
1998 2.6 4.5 5.2  
1999 2.3 4.2 4.8  
2000 2.1 3.6 4.6  
2001 2.1 3.2 4.3  

The evidence is fairly clear - the Phillips curve for the British economy since the early 1990s has been essentially flat. There has been a definite improvement in the trade-off between unemployment and inflation. A commitment to price stability need not be at the expense of employment.

The Phillips curve has shifted inwards and there has also been a fall in the non-accelerating inflation rate of unemployment. The possible causes for this include:

(a) A more flexible labour market through policies such as the New Deal gateway, the restriction of unions power, which aim to increase the incentives to work and reduce labour market rigidities

(b) Increased female participation in the labour market and other trends that have encouraged a large rise in the available labour supply (thereby reducing the natural rate of unemployment)

(c) The use of inflation targets in monetary policy, with an independent Bank of England helping to deliver consistently low inflation rates and helping to reduce inflation expectations

(d) Lower rates of global inflation and increased competition in domestic markets. Lower than expected inflation has caused a fall in inflation expectations and therefore a downward shift in the Phillips Curve. Globalization may also have caused a fall in inflationary pressure - in part because of the increased competition and the ability to import goods and services more cheaply than before

(e) A reduction in structural unemployment because of the effects of active labour market policies to improve the employment prospects of the long-term unemployed

A great quote from Kaletsky

_The fact is that there is no direct relationship between inflation and unemployment or economic growth._

_Since 1993, the Phillips curve has been horizontal, not vertical. As a result, the theoretical underpinnings of central bank independence and inflation targeting have fallen away._

_If you want a sound and pragmatic growth-oriented monetary policy there is ultimately no intellectually honest alternative to the dual mandate accepted by the US Federal Reserve Board. The Fed is explicitly required by Congress to promote high levels of growth and employment, as well as to maintain low inflation. That is in practice what the Bank of England has been doing._

**Evaluation Continued**

**Benefits from low stable inflation**

If inflation is kept under control

- Planned capital investment is likely to be higher in the long run - boosting LRAS
- A country open to trade in goods and services will maintain its cost and price competitiveness (for a given exchange rate)
- Inflationary expectations will be lower - putting less upward pressure on labour costs and profits
- Long term interest rates can fall - providing a boost to corporate investment, housing and allowing increased government spending on public and merit goods
All of these factors should help to stimulate employment / reduce unemployment in the long term

**Demand management and the risk of deflation**

If a government is committed to price stability through tight control of aggregate demand, then there is a danger that actual GDP will remain below potential (i.e. a negative output gap) and this will mean that the demand for labour will be lower than it might otherwise be - with negative implications for employment.

An associated risk is that price stability may turn into outright price deflation - which as we have seen with Japan can lead to deep recessions and much higher unemployment

But.......

Unemployment and inflation can fall at the same time, providing that the economy continues to grow (i.e. there is sufficient aggregate demand) and the supply-side responds with an increase in real output.

Supply-side policies to improve the functioning of the labour market together with other exogenous factors have contributed to a clear improvement in the unemployment-inflation trade-off for Britain. The Phillips Curve is not dead - but it is certainly flat, and the rate of unemployment consistent with a given rate of inflation has certainly fallen (i.e. the NAIRU has declined)