

## S.5 ECONOMICS NOTES

TOPIC: Inflation

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N.B: This is a continuation from where we stopped.

### 7. Structural/Bottleneck/Scarcity Inflation.

Structural inflation refers to the persistent increase in the general price level due to supply rigidities and structural bottlenecks that result into a decline in the supply of essential goods in the economy.

OR

It is the type of inflation caused when prices persistently increase due to supply rigidities and structural bottlenecks making it difficult for supply of goods to reach demand.

#### Causes of structural inflation

- ❖ Breakdown of key the industry.
- ❖ Infrastructural breakdown in the economy.
- ❖ Political instability/political turmoil.
- ❖ Natural hazards such as floods, prolonged drought which reduces agricultural output.
- ❖ Hoarding of commodities/goods by producers/traders.
- ❖ Scarcity of inputs/raw materials or limited raw materials.

- ❖ Foreign exchange shortages/bottlenecks.
- ❖ Speculation/ anticipation by the businessmen.

### **Ways of controlling structural inflation.**

- ❖ Maintaining political stability in the economy.
- ❖ Rehabilitating/improving the basic infrastructure in the economy.
- ❖ Undertaking modernization of agriculture.
- ❖ Further privatization of the public enterprises.
- ❖ Further liberalization of the economy.
- ❖ Offering investment incentives in order to encourage production in the economy.
- ❖ Importing raw materials/inputs especially from cheaper sources.
- ❖ Conducting regular repairs and replacement of worn out industrial machines.

### **8. Imported inflation.**

This is the persistent increase in the general price level arising from the importation of commodities from countries experiencing inflation.

**OR**

Is the type of inflation resulting from importation of goods from another country at relatively high prices so that the high prices of imports result into rising prices of commodities in the domestic market.

### **Causes of imported inflation.**

- ❖ Importation of commodities from countries experiencing inflation.
- ❖ Rising prices in the international markets for example petroleum products.

### **Solutions to imported inflation.**

- ❖ Establishing import substitution industries.
- ❖ Restricting imports through fixing total ban and quota system.
- ❖ Importing commodities from relatively cheaper sources/countries.
- ❖ Ensuring stability of the foreign exchange rates.

### **9. Sectoral inflation.**

This refers to the persistent rise in prices occurring in different commercial sectors of the economy/country.

### **10. Monetary inflation.**

This refers to the persistent rise in the general price level caused by excessive increase in money supply/amount of money in circulation in the economy.

### **11. Pricing power inflation/ Administered price/Oligopolistic inflation.**

This refers to the persistent rise in the general price level which occurs when entities and industries decide to increase the prices of their respective goods and services in order to increase their profit margins.

## **General causes of inflation in Uganda.**

**Break-down of the basic infrastructure.** The breakdown of basic economic infrastructure such as roads, give rise to scarcity of commodities in many areas of the country. This is because it limits the movement of goods from areas of production to the market thereby causing shortage and increase in prices thus inflation.

**Excessive money supply/issuance of currency.** This leads to excessive amount of money in circulation which is not followed with an increase in production of goods and services. This consequently results into a situation where too much money is chasing few commodities which forces prices to rise thus inflation.

**Excessive government expenditure.** Excessive government expenditure in form of recurrent expenditure increases the amount of money in the hands of the people which eventually results into excessive demand for goods and services over supply hence forcing prices to increase thus inflation.

**Poor political atmosphere/climate.** This destroys productive infrastructures and scares away potential investors leading to low production of goods and services which forces prices to increase due to shortages thus structural inflation.

**Persistent importation of goods from countries experiencing inflation.** The importation of goods from such countries makes importers to buy imports at relatively higher prices than those in the domestic market. This forces importers to sell such commodities at increased prices in the

domestic market so as to recover the heavy costs incurred to import hence giving rise to imported inflation.

**Rising costs of production.** Increasing costs of production due to rising prices of raw materials, power tariffs, interest rates, costs of transport and wages, force producers to increase prices at which their products are sold to the final consumers in order to recover the money spent on production hence cost push inflation.

**Excessive desire for higher profits by the producers/traders.** Many producers aim at getting abnormal profits and as a result end up increasing prices for their products even when it is not necessary. This increases the market prices for goods and services hence causing inflation in Uganda.

**Speculation by traders/businessmen.** Sometimes traders anticipate an increase in the demand for their goods in future and deliberately hoard goods which creates artificial shortages of goods on the market hence forcing prices to increase in Uganda.

**Unfavourable natural factors.** Natural hazards such as floods, long dry spell, pests and diseases lead to a fall in supply especially from the agricultural sector which results into scarcity of goods forcing prices to increase hence causing inflation in Uganda.

**Excessive exportation of essential goods/Increasing demand for Ugandas exports in the foreign markets.** Increasing demand for Ugandas exports especially in the neighboring countries brings about shortage of goods in the domestic market which forces prices to increase resulting into inflation.

**Excessive inflow of incomes from abroad.** This is in form of external borrowing, foreign investments and remittances by Ugandans working abroad which increases the amount of money in circulation leading to excessive aggregate demand for goods and services over aggregate supply hence forcing prices to increase in Uganda.

**Excessive credit creation by commercial banks.** This increases the amount of money in circulation without a corresponding increase in the volume of goods and services in Uganda hence forcing prices to increase.

**Excessive borrowing of money from the central bank by government.** This results into increased money supply which leads to excessive aggregate demand over aggregate supply of goods and services forcing the prices to increase hence inflation in Uganda.

### **Consequences/effects/impact in inflation in Uganda.**

#### **Positive effects of inflation (Effects of mild/moderate/gradual inflation)**

**Mild inflation stimulates people's effort and hard work.** People are stimulated to carry out economic activities to earn income and be able to meet the rising cost of living.

**Moderate inflation stimulates investment and production.** Producers are encouraged to produce more goods and services since it becomes profitable at the time of rising prices. This increases the amount of profits earned and gross domestic product.

**Gradual inflation creates more employment opportunities.** Due to the increased profits earned by the producers, they are able to expand their investments by employing more factors of production/resources which creates more employment opportunities.

**Moderate inflation generates more government revenue.** The government charges taxes on the economic activities and profits earned by the producers which generates more tax revenue.

**Low rate of inflation increases the exploitation and utilization of resources.** Due to increased investment and production, more available resources are put to use to produce goods and services and this reduces on the wastage of resources.

**Low rate of inflation encourages innovativeness and creativity among the people.** In order to maximize profits, producers develop new and better methods of production and the consumers make effort to meet the rising costs of goods and services.

**Moderate inflation enable borrowers/debtors to gain in real terms at the expense of creditors.** At the time of borrowing the money value is high but as the prices increase, the money value reduces and this makes the borrowers pay back less than what they are meant to pay in real terms.

**Creeping inflation promotes commercialization/monetization of the economy.** There is increased production for market due to the high profits that attract producers and this reduces the size of the subsistence sector.

**Mild inflation promotes entrepreneurship.** The increase in profit margins encourage many people to risk in business ventures in order to have some items to sell and get the profits.

**Moderate inflation stimulates production of goods and services.** The increased profit margins attract producers to produce more goods and services to benefit from the increasing prices and this increases the rate of economic growth.

**Moderate inflation encourages labour mobility.** Due to the rising cost of living, workers move from one job/area to another in search for better paying jobs so as to meet the rising cost of living.

**Low rate of inflation helps the economy to recover from an economic depression.** Since mild inflation stimulates investment due the increased profits and this increases the number of economic activities which helps the economy to recover from a depression.

**Moderate inflation encourages forced savings.** During the times of gradual inflation, the government forces the public to save money for future use, this reduces the amount of money in circulation and checks on the further increase in prices of goods and services.



## **Negative effects of inflation (Effects of hyper/Galloping/runaway inflation)**

**Hyper inflation discourages savings.** High rate of inflation discourages voluntary saving because people fear to save since money loses value at a very fast rate.

**High rate of inflation leads to loss of confidence in the countrys currency.** A very high rate of inflation makes money lose its function as a store of value because the public considers it worthless and the public resorts to use of barter trade.

**High rate of inflation worsens the balance of payment problem.** A very high rate of inflation makes our exports very expensive in the foreign markets, this reduces their demand and the countrys export earnings hence worsening the balance payment problem.

**Hyper inflation leads to industrial unrest.** This arises due to constant demand for wage increase by the workers in order to meet the rising cost of living.

**Runaway inflation worsens income and wealth inequalities.** High rates of inflation greatly benefit the rich businessmen who are able produce the goods and earn more incomes while the poor are buying goods expensively and thus making them poorer.

**Hyper inflation discourages local and foreign investment.** Increasing prices for raw materials, labour costs, power tariffs and interest rates discourage production of goods and services due to fast rising costs of production and reduced profits.

**Hyper inflation leads to unemployment and its associated evils.** Due to high rates of inflation, production cost rise at a very high rate and some firms find it difficult to continue producing hence close down giving rise to unemployment.

**High rate of inflation make the government in power unpopular.** The public suffers very high prices for goods and services and holds the government responsible for the high prices which makes the government unpopular.

**High rate of inflation leads to production and consumption of poor quality goods and services.** In an act by the producers to cut the production costs many leave out certain ingredients required in the production of some commodities and end up producing low quality goods and services.

**Runaway inflation makes government planning difficult.** The frequent upward changes in the prices make the costing of government plans very difficult since money set aside to finance development projects become inadequate at the time of implementation.

**High rate of inflation makes fixed income earners suffer as real income falls.**

Individuals who earn fixed income suffer greatly with the rising cost of living because they continue to earn the same income yet its purchasing power continues to reduce with rising prices for goods and services.

**High rate of inflation discourage lending.** The creditors/lenders are paid back less in real terms than what they lent out since they are paid back in currency/money that has greatly lost value which discourages lending in the economy.

**Runaway inflation encourages illegal activities/trade malpractices.** In an effort to survive considering the rising cost of living as result of prices increasing at a very high rate, people engage in illegal activities such as smuggling,

black-marketing, corruption, prostitution, robbery among others to earn income so as to be able to meet the rising cost of living.

**Hyper inflation increases government administrative costs.** This is so in case of price legislation where government has to hire manpower to enforce such a legislation.

**High rate of inflation promotes brain drain.** Due to the rising cost of living, highly skilled workers are forced to look for better paying jobs in other countries which results into the loss of skilled manpower at home and slows down the rate of development process.

## **Measures to reduce inflation.**

**Increase direct taxes on peoples incomes.** This reduces disposable income and purchasing power which eventually reduces aggregate demand and forces prices of goods and services to fall.

**Reduce government expenditure on provision of non- essential goods.** This is intended to reduce money supply and aggregate demand for goods and services which forces prices to fall hence controlling inflation.

**Further liberalization of the economy.** This involves removal of unnecessary controls/barriers to economic activities which helps to increase domestic production of goods and services hence controlling structural inflation.

**Improve the basic infrastructural facilities in the economy.** This is intended to encourage production due to the ease of transportation of raw materials to production centres and finished products to the market centres and this reduces structural inflation.

**Further privatization of the state enterprises.** Privatization increases production and supply of goods and services due to better management and improved technology used by the private producers hence controlling structural inflation.

**Control the issuance of currency/reduce money supply.** This reduces the amount of money in the hands of the public and as a result the public has less money to spend on consumption of goods which forces prices to fall hence reducing inflation.

**Provide investment/tax incentives to the investors.** This increases the production of goods and services leading to increased supply and this controls demand pull inflation.

**Use of a restrictive/contractionary monetary policy.** This reduces the amount of money in circulation, the purchasing power and the level of aggregate demand which forces prices to fall.

**Improve the political climate/ atmosphere.** This increases the level of economic activities leading to more supply of goods and services hence controlling structural inflation.

**Modernize the agricultural sector.** This increases agricultural production thus reducing scarcity of food items and controlling demand pull inflation.

**Reduce indirect taxes on production of essential goods and services.** This reduces the cost of production and the producers consequently reduce the prices of goods and services hence controlling cost push inflation.

**Encourage importation of goods from cheaper sources.** Such a policy helps to avoid buying goods from countries experiencing inflation thereby reducing the rate of imported inflation.

**Encourage establishment of import substitution industries.** This increases domestic production of formerly imported goods and reduces the level of importation of goods and services which helps to control imported inflation.

**Control the exportation of essential goods to foreign markets.** This ensures large domestic supply of such goods and forces prices to fall hence controlling inflation.

**Reduce government borrowing from the central bank.** This reduces the amount of money in circulation, the purchasing power and forces the prices of goods and services to fall due to reduced aggregate demand.

**N.B.** *If the question asks for steps **being** taken to reduce inflation in Uganda same points are stated but in present continuous tense ( **ing** tense) e.g. **Increasing** direct taxes on peoples incomes, **Reducing** government expenditure on provision of non-essential goods, **Further liberalizing** of the economy among others and the **explanations** must follow the same tense.*

### **Reasons/rationale for/objectives of controlling inflation**

**To reduce balance of payment problem.** The stable prices at home lead to a rise in export earnings and a decrease in import expenditures which improves the balance of payment position.

**To build confidence in the local currency.** The money begins to effectively perform its function as a store of value and medium of exchange and avoids loss of confidence in the local currency by the public.

**To encourage saving in the country.** Maintaining a low rate of inflation ensures stability in the value of money which induces the public to save part of their incomes for future use since there no fear for loss of money value.

**To encourage production and investment.** A low rate of inflation stabilizes the costs of factor inputs and guarantees the producers stable profits hence attracting them to produce more goods and services.

**To reduce income inequality and its associated evils.** A low rate of inflation is necessary for purposes of controlling income inequalities between the poor and the rich or between the salary earners and traders.

**To minimize illegal activities in the country.** The government strives to control inflation so as to control malpractices like corruption, smuggling, black marketing and hoarding that are associated with the shortage of goods.

**To reduce unemployment the country.** Maintaining a low rate of inflation stimulates investment and production thereby creating more employment opportunities as more factors of production are put to use.

**To minimize brain drain.** Controlled inflation creates a stable environment where the cost of living is relatively low and this enables the highly trained workers to remain the country and take part in the production of goods and services.

**To encourage lending by creditors.** Maintaining a low rate of inflation keeps the interest rates low which increases the rate of borrowing for investment purposes in the economy.

**To ensure effective government planning.** Stable prices facilitate proper government planning because they make it possible to implement the different government projects due to the stability in the costs of implementing the projects.

**To improve the peoples standard of living.** Stable prices increase consumption of goods and services by the consumers which improves their standards of living.

**To reduce industrial unrest.** The control of inflation ensures stability in prices and cost of living which reduce labour strikes and other forms of industrial unrest since workers do not ask for wage increments from time to time.

**To make the government in power more popular.** Maintaining a low rate of inflation increases the popularity of the government among the masses since there is limited frustration due to high prices of goods and services.

#### **Circumstances under which inflation is desirable in the economy**

**When there need to promote economic growth/domestic production.** The existence of mild inflation encourages producers to increase output in order to more goods and services to earn more profits. The increase in output brings higher levels of economic growth thereby making inflation desirable.

**When there is need to increase the profit margins of producers.** A slight increase in the general price level during periods of inflation enables producers to earn more profits and this makes inflation desirable to the producers in the economy.



**In case there is need to stimulate inventions and innovations.** During periods of mild inflation the cost of living increases. This makes the public to be more creative and hardworking so as to earn income needed to meet the rising cost of living making inflation desirable in the economy.

**In case there is need to stimulate investment.** Some producers desire to make more profits during periods of mild inflation by expanding their investments and as a result resources are put to better use which makes inflation desirable.

**In case there is need to reduce voluntary unemployment.** Inflation increases the cost of living and this forces people who would not have taken up jobs to get into active employment so as to earn income and be able to meet rising cost of living.

**When there is need to overcome an economic depression/recession/slump.** Existence of mild inflation encourages producers to increase production by employing more factors of production thus increasing peoples incomes and lifting the economy from a recession.

**When there is need to stimulate aggregate demand.** As prices start to increase, people buy more goods and services during the current period thus aggregate demand for goods and services and making inflation desirable.

**In case there is need to promote forced saving.** A low rate of inflation gives the government ground to enforce compulsory saving by the public in order to avoid further increase in the prices.

**In case there is need to reduce excess capacity.** Moderate inflation encourages the use of the available resources resulting into increased production of goods and services and reduction in the level of excess capacity.

**In case there is need to encourage mobility of labour in the economy.** Due to inflation, labour moves from low paying jobs/areas to high paying jobs/areas and this gives rise to mobility of labour. In such a situation, a low rate of inflation becomes desirable.

**When there is need to Mild inflation promotes entrepreneurship.** The increase in profit margins encourage many people to risk in business ventures in order to have some items to sell and get the profits.

### **The concept of stagflation**

This refers to a situation where there is co-existence of high rates of inflation and high levels of unemployment.

### **Adverse effects/Costs/Demerits of stagflation**

- ❖ Increase costs of living due to increased prices.
- ❖ Decline in people's welfare due to rising prices of goods and services and high levels of unemployment.
- ❖ Decline in the rate of savings due to low incomes and high rate of inflation.

- ❖ Loss of confidence in the countrys currency as a medium of exchange.
- ❖ Worsens the income inequality problem.
- ❖ Discourages investment due to high cost of borrowing capital.
- ❖ Increases social distress or tension in the country.
- ❖ Worsens the balance of payment problem due to stagnant output.

#### Measures to reduce stagflation

- ❖ Reduce taxes to encourage investment.
- ❖ Liberalize the economy.
- ❖ Subsidize producers to reduce production costs and thus promote investment.
- ❖ Increase government expenditure on production and investment activities.

#### Relationship between inflation and unemployment

- ❖ High rates of inflation discourage saving and investment thus causing unemployment.
- ❖ High level of unemployment of resources may lead to low production thus causing inflation.

- ❖ High level of inflation leads to high demand for wages making employers adopt capital intensive techniques of production thus causing unemployment.
- ❖ High inflationary rates reduce the level of aggregate demand hence unemployment of resources especially labour.
- ❖ Fighting inflation through reduced government expenditure limits funds available for investment leading to unemployment.

## Theories of inflation

### 1. Monetary theory of inflation.

This states that if the money supply rises faster than the rate of growth of national income then there will be inflation in the economy.

### 2. Demand pull theory of inflation.

According to Lord J.M Keynes who put forward this theory,

inflation is caused by excessive aggregate demand that is not matched by aggregate supply at full employment level of resources . In other words, increase in aggregate demand without increase in aggregate supply forces prices to shoot up leading to inflation.

According to this theory, inflation occurs when demand for goods and services exceed the existing supply of goods and services.

### **3. Cost push theory of inflation.**

This theory suggests that inflation results primarily from the increase in the production costs usually by rising prices of raw materials, excessive wage increase from trade union pressure among others.

### **4. The Structuralists theory of inflation.**

According to the structuralists, inflation is caused by a structural breakdown of the economy either due to bad economic policies, wars or poor harvests in the agricultural sector caused by unfavourable natural factors. According to the structuralists, inflation results from supply rigidities and supply bottlenecks.

#### **Guiding questions**

1. (a) (i) Distinguish between structural inflation and cost push inflation.  
(ii) Give any two causes of cost push inflation.
- (b) (i) Distinguish between cost push inflation and bottleneck inflation.  
(ii) Mention any two measures that can be taken to control  
bottleneck inflation.
- (c) (i) Distinguish between suppressed inflation and hyper inflation.  
(ii) Give any two effects of hyper inflation in an economy.

(d) (i) What is meant by stagflation?

(ii) Suggest three measures that can be taken to reduce stagflation in an economy.

(e) (i) Differentiate between inflation and deflation.

(ii) Mention any two positive effects of creeping inflation in Uganda.

2. (a) Distinguish between mild inflation and hyper inflation.

(b) Explain the effects of hyper inflation in Uganda.

3. (a) Distinguish between cost push inflation and demand pull inflation.

(b) Account for the persistent inflation in Uganda.

4. (a) Distinguish between creeping inflation and galloping inflation.

(b) Examine the effects of inflation in Uganda.

5. (a) Differentiate between imported inflation and scarcity inflation.

(b) Assess the impact of inflation in Uganda.

6. (a) What is the rationale for controlling inflation in Uganda?

(b) Under what circumstances may inflation be desirable in Uganda?

7. (a) What are the causes of inflation in Uganda?

(b) Examine the measures that are being taken to solve the problem of inflation in Uganda.

8. (a) ) Explain the causes of inflation in Uganda.
- (b) Examine the objectives of controlling inflation in Uganda.
9. (a) Examine the causes of inflation in Uganda.
- (b) Why may a low rate of inflation in an economy be desirable.
10. (a) Why is inflation considered a problem in Uganda?
- (b) Suggest measures that should be taken to control inflation in Uganda.

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