INSTRUCTIONS

Please copy these notes after the Labour Economics notes in the second Economics book.

INFLATION:

Inflation is the **persistent i**ncrease in the **general price level** of goods and services in an economy in **a given period of time**.

OTHER CONCEPTS RELATED TO INFLATION:

DEFLATION; This refers to **persistent decline/fall** in the general price level of goods and services in the economy due to fall in aggregate demand in an economy.

Measures that can be taken to control /check a deflationary gap:

- Use expansionary monetary policy
- Increase government expenditure
- Reduce direct taxes/reduce taxes on incomes
- Provide subsidies to consumers
- Increase wages of workers.
- Encourage exports

REFLATION: This refers to a deliberate government policy which is undertaken to force prices upwards in order to help an economy to recover from an economic depression.

Instruments of a reflationary policy in an economy include the following:

- Reduce direct taxes/ reduce taxes on incomes.
- Increase in government expenditure through subsidisation
- Encourage exports
- Use expansionary monetary policy e.g. through lowering the bank rate, buying back government securities.
- Increase the level of wages of the workers.
- Subsidise consumers

DIS-INFLATION: This refers to policies undertaken by the government to control inflation rates in the country.

SUPPRESED INFLATION: This is a situation where demand exceeds supply but the effect of this on prices is minimised by use of price controls and rationing of goods.

HEADLINE INFLATION; This measures changes in the price levels of all goods in a given country over time.

UNDERLYING INFLATION: This measures changes in the price levels of goods excluding the value of foodstuffs in a given country over a given period of time.

STAGFLATION; This is a situation in an economy in which high **rates** of inflation co-exists with **high rate** of unemployment

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TYPES OF INFLATION ACCORDING TO THE DEGREE OF CHANGE IN PRICES/ STATE OF INFLATION:

NB: State of inflation is the speed at which the general price level is changing.

OR: State of inflation is the rate/speed/ degree of intensity at which prices increase in an economy over time.
The state of inflation is categorized into two;

1. **Mild /Creeping/Gradual inflation;** This is a type of inflation whereby the persistent increase in the general price level proceeds at a **slow rate** below 10%.

2. **Hyper /Run-away/Galloping inflation;** This is a type of inflation where the general price level increases at a **very high rate**, which exceeds 10%.

3. **Walking** inflation. This is a type of inflation where the general price level increases at a rate between 3% and 4% per annum.

CLASSIFICATION OF INFLATION ACCORDING TO CAUSES (THEORIES OF INFLATION)

1. **DEMAND-PULL INFLATION;** This refers to persistent increase in the general price level that arises due to excess aggregate demand over aggregate supply.

Causes of demand-pull inflation in Uganda

- Excessive issuance of currency by central bank which is not followed by increase in the level of output.
- Excessive recurrent government expenditure on non-productive activities/ventures leading to increased money supply.
- Excessive inflows of incomes from abroad in the form remittances by nationals living abroad.
- Excessive exportation of essential goods/Increasing demand for our exports.
- Excessive /Uncontrolled credit creation by commercial banks.

SOLUTIONS TO DEMAND-PULL INFLATION:

- Control wages and incomes of the people (wage freeze).
- Reduce government expenditure especially on non-productive ventures
- Import goods from cheaper sources to supplement domestic output
- Discourage exportation of scarce goods to avoid shortages.
- Increase direct taxes in order to reduce people's incomes.
- Apply restrictive monetary policy

2. **COST-PUSH INFLATION;** This refers to persistent increase in the general price level that arises out of increase in the costs production**.**

Cause of cost push inflation in an economy;

- **Increasing/rising** costs of raw materials
- **Increasing/rising** wages/salaries
- **Increasing/rising** cost of transportation for raw materials and the goods
- **Increasing/rising** level of taxes on goods
- **Increasing/Rising** rate of interest on loans
- **Increasing/rising** costs of advertising

WAYS OF CONTROLING COST PUSH INFLATION IN AN ECONOMY:

- Provide subsidies to the producers/Reduce taxes charged on producers
- Adopt wage control measures to avoid unnecessary increase in wages
- Control interest rate in order to reduce the cost of borrowing.
- Adopt price control measures by fixing maximum prices

3. **Price-Wage inflation.** This occurs when an increase in prices of commodities induces workers to demand for higher wages which increases the costs of production and this leads to continuous rise of prices all commodities.

NB: Price-wage inflation is also known as an inflationary spiral;

4. **Wage- price inflation.** This occurs when the workers through their trade unions demand for higher wages causing increased costs of production which forces employers to increase prices for their products in order to maintain their profit margin.

5. **The wage –wage inflation.** This occurs due to inter-sector or inter-industry comparison of wages by workers i.e. if workers in the similar type of employment are paid higher wages. This makes their counterparts to demand for an increase in their wages leading to increased production costs and higher prices for the good and services.

6. **Profit Push inflation.** This occurs due to too much desire for higher profits by producers/traders which makes them put less output on the market hence forcing prices of goods and services to increase.

7. **Structural /Bottleneck / Scarcity inflation; T**his refers to persistent increase in the general price level /average price level due to supply rigidities and structural bottlenecks in the sectors of the economy leading to a decline in the supply of essential goods**.**

OR: It is the type of inflation caused by supply rigidities and structural bottlenecks.

Causes of structural inflation:

- Infrastructural break down
- Political instability/political turmoil
- Natural hazards e.g. floods, drought which reduces agricultural output
- Scarcity of inputs/scarcity of raw materials/limited raw materials
- Foreign exchange shortages

Ways of controlling structural inflation:

- Maintain political stability in the country
- Rehabilitate infrastructure
- Undertake modernisation of agriculture

8. **Imported inflation;** This is the persistent increase in the general price level arising from the importation of commodities from countries that are experiencing inflation.

9. **Monetary inflation;** This is the type of inflation caused by excessive increase in money supply in the economy.
10. **SECTORAL INFLATION**; This refers to the rise in prices occurring in different commercial sectors of the country.

11. **Pricing power inflation/administered price inflation / oligopolistic inflation.** This type of inflation occurs when business entities and industries decide to increase the prices of their respective goods and services to increase their profit margins.

GENERAL CAUSES OF INFLATION IN DEVELOPING COUNTRIES:

1. **Excessive issuance of currency**; This increases money in circulation increasing aggregate demand forcing prices to rise.
2. **Excessive/Uncontrolled credit creation by commercial banks**; This increases money in circulation increasing aggregate demand forcing prices to rise.
3. **Excessive borrowing of money from the central bank by the government;** This increases money in circulation increasing aggregate demand forcing prices to rise.
4. **Excessive/ Increasing inflow of incomes from abroad;** This increases money in circulation increasing aggregate demand forcing prices to rise.
5. **Excessive government expenditure**. This increases money in circulation increasing aggregate demand forcing prices to rise.
6. **Poor political atmosphere/climate**. This destroys productive infrastructure and scares away investors due to fear of loss of lives and property, which limits production forcing prices to rise.
7. **Unfavourable natural factors/natural**. These destroy crops and animals which reduces agricultural produce forcing prices to rise.
8. **Break-down of infrastructures.** This limits distribution of goods to areas of scarcity causing shortages forcing prices to rise.
9. **Excessive exportation of essential goods/ increased demand for exports.** This causes shortage of essential economy forcing. prices to rise.
10. **Speculation by traders and consumers**. People anticipate that there is likely to be shortage of goods which makes the traders to hoard such goods forcing prices to rise.
11. **Greed for higher profits by traders.** They deliberately increase prices of their goods in order to increase the profit levels.
12. **Importation from countries experiencing inflation.** This forces importers/traders to increase prices of such goods in the importing country in order to cover the high costs of importation
13. **Rising production costs**. The producers are compelled to increase the prices of goods in order to cover the rising cost of production.
14. **Depreciation of the local currency.** This makes importation expensive which forces the importers to increase prices of imported goods.

MEASURES THAT CAN BE TAKEN TO REDUCE INFLATION IN AN ECONOMY

1. **Reduce government expenditure on provision of non-essential goods.** This will reduce money supply which will reduce aggregate demand thus force prices to fall
2. **Control issuance of currency**. This will reduce money supply which will reduce aggregate demand thus force prices to reduce. This will reduce money supply which will reduce aggregate demand thus force prices to fall
3. **Use contractionary / restrictive monetary policy**; This will reduce money supply which will reduce aggregate demand thus force prices to fall

4. **Reduce government borrowing from the central bank**. This will reduce money supply which will reduce aggregate demand thus force prices to fall
5. **Improve/Develop infrastructural facilities**. This will ease distribution of goods to areas of scarcity and minimise shortages thus force prices to fall.
6. **Further liberalisation of economy**. This will remove unnecessary restrictions on economic activities which will increase supply of goods and thus force prices to fall.
7. **Further privatisation of state enterprises**. This will increase efficiency in the management of such privatised enterprise which will lead to increased production and supply of goods and thus force prices to fall.
8. **Improve political climate /Atmosphere**. This will promote investment since investors will not be scared of losing their lives and property which lead to increased production of goods and services and thus force prices to fall.
9. **Modernise agriculture**. This will ensure continuous production due to use of irrigation farming which will stabilise supply of goods and thus force prices to fall.
10. **Provide investment/tax incentives to the investors**. This will reduce the cost of production and attract more investors to increase production and supply of goods which will force prices to fall.
11. **Encourage importation from cheaper sources**. This will minimise bringing in goods from countries experiencing inflation.
12. **Encourage establishment of import substitution industries**. This will increase domestic production of goods which minimise importation of goods from countries experiencing inflation.
13. **Control the exportation of essential goods/certain goods.** This will ensure large domestic supply of such essential goods and thus force prices to drop.
14. **Increase direct taxes on incomes of the people**. This reduce will their disposable income and purchasing power which will force prices to fall

EFFECTS /IMPACT/CONSEQUENCES/OUTCOMES OF INFLATION IN AN ECONOMY

POSITIVE EFFECTS OF INFLATION/ EFFECTS OF MILD INFLATION IN AN ECONOMY.

1. **It encourages/stimulates effort and hard work**. People are compelled to work hard in order to earn income and cope with rising cost of living.
2. **It is an incentive for investment and production**. Inflation increases profit levels which attracts investors to join and benefits from the higher profits.
3. **Producers increase output/promotes economic growth.** Many producers are tempted to increase output in order to increase the profit levels.
4. **Lead to creation of More employment opportunities.** The higher levels of profits encourage producer to expand the level of production which leads to creation of more jobs.
5. **It widens the tax base.** The government taxes the increasing profits and incomes of individuals.
6. **It encourages/Increases resources utilisation.** This is because of increased investment which necessitates use of more raw materials.
7. **It encourages innovativeness and creativity among the people/Stimulates entrepreneurship.** The rising profit levels encourages many people to venture in many economic activities.

8. **The borrowers/debtors gain in real terms**. This is because they pay back in a currency which has lost value.

9. **It promotes commercialisation/ monetisation of the economy**. This is so because producers are attracted to produce more and put on market to earn more profit.

10. **It encourages labour mobility**. People move to more paying jobs in order to cope with the rising cost of living.
11. **It increases levels of output/ promoting economic growth**. This is because producers increase output so as to gain from the high profits resulting the slowly rising prices.
12. **It promotes forced savings**. This is because consumers' certain commodities too expensive and they halt purchases so enables them to keep their money as they wait for the prices to reduce**.**

NEGATIVE EFFECTS OF INFLATION/ EFFECTS OF HYPER INFLATION IN AN ECONOMY

1. **It discourages savings.** This is because people spend most of the money on consumption and they remain with little or nothing for saving.
2. **It leads to loss of confidence in the country's currency**. This is because the currency loses value very fast and people discard it in preference to foreign currency
3. **It worsens the balance of payment problem/ deficit.** This is because it makes the country's exports expensive and discourages buyers of exports which leads to a fall in foreign exchange earnings**.**

4. **It leads to industrial unrest/strikes.** This is because the workers constantly demand for an increase in wages to cope with the rising cost of living and yet the employers are reluctant to increase.
5. **It worsens income and wealth inequalities/Worsens income inequalities.** Producers earn more profits from the increasing prices and become richer while consumers buy goods expensively and become poorer.
6. **It discourages investment.** This is because inputs become very expensive which discourages investors due to reduced profits.
7. **It leads to unemployment.** Some firms collapse due to the high cost of production and people lose jobs.
8. **It makes the government unpopular**. The public blames the government for not doing enough to stop the rising prices which them suffer.

9. **It leads to production of poor quality goods**. In an attempt by the producers to cut the costs of production some ingredients in the production of certain products are left out, this leads to production of poor quality products.

10. **It makes planning difficult/distorts planning.** This is because the cost of doing business keeps on rising which compels people to redraw production plan or even abandon production plans.
11. **The fixed income earners lose/suffer greatly as real income reduces.** This is because as prices rise the purchasing power of their incomes reduces making it hard for them to acquire certain commodities.

12. **Discourages lending / Creditors lose.** This is because they receive back less in real terms because of the continued loss of the money value
13. **It encourages/ promotes malpractices/illegal activities.** People resort to illegal ways of earning to cope the rising cost of living.
14. **Strain the public.** This is because people work very hard to increase incomes in order to cope with the rising cost of living**.**
15. **It leads to brain drain**. Highly trained people migrate to other countries to seek employment as well as a better standard of living.