CHAPTER 13 Inflation and Deflation

INTRODUCTION

Economic activities have always been characterized by rising and falling prices of goods and services. However, increasing and decreasing prices of goods has posed serious economic problems to policy makers all over the world. This chapter shall therefore examine the meaning of inflation and deflation, their types, causes and control of inflation and deflation, inflation and inflation in Nigeria.

OBJECTIVES

At the end of this chapter, students should be able to:

- Explain the meaning of inflation and deflation;
- State and explain the types of inflation;
- List all the causes of inflation and deflation;
- Explain the effects of inflation and deflation;
- Highlight and explain how inflation and deflation can be controlled;
- Provide the historical explanation of inflation in Nigeria.

13.1 Meaning of Inflation

Inflation means persistent rise in the general price level. Once there is an increase in the general level of prices, it implies that there is a fall in the value of money and an increase in the cost of living. It is a situation where too much money is pursuing few goods within an economy.

13.2 Types of Inflation

The following are the types of inflation. These are demand–pull inflation, cost push inflation, hyper inflation and imported inflation.

a. **Demand–Pull Inflation:** This is when the aggregate demand for goods and services is greater than the aggregate supply. This makes too much money to chase too few goods. Note that if too much money is spent on few goods, it can cause inflation. This situation cannot persist over a given time because of increase in supply of goods in circulation.

b. **Cost Push Inflation:** Cost push inflation arises due to increase in the cost of factors of production. If the wages of workers increase rapidly, due to demand from trade unions or increase in the cost of goods and services, this will lead to inflationary pressure.

c. **Hyper Inflation:** This is a type of inflation that occurs whenever rapid rate which makes money to lose its function as a store of value and medium of exchange. This is usually experienced when there is war, natural disaster, deficit budgeting, e.t.c. People are therefore unwilling to receive money, but prefer trade by barter.

d. **Imported Inflation:** This is a type of inflation that occurs whenever raw materials, equipments and machineries and other finished products are imported into a country at a very high cost.

13.3 Causes of Inflation

a. **Natural Calamities and War:** When there is war and natural disasters such as drought and earthquake, the supply of goods and services are reduced. This will lead to shortage amidst high demand by the consumers, thereby resulting to inflation.

b. **Excessive Money Supply in the Economy:** An increase in money supply without a corresponding increase in quantity of goods and services results to increase in prices and inflation will occur.

c. **Budget Deficit:** This is when a country's national expenditure is greater than the estimated national income. The country runs into deficit, thus leading to inflation.

d. **Increases in the Cost of Factors of Production:** Increase in the prices of the factors of production will lead to increase in the cost of finished product.

e. **Increase in Population:** An increase in the population of an economy will lead to increase in the demand for goods and services. This will thus lead to inflation, if there is no corresponding increase in the production of goods and services to meet up with the increased population.

f. **Increase in Wages and Salaries:** If there are increases in wages and salaries of workers, without corresponding increase in production of goods and services, purchasing power which is not backed up with corresponding increase in output will lead to inflation.

13.4 Effects of Inflation

The effects of inflation include the following:

a. High Profit: Higher profit is earned by businessmen because of the rise in prices of their products which thereby encourages further investments.

b. Creditors Lose While Debtors Gain: Since the value of money falls during inflation, creditors receive less in real terms than what they lent out, while debtors repay less in real terms.

c. The Loss of Salary Earners and the Gain of Businessmen: Salary earners suffer during an inflationary period in an economy because the value of real income falls. This therefore leads to re-distribution of income in favour of investors.

d. Loss of Confidence in the Monetary System: A prolonged hyper inflation may lead to loss of confidence in a nation's monetary unit of account.

e. Reduction of the Burden of National Debts: The value of loans taken by government falls in real terms in an inflationary period in a country.

f. Low Level of Savings and Capital Formation: People are not encouraged to save because they spend more money on goods and services during the inflationary period. The public is also afraid that the value of their savings in the bank will fall. Therefore, capital formation which depends on savings is low.

g. Increased Balance of Payments Difficulties: Inflation increases the prices of exports relative to the prices of imports. This leads to payment disequilibrium and difficulties.

13.5 Control of Inflation

Inflation could be controlled with a number of measures listed below:

a. Monetary Policy: This involves reducing the quantity of money supplied in circulation by using the tools of monetary control which includes Open Market Operation [OMO].

b. Price Control Measure: Government may set up price control board to fix the minimum and maximum prices of commodities.

c. Fiscal Policy: This is the increase in income tax paid by workers and reduction in government spending.

d. Import Restriction: This is to reduce or to impose total ban on the

importation of certain goods.
e. Wage Control: This involves the use of an appropriate income policy in which wages are only increased as the level of productivity increases.
f. Increase in Domestic Production of Goods and Services: This could be achieved through the importation of scarce but essential commodities to supplement domestic production and reduce their prices.
g. Improving the Distributive System: Network distribution of the nation's needs should be improved in order to ensure efficiency in the transportation system and to prevent unnecessary scarcity of commodities.

13.6 Inflation in Nigeria

Inflation is a worldwide phenomenon but the rate varies from country to country. Nigeria's inflation experience since 1970 has been a mixed one. This was due to the monetization of the earnings from oil whose earnings in 1973 soared to N5.318 billion from about N510 million in 1970. This experience led to upward pressure on the general price level. By July 1986, Nigerian government adopted the Structural Adjustment Programme (SAP) during which there was wholesale depreciation of the naira on the foreign exchange market. This increased the prices of imported goods without a corresponding growth in output of the agricultural and manufacturing sectors of the economy. There was also an unprecedented growth in money supply. As at early 1990s when inflation was exceptionally high at 45%, 57% and 72% in 1992, 1993 and 1995, respectively. But the late 1990s witnessed a sharp reduction in the rate of inflation. Nigeria has been experiencing a high rate of inflation estimated to be well over 45%.
In the face of a persistent inflation and fully aware of the danger inherent in uncontrolled inflation, each succeeding government has introduced measures aimed at controlling the rising prices. Nigerian Central Bank records that inflation rate in Nigeria as at December 2010 was 12.00 percent, while in March 2011, it was 11.60 percent.

13.7 Meaning of Deflation

This is a persistent fall in the general price level of goods and services. It is the opposite of inflation. Deflation usually occurs when there is depression.

13.8 Causes of Deflation

a. Excessive Budget Surplus: This occurs when government spends lesser amount of money than its expected revenue and the total amount of money in circulation would fall.
b. Excess Supply of Commodities over its Demand: Producers of goods and services would be forced to sell at lower prices, if the supply of commodities continues to be in excess as against the demand.
c. Excessive Credit Squeeze: Too much restriction on bank lending decreases the amount of money in circulation and reduces aggregate demand. This leads to lower prices of commodities.
d. Excessive Use of Government Fiscal Policy: High rates of taxation would reduce aggregate demand considerably since disposable incomes are greatly reduced.

13.9 Effects of Deflation

Deflation has a number of effects which are listed below:
a. Decrease in business earnings and profits.
b. Increased rate of unemployment.
c. Fixed income earners gain.

d. Lenders gain at the expense of borrowers.
e. There will be an increase in the burden of the national debt.
f. Exports become cheaper than imports.

13.10 How to Control Deflation

There are some measures that could be used in controlling deflation in an economy. They include:
a. Deficit Financing: Government should spend more money than her revenue so as to increase aggregate demand for goods and services, while there will further be increase in prices.
b. Use of an Expansionary Monetary Policy: Banks should be encouraged to increase their lending to the public there by increasing aggregate demand.
c. Use of a Liberal Fiscal Policy: Taxes should be reduced so as to increase people's disposable incomes and increase their demand for goods and services.
d. Increasing Wages and Salaries: If wages and salaries are increased, people would have more money to spend in the economy.

Summary

This chapter has discussed:
❖ This chapter has discussed the meaning of inflation which is a persistent rise in the general price level, while deflation is persistent fall in the general price level of goods and services. Types of inflation that we have are: demand-pull, cost push, hyper inflation, imported inflation.
❖ Inflation is caused by: natural calamities and war, excessive money supply in the economy, budget deficit, increases in the cost of factors of production, increase in population, increase in wages and salaries, and so on.
❖ Effects of inflation include: high profit, creditors lose while debtors gain, the loss of salary earners and the gain of businessmen, loss of confidence in the monetary system, reduction of the burden of national debts, low level of savings and capital formation and increased balance of payments difficulties.
❖ Further, inflation is controlled through: monetary policy, price control measure, fiscal policy, import restriction, wage control, increase in domestic production of goods and services, improving the distributive system. The status of inflation in Nigeria was examined.
❖ In addition, causes of deflation included: excessive budget surplus, excess supply of commodities over its demand, excessive credit squeeze, and excessive use of government fiscal policy.
❖ The effects of deflation include: decrease in business earnings and profits, increased rate of unemployment, fixed income earners gain, lenders gain at the expense of borrowers, an increase in the burden of the national debt, exports become cheaper than imports.
❖ Deflation is controlled through the following means: deficit financing, use of an expansionary monetary policy, use of a liberal fiscal policy, increasing wages and salaries.

Class Activity

Class teacher should lead the students to find out effects of past inflation and deflation on Nigeria's economy.

Review Questions

Objective Questions

1. An inflation in which the price level rises steadily at an average rate of about 2% per annum is best described as .
(a) galloping **(b)** induced **(c)** creeping **(d)** suppressed **(e)** run away **(SSCE 1989)**
2. Which of the following categories of people do not gain during inflation?
(a) debtors **(b)** business men
(c) shareholders **(d)** investors
(e) creditors **(SSCE 1998)**
3. Inflation in any economy .
(a) has no monetary connection
(b) implies a sustained decrease in the general price level
(c) always increase the value of the national currency
(d) tends to redistribute income arbitrarily
(e) tends to bring down market prices **(SSCE 1989)**
4. Deflation can be controlled by increase in .
(a) the bank rate
(b) income tax
(c) the rice level
(d) the budget deficit **(SSCE 1999)**
5. Inflation can best be checked by .
(a) allowing supply to remain constant
(b) decreasing supply and wages
(c) increasing supply and holding wages constant
(d) decreasing supply and increasing wages **(SSCE 2000)**

Essay Questions
1. (a) What is inflation?
(b) Why is price control not suitable in checking this type of inflation? **(SSCE 1988)**
2. (a) What is demand pull inflation?
(b) What efforts have been made by the government to combat inflation in Nigeria? **(SSCE 1990)**
3. (a) Describe the effects of inflation on the economy of a country. **(SSCE 1995)**
(b) What are the positive and negative effects of inflation on the economy? **(SSCE 1999)**
4. (a) Distinguish between cost push inflation and demand pull inflation.
(b) Explain any four ways of controlling inflation. **(SSCE 2003)**

Glossary
Inflation: This is the persistent increase in the general price level of goods and services.
Deflation: This is a persistent fall in the general price level of goods and services.
Cost Push Inflation: Cost push inflation arises due to increase in the cost of factors of production.
Open Market Operation [OMO]: This is a monetary policy used in reducing the quantity of money supplied in circulation.
Expansionary Monetary Policy: It is a policy where by banks are encouraged to increase their lending to the public and thereby increase aggregate demand.