Evaluate the view that demand-side policies are more effective than supply-side policies in reducing the inflation rate in the UK.

Demand-side and supply-side policies are policies used by the government and the Bank of England in the UK to influence both aggregate demand (AD) and long-run aggregate supply (LRAS) to control the economy and achieve the main macroeconomic objectives. Demand-side policies include fiscal policy and monetary policy. Inflation is defined as the persistent rise in the general price level and the government sets the Bank of England a symmetric target of keeping CPI inflation at 2% +/- 1%. It will be argued in this essay that both types of policy can be effective but that in order to fully control the inflation rate in the UK a combination of policies should be used.

The first method of reducing inflation in the UK to be discussed is fiscal policy. Fiscal policy is the use of government spending, taxation and borrowing to influence AD. To reduce inflation, the government could implement a contractionary fiscal policy, increasing the tax rates and reducing government spending. For example, the government could increase direct tax rates (e.g. income tax and corporation tax). An increase in income tax would reduce disposable income for people and therefore reduce consumption in the economy. At the same time, a rise in corporation tax rates would lower the amount of profit firms have available to reinvest, thus lowering investment levels in the economy, assuming no change in access to alternative sources of finance. As consumption and investment are components of AD (AD = C + I + G + (X-M)), as consumption and investment fall AD will also fall, as shown in diagram below from AD1 to AD2.

The fall in AD will increase the level of spare capacity in the economy, reducing pressure on scarce resources and therefore on prices so that the general price level falls (P1 to P2) and thus causes a fall in the rate of inflation. However, although the rate of inflation would be lower, there may be a conflict with other macroeconomic objectives as the fall in consumption could lead to a rise in unemployment, as labour is a derived demand, which would in turn lower people’s standard of living. This could lead to a negative multiplier effect, causing even further decreases in AD, which could then cause the rate of inflation to fall below the target level. Getting the balance right in terms of the size of the initial contraction is challenging.

Monetary policy is the second demand-side policy that can be used to reduce the inflation rate in the UK. The base rate is set by the Monetary Policy Committee at the Bank of England and to reduce the inflation rate they would raise the base rate. If commercial banks passed on this increased rate to their customers, it would raise the cost of borrowing (dis-incentivising borrowing) and increase the reward for saving (incentivising saving). This would cause consumers to save more and spend less, thus reducing consumption, and reduce borrowing by firms, which would lower investment. Furthermore, there would be a greater inflow of hot money on the financial account of the BOP, which in turn reduces demand for the currency and causes an appreciation, ceteris paribus. So, demand for exports would likely fall as they become less price-competitive, and demand for imports would likely rise. Therefore, this would cause a reduction in AD and, as explained above, would reduce the inflation rate in the UK. However, there is a time lag involved with monetary policy, as it can take up to 2 years for a
change in the base rate to have an impact on the economy and so there would be no immediate
effect on the inflation rate in the UK when the interest rate at the Bank of England is first
increased. That said, many global interest rates are very low and so any change in the UK’s rate
could attract significant hot money as the returns elsewhere are low.

Supply-side policies can also be used to reduce the inflation rate, and arguably more effective
than demand-side policies in the longer term. Supply-side policies can include a range of policies,
requiring either government spending or are more ‘free-market’ in nature. One interventionist
policy could be the implementation of improved education and training policies by the
government. An increase in education and training (perhaps via equipping school-leavers with
better workplace skills, or supporting low-skilled workers to gain more qualifications, or
subsidising apprenticeships etc.) should provide the workforce with greater skills and
thus they would become more productive, lowering costs for firms and raising output
even from the same number of workers. This would increase efficiency for firms, enabling
them to produce more and would increase the productive capacity of the economy.
Therefore, the LRAS of the economy should increase, as shown in the diagram, from
LRAS₁ to LRAS₂. This causes the price level to fall from P₁ to P₂, thus reducing the inflationary
pressure in the UK, and helping low inflation to be maintained in the longer term. However,
there is an opportunity cost for the government (true of many interventionist supply-side
policies) meaning that resources may be diverted away from other crucial areas of the economy
that could potentially provide a faster and more effective increase in LRAS. The government may
need to raise tax rates, such as VAT, which would raise costs of production for firms and lead to
an increase in price levels via an upwards shift in SRAS. Therefore, this could cancel out the
reduction of the inflation rate from higher education and training levels.

Whether demand-side policies or supply-side policies are more effective in reducing the inflation
rate in the UK will depend on several factors. First, it will depend on the current state of the
economy. For example, the high inflation rate may be during a period of economic boom when
consumer and business confidence is high. Therefore, the demand-side policies will be less
effective as consumption and investment may not fall when contractionary demand-side policies
are implemented, and so supply-side policies may be more effective in this case. In addition, it
will depend on how anticipated the inflation is. Since both monetary policy and many supply-
side policies involve a time lag, if the inflation is caused by an unanticipated exogenous shock
the most responsive short-term solution may be to use fiscal policy, whilst implementing other
policies in the long-term to support this. Demand-side policies to control inflation could lead to
a fall in the rate of short-term economic growth and a rise in the rate of unemployment.
Therefore, these policies may cause an adverse effect on the economy if used for a prolonged
period of time so supply-side policies may be needed to keep inflation low in the long-run whilst
also promoting higher levels of economic growth and employment.

Overall, both demand-side and supply-side policies are effective in reducing the inflation in the
UK and, if used in tandem, can help to create price stability in a stable macroeconomic
environment where the other macroeconomic objectives can also be achieved.