

**Inflation**

Inflation occurs when there is a general rise in price levels. Inflation is potentially a very destabilising force. A small increase in prices can quickly escalate as people whose wages and other incomes have fallen behind try to catch up, leading to further increases in costs. That is why the government places such an important emphasis on controlling inflation. The principal means of doing this is through interest rates. When this Labour government came into power in 1997 one of the first things it did was to create the Monetary Policy Committee which works as part of the Bank of England. This committee is made up of officials from the Bank of England and independent experts who each month decide on an appropriate interest rate for the UK. The interest rate should be set at a level which deters inflation while stopping the economy from deflating rapidly.

Deflation involves a general slowdown or reduction in prices, which can have disastrous effects as employers cut their labour forces, and there is a general reduction in economic activity.

**Harmonised prices index**

The Monetary Policy Committee has the responsibility for setting an interest rate which is in line with enabling the government to achieve a targeted level of inflation each year. This inflation rate is calculated by what is termed the Harmonised Prices Index which is a common measure for measuring price inflation in the European Union.

Inflation is harmful to trade. Manufacturers generally sell goods on credit. When they seek repayment they find that the money they receive is less than they expected. They therefore become reluctant to trade.

Inflation can also lead to unemployment. Businesses faced by rising costs may be forced to cut back on production and on the number of employees. Comparative inflation rates are frequently used as an indicator of international competitiveness. If prices are rising faster in the UK than in Germany, France, the United States, Japan, Pacific Rim countries and other competing countries, then we will find it increasingly difficult to sell our goods abroad.

For example, suppose that a German bicycle and a British bicycle are the same price on international markets in 2000 but British domestic prices are rising faster than German ones. This may mean that in 2005 the German bicycle becomes cheaper than the UK one. Over a period of time this loss of competitiveness can be catastrophic.