INFLATION

Introduction

Inflation refers to an economic situation where the demand for goods and services in the economy is continuously increasing without corresponding increase in supply which pushes the general prices up.

The opposite of inflation is called **deflation**.

Inflation is measured by considering the Consumer Price Index (C.P.I) which involves comparison of prices of certain goods and services for two different periods.

In constructing the C.P.I;

- **i.** A basket of commodities is selected which includes selecting the generally consumed commodities by average consumers.
- **ii.** Choosing the base period which should be a period when the prices were fairly stable.
- **iii.** The price of commodities both in the current period (P_1) and base period (P_2)

Consumer Price Index (C.P.I)= $\frac{\text{Price of commodity in current year (P1)}}{\text{Price of commodity in the base year (P2)}} \times 100$

Types and causes of inflation

Inflation is classified in relation to its causes.

Demand pull inflation

This is a type of inflation caused by excessive demand for goods and services without a corresponding increase in production resulting into rise in prices.

Causes of demand pull inflation

- ✓ **Increase in population.;**Increased number of people in a family calls for increased demand of goods and services thus fueling demand-pull inflation.
- ✓ **Increase in government expenditure**;The government expenditure has the effect of making money available to people thus increasing the aggregate demand for goods and services.
- ✓ **A fall in the level of savings;** This increases the consumer expenditure on goods and services which brings pressure on the available goods and services thereby pulling up prices.
- ✓ **Effects of credit creation by the commercial banks;** When banks lend more money to the public, their purchasing power increases hence increasing demand which in turn leads to increase in the prices.

- ✓ **Consumers' expectation of future price increases**; When consumers expect the prices of goods and services to increase in the future, they will buy more in the present thus increasing the demand thus fueling demand-pull inflation.
- ✓ **General shortages of goods and services;** Any shortage in goods caused by factors such as; adverse climatic conditions, hoarding, smuggling, withdrawal of firms from the industry and decline in level of technology calls for scramble for the available goods thus increasing their demand and prices.

Cost push inflation

This is a type of inflation caused by increase in cost of factors of production which translates to increased prices of goods and services.

Causes of cost push inflation.

- ✓ **Increase in wages and salaries**; An increase in the wages and salaries may increase the cost of labour. The increased cost of labour may be reflected in the increased prices of commodities which in turn would cause **wage push inflation.**
- ✓ **Increase in cost of raw materials and other inputs;** This increases the cost of production thus increased prices.
- ✓ **Increase in indirect taxes;** This increases the cost of production and this causes firms to raise the prices of their product.
- ✓ Increase in profit margin; If the business decides to raise its profit, it leads to an increase in the price of the commodities resulting to **profit push inflation.**
- ✓ **Reduction in subsidies;** removal of a subsidy implies that the producer would produce at a higher cost that was being met by the subsidy. This increase cost is finally reflected in increased prices.

Imported inflation

This is a type of inflation which is caused by importation of high priced inputs of production such as; technology/machines, skilled human resources
and crude oil.

This in turn increases the prices of locally produced goods which may lead to inflation.

Causes of imported inflation

- ✓ Importation of expensive technology especially highly skilled labour.
- ✓ Importation of expensive machines and equipment.
- ✓ Importation of high priced oil.

- ✓ The currency depreciating thus increasing the price of the country's imports.

LEVELS OF INFLATION

i. Mild / Creeping/Moderate Inflation

This a slow rise in price level of not more than 5 % per annum. It is associated with some beneficial effects on an economy especially to firms and debtors.

ii. Galloping /Rapid Inflation

This is a very rapid accelerating inflation characterized by a situation whereby the general prices levels increase rapidly.

iii. Stagflation;

This is an economic condition in which unemployment is high, the economy is stagnant, but prices are rising.

iv. Hyper /Runway Inflation;

This is when prices are rising at double or triple digit rates of 20%, 100%, 200%.

The price levels are extremely high and under this situation people may lose confidence in the money as a medium of exchange and as a store of value.

Effects of inflation in an economy

Desirable effects of inflation

i. Mild inflation motivates people to work hard as they try to cope with the effects of the inflation in order to maintain their standards of living.

ii. Mild inflation encourages proper utilization of resources with an attempt of avoiding wastage as much as possible.

iii. Mild inflation increases investment especially in trading activities since sellers buy goods when prices are low and sell later when prices are higher.

iv. It promotes creativity in an economy in terms of production in order to survive the effects of inflation.

v. It benefits debtors since they obtain goods on credit and pay for them in future at the old low prices.

Negative effects

i. It leads to reduction in profits as sales volumes reduce since inflation reduces the purchasing power of consumers resulting to low sales.

ii. It wastes time as a lot of time is wasted in shopping around for reasonable prices and also firms may waste a lot of time adjusting their price lists to reflect new prices.
iii. It leads to conflicts between employers and employees as firms are pressurized by employees and trade unions to raise wages and salaries to cope with inflation.
iv. It leads to loss by creditors as they lend money when the value of money is high but at the time of payment is low since the value of money will have been eroded by inflation.
v. It leads to decline in standards of living as consumers' purchasing power decrease and therefore one can not lead the lifestyle he/she used to live before.
vi. Leads to unemployment.
vii. Discourages savings and investment since during inflation people tend to spend most of their earnings leaving little or nothing to save.
viii. Leads to retardation of economic growth.
ix. Worsens balance of payments position.

Control of Inflation

The govt. may adopt the following policies depending on their situation to reduce inflation to manageable levels. They include;

a) Monetary policy

This is a deliberate move by the govt. through the central bank to regulate and control the money supply in the economy which may lead to demand pull inflation. The policies include;

- Increase rate of interest of lending to the commercial banks. This forces them to increase the rate at which they are lending to their customers, to reduce the number of customers borrowing money, reducing the amount of money being added to the economy
- Selling of govt. securities in an open market operation (O.M.O). the selling of securities such as Bonds and Treasury bills mops money from the economy, reducing the amount of money being held by individuals
- Increasing the commercial banks cash/liquidity ratio. This reduces their ability to lend and release more money into the economy, reducing their customer's purchasing power
- Increasing the compulsory deposits by the commercial banks with the central banks. This reduces their lending power to their customers, which makes their customers to receive only little amount from them, reducing the amount of money in the economy
- Putting in place the selective credit control measures. The central bank may instruct the commercial bank to only lend money to a given sector of the economy which needs it most, to reduce the amount of money reaching the economy
- Directives from the central banks to the commercial banks to increase their interest on the money being borrowed, to reduce their lending rates
- Request by the central bank to the commercial banks (the moral persuasion) to exercise control on their lending rates to help them curb inflation.

b) Fiscal policy

These are the measures taken by the govt. to influence the level of demand in the economy especially through taxation process controlling government expenditure. They include;

- Reducing govt. spending. This reduces the amount of money reaching the consumers, which is likely to increase their purchasing powers, leading to inflation
- Increasing income taxes. This reduces the level of the consumers disposable income and lowering their spending levels, reducing the inflation
- Reducing taxes on production. This reduces the cost of production, lowering the prices of goods reaching the market
- Subsidizing the production. This reduces the cost of production in the economy, which in turn passes over the benefits to the consumers inform of reduced prices.
- Producing commodities that are in short supply. This increases their availability to meet their existing demand in the market, controlling demand pull inflation

c) Statutory measures

These are laws made by the govt. to help in controlling the inflation. They include;

- Controlling wages and salaries. This reduces the pressure put on the employers to meet high cost of labour for their production which in turn is just likely to lead to cost push inflation. It also minimizes the amount reaching the consumers as their income, to control their purchasing power and the level of demand, controlling the demand pull inflation
- Price controls. This reduces the manufactures ability to fix their prices beyond a given level which may cause inflation due to their desire to receive high profits.

- Restricting imports. This reduces the chances of high prices of imported goods impacting on the prices of the goods in the country (imported inflation) and making the manufactures to look for alternative source of raw materials for their production

- Restricting the terms of hire purchase and credit terms of sales. This reduces the level of demand for those particular commodities in the economy which if not controlled may lead to demand pull inflation

- Controlling exports. This ensures that the goods available in the local market are adequate for their normal demand. Shortage of supply of goods in the market is likely to bring about the demand pull inflation.

Revision Question

Outline measures that the government may employ to control the following types of inflation;

- Demand pull inflation
- Cost push inflation

- **Cost push inflation**
  - By controlling the wages and salaries in the economy
  - Restricting import on raw materials
  - Reducing taxes on production
  - Subsidizing the production
  - Employing the price control techniques

- **Demand pull inflation**
  - Increasing the rate of interest of lending to the commercial banks
  - Selling govt. securities on O.M.O
  - Increasing the commercial banks cash/liquidity ratio
  - Increasing the compulsory deposits from the commercial banks to the central bank
  - Putting in place the selective credit control measure
  - Directives to the commercial banks
  - Request to the commercial banks
  - Reducing govt. expenditure
  - Increasing income taxes
  - Producing commodities that are short in supply
  - Restricting terms of hire purchase and credit terms of sale
  - Controlling export

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