STANDARD HIGH SCHOOL ZZANA

S.6 ECONOMICS NOTES

Instructions . Read and write these notes please

INFLATION

This refers to the persistent increase in the general/ average price level of goods and services over a given period of time.

Inflationary rate

This refers to the percentage increase in the general price level.

MEASUREMENT OF INFLATION

The following are the methods used to calculate inflation.

1. **Use of price index.**

   Under this method, inflation rate is calculated as follows;

$$\frac{Pt - Pt - 1}{Pt - 1} \times 100$$

   Where Pt is the price of the current year

   Pt-1 is the price of the previous year

2. **Use of GDP deflator**

   Under this method, inflation rate is calculated as follows

$$\frac{GDP\ of\ current\ year}{GDP\ of\ base\ year} \times 100$$

   OR

$$\frac{Nominal\ GDP}{Real\ GDP} \times 100$$

STATE OF INFLATION

This is the speed at which the general price level is increasing in the economy and its categorized according to different types of inflation and includes the following;

1. **Creeping/ mild inflation**

   This refers to an increase in the general/ average price level at a slow rate usually less than 10% per annum. This state of inflation is desirable.

2. **Moderate/ running inflation**

   This is one whereby the persistent increase in the general price level proceeds at a high rate usually above 10% per annum. Such inflation adversely/ negatively affects the poor and the middle class groups hence it requires strong monetary and fiscal policies or else it leads to hyper inflation.

3. **Hyper/ galloping/ runaway inflation**

   This refers to inflation where the general price level increases at a very high rate, the increase taking place within hours, days or weeks and the percentage point increase per annum is over 20%.

THEORIES OF INFLATION

There are many theories of inflation and these include;

Cost push inflation

Demand pull inflation

Structural inflation

Imported inflation

Monetarist inflation

Speculative inflation

Wage –wage inflation

Wage –price inflation

Price –wage inflation

COST PUSH INFLATION

This refers to a persistent increase in the general/ average price level due to rising cost of production.

Causes of cost push inflation

Rising costs of raw materials

___Rising wages and salaries

___Rising costs of energy/ fuel

___Rising rates of rent

___Rising costs of borrowing

___Rising rates of indirect taxes

___Rising transport costs

___Rising costs of improving working conditions due to trade union pressure.

<u>Solutions to cost push inflation</u>

Reduce bank rate/ lending rates by the central bank.

___Improving infrastructures like roads to reduce on transport costs

___Reducing indirect taxes

___Offering subsidies to producers to reduce the cost of production.

___Wage control measures/ controlled trade union influence

DEMAND PULL INFLATION

This refers to a persistent increase in the general/ average price level due to aggregate demand being greater than aggregate supply at full employment situation of national income/ resources.

<u>Causes of demand pull inflation</u>

Increase in wage levels hence increased purchasing power

___Increase in population size

___Excessive issuance of currency which increases aggregate demand in the economy without corresponding increase in output.

___Reduced importation of essential goods that are highly demanded in the local market.

___Excessive exportation o f essential goods which reduces domestic supply.

___Excessive government supply.

___Natural factors/ industrial unrests/ breakdowns which lead to a fall in production levels.

___Excessive inflows of income from abroad.

___Uncontrolled creation of credit by commercial banks.

___Reduced direct taxation which increases purchasing power of the people.

<u>Measures to reduce demand pull inflation</u>

Reduce government expenditure especially on provision of non-essential products.

- Increase direct taxes to reduce disposable income.
- Control export of essential goods.
- Encourage importation of essential goods that are highly demanded in the local market especially from cheaper sources.
- Undertake restrictive monetary policy to reduce the amount of money in circulation e.g. increase the bank rate.
- Wage control measures/ controlled trade union influence
- Control population growth rates.

STRUCTURAL INFLATION

This refers to a persistent increase in the general 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

Is one caused by supply rigidities in the economy.

Causes of bottleneck inflation

Breakdown of infrastructures such as bridges, roads causing difficulty in transporting commodities form areas of plenty to areas of scarcity.

Natural calamities/ hazards such as floods, droughts, etc causing drastic reduction in supply of agricultural commodities.

Political instabilities. These discourage productive activities causing shortage of goods and services leading to increase in prices.

Scarcity/ exhaustion of raw-materials/ inputs.

Breakdown of major industries hence causing shortage of goods in the economy leading to increase in prices.

Shortage of foreign exchange.

Speculation by businessmen.

Hoarding of goods by traders.

Solutions to structural inflation

Improve infrastructures e.g. roads

Improve political climate

Agricultural modernization to reduce dependence on nature e.g. undertaking irrigation to overcome the problems of natural calamities like drought.

Importation of raw-materials/ inputs from other countries hence ensuring continued production thereby overcoming problems of scarcity of goods.

Encourage private, local and foreign investors/ further liberalization of the economy.

Rehabilitation and establishment of industries.

Diversification of production.

IMPORTED INFLATION

Is one where the persistent increase in the general price level is as a result of a country importing from another country prone to inflation/ experiencing inflation leading to price increment in the domestic economy.

Possible solutions

Encourage importation from cheaper and friendly sources.

___Reducing on import tariffs and subsidizing importers of essential goods.

___Undertake import substitution industrial strategy to produce goods that were formerly imported.

MONETARIST INFLATION

This is one whereby persistent increase in the general price level is due to excessive money supply in the economy without corresponding increase in the value of output.

SPECULATIVE INFLATION

This is one which arises due to anticipation of future increase in prices that eventually leads to increase in demand forcing the producers to increase prices of goods and services.

WAGE –WAGE INFLATION

This occurs due to inter-sectoral comparisons among workers whereby workers with the same type of employment demand for a high wage when workers in similar occupations are also earning a high wage elsewhere forcing the employers to increase prices so as to effect those wages.

WAGE PRICE INFLATION

This is one where workers demand for increased pay without corresponding increase in output forcing employers to increase prices of final goods in order to increase workers 'wages and also maintain their profit margins.

PRICE WAGE INFLATION (INFLATIONARY SPIRAL)

This is one that arises due to continuous increase in prices which increases the cost of living forcing workers to continuously demand for higher wages forcing the employers to increase prices of goods and services so as to increase wages for the workers

OR

This is a situation where the increase in the price level in the economy forces the workers to demand for higher wages leading to increase in the cost of production and thus firms (producers) are forced to increase prices of goods and services which again forces workers to demand for higher wages.

GENERAL CAUSES OF INFLATION

1. **Breakdown of infrastructures.** Infrastructures such as roads, bridges and railways are ever breaking down making it very expensive and difficult to transport raw-materials to production centres and finished goods to markets. This results into low levels of production causing shortage of commodities in the economy leading to inflation.
2. **Excessive/ uncontrolled credit creation by commercial banks.** Commercial banks in the country are lending money to willing borrowers excessively so as to earn more profits by charging interest on them and this is putting too much money in circulation causing excessive aggregate demand over aggregate supply leading to inflation.
3. **Excessive issuance of currency by the central bank.** The central bank is excessively issuing a lot of currency without corresponding increase in the level of output being produced in the country thereby causing excessive aggregate demand over aggregate supply causing demand pull inflation.
4. **Excessive inflow of funds from abroad.** LDCSs are receiving a lot of income from abroad in form of donations, grants, loans, income of nationals abroad and income from the country 's investments abroad. This results into excessive money supply in the economy causing excessive aggregate demand leading to demand pull inflation.

5. **Excessive government expenditure.** Government is spending excessively on issues like elections, infrastructure, wages, compensations etc thereby leading to excessive money supply in the economy leading to excessive aggregate demand over aggregate supply causing inflation.
6. **Excessive exportation of essential goods.** Excessive exportation of essential goods such as sugar and other food stuffs to neighbouring countries like Kenya, Rwanda and southern Sudan leads to shortage of goods in the domestic economy yet their demand is high hence leading to inflation.
7. **Decline in the value of the local currency relative to other currencies.** The value of the local currency has been persistently falling in relation to foreign currencies therefore importation of raw-materials and other essential commodities becomes very expensive leading to price increase in the domestic economy.
8. **Rising costs of production e.g. rising wages, interest rates, fuel prices, etc.** These costs force the producers to increase the prices of final goods and services in order to cover such costs and at the same time maintain their profit margins hence leading to cost push inflation.
9. **Importation of goods from countries experiencing inflation.** LDCs over rely on imports but some of these imports are bought from countries that are prone to inflation and therefore they are sold in the domestic market at high prices thereby causing imported inflation.
10. **Greed for profits by traders.** Some traders want to obtain a lot of profits therefore cause artificial shortages of goods by hoarding them so as to increase prices hence causing inflation in the economy.
11. **Speculation by traders and consumers.** As consumers anticipate future price increases, they increase their demand for the available goods on the market whose price is expected to increase. Such increase in demand forces the producers to increase prices of goods and services causing inflation.
12. **Natural hazards/ calamities such as drought, landslides, floods.** These lead to drastic fall in supply from agricultural sector yet demand for such commodities is increasing pushing prices upwards.
13. **Political instability/ unfavourable political climate in some parts of the country.** This leads to destruction of productive infrastructure leading to low levels of output in the economy in relation to demand hence causing inflation.

NOTE

Emphasis on explanations should address issues/ factors that lead to scarcity of goods relative to their demand forcing prices upwards.

OR

Factors that put too much money in circulation leading to excessive aggregate demand without corresponding increase in output pushing prices upwards.

ASSIGNMENT

To what extent is inflation in developing countries caused by rising costs of production?

SOLUTION

To a minor extent, inflation in developing countries is caused by rising costs of production such as;

- Rising costs of raw materials
- Rising wages and salaries
- Rising costs of energy/ fuel
- Rising rates of rent
- Rising costs of borrowing
- Rising rates of indirect taxes
- Rising transport costs
- Rising costs of improving working conditions due to trade union pressure.

To a larger extent, inflation in developing countries is caused by other factors other than rising costs of production as explained below;

- Breakdown of infrastructures.
- Excessive/ uncontrolled credit creation by commercial banks.
- Excessive issuance of currency by the central bank
- Excessive inflow of funds from abroad.
- Excessive government expenditure.
- Excessive exportation of essential goods.
- Decline in the value of the local currency relative to other currencies

- Importation of goods from countries experiencing inflation
- Greed for profits by traders
- Speculation by traders and consumers.
- Natural hazards/ calamities such as drought, landslides, floods.
- Political instability/ unfavourable political climate in some parts of the country.

EFFECTS OF INFLATION ON AN ECONOMY

POSITIVE EFFECTS

1. **Mild inflation helps the economy to recover from a recession/ depression.** This is because the increasing prices being experienced in the economy promote more investments and lead to increase in the supply of goods due to increased profits thereby pulling the economy out of a recession.
2. **It stimulates peoples 'effort.** This is because they have to work harder to meet the rising cost of living as prices of goods and services increase thereby helping the country to increase its productive capacity.
3. **Increased prices stimulate investments** since they increase the profits of the producers and such investments lead to increased production (output) leading to high economic growth rate.
4. **Employment opportunities may be generated.** This is due to the fact that as prices increase, entrepreneurs are encouraged to work harder and increase their scale of production which necessitates employment of more workers.
5. **It may encourage adoption of import substitution strategy.** Imported inflation encourages the country to adopt import substitution industrialization strategy so as to produce internally formerly imported industrial goods as a way of reducing importation of highly priced industrial goods hence leading to increased industrial development in the economy.
6. **Government revenue increases.** This is mainly through increasing direct taxes on incomes of the rich so as to reduce their purchasing power. The revenue collected through taxation is used to meet government expenditure needs.
7. **It encourages forced savings.** This is because the funds that would have been spent are saved to be used later on when the inflation rates are low because as prices increase, the purchasing power of money reduces.

8. **It encourages innovativeness and creativity in the economy.** This is arises due to the need for producers to obtain higher profits and survive the hard times when inflation rates are high. Producers increase research and improve their production techniques so as to continue surviving in business leading to improved quality and quantity of output produced in the economy.
9. **Borrowers/ debtors stand to gain.** This is because they borrow money when its purchasing is high due to low prices of goods but pay back or return the money when inflationary rates are high implying that by the time they pay back this money, its purchasing power is low.
10. **It encourages labour mobility.** As prices persistently increase, it forces labour especially skilled labour to move to different areas hence being able to utilize such skilled labour for production hence promoting growth of such areas.

NEGATIVE EFFECTS

1. **Discourages local and foreign investors** due to persistent increase in the production costs and also increased prices of goods and services leads to reduced demand for goods and services making producers to make losses.
2. **Worsens BOP position.** This is because of the heavy expenditure required by the country to import goods to supplement domestic output hence worsening the country's BOP position.
3. **It leads to loss of confidence in the country's currency.** This is because as prices persistently increase, the value of money falls continuously making people not to trust the country's currency as a medium of exchange.
4. **Leads to uneven distribution of income.** High rates of inflation negatively affect the poor and middle class groups as compared to the high income earners hence leading to income inequalities.
5. **It makes planning difficult.** Planning on the side of producers, government and consumers becomes very difficult since prices are not stable therefore being unable to know how much to save and how much to spend.
6. **Leads to industrial unrests especially strikes.** This is because workers continuously demand for higher wages to meet the rising cost of living and this disrupts the production process leading to less output being produced by the industries.

7. **Leads to brain drain.** Inflation makes the economy and the country's highly skilled manpower to move to other countries where there is economic stability and better paying opportunities leaving the country with limited supply of skilled manpower hence retarding economic growth and development.
8. **People are strained** because they have to work extremely hard, forego leisure and work under poor working conditions in an attempt to cope with the rising cost of living.
9. **Government becomes unpopular.** This is because the population blames the government for their suffering due to its failure to curb inflation resulting into demonstrations, riots and sometimes political instabilities.
10. **Lending is discouraged as creditors stand to lose.** This is because whenever prices increase, the value of money declines therefore lenders receive back their money with a low purchasing power than when they lent it out before the price increase.
11. **Leads to production and consumption of poor quality goods.** This is because production becomes less affordable due to high costs involved.
12. **It encourages illegal activities such as corruption, smuggling** which makes the government to lose a lot of revenue that would otherwise be realized through taxation.
13. **Discourages savings.** This is because the funds that would have been saved are used to purchase goods and services at higher prices thereby limiting the level of capital accumulation in the country.
14. **Leads to collapse of some firms.** High costs of production incurred by firms during periods of high inflation rates such as high costs of raw-materials , fuel, rent force some firms to close down leading to reduced output and retarded economic growth.
15. **Leads to unemployment.** This is because some firms are forced to close down as production costs increase and others substitute labour with machines to increase on resource exploitation and also cut down the costs of supporting existing labour.
16. **Fixed income earners suffer.** This is because as prices increase, the purchasing power of these people reduces since their income remains the same yet the cost of living is rising. This lowers their standards of living.

ASSIGNMENT

Why does government control inflation in your country?

NOTE

A student should be well versed with negative effects of inflation if they are to attempt this question.

Answers should address the intention/ objectives.

SOLUTION

- To attract local and foreign investors
- To reduce capital outflow
- To avoid loss of confidence in the country's currency.
- To reduce uneven distribution of income.
- To ease planning
- To reduce industrial unrests arising due to demand for higher wages
- To reduce brain drain
- In order to avoid straining the people which arises as the cost of living rises.
- To make government more popular
- To encourage lending by creditors
- To discourage production and consumption of poor quality goods/ to promote production of better quality products
- To avoid/ overcome illegal activities such as corruption, smuggling arising out of hyper inflation.
- To encourage savings
- To encourage resource exploitation/ to accelerate economic growth.

MEASURES THAT SHOULD BE TAKEN TO CONTROL INFLATION IN LDCs/ UGANDA

1. **Reduce government expenditure especially on provision of non essential goods.** This helps to reduce the amount of money in circulation thereby reducing aggregate demand in the economy leading to a fall in prices of goods and services.
2. **Further liberalize the economy.** Liberalization of the economy involves removing unnecessary restrictions on economic activities hence giving people liberty to carry out economy activities without unnecessary government interference. This increases the level of output in the economy and competition among producers and traders leading to a fall in prices of goods and services.

3. **Improve the investment climate.** This is achieved through providing tax holidays, free land for investment, subsidies to reduce production costs and attract more investors which help to increase output in the economy hence leading to a decline in the prices of goods and services.
4. **Development of infrastructure such as roads, bridges, railways.** These infrastructures facilitate fast and cheap movement of raw materials to production centres and finished products to markets thereby leading to increased production/ supply of goods and services hence controlling structural inflation.
5. **Undertaking a contractionary/ restrictive monetary policy for example increased bank rate, sale of government securities.** Such a policy reduces the capacity of commercial banks to create credit thereby reducing the amount of money in circulation hence controlling aggregate demand leading to a decline in prices of goods and services.
6. **Control issuance of currency by the central bank.** The central bank should control issuance of currency especially that which is not in line with the level of economic activities in the country so as to reduce excessive money supply in the economy which helps to reduce aggregate demand thereby controlling demand pull inflation.
7. **Modernization of agriculture.** This should transformed form subsistence to commercial high yielding production through use of methods such as irrigation, land reforms, improving of infrastructures, use demonstration farms, etc. This helps to increase the supply of agricultural commodities hence leading to a fall in prices.
8. **Carrying out further privatization of state owned enterprises i.e. transferring of ownership of state owned enterprises to private individuals.** This is increases efficiency in the running of the enterprises and the scale of production also expands thereby increasing production of goods and services in those enterprises hence controlling structural inflation.
9. **Improve political climate/ atmosphere,** through negotiating for peace talks with rebels and other discounted groups in the country hence promoting production of more goods and services and also attract more investors thus increasing the productive capacity of the country leading to a fall in prices of goods and services.
10. **Reduce indirect taxes especially on essential goods such as petroleum products, soap, sugar, etc** so as to reduce production costs which eventually leads to a fall in prices of goods and services.

11. **Control export of some goods produced in the country e.g. sugar, meat and other food stuffs.** Their exportation should be controlled so as to ensure adequate supply of such goods in the local market hence overcoming the problem of scarcity leading to a decline in prices.
12. **Undertake import substitution industrial strategy,** whereby goods that were formerly imported are produced internally thus enabling the country to overcome imported inflation which arises due to importation of goods from countries experiencing inflation.
13. **Increase direct taxes especially on high income earners** so as to reduce their disposable income which reduces their purchasing power hence controlling the level of aggregate demand in the economy leading to a fall in prices of goods and services.
14. **Encourage the use of instruments of credit such as cheques, bank drafts, promissory notes.** This helps people to move with such written documents instead of moving with big sums of money that encourage them to spend thereby controlling aggregate demand leading to a fall in prices.
15. **Use of price controls,** especially maximum price legislation i.e. a policy where prices are fixed below equilibrium price such that even when there is excess demand, prices cannot be increased.
16. **wage control measures/ controlled trade union influence**
17. **Compulsory saving schemes e.g. NSSF.**

ASSIGNMENT

Why may an increase in money supply not necessarily lead to inflation in your country?

SOLUTION

An increase in money supply may not necessarily lead to inflation in my country because there may be an increase in money supply but when…

- There is price controls especially maximum price legislation i.e. a policy where prices are fixed below equilibrium price such that even when there is excess demand, prices cannot be increased.
- The marginal propensity to save is high such that the percentage of additional incomes is saved but not consumed.
- The increase in money supply is accompanied by an increase in output.

- The increase in money supply is accompanied by higher direct taxes on peoples 'income which reduces their disposable income thereby controlling the purchasing power of consumers.
- There is an increase in the rate of interest.
- An increase in money supply is channeled to production of capital goods.
- An increase in money supply is followed by a reduction in the volume exports.
- An increase in money supply is followed by an increase in the volume of imports
- The economy is undergoing an economic recession characterized by low investments, low incomes, high poverty levels etc hence an increase in money supply only helps to stimulate economic activities through increased purchasing power of consumers.
- The increase in money supply aims at exploiting idle resources such that as exploitation of resources increases, the volume of goods and services also increases hence not leading to inflation.

OTHER CONCEPTS

1. DEFLATION

Refers to a persistent decrease in the general price level of goods and services mainly due to a fall in aggregate demand

Causes of deflation

Reduced government expenditure especially on provision of essential goods.

___Use of restrictive monetary policy e.g. increased bank rate.

___Increased direct taxes on peoples 'income.

___Reduced incomes/ wages.

___Reduced inflow of incomes from abroad.

___Reduced exportation of goods causing excessive supply of goods in the local market.

Effects of deflation

Leads to high unemployment levels. This is because as prices fall, even profits reduce and many firms close down because they are unable to cover the average cost of production.

___Leads to decline in government revenue because some firms reduce output.

___High income earners suffer. This because large scale traders/ industrialists and real estate developments are faced with falling prices of their products which reduces their profit margins.

___Discourages investments since low prices scare both local and foreign investors.

___Leads to slow economic growth rate since low prices lead to declining output.

___It makes people gain more confidence in the currency because as prices reduce, the value of money increases.

___Creditors gain as debtors lose. This is because creditors receive back their money when it has more purchasing power than when it was lent out.

___It leads to low resource exploitation due to decline in profit margins as price falls hence leading to resource wastage.

2. STAGFLATION

Is a situation in which high inflation rates co-exist with high levels of unemployment.

Effects of stagflation

Leads to brain drain

___Results into low government revenue

___It results into low production

___Increases income and wealth inequalities.

___Leads to low aggregate demand for goods and services.

___Leads to decline in savings.

___It makes the government unpopular.

___Etc.

Measures for reducing stagflation

Reduce direct taxes to increase disposable income which increases consumption hence encouraging investments.

___Subsidize producers to reduce production costs.

___Use of expansionary monetary policy e.g. reducing the bank rate which leads to provision of cheap/ affordable loans for investments.

___Increase government expenditure especially on productive ventures hence increasing the level of production thereby increasing employment opportunities and reducing inflation through increased output.

3. STAGNATION

This refers to an economic period of static economic activities characterized by low levels of investments, low levels of employment and constant economic growth rates.

Causes

- low income levels
- reduced government expenditure
- high indirect taxes
- unfavourable political climate/ political instability

Measures to curb stagnation

- Use of expansionary monetary policy e.g. reducing the bank rate.
- Increasing government expenditure especially on provision of essential goods.
- Reduction of direct taxes. This helps to increase disposable incomes of consumers thereby stimulating investment, employment and output.
- Giving incentives to investors such as tax holidays, subsidies, etc. Such incentives lead to increased investment, employment creation and output hence helping the economy to overcome stagnation.
- Improve the political climate. This helps to promote economic activities and attract more investors thereby leading to increase in incomes, investment, output and employment opportunities.
- Develop infrastructure.
- Etc.

4. REFLATION (REFLATIONARY POLICY)

This refers to the deliberate government policy of forcing prices upwards so as to recover from an economic recession.

Instruments of reflationary policy

- Tax reduction
- Expansionary monetary policy.
- Increase in government expenditure/ subsidization
- Increasing wages
- Encouraging exports

5. **OPEN INFLATION**

This is one where the persistent increase in the general price level is as a result of operation of a free market system whereby resource allocation is done by market forces of demand and supply with limited or no government intervention.

6. **SUPPRESSED INFLATION**

Is a situation where demand exceeds supply but the effect of this on prices is minimized by price controls and rationing.

Effects

Leads to misallocation of resources whereby producers shift their resources/ capital from commodities that are rationed and have price controls to commodities that have no such controls.

___It reduces incentives of producers to work hard. This is because putting of price controls and rationing reduces the producers' profit margins hence reducing their scale of production.

___It results into trade malpractices such as smuggling, black marketing so as to sell commodities at a higher price hence government losing a lot of revenue that would have been got from taxes.

___It increases employment problems. This is because some firms are forced to close down while others substitute labour with machines as a way of cutting down labour costs.

___Leads to exploitation of consumers especially on commodities where there are no price controls by government hence leading to low standards of living.

7. **HEADLINE INFLATION**

This is where persistent increase in the general price level in the economy includes the prices of foodstuffs.

8. **UNDERLYING INFLATION**

This is whereby the persistent increase in the general price level in the economy includes all commodities in the country but excludes prices of foodstuffs.