Subject : Economics

Topic : Inflation

INFLATION (Notes for March 2020) – Teacher Sarah

This refers to the persistent increase in the general price level of goods and services in an economy in a given period of time..

OR Inflation is defined as the persistent and continuous increase the general price level of goods and services in an economy in a given period of time.

For a condition or situation, to be referred to as inflation; price must be increasing but not necessary high.

- The increase in prices must be persistent.
- The increase in prices must be for all or most of the commodity.
- Inflation measures the value of money and it is measured with respect to time. When prices of commodities increase, the value of money falls and when prices of commodities decreases, the value of money rises.

Value of money refers to the amount of goods and services a unit of money can buy from the market e.g. if a student has shs.1000 and buys 2pens, then the value of money is expressed in terms of the two pens bought.

MEASUREMWNTS OF RATE OF INFLATION

The rate of inflation in an economy can be measured by the use of price indices.

$$\text{Rate of inflation} = \frac{\text{current year price-base year indices}}{\text{Base year price index}} * 100$$

For example

If the computed price index =108, then the rate of inflation

$$= \frac{108-100}{100} * 100$$

=8%

If the computed current year price index is 95, then

Rate of inflation=95-100*100

100 = -5%

This implies that the general price level of goods and services has fallen this is what is referred to as deflation.

DEFLATION

This is the persistent decrease in the general price level of goods and services in an economy.

STATES OF INFLATION/ CLASSIFICATION

This refers to the speed at which the general price level of goods and services is increasing.

There are two major states of inflation

i. **Mild/ creeping/Gradual inflation**

   This is where by the persistent increase in the general price level of goods and services proceeds at a very slow rate which is usually less than 10%

   This state of inflation is desirable for an economy and it has good number of advantages.

ii. **Galloping/Hyper/Runway**

   This is where by the general price level of goods and services an economy is increasing at a very high rate usually 10% and more.

   Usually this state of inflation is undesirable for an economy and it has a number of disadvantages.

   This type of inflation greatly reduces the value of money in the short period of time.

THEORIES OF INFATION

These theories explain the cause of the different types of inflation.

I. The demand pull theory of inflation. This explains that inflation in an economy is caused by excessive aggregate demand for goods and services over the aggregate supply at full employment level of resources.

Excessive aggregate demand, which is not matched with supply results into increase in price hence inflation.

II. The cost-push Theory of inflation.

This explains that inflation in an economy is brought about by rising costs of production.

Due to increased costs of production, producers have to increase prices of their goods in order to maintain their profit margin hence leading to an inflationary situation.

III. Structural Theory of Inflation. This theory explains that inflation in an economy comes about as a result of supply rigidities.

Supply rigidities like natural calamities, political; instabilities, breakdown of the country's infrastructure etc. hinder production of goods and therefore lead to an increase in prices.

IV. Speculative Theory of inflation. This explains that inflation in an economy comes about as a result of speculative tendencies in an economy by the producers or consumers .

If producers predict that prices are going to increase in the near future, they hoard goods which results into shortages and hence increase in prices.

In the same way, if consumers predict that prices are going to increase drastically in the near future, they may increase their purchase in the current period resulting into excess demand and thus increase in prices of goods and services.

V. Monetary Theory of Inflation.

This explains that inflation in an economy is caused by increases in the money supply which is not accompanied by the corresponding increase in production of goods and services .

Excessive money supply results into a situation where there is too much money purchasing few goods and services hence the increase in prices.

TYPES AND CAUSES OF INFLATION AND THE SOLUTIONS

1. Demands pull inflation. This refers to the persistent increase in the general price level of goods and services in an economy which is brought about by excessive demand for goods and services over the aggregate supply in an economy at full employment level of resources.

OR

Demand pull inflation is one that arises out of excessive aggregate demand over aggregate supply (at full employment of resources).

Demand pull inflation is caused by factors that lead to an increase in aggregate demand for goods and services in an economy.

Causes of demand pull inflation.

- Excessive issuance and printing of a country's currency by the central Bank . This leads to an increase in the amount of money in circulation which increases peoples purchasing power and aggregate demand for goods and services.
- -Excessive government expenditure. This also increases the money supply, people's purchasing power and aggregate demand for goods and services.
- -Excessive inflow of incomes from abroad. This leads to an increase in aggregate demand for goods and services.
- -Uncontrolled credit creation by the commercial banks. This increases the level of lending which increases the amount of money in circulation and aggregate demand.
- -Excessive borrowing by the government from the central bank .this also leads to an increase in government expenditure which increases the amount of money in circulation and thus results into increasing aggregate demand.
- -Excess demand for the country's exports especially by the neighboring countries. This creates shortages of these goods in the country. As the goods become scarce, the prices increase.
- Excessive wage increase

<u>SOLUTIONS</u>

It can be controlled/ solved by the use of measures that reduce/ control aggregate demand in addition to other measures.

- Increasing direct taxes on income.
- Reducing government expenditure.
- Use of a restrictive monetary policy e.g. sale of treasury bills and bonds to the public.

- Reduce government borrowing from the Central Bank.
- Use of wage control measures to prevent wage increases e.g. wage freeze and wage restraint.

NB: **Wage freeze** is the legally backed government policy of keeping wages at a specific level for a specified period of time so as to control inflation.

Wage restraint is a voluntary restriction of wage increases by employers and trade unions so as to check/ control inflation.

Use of price controls especially maximum price legislation where prices can't go above those set by the government.

However, price controls result into suppressed inflation.

Suppressed Inflation.

This is one where aggregate demand for goods and services is greater than aggregate supply but when increases in the prices have been prevented by measures like price controls, rationing of goods.

OR

This is one which occurs when aggregate demand exceeds aggregate supply but the government minimizes it by using price control and rationing of goods.

1a) Distinguish between cost push and demand pull inflation.

b) Mention two causes of demand pull inflation in your country.

2a) Distinguish between deflation and reflation.

b) Mention two instruments of reflationary policy.

3a) Distinguish between creeping and runaway inflation.

b) Give two policy instruments for controlling inflation in your country.

<u>Cost-push inflation.</u>

This refers to the persistent increase in the general price level of goods and services brought about by the rising costs of production.

When costs of production increase, producers respond by increasing the prices of final goods and services that they produce in order to cover up the increasing costs.

CAUSES OF COST PUSH INFLATION.

- Rising wages/ increase in wages. This results into wage push inflation.

NB: wage push inflation refers to the persistent increase in general price levels of goods and services brought by increase in wages. As the workers demand for higher wages , the producers after granting the higher wages , inevitably have to increase the prices of their products.

Cost push inflation usually occurs in form of an **inflationary spiral** which Is a situation where a persistent increase in the price level results into demand for higher wages by the workers which increases the production costs hence resulting into rise in prices.

- Rising/increasing interest rates on capital / borrowed money. Increase in the interest rates charged on loans by commercial banks results into an increase in prices of final products.
- Rising transport costs. This arises due to increasing fuel prices which causes an increase in the cost of transporting the goods.
- Increasingprices of raw materials especially those that are used as inputs in production of final goods and services .This at times is used by rising indirect taxes on those raw materials.
- Rising rates of taxation on the producers. This also increases the production costs and prices of final goods and services.
- Rising costs of advertisement .this also increases the production costs which results into increase in the prices of final products.

Solutions

This can be controlled by measures that control/ reduce the production costs. e.g.

- Provide tax incentives to the producer e.g. tax holidays and tax reductions
- Develop/ improve the country's infrastructure especially the transport system which reduces the transport costs.
- Subsidize producers

- Wage control methods which limits/ increase wages e.g. wage freeze and wage restraint.
- Reduce interest rate on loans advanced by commercial banks.
- Reduce indirect taxes levied on individual raw materials and spare

Structural/bottleneck/scarcity inflation.

This refers to the persistent increase in the general price level of goods and services brought about by supply rigidities in an economy.

Supply rigidities refer to the factors that hinder or prevent smooth production of goods and services leading to shortages in an economy and consequently resulting into increased prices.

An example of supply rigidities is breakdown of infrastructure where supply of goods cannot be increased to desired levels. Shortage of goods arises on the market and prices finally increase.

Causes of structural inflation.

1. Political instability. This hinders smooth production of goods and services which brings about shortages and rising prices in the market.
2. Natural hazards / unfavorable natural factors. This hinders production especially in the agricultural sector resulting into shortages and rising prices.
3. Breakdown of the country's infrastructure .this hinders production and also causes delays in distribution of commodities to the market causing shortages in different areas and hence rising prices of goods.
4. Scarcity /shortage of inputs/raw materials. This also hinders smooth production of goods and services thereby leading to shortages and rising prices.
5. Speculation by business people through hoarding of commodities which results into shortages hence causing inflation.

Solutions

This can be controlled by policies / measures which increase production of goods and services after removing all the bottlenecks or supply rigidities that hinder production.ie

- Improve political climate

- Develop the country's infrastructure
- Liberalize trade
- Modernize agriculture which reduces dependence on natural factors provide capital to facilitate production

QN.

1a) Distinguish between cost push and bottle neck inflation.

b) Mention two causes of bottleneck inflation.

4. Imported inflation

This is the persistent increase in the general price level of goods and services that results from importation of commodities from countries experiencing inflation.

This happens if the imported products are used as inputs but also happens when the imported goods are final goods

When such goods are brought into the country , the importers have to sell them expensively thereby creating imported inflation.

Causes of imported inflation.

- Importation of commodities from countries experiencing inflation.
- Importation of commodities whose prices are rising on the international market.
- Depreciation of country's currency.

Solutions

This can be controlled;

- Encouraging importation from cheaper sources
- Establish import substitution industries to start producing those commodities that were originally imported from countries facing inflation
- Subsidize the importers
- Use of trade restrictions to discourage importation of commodities from countries experiencing inflation.

Profit push inflation.

This refers to a persistent increase in the general price level of goods and services that arise when the business people increase the prices of final goods in order to make more profits.

It is mainly brought about by the greed of the business people for higher profits.

CAUSES OF INFLATION IN LDCs/ UGANDA

1. Excessive government expenditure especially on non-productive activities. This increases money supply in the economy which increases aggregate demand and consequently results into increase in price of goods and services.

OR

Excessive spending by the government on presidential and parliamently elections, on salaries and allowances of politicians causing a significant increase in the volume of money in circulation. This increases peoples' purchasing power, aggregate demand and this finally causes inflation.

2. Excessive issuance and printing of a country's currency by Central bank. This increases the amount of money in circulation which increases aggregate demand and thus rising prices for goods and services.
3. Excessive inflow of income from abroad. This also increases the amount of money in circulation which increases aggregate demand thus rising prices of goods and prices.
4. Excessive/uncontrolled credit creation by commercial banks. This increases the level of leading in the economy which increases the amount of money in circulation and thus results into increasing aggregate demand and rising prices of goods and services.

OR

Uncontrolled lending of money to the public by commercial banks creates excessive money supply in the country. As the money supply increases, aggregate demand for goods and services also increases and thus leading to rising prices.

5. Excessive borrowing from Central bank by the government. This leads to increase in government expenditure which increases amount of money in Circulation and aggregate demand and thus leading to rising prices of goods and services.
6. Excessive demand for country's exports especially the essential goods. This creates shortages in the domestic market hence leading to rising prices of goods and services in the domestic market.

OR

There is increased demand for goods produced in Uganda by the neighboring countries. This creates scarcity of these goods in the country. As the goods become scarce, prices increase thereby causing inflation.

7. Political instabilities. This disrupts / hinders smooth production of goods and services leading to shortages in the domestic market and thus leading to rising prices of goods and services in the market.

OR

This disrupts and limits production in some areas of the country. Insecurity in some areas limits production in industry and agricultural sector. As a result, supply of commodities reduces scarcity is created, price increased and thus inflation.

8. Natural calamities. This also hinders production in the agricultural sector which leads to shortages in the market and thus leading to rising prices of goods and services in the market.
9. Breakdown of the country's infrastructure. This hinders production and causes delays in distribution of commodities to the market hence causing shortages in different areas of the country.
10. Importation of commodities from countries experiencing inflation. Such commodities have to be sold at even higher prices in the country in order to cover the cost incurred in importation but in addition, some of these commodities are used as inputs in production which results into higher prices for commodities in the domestic market.

11. Speculation by the business people. Sometimes businessmen hoard commodities in order to sell them at higher prices in future which creates artificial shortages and consequently leads to increases in prices in the market.
12. Rising costs of production. Because of the rising costs of production, producers increase the prices of final goods and services they produce in order to cover up the incurred costs which eventually lead to increase in prices of goods and services in the market.

OR

The rising costs of production e.g rising costs of advertisement causeasignificant rise in costs of production. Producers respond or react by increasing the prices of commodities sold to the final consumers in order to recover the money spent during the production process.

13. Depreciation in the country's currency. A decline in the value of a country's currency relative to the foreign currencies results into greater quantities of the local currency being used to purchase the same amount of goods and services and hence resulting into increases in price in the domestic market.
14. Greed for higher profits by the business people. This increases prices of goods and services in order to increase their profit margins which eventually leads to rising prices of goods and services.

Question.

1a) Distinguish between underlying and headline inflation

B) To what extent is inflation in your country a result of rising costs of production?

2a) Account for the persistentn inflation in your country.

b) Suggest measures that should be taken to control inflation in your country.

3a) Explain the measures being taken to control inflation in your country.

MERITS OF INFLATION/POSITIVEIMPACT/CONSEQUENCES/EFFECTS OF INFLATION.

Inflation is associated with both positive and negative effects in an economy.

i). Position effects are generated from mild/creeping/gradual inflation.

ii). Negative effects are generated from hyper/galloping inflation

NB: Whenever a question is asking for the effects of hyper/galloping inflation, we only consider the negative effects of inflation.

POSITIVE EFFECTS

1. Inflation leads to an increase in the level of investment. This is because during the time of mild inflation, producers make more profits which encourages investment.

OR

This comes about as a result of the increased profits made by the investors during the time of inflation because goods are sold at slightly higher prices.

2. Inflation leads to an increase in employment opportunities. As the investors are getting higher profits from mild inflation, they are able to expand their investments and this promotes creation of more jobs for the people.
3. It leads to an increase in government revenue from taxation. This comes about as a result of increase in investment and output on which taxes are imposed.
4. It leads to an increase in the level of exploitation of the country's resources. This arises as a result of increased level of investment by the investors so as to make more profits.
5. It promotes increase in production of goods and services and hence economic growth. This comes about as a result of increased investment during the time of mild inflation which results into production of more goods and services.
6. Inflation promotes/ encourages hard work. This is because people are forced to work harder to get higher incomes so as to afford good and services whose prices are increasing

NB; it forces the people to work harder to meet the rising cost of living.

7. It promotes /encourages creativity and innovativeness. In the economy. This arises as the people look for alternative ways of increasing upon their incomes so as to purchase goods and services whose prices are rising.

8. Inflation lifts the country's economy out of economic depression. This is because it results into increase in prices which increase income levels and thus increases aggregate demand which enables the country to overcome the depression.
9. Inflation encourages mobility of labour because during periods of inflation, labourers move from job and area to area trying to look for better paying employment opportunities and this helps to reduce labour shortages in some areas.
10. Inflation encourages forced saving in the economy. Since during periods of rising prices, people may forego consumption of some commodities which are not very necessary and therefore money is saved for future use..
11. Borrowers/debtors gain during periods of inflation. This is because they pay back less in real terms compared to what they borrowed

OR

All the time of borrowing, the value of money is still high and the borrower uses more money to buy goods on the market.However by the time the borrower pays back the money, its value will have gone down but he or she would have gained in real terms

DEMERITS/NEGATIVE EFFECTS/IMPACTS/CONSEQUENSES /IMPLICATIONS OF INFLATION

1. Inflation discourages saving in the economy. This is because money loses value during periods of inflation implying that if one saves, he takes back less in real terms when it comes to spending the money he saved.

This is because money loses value during the times of inflation and thus people fear to save because if the money is saved, it is of little use in the future when its value is low.

2. It leads to loss of confidence in the country's currency. This is because during the times of inflation, the country's currency loses value and as a result people and institutions may start using foreign currencies in carrying out transactions.
3. It leads to a decline in people's welfare. This is because people buy less goods and services because of the rising cost of living.

4. Leads to production and consumption of low quality goods. Since they may not afford the better quality goods and services in periods of rising prices, therefore they opt to buy and consume the cheaper, poor quality goods and services.
5. It worsens the country's B.O.P. This is because people opt to buy the imported goods which leads to high expenditure abroad while the demand of exports reduces which leads to a reduction in the country's income from abroad.
6. Inflation increases income inequality in a country. This is because during periods of inflation, the business people make more profits and become richer while the fixed income earners become poorer and poorer.
7. Inflation makes government planning difficult. This is because during periods of inflation, funds put a side for implementing projects become inadequate leading to failure of such projects in the country.

   OR

   Due to hyperinflation, the money previously put aside by the government to finance development projects becomes insufficient. This makes the government to abandon some projects and they are not implemented hence limiting economic growth.
8. Inflation discourages investment in the country due to the rising costs of production which makes investment unprofitable.
9. It results into industrial unrest. This is because during periods of high rates of inflation, workers complain/ demand for higher wages which the employer may not be able or willing to grant and thus leading to demonstrations and strikes.
10. Inflation discourages lending. This is because the creditor or lender loses during periods of inflation as they are paid back less in real terms.
11. Inflation discourages production/ leads to a decrease in production. This is because of the increased cost of production that discourages investment thus reducing production and output during periods of inflation.
12. Government becomes unpopular during periods of high rates of inflation which sometimes results into riots and political unrest as people usually blame government for the rising prices/ for failure to control the prices.
13. It leads to brain drain. This is because educated/ skilled individuals opt to go and work to other countries where the prices are relatedly stable.

14. It results into malpractices e.g. smuggling, corruption etc. as people try to look for alternative means of survival.

    OR

    People look for possible opportunities of supplementing their income through illegal means so that they get additional money which can make them survive amidst a high cost of living created by hyperinflation.
15. People are strained in an attempt to cope up with the rising cost of living. People tend to fore go leisure and engage in income generating activities in order to obtain income to supplement what they are currently earning such that they survive amidst the hyperinflation.
16. The fixed income earners suffer greatly as real income fall. These individuals who earn fixed incomessufer due to rising cost of living, they continue to receive the same amount of nominal income yet prices of goods and services are rising at a very high rate. Hyperinflation reduces the purchasing power of the fixed income earners.
17. It leads to unemployment. This is due to some firms closing down due to hyperinflation, the production costs rise at a very high rate. Some firms find it difficult to continue producing and so they close down leading to unemployment.

Questions

1a) Distinguish between supposed inflation and structural inflation.

b) Examine the effects of inflation in an economy.

2a) Distinguish between structural and imported inflation

b) Assess the effects/ impacts of inflation.

3a) Differentiate between demand pull and structural inflation.

b) Mention any two effects of demand pull inflation in our country.

4a) Examine the effects of hyper inflation in your country in an economy.

Circumstances under which inflation may be desirable in an Economy.

NB. Here we derive the points from the merits of inflation or positive effects and since we are focusing on circumstances, the points must be presented in a conditional tense i.e. by use of when incase, during period of etc.

1. When it stimulates economic growth. Rising prices during the times of inflation increase profit levels which increases profit level which increases investment, production, output and economic growth.

   OR

   The existence of mild inflation encourages producers to increase output in order to sell more goods and services to make higher profits.

   This increases output brings about economic growth.
2. When it promotes investment and production in the country. Rising prices increase profit levels which encourages investment and production in the country.
3. When it leads to an increase in employment in the country. This comes about as a result of increase in investment during the time of inflation.

   Rising prices increase the cost of living and this forces people who would not have taken up jobs to get into active employment because they need to earn income to survive amidstthe high cost of living.
4. When it helps an economy to overcome a depression. This is because the increase in prices leads to increase in income and aggregate demand which lifts the economy out of a depression.
5. When it stimulates aggregate demand/ expandmarket. Rising prices lead to an increase in income which increases aggregate demand.
6. When it encourages labor mobility. Due to inflation, workers shift from low paying jobs to high paying jobs this gives rise to occupational mobility of labour.
7. When it promotes forced savings. During a time of inflation, people are forced to forego consumption of some of the commodities that they have been purchasing.
8. When it encourages hard work/ when it stimulates innovations and inventions. During periods of inflation, the cost of living rises, this makes the public to be creative and hard working so as to receive money and able to survive amidst the inflation.

OR

The people are encouraged to work hard to get money in order to buy thopse goods whose prices are rising slowly.

9. When it promotes utilization of resources. Rising prices encourage investments which leads to an increase in production and expectation of resources.
10. When it benefits the borrowers in real terms. At the time of borrowing, money has a higher value. The borrower uses the money to buy more goods from the market. However, by the time the borrower pays back the money, its value is lower but he has already gained in real terms.

<u>Objectives of fighting inflation/Reasons for keeping a low Rate of Inflation/why Government strives to keep a low rate of inflation/ Why Government control inflation.</u>

1. To promote savings among people. The government controls inflation to ensure stable prices in order to enable people gain confidence in the currency which encourages saving.
2. To reduce unemployment .the government strives to keep a low rate of inflation to ensure stable prices which results into stable costs of production and thus reducing closure of firms hence reducing unemployment.
3. To promote people's confidence in the local currency. The government strives to keep a low rate of inflation to ensure prices in order to enable the country's currency to gain value hence promoting confidence in the currency.
4. To enable the fixed income earners to enjoy a better standard of living
5. To encourage lending by financial institutions
6. To reduce brain drain.
7. To reduce income inequality.
8. To improve the B.O.P Position.
9. To encourage and promote production of high quality goods.
10. To encourage local and foreign investors.
11. To reduce industrial unrest.
12. To discourage illegal activities for example bribery and smuggling of goods
13. to encourage local and foreign investors.

14. To ease or facilitate economic development planning.

15. To make the government in power popular among the public.

16. To maintain a low cost of living and ensure that people are not over strained.

Questions

1a) What is meant by the term stagflation..

b) Under what circumstances may inflation be desirable in an economy.

2a) Why may inflation be desirable in an economy.

b)Why may a low rate of inflation be desired in Uganda.

3a) Why may a high rate of inflation be undesirable in an economy.

Policy Measures for Controlling Inflation in Uganda

1. Increase direct taxes/ taxes on incomes. This reduces the disposable income which reduces aggregate demand and hence preventing prices from rising.

   OR

   By increasing direct taxes, there is a reduction in disposable incomes of people which reduces aggregate demand and hence controlling inflation.
2. Control issuance of the country's currency. This controls the amount of money in circulation which controls aggregate demand and thus preventing prices of goods and services from rising further.
3. Reduce government expenditure,. This reduces the money supply which also reduces aggregate demand and thus controlling inflation.
4. Improve/ Develop the country's infrastructure e.g. the transport system which encourages resource movement as well as movement of goods in the different areas in addition to encouraging more production whic h reduces shortages and hence preventing prices from rising.

   OR

   Well developed infrastructure/ improved road network or better roads facilities quick delivery of goods to market places. This eliminates scarcity of goods since aggregate supply increase hence reducing inflation.

5. Undertake trade liberalization. This leads to an increase in the level of investment which increase output of goods and services and thus reducing shortages which prevents prices from rising.

OR

Controls on trade are relaxed by the government which encourages investors to produce more goods and services and this increases aggregate supply because more goods are available on the market which helps to eliminate scarcity and thus controlling inflation.

6. Privatise public enterprises. This increase the level of efficiency in the operation of the enterprises which increases production and supply of goods and services on the market thus controlling inflation.
7. Improve political climate/ maintain stability. This promotes investment in the country which increase production and supply of goods and services thus reducing shortages and hence controlling inflation.

OR

By ensuring political stability, investment is promoted because there is no fear for loss of lives and property. More goods are produced and aggregate supply increases hence controlling inflation.

8. Provide investment incentives to both the local and foreign investorse.g through extensions of tax holidays to the investors. This promotes investment because it reduces the production costs hence leading to increase in production and supply of goods and services thus controlling inflation.
9. Use of a restrictive monetary policy e.g through the sale of treasury bills by the central Bank to the public. This reduces money supply and aggregate demand for goods and services thereby controlling inflation.
10. Reduce government borrowing from the Central bank. This reduces the amount of money in circulation thereby reducing aggregate demand hence controlling inflation.
11. Modernize agriculture. This leads to an increase in agricultural output even in the dry period which reduces shortages hence controlling inflation.

OR

By modernizing agriculture more food items are produced and supplied on the market. As food items become more available, prices stabilize thereby controlling inflation.

12. Encouraging use of instruments of credit e.g. cheques, bills of exchange etc. tis reduces the use of cash in carrying out transactions which reduces the amount of money in circulation thereby reducing aggregate demand and for goods and services.
13. Reduce indirect taxes. This lowers the prices of goods and services hence controlling inflation.

Questions

1a) Discuss the causes of inflation in Uganda.

b) Suggest measures that should be taken to control inflation in Uganda.

2a) Account for persistent inflation in Uganda.

b) Explain the measures being undertaken to control inflation in Uganda.

3a) To what extent are inflationary tendencies in Uganda as a result of excessive demand.

b) Discuss the measures used/ taken/ have been taken to control inflation in Uganda.

Stagflation.

This is where high rate of inflation co-exist with high rates of unemployment. It is caused by a decline in aggregate supply which leads to a decline in output hence unemployment due to laying off of workers.

NB: the demerits of stagflation are the negative effects of inflation.

Reflationary Policy.

This refers to a deliberate government policy to force prices upwards to recover from a depression.

Instruments / Methods of Reflationary Policy

- Increase in government expenditure
- Increase in wages
- Use of an expansionary monetary policy e.g. buying government securities from the public
- Tax reduction on incomes/ reducing direct taxes
- Encouraging exports.

Question

a) Distinguish between deflation and reflation.

b) Mention two instruments of reflation in an economy.

Inflationary spiral

This refers to a situation where a persistent rise in the general price level creates a persistent demand for higher wages which again generates a further increase in the prices of commodities.

The increased wages result into an increase in the cost of production and this forces producers to increase prices of the commodities.

The workers again demand for an increase in the wages and the trend goes on and on.

- Use of trade restrictions to discourage importation of commodities from countries experiencing

<u>Why is it difficult to control inflation in Developing Countries</u>

Challenges

1. High rate of rural-urban migration. This increases the cost of living in town hence inflation.
2. The need to import essential commodities and raw materials which are lacking in the country e.g petroleum products make it difficult to control imported inflation.
3. Frequent wage increases by the government. This leads to an increases in the level of income hence increases in demand for goods and services.
4. The need for high revenue from indirect taxes by the government which causes producers to increase prices of commodities.
5. Lack of appropriate measures to control populationgrowth rates. This leads to excessive demand for goods and services hence hence inflation.
6. Political instability and insecurity. These demand for increased government expenditure hence increased money supply and aggregate demand.

7. Occurrence of unforeseen circumstances e.g pests and disease, bad weather etc which leads to shortage of goods and services especially in the agricultural sector.

8. Limited capital required to establish industries to increase domestic production of goods and services.

9. Existence of poor infrastructure e.g. in form of poor transport and communication facilities which makes it difficult to transport goods to areas of scarcity.

10. Low productivity in the agricultural sector. This leads to shortages of food hence increase in food prices.

11. High level of corruption and embezzlement of public funds meant for productive activities. This leads to shortage of goods hence inflation.

12. Under developed financial sector. This makes it difficult to use the tool of monetary policy to control money supply hence inflation.