COURSE CODE: AEM 102

COURSE TITLE: PRINCIPLES OF ECONOMICS

TOPIC: INFLATION, DEFICIT AND DEBT

LECTURER: MRS O.O. AYODEJI

MODULE VII: INFLATION, DEFICIT AND DEBT

Topic Outline

- Meaning of inflation
- Types of inflation
- Causes of inflation
- Effects of inflation
- Control of inflation
- Phillips curve
- Government deficit
- Public debt

INFLATION

- Inflation depicts an economic situation where there is a general rise in the prices of goods and services, continuously. It is frequently described as a state where "too much money is chasing too few goods".
- When there is inflation, the currency loses purchasing power. The purchasing power of a given amount of naira will be smaller over time when there is inflation in the economy.
- For instance, assuming that N10.00 can purchase 10 shirts in the current period, if the price of shirts double in the next period, the same N10.00 can only afford 5 shirts.

INFLATION CONT'D

- In the definition of inflation, two key words must be borne in mind. First, is aggregate or general, which implies that the rise in prices that constitutes inflation must cover the entire basket of goods in the economy as distinct from an isolated rise in the prices of a single commodity or group of commodities.

INFLATION CONTD

- Second, the rise in the aggregate level of prices must be continuous for inflation to be said to have occurred.

- In order word, the aggregate price level must show a tendency of a sustained and continuous rise over different time periods. This must be separated from a situation of a one-off rise in the price level.

- Inflation is usually estimated by inflation rate or price index (consumer price index).

- The CPI is the price of this basket of goods and services relative to the price of the same basket in some base year. It is the most commonly used measure of the level of prices.

CPI CONT'D

- For example, suppose that the typical consumer buys 5 apples and 2 oranges every month. Then the basket of goods consists of 5 apples and 2 oranges, and the CPI is:

$$\text{CPI} = \frac{(5 \times \text{Current Price of Apples}) + (2 \times \text{Current Price of Oranges})}{(5 \times 2009 \text{ Price of Apples}) + (2 \times 2009 \text{ Price of Oranges})}.$$

- In this CPI, 2009 is the base year. The index tells us how much it costs now(2022) to buy 5 apples and 2 oranges relative to how much it cost to buy the same basket of fruit in 2009. The consumer price index is the most closely watched index of prices, but it is not the only such index.

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PRODUCER PRICE INDEX

- The Producer Price Index (PPI) measures the average change over time in the selling prices received by domestic producers for their output.

- Because wholesale prices are eventually translated into retail prices, changes in the PPI for consumer goods are usually a good predictor of changes in the CPI.

- Note: Do not confuse the CPI with the PPI, or producer price index, which is an index of prices of domestically produced goods in manufacturing, mining, agriculture, fishing, forestry, and electric utility industries.

TYPES OF INFLATION

1.Creeping Inflation: Creeping or mild inflation occurs when the rise in price is very slow. A sustained annual rise in prices of less than 3 per cent per annum falls under this category. Such an increase in prices is regarded safe and essential for economic growth. **This kind of mild inflation makes consumers expect that prices will keep going up. That boosts demand.** Consumers buy now to beat higher future prices. That's how mild inflation drives economic expansion. For that reason, the Fed sets 2% as its target inflation rate.

2.Walking Inflation: This strong, or destructive, inflation is between 3-10% a year. It is harmful to the economy because it heats-up economic growth too fast. **People start to buy more than they need to avoid tomorrow's much higher prices**. This increased buying drives demand even further so that suppliers can't keep up. More important, neither can wages. As a result, common goods and services are priced out of the reach of most people.

TYPES OF INFLATION CONT'D

- **3.Galloping Inflation**: When inflation rises to 10% or more, it wreaks absolute havoc on the economy. **Money loses value so fast that business and employee income can't keep up with costs and prices.** This type of inflation has tremendous adverse effects on the poor and middle class.
- **4.Hyperinflation**:Hyperinflation occurs when prices rise very fast at double or triple digit rates. **This could get to a situation where the inflation rate can no longer be measurable and absolutely uncontrollable**. Prices could rise many times every day. Such a situation brings a total collapse of the monetary system because of the continuous fall in the purchasing power of money

OTHER CONCEPTS OF INFLATION

- **Pure inflation** – A situation in which all prices including wages and other sources of income rise at an equal rate
- **Shock inflation** – a sudden change in the price level that is caused by a rise in price of an important good.
- **Stagflation** – This is when economic growth is stagnant, but there still is price inflation. It is a combination of inflation + slow economic growth and high unemployment.
- **Deflation**- is the opposite of inflation. It's when an annual fall in the general price level.
- **Disinflation** – a decrease in the rate of inflation.

OTHER CONCEPT OF INFLATION CONT'D

- **Wage Inflation**: Wage inflation is when workers' pay rises faster than the cost of living. When wages increase, consumers are likely to spend more, which ultimately increases consumer prices.

CLASS WORK

- Is Nigeria currently experiencing inflation? If yes, what type of inflation are we experiencing?
- What can the Government do to curb inflation in the country? Discuss.
- Is an increase in petroleum product prices in Nigeria a signal of inflation? Discuss.
- In year 2009, the price level was N200 and in year 2010, the price level was N210, what is the annual percentage of inflation ?

CAUSES OF INFLATION

- **Demand pull/demand-induced/Excessive demand inflation-**Demand-pull inflation exists when aggregate demand in an economy is more than aggregate supply. If demand exceeds supply, firms will respond by pushing up prices as firms try to meet the increased demand because of a lack of needed supply.

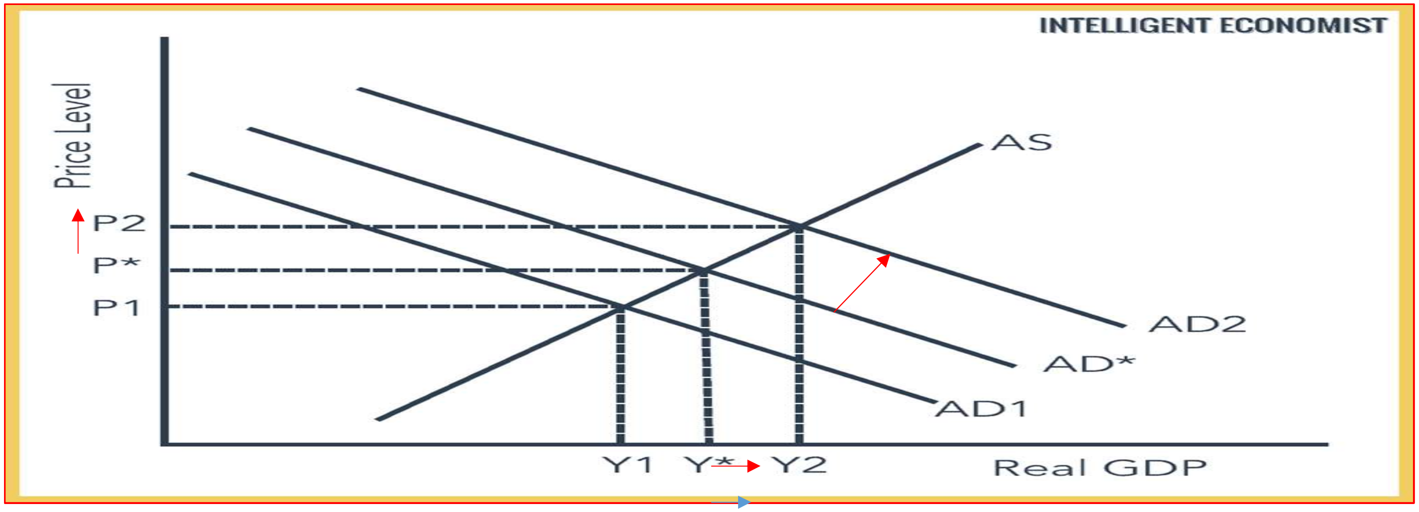


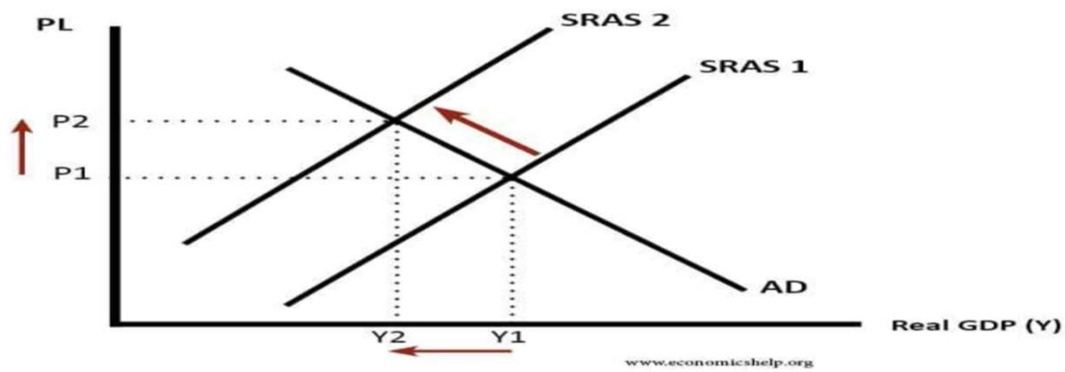
Figure1: Graphical Illustration of Demand pull inflation

CAUSES OF DEMAND PULL INFLATION

- Rising inflation rate-When the inflation rate rises then demand goods and services usually rises as well because people want to protect their money by buying goods while they are still affordable.
- Increase in population
- Increase in income(demand) or a combination of both
- Technological Innovations-When new technologies are introduced, demand for the products and services that support them often goes up.

COST PUSH INFLATION

- Cost-push inflation is a type of inflation that is caused by the increase in the cost of labor and materials thereby causing an increase in prices for goods and services which results to a decrease in supply.
- A case is if the Nigeria Labour Congress (NLC) is able to get significant increase in wages without corresponding increase in production which result in higher cost.



CAUSES OF COST PUSH INFLATION

- 1.Rural-urban drift / migration leading to the neglect of agricultural sector
- 2.War effect- Efforts are diverted from production of goods to production of war equipment/ armament
- 3.Bad weather/ drought such as the 1973 Nigerian drought
- 4.Imported inflation i.e importing large quantities of goods and services from countries which have inflation.

EFFECTS OF INFLATION

A. Effect on income and standard of living:

1. Value of money falls

2. Fixed income earners such as recipients of transfer payments (pensions, unemployment insurance, social security, recipients of interest & rent, lose. **These people lose because they receive fixed payments while the value of money continues to fall with rising prices.**

3. Those of flexible income group like businessmen, shareholders, industrialists, traders real estate holders, speculators, gain. This category of persons becomes rich at the cost of the fixed income group. **This is because there is transfer of income and wealth from the poor to the rich.**

EFFECT OF INFLATION CONT'D

B. Effect on income distribution:

1.the rich tends to be richer & the poor, poorer during inflation.

2.During inflation, usually people experience rise in incomes. But some people gain during inflation at the expense of others. Some individuals gain because their money incomes rise more rapidly than the prices and some lose because prices rise more rapidly than their incomes during inflation.

EFFECT OF INFLATION CONT'D

C. Effect on borrowers and lenders (creditors and debtors)

When there is inflation, creditors are generally worse off because, the real value of their future claims is **reduced** to the extent of the rate of inflation. On the other hand, when inflation occurs, debtors tend to **pay less** in real terms than they had borrowed. Therefore, it could be said that inflation favours debtors at the detriment of creditors.

- **D. Effect on salaried or wage earners:** Those with white-collar jobs lose during inflation because their salaries are slow to adjust when prices are rising. Wage earners may gain or lose during inflation depending on the speed with which their wages adjust to rising prices.

CONTROL OF INFLATION

- **Contract the economy by using monetary and fiscal policies**

➢ forcing a recession/austerity measures/cutting down spending which may lead to hardship, reduction of unemployment benefits

➢ Indexation. Here people become partially/wholly immunized from changes in the general price level through things like cost- of- living adjustment

- **Tax-based income policy**: This involves subsidizing companies whose wages and prices are rising slowly and taxing those that boost inflation.
- experiencing inflation.

CONTROL OF INFLATION CONT'D

- **Price control measure:** This involves setting up a price control board by government which **fixes** maximum prices of certain commodities.
- Total ban on importation of certain items.
- Increase in the production of essential consumer goods like food, clothing, kerosene oil, sugar, vegetable oils, etc.
- Rationing: This aims at distributing consumption of scarce goods so as to make them available to a large number of consumers. It is meant to stabilize the prices of necessary goods and assure distributive justice.

WHAT IS PHILLIPS CURVE?

- The Phillips Curve is a graphical representation of the inverse, or negative, economic relationship between the rate of unemployment (or more precise, the rate of change in unemployment) and the percentage rate of change in money wages (Inflation rate).

- The theory behind this is fairly straightforward. Falling unemployment might cause rising inflation and a fall in inflation might only be possible by allowing unemployment to rise.

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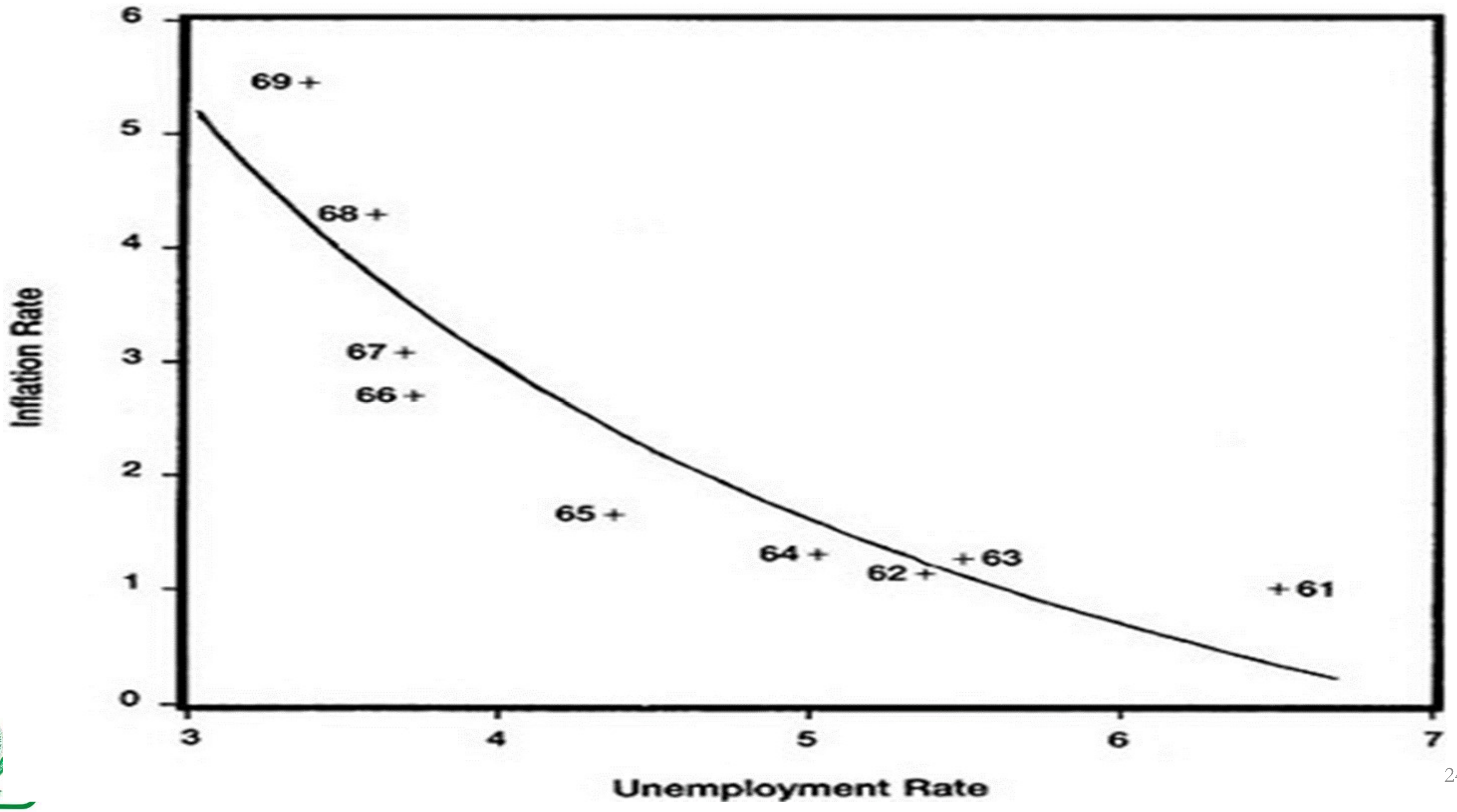
PHILIPS CURVE CONT’D

- A high inflation and high unemployment are incompatible; therefore, governments have to choose the best combination of both.
- If the government wants to reduce the unemployment rate, it could increase aggregate demand but, this might temporarily increase employment, but it could also have inflationary implications in labour and the product markets.

TYPICAL EXAMPLE OF PHILLIPS CURVE



DEFICIT SPENDING

- Deficit spending can simply be called "deficit," or "budget deficit," the opposite of budget surplus.

- **Deficit spending** is the **amount** by which a government, private company, or individuals **spending exceeds income over a particular period of time**

PUBLIC DEBT

- It is the **cumulative** amount of money owed at any given time by any branch of the government.
- Public debt is distinct from a budget deficit in that it is **cumulative,** whereas deficit refers to a **particular budget year's shortfall**
- It encompasses the one owed by the federal government, the state government, and even the municipal and local governments

PUBLIC DEBT CONT'D

- Public debt is made up of **external debt**, which is money that is owed by the government to foreign lenders, either in the form of international organizations, other governments, or groups like sovereign wealth funds.

- It is also made up of internal debt, where citizens and groups within the country lend the government money to continue operating.

- In some ways, this is a lot like lending to oneself, since ultimately the responsibility for public debt falls back on the very people lending money.

PUBLIC DEBT CONT'D

- Public debt can also be broken down by the length of period of the loan
- Short-term public debt lasts only one or two years, and the turnover rate is fairly high
- Mid-term public debt lasts anywhere between three and ten years.
- Long-term public debt is designed to last more than ten years, with some long term debt lasting considerably longer than that.

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ASSIGNMENT

- What do you think are some reasons for government indebtedness?
- In what ways do you think a nation can improve its budget deficit?
- What are the implications of budget deficit on the economy?
- What is the difference between budget deficit and public debt?

THANK

YOU

FOR

LISTENING