INFLATION

Also by P. J. Curwen

**MANAGERIAL ECONOMICS
THE THEORY OF THE FIRM**

With A. H. Fowler

ECONOMIC POLICY

INFLATION

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Introduction

This book is concerned primarily with analysing the causes of, and cures for, inflation. The nature of advanced industrial economies is, however, such as to require considerable attention to be paid simultaneously to the other principal objectives of economic policy, namely the level of employment, the state of the balance of payments, and the rate of economic growth. One particular concern of this book must therefore be to explore the relationship between the rate of inflation and these three other objectives, with the greatest emphasis being placed upon the relationship between inflation and employment.

For a period of approximately two decades between the First and Second World Wars the overriding fact of economic life was an historically high level of unemployment, which proved largely impervious to the impact of control techniques which had their origins in the very different conditions of the late nineteenth century. Then in 1936 Keynes published *The General Theory* and seemingly demonstrated for all time that involuntary unemployment is an unnecessary evil which lies within the powers of any enlightened government to eradicate in its entirety.

At the time it seemed to most of those who read *The General Theory* that it contained precepts for the management of the economy which would ensure continued prosperity. The effects of sustained high levels of employment upon the price level were paid scant attention since the prevailing trend of prices during the 1930s was

downwards rather than the reverse, and there was little reason to foresee that the eradication of long-term unemployment would coincide with continued inflation. Certainly it was well known that the U.K. economy had previously undergone several protracted periods of inflation, but these had all been characterised by an increase in the money supply far in excess of the rate of productivity growth. Fiscal policy, on the other hand, was expected to function without a strong inflationary bias, and it must surely have seemed inconceivable to policy-makers during the 1930s that the economy would ever develop the alarming characteristic known popularly as 'stagflation' – the conjunction of a stagnant economy and accelerating inflation.

During the course of the Second World War the economy attained a state of full employment, and this was sustained during the early post-war years, somewhat to the surprise of the authorities who were anticipating the recurrence of industrial depression. This historically high level of employment was, however, accompanied by relatively mild inflation which resulted in periodic crises in the balance of payments. The stock response of the authorities in these circumstances was, first, to cut back on aggregate demand in order to ameliorate the payments imbalance, and subsequently to expand aggregate demand in order to mitigate the resultant increase in unemployment, a procedure which became known as the 'stop-go' cycle.

During the 1950s the first serious work began to appear on the problems generated by on-going inflation, with particular reference to the relationship between inflation and unemployment. As we shall go on to discover in detail in the main body of the text, the most lasting impact was made by the discovery of the 'Phillips Curve' which purported to show a stable inverse relationship between the rate of change of prices and the level of unemployment. This relationship was seized upon for policy purposes since it apparently put the authorities in the happy position of being able to predict how much inflation would be associated with any given level of employment. Furthermore, it indicated that inflation could be controlled by recourse to periodic sharp doses of unemployment.

But in 1966 the rate of inflation began to speed up appreciably, and when eventually the then Conservative Government decided that a heavy dose of unemployment could no longer be postponed, its imposition had no visible impact upon the inflation rate whatsoever.

Indeed inflation began to accelerate upwards even more swiftly, apparently quite independently of the level of employment.

That both inflation and employment could get worse simultaneously was indeed a new departure in the history of economics. Academics and economic advisers hurried back to their respective ivory towers and corridors of power to contemplate what had gone wrong and what could be done about it. Alternative, and often conflicting, versions of the inflationary process poured forth from all sides. Meanwhile things got steadily worse with price inflation reaching 20 per cent at the end of 1974. The imminent collapse of the U.K. economy was prophesied by economists and politicians of all leanings, some with infinite regret and some with little short of outright glee, but the economy struggled on into 1975. At the time of writing, early in 1975, the economy shows signs of acute schizophrenia. On the one hand, there are widespread bankruptcies, negligible industrial investment, the largest budget deficit in history and wage claims averaging well over 20 per cent while, on the other hand, the Stock Market is rising sharply, Building Societies are recording unparalleled inflows of savings, and exports are booming.

Now, more than ever, it is essential to clarify what inflation means, how it affects the distribution of income, what causes it, and how it can be cured. Unfortunately, as will become clear in the course of this book, the state of economic science is still far too primitive to give a cast-iron answer to the vital question of what causes inflation. Nor is there any consensus amongst those who claim to have some expertise in the area about the policies which the current crisis demands. Under the circumstances it is hardly surprising that the general public is extremely confused about the whole issue.

This book lays no claim to making an original contribution to the analysis of inflation. Instead it serves what the author believes to be a fundamentally important purpose, namely to chart a path through the morass of literature on inflation (by no means all of which is encompassed by this volume despite its sizeable bibliography) in order to render the main issues comprehensible to those who lack the necessary technical training in economics to read source material at first hand. Curiously, perhaps, no other attempt to do this has as yet been published so far as the author is aware. Certainly many articles have appeared in the newspapers and in, for example, bank journals, but these invariably have an axe to grind and, for

reasons of brevity, tend to treat as established fact many assertions of dubious validity. The author himself has no wish to lay claim to complete impartiality, but seeks to explore every point of view which currently has a widespread following, in the hope that the reader will at least be able to decide for himself on the basis of all known facts.

The bulk of the text consists of two main sections, the first of which considers the causes of inflation and the second of which considers the cures. The opening section of the book is, however, the most fundamental to the issue at hand. This contains the basic statistical data used in the book, an explanation of what precisely the term inflation means and how it is measured, and an analysis of why inflation needs to be controlled.

After completing this book the reader may well feel a sense of disappointment that there are no easy answers to the control of inflation, and that he cannot put the Chancellor of the Exchequer's constant policy switches down to sheer political cussedness. On the other hand, he may well feel pleased that the book confirms his prejudices about, for example, the inefficacy of prices-and-incomes policies. No matter, however, which school of thought the reader supports he will at the very least have the satisfaction of being armed with extensive ammunition with which to confound his opponents in debate, and that at least is some small reward for his labours in working his way through the pages which follow.

This book is intended primarily for all those who have completed a basic course in economics. Although parts of the book can be read without difficulty by the first-year student or, indeed, by the layman, the nature of the literature surveyed makes it necessary to raise many issues, especially in the theoretical sections, of a technically complex kind. It is hoped that final-year undergraduates and post-graduates will find this book of value as a basis for their detailed reading of source material. The book is fully referenced in order to assist both advanced students and lecturers with the otherwise time-consuming task of tracking down a widely diffused literature.

By way of conclusion I wish to thank my colleagues Nick Foster and David Holmes for their careful reviews of earlier drafts of this book, and also David Pearce of Leicester University and John Burton of Kingston Polytechnic for acting as referees. All remaining errors are, however, entirely my own responsibility.

P.J.C.