TOPIC 12: INFLATION.

Definition: Inflation is defined as the **persistent and continuous increase** (rise) in the general price level of goods and services in a **given period of time**.

N.B.i) Inflation measures the **value of money** and it is measured with respect to time.

ii) ***Value of money*.** Value of money refers to the amount of goods and services a unit of money can buy from the market. **Or *Value of money*** refers to the purchasing power of a unit of money.

For example, if a student has shs 1,000 and buys two pens each at shs 500, then the value of shs 1000 is expressed in terms of the two pens bought. As far as the student is concerned the purchasing power of shs 1,000 is two pens.

MEASUREMENT OF A RISE IN PRICES FOR A SINGLE COMMODITY:

The percentage rise in price is computed as follows:

% rise in price = pn- po / po

Where: P**n**= new price

P**o** = old price

Example: Given a base year price of a commodity as shs 2,000 and a current year price as 2,200, calculate the percentage increase in price of the commodity.

Percentage rise in price = $\frac{2,200 - 2,000}{2,000} \times 100$ = **10%**

CAUSES OF PERSISTENT INFLATION IN UGANDA: (“*SPRING BED*”)

From a macro-economic perspective inflation can arise from one or a combination of the following:

1. **Speculation by traders**. Traders hide goods and create artificial scarcity hence a rise in prices of commodities.
2. **Political instability**. This limits investment and production due to fear of loss of lives and property. Aggregate supply reduces relative to the increase in aggregate demand thus causing inflation.
3. **Rising costs of production in form of rising wages, rising fuel prices e**.tc. Producers increase prices to cover the escalating production costs and make some profits hence causing cost-push inflation.

4. **Importation from countries experiencing inflation**. Importers increase prices to cover the heavy costs they have incurred to purchase goods from other countries hence causing inflation.
5. **Natural hazards**. Hazards like prolonged drought lead to a fall or decrease in supply of agricultural goods on market yet demand for them is rising and this causes inflation. (Head-line inflation).
   N.B: Headline inflation is one that is caused by rising prices of food items on the market.
6. **Greed for profits by traders**. Such traders continuously increase prices of goods even when it is not necessary to do so hence causing inflation.
7. **Break-down of infrastructure.** This increases costs of production and there is reduction in output. Shortages of goods are experienced and prices increase.
8. ***Excessive* government expenditure**. This increases money supply which in turn increases aggregate demand relative to low aggregate supply and this causes inflation.
9. ***Excessive*** inflows of income from abroad/ Excessive inflow of capital with high finance component. This leads to an increase in money supply. Aggregate demand increases relative to low aggregate supply thereby causing (demand–pull) inflation.
10. ***Excessive* issuance of currency**. Money supply is increased and this increases aggregate demand yet aggregate supply is low thus causing inflation.
11. ***Excessive* /uncontrolled credit creation by commercial banks.** Due to massive lending by commercial banks, money supply increases. In turn, aggregate demand increases yet aggregate supply is low resulting into a rise in prices of commodities**.**
12. ***Excessive* exportation of essential goods/ *excessive demand for essential goods in the export markets.*** This reduces aggregate supply yet there is increased aggregate demand in the domestic market. This causes an increase in prices thus inflation.
13. **Excessive borrowing from the central bank**. As commercial banks borrow massively from the Central bank, they also increase their lending to the public. Money supply increases leading to an increase in purchasing power of the public hence increasing prices of goods and services.
14. **Depreciation of local currency/Falling value of the local currency relative to other currencies.** This increases prices of imported inputs and final goods in Uganda. This is because it is expensive for importers to buy foreign currencies using the local currency.

POLICY MEASURES WHICH ARE BEING UNDERTAKEN TO CONTROL INFLATION IN UGANDA (to be given to students for sticking in their note books)

N.B.The presentation requires strictly the Present continuous tense (**Now tense**). In the explanation you have to show how prices of goods and services are being reduced or kept stable.

N.B: Take note that some measures are **aimed at increasing aggregate supply** while others are aimed at **reducing aggregate demand**. Such a link is vital in the explanation of the measures to fight inflation.

1. **Reducing government expenditure on non-essential goods**. This is intended to reduce money supply which reduces aggregate demand and purchasing power of consumers hence reducing (demand pull) inflation.
2. **Increasing direct taxes/ increasing taxes on incomes**. The measure aims at reducing disposable incomes which in turn reduces purchasing power and aggregate demand thereby reducing inflation.
3. **Developing infrastructure**. This reduces production costs and investors are able to increase output and supply more goods and services hence stabilizing prices.
4. **Providing tax incentives to investors**. This reduces costs of production. Investors increase production scale and aggregate supply increases hence controlling inflation.
5. **Improving the political atmosphere**. This reduces fear for loss of property and lives by investors. Investors increase production and aggregate supply increases hence checking inflation.
6. **Undertaking import substitution industrial strategy**. The measure is aiming at producing cheaper commodities locally (within Uganda) hence fighting imported inflation.
7. **Undertaking contractionary or restrictive monetary policy**. The measure aims at reducing money in the hands of the public which in turn reduces their purchasing power and aggregate demand hence a fall in prices.
8. **Encouraging importation from cheaper sources**. This is aimed at supplementing domestic supply. This finally reduces or stabilizes prices of commodities.
9. **Controlling issuance of currency**. The aim is to reduce the amount of money in circulation which in turn reduces aggregate demand/ reduces purchasing power. This finally checks inflation.
10. **Liberalizing the economy**. The costs of production reduce due to relaxed tariffs. Producers are able to increase output and more goods and services are supplied on market. This stabilizes prices.
11. **Modernizing the agriculture sector**. By carrying out irrigation,farmers maintain continuous production throughout the year. The constant supply of agricultural goods stabilizes prices hence controlling inflation.
12. **Controlling government borrowing from the central bank**. This reduces money supply. Aggregate demand reduces. Purchasing power of the public reduces hence helping in keeping prices stable.
13. **Privatizing public enterprises**. This increases efficiency in privatized firms. Output increases and prices of commodities reduce thereby fighting inflation in Uganda.
14. **Controlling the export of certain goods**. This increases domestic supply of commodities which reduces their prices hence controlling inflation.

SUGGESTED MEASURES THAT SHOULD BE TAKEN TO REDUCE INFLATION IN UGANDA.

N.B: However, also note that if a question is asking you to suggest measures that should be taken to reduce inflation in Uganda, the answers must be written in the **Suggestive tense** with words: *CAN/MAY/ SHOULD.*

The stating of the points changes and the explanation must be in a **suggestive form** using **CAN/MAY/SHOULD.**

1. Direct taxes should be increased.
2. Government expenditure on non-essential goods should be reduced.
3. Further Liberalization of the economy can be undertaken.
4. Incentives should be provided to investors to increase output.
5. Infrastructure should be improved.
6. Restrictive monetary policy should be implemented by Government through the central bank.
7. Government should control the issuance of currency.
8. Modernization of Agriculture should be undertaken to increase supply of food items in the country.
9. Further privatization of public enterprises should be undertaken.
10. Importation of goods from cheaper sources should be encouraged to avoid imported inflation.
11. The political atmosphere or climate should be improved.
12. Government borrowing from the central bank should be reduced.
13. Indirect taxes on essential goods should be reduced. This can reduce market prices of goods thus reducing inflation in Uganda
14. Control the export of certain goods. This can increase availability of goods on the local market in Uganda and this reduces inflation.
15. Establishment of import substitution industries should be encouraged.
16. Use of instruments of credit should be encouraged. The use of instruments of credit such as cheques, promissory notes and Bills of exchange can reduce the volume of cash transactions. This may reduce paper notes and coins in the hands of the public. Aggregate demand may reduce or fall and this can reduce demand pull inflation.

N.B: **CLASS ACTIVITY**:

The teacher guides students to draw a **Three - column summary table** with headings: measures **being taken**, measures **that have been taken** and measures that **should be taken** to reduce inflation in Uganda. Students fill the table with appropriate measures in the relevant tense. Pay attention to the variations in point statements.

CLASSIFICATION OF INFLATION:

Inflation is classified by some Economists using the criteria below:

1. Classification according to the **degree of intensity** (according to the speed at which prices increase)
2. Classification according to **its cause**. (according to what causes inflation)

1. **<u>Classification according to the degree of intensity (speed at which prices rise)</u>**. In this classification, we consider the speed or rate at which general prices increase in an economy in a given period of time.
   N.B: Inflation rate or speed of inflation is the percentage of annual increase in the general price level. It is measured by the consumer price index.
   In this classification, we have the following types /forms of inflation
   - Creeping inflation **or** Gradual inflation **or** Mild inflation
   - Walking inflation/Trotting inflation
   - Running inflation
   - Galloping inflation **or** Run-away inflation **or** Hyper inflation

   1. Creeping inflation/mild inflation/Gradual inflation: It is one where the persistent increase (rise) in the general price level is at a **<u>very slow rate</u>**. The annual rate at which prices increase does **not exceed 3%.** It is a **<u>single-digit inflation rate.</u>**

This form of inflation is desired by the producers and traders because it causes a slight increase in their profit margins.

2. **Walking inflation/ Trotting inflation**. It is one where the persistent rise in the general price level is at a **<u>moderate rate.</u>** The annual rate at which prices increase is intermediate between **3% - 7%.** It is also a single digit inflation rate.

3. **Running inflation**. It is one where the persistent increase in the general price level is **<u>rapid</u>** (prices increase rapidly). The rate of price increase is between **10-20%** per annum.

4. Galloping inflation/Run-away inflation/Hyper inflation: It is one where the persistent increase in the general price level increases at a ***<u>very high rate or very fast rate.</u>*** The prices rise very fast within hours, days or weeks and the percentage increase **per annum is over 20%.** It even becomes <u>double or triple digit if not checked</u>.

This type of inflation is not desired in an economy because it greatly reduces the value of money within a short period of time. The public loses confidence in the local currency. It discourages savings and investment. Generally it brings about **<u>only negative</u>** implications or effects (it does **not have** the positive side).

2. **<u>Classification according to the cause</u>:**

Under this classification we have the following:

1. **Demand–Pull inflation**. This is a type of inflation which is caused by **excess** <u>Aggregate demand</u> over <u>Aggregate supply,</u> at full employment level of income (resources).
   Causes of Demand pull inflation are (Please refer to the causes of **Inflationary gap** in National Income)
   - <u>Excessive</u> government expenditure.

- Excessive issuing of currency by the central bank..
- Excessive lending by commercial banks or uncontrolled creation of credit by commercial banks.
- Excessive inflows of income from abroad.
- Increasing /excessive demand for exports.

N.B: The remedies **or** solutions to Demand –pull inflation are the ones for solving an Inflationary gap (refer to work covered in S.5 under the Topic of National Income)

2. **Cost – Push inflation**. This is a type of inflation which is caused by the **increase or rise** in costs of production.
   Or.
   It is a type of inflation which is caused by **rising** costs of production.
   As production costs increase, producers also increase prices of commodities in order to recover the rising costs of producing those commodities.
   Causes of Cost- push Inflation:
   N.B: Pay serious attention to the aspect of **rising**……. or **rise in**…… or **increase in**……………
   - **Rising** prices of fuel. This causes an increase in the costs of transporting raw materials to factories. It also increases costs of distributing final goods to the markets.
   - **Rising** costs (prices) of imported inputs/raw materials.
   - **Rising** tax levels E.g Increase in indirect taxes which are levied on industrial raw materials.
   - Increase in wages/salaries paid to workers (rising wage bill for the producers)
   - **Increase** in interest rates charged on loans from commercial banks and other financial institutions/ **increasing** costs of borrowing.
   - **Increase** in power expenses / **rising** expenses on energy e.g rising electricity expenses which are incurred by producers from time to time.
   - **Rising costs** of repairing machines used in production.
   - **Rising** costs of advertising or sales promotion.
   - **Rising** costs of rent /**rising** costs of renting storage facilities.
   - Depreciation of the local currency against foreign currencies. This increases costs of buying raw materials and industrial spare parts from other countries. To recover such costs, the producers increase prices of final goods that they sell to consumers.

   Possible solutions or remedies to Cost- push Inflation;

- Downsizing/ reducing the size of the work force in order to reduce costs on wages.

- Government can construct fuel reserves in the country to serve the country in times of fuel shortages.
- Improving infrastructure like roads to reduce on transport costs.
- Adopting or implementing wage control measures
- Reduce interest rates on loans advanced by commercial banks.
- Subsidize the cost of electricity supplied to industries or manufacturing firms.
- Reduce taxes levied on industrial raw materials and spare parts.

3. **Structural inflation/ Bottle-neck inflation**:

This is a type of inflation which is caused by **supply rigidities** in an economy. E.g when there is a break-down of infrastructure in an economy, supply of goods cannot be increased to the desired levels. Shortages of goods arise on the market and prices increase. This break-down of infrastructure in an economy is an example of ***supply rigidity***. Supply rigidities create shortages of goods in an economy.

Causes of Structural inflation:

- Break-down of infrastructure.
- A fall in production in key industries due to the use of obsolete technology.
- Political instability.
- Natural hazards/ un-favorable natural factors.
- Hoarding of goods by profit – hungry traders/ Speculation by traders.
- Scarcity of inputs or raw materials.
- Shortages of foreign exchange for buying basic inputs and industrial spare parts.

Solutions / remedies to Structural inflation:

- Improving basic infrastructure.
- Ensuring political stability.
- Undertake agricultural modernization with emphasis on irrigation.
- Increase supply of foreign exchange.
- Improve the system of marketing and distribution of goods to market places.
- Importing raw materials from cheaper sources.
- Constant repair and replacement of worn –out industrial machines.

4. **Imported Inflation**: This is a type of inflation which is caused by the buying of goods from countries experiencing inflation. The importers increase prices of imported goods so as to recover the costs of buying them from other countries thus causing **imported inflation.**

Solutions / remedies to imported inflation

- Establish and support the import- substitution industries.
- Fixing total ban or embargo on certain imports.
- Importing goods from cheaper sources.

- Fighting the depreciation of **local currency.**

5. **Suppressed inflation/Repressed inflation**: It is that type of inflation which arises from demand exceeding supply but government minimizes the effect of this on prices through _use of price controls and rationing of goods._
6. **Headline inflation;** It is a type of inflation which is caused by increasing or rising prices of food items in a country in a given period of time.
7. **Under-lying inflation:** It is a type of inflation which is caused by increasing or rising prices of non- food items in an economy. It takes into account rising prices of manufactured goods and utilities such metered water, electricity e.t.c.

EFFECTS /IMPACT/CONSEQUENCES/OUTCOMES OF INFLATION IN AN ECONOMY

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

- The positive effects/ good outcomes are generated from the **Mild or Creeping or Gradual** form of inflation.
- The negative effects/consequences are generated from the **Hyper or Run-away or Galloping** inflation.

N.B: Therefore whenever a question is asking for the effects of Hyper or Run–away or Galloping inflation we only consider the ***negative effects of inflation (bad side of inflation)***.

i) Positive effects of inflation in an economy (These are generated from Mild-inflation only)

1. ***It helps to increase government revenue***. Government increases taxes on incomes to reduce purchasing power of the people and control inflation.
2. ***It encourages investment /entrepreneurship***. This is due to the desire for higher profits associated with mild inflation.
3. ***It leads to creation of employment opportunities***. Due to rising profit margins more business enterprises are set up. These firms hire and use more labour.
4. ***It Encourages innovations and inventions/ it promotes entrepreneurship***. People become progressive and think of starting several income generating projects sources to cope with the rising cost of living.
5. ***It increases output hence economic growth***. Firms increase output due to the desire for higher profits which are enjoyed from mild inflation.
6. ***It promotes hard work/effort among citizens***. Individuals put more effort in economic activities so as to earn income and be able to buy goods whose prices are slowly rising.

7. ***It increases the level of industrialization***/encourages import substitution industries. More industries are set up to increase production and benefit from the slowly rising profit margins as a result of mild inflation.
8. ***It increases labour supply***. Workers end up supplying more hours of work to earn more income to cope with the rising cost of living.
9. ***It increases the rate of utilization of resources***. Mild inflation leads to higher profits. This increases the number enterprises that process raw materials to produce more output hence reducing wastage.
10. ***Borrowers gain in real terms/debtors gain***. By the time the borrowers pay back, money will have lost its value yet they have already used it to purchase goods and gained in real terms
11. ***It increases labour mobility***. Workers look for higher or better paying jobs so as to cope with the rising cost of living i.e workers move from low paying jobs to higher paying jobs thus promoting occupational mobility of labour.
12. ***It encourages monetization (of the economy)***. More output is produced for sale since there is desire to get higher profits. This promotes production for monetary exchange hence expanding the commercial sector.
13. ***It encourages forced saving***. Instead of spending on goods which have become more expensive due to inflation, some people decide to keep money for use in the future when prices.
14. **It helps an economy to recover from a depression**. Due to mild or gradual inflation, producers are encouraged to invest and earn more profits. They produce more goods and services thus enabling an economy to recover from a depression.

(ii) ***<u>Negative effects of inflation in an economy (These are generated from Hyper inflation.</u>***

1. ***It discourages savings***. Due to inflation, consumption expenditure increases and this reduces savings.
2. ***It discourages local and foreign investment***. Inflation increases costs of production. Investment reduces due to fear of making losses or earning low profits.
3. ***It worsens Balance of payments position***. This is due to increased importation of goods to supplement domestic output/local production. As a result, foreign exchange expenditure increases hence B.O.P problems.
4. ***Promoted rural –urban migration and associated evils***. People move from rural to urban areas in search of higher paying since cost of living is rising.
5. ***It leads to unemployment as some firms close down***. Inflation increases costs of production forcing some firms to close down. This causes loss of jobs.
6. ***It discourages hard work among the poor***. The rising cost of living and fall in money value makes people to lose hope and they are reluctant to work hard. This is because their welfare remains the same despite the hard-work.

7. ***It promotes tax evasion/low government revenue through taxation***. Traders under declare tax obligations so as to remain with some profits. Hyper inflation eats away much of their profits.
8. ***Lenders stand to lose/ lending is discouraged***. Since money is rapidly losing value, the lenders get back the money they lent out when its value has greatly declined or reduced.
9. ***It promotes industrial unrest due to constant demand for higher pay.*** Workers organize sit down strikes to demand for higher wages so as to cope with the rising cost of living caused by hyper inflation. This causes loss of production time.
10. ***It leads to unpopularity of government/ Government becomes unpopular***. The sharp rise in cost of living creates misery and suffering. The citizens organize riots and blame the government in power for failing to reduce inflation. This creates political tension.
11. ***It promotes speculation***. Some traders hide (hoard) goods to create shortages so that they can sell the few goods on the market at even higher prices. This further increases the cost of living.
12. ***The fixed income earners suffer/it has causes misery among the poor***. The cost of living is sharply rising yet some individuals get fixed nominal incomes. They fail to buy certain goods hence reduced welfare (Hyper inflation greatly reduces the purchasing power of fixed income earners).
13. ***It encourages production of low quality goods***. Some inputs become more expensive and producers end up using fewer inputs or sub-standard cheaper inputs hence production of poor quality goods. (some producers concentrate on increasing supply of goods without paying much attention to quality improvements)
14. ***It encourages brain drain***. Skilled labour is forced to migrate to other countries where the inflation rate is low or cost of living is low. This loss of highly skilled labour retards the development process due to inefficiency in production firms.
15. ***It promotes social vice***; for example crime and immorality. The rising cost of living due to hyper inflation, forces people into vices such as prostitution, robbery, bribery so as to get additional money that can enable them to survive.
16. ***Workers are strained due to long hours of work***. Some individuals take on more than one job such that they earn additional income to survive on since prices of commodities are increasing at a very fast rate.
17. ***It makes planning difficult***. Inflation increases the cost of plan implementation. The items needed in planning become more costly than originally budgeted and some plans are abandoned.
18. ***It reduces economic growth***. The rising costs of production create a fall in profits and some firms close down. This reduces production of goods and services hence low rate of economic growth/Low GDP.

19. ***It worsens income inequalities/ it causes inequitable income distribution***. This is because the businessmen/ traders earn more during periods of hyper inflation compared the fixed income earners or salaried workers.
20. ***It leads to capital flight***. Foreign investors repatriate profits to their mother countries because it becomes expensive to do business in a country which is suffering from hyper inflation.
21. ***It leads to loss of confidence in the local currency***. This is due to loss of money value. People prefer to transact using foreign currencies which have a higher value. Some individuals even prefer to exchange goods for goods (they carry out barter trade).

Why may Government induce a low rate of inflation in Uganda?/ Reasons for keeping a low rate of inflation.

N.B: We derive some of the reasons from the merits of creeping or gradual or mild inflation

- So as to stimulate hard work among people.
- To encourage savings and higher investment levels. This is because mild inflation increases profit margins of producers/business enterprises.
- For purposes of creating more employment. This is due to higher profits which encourage investment hence more jobs are created for the people.
- To increase government revenue. Due to increased production of goods and services, the government is able to collect more revenue through taxing the commodities produced.
- To encourage innovations and creativity/ to promote entrepreneurship.
- In order to stimulate or increase economic growth. Since mild inflation encourages investment, more goods and services are produced. This increases economic growth/GDP.
- In order to encourage labour mobility. Due to the slight increase in the cost of living, workers strive to shift from low paying to higher paying jobs.
- To facilitate or promote resource utilization. Producers tap resources so as to produce more goods for sale at the slowly rising prices and get higher profits. This checks wastage of resources.
- To encourage borrowing for investment. This is because borrowers gain in real terms during periods of mild inflation. They are able to use the money borrowed when it still has a higher value than when the loans are paid back.

- To ease economic development planning. This is because mild inflation leads to low costs of implementing development plans.
- To promote confidence in the local currency.
- To reduce brain drain.
- To discourage illegal activities.
- To ensure that people are less strained since the cost of living is low.
- To make the government in power more popular among the public. This is intended at reducing civil unrest in form of riots, armed rebellion e.t.c
- To reduce industrial unrest. Workers do not agitate for wage increase since the cost of living is low during periods of mild inflation.
- In order to ensure production of high quality goods.
- To discourage capital outflows/To improve B.O.P position. Foreign investors are encouraged to continue plough-back profits since production costs are low during mild inflation instead of repatriating such profits.

Circumstances under which inflation may be desirable in an economy:

N.B: We extract the circumstances from the **positive effects of inflation**. The presentation of points must be in **a conditional tense**. Therefore begin with:

- **When ……………………………………………………………**
- **In case** ……………………………………………………….

1. **When it promotes economic growth**. The existence of mild inflation encourages producers to increase output in order to sell more goods and services so as to make higher profits. The increase in output brings about higher levels of economic growth.
2. **When it results into an increase in the profits of producers**. As prices of goods slightly rise traders, earn more profits and this makes inflation to be desired by traders in an economy
3. **When it stimulates inventions and innovations / when it encourages hard work among people.** The slowly rising cost of living created by mild inflation makes the public to be creative and hard working so as to receive income and be able to survive during periods of inflation. Many people become entrepreneurs and they take risks in business enterprises hence making inflation to be desirable.
4. **When it helps to reduce voluntary unemployment among people**. Inflation increases the cost of living and this forces people to engage in income generating projects in order to earn income thereby reducing voluntary unemployment.

5. **When it promotes investment levels /when it promotes utilization of resources**.. The expansion in investments as a result of mild inflation leads to the use of resources which would have remained idle hence making inflation to be desired in an economy.
6. **When it helps an economy to overcome a depression**. Due to mild inflation, producers increase production. Incomes of producers increase and they are able to undertake further investment. This may pull an economy out of a depression hence inflation becomes desirable.
7. **When it promotes forced savings**. The money saved becomes available for future use by savers and this makes inflation to be desired in economy.
8. **When it benefits the borrowers in an economy**. Inflation is good to the borrowers because they borrow money when it still has a higher value and pay back when its value is lower. Therefore by the time borrowers pay back the money, they will have put it to more profitable use. This makes inflation to be desired in an economy.
9. When it encourages labour mobility in an economy.
10. When it stimulates aggregate demand.

<u>SOME TERMS USED IN CONNECTION WITH INFLATION</u>:

1. **STAGFLATION:** This is an economic situation where **<u>high rates of inflation</u>** co-exist with **<u>high levels of unemployment</u>** and there is **<u>stagnant output</u>** in an economy. This situation results into resource under-utilization since there is stagnant output in an economy.
   N.B: The <u>costs (demerits)</u> of stagflation are <u>the negative effects</u> of inflation.

2. **REFLATION**: It refers to a **deliberate** government policy which is undertaken to force prices upwards **in order to help an economy recover from a depression**.
   Instruments / methods of a Reflationary policy:
   The government can do the following to achieve reflation:
   1. Increasing government expenditure
   2. Use of expansionary monetary policy e.g. by lowering the bank rate, buying back government securities from the public, removing selective credit control, e.t.c
   3. Reducing direct taxes / reducing taxes on incomes.
   4. Providing subsidies to the consumers.
   5. Increasing wages of the workers
3. **DEFLATION:** It refers to a ***persistent decline (fall)*** in the general price level of goods and services due to a fall in aggregate demand in an economy. A deflation is always controlled or checked through the following measures:
   1. Use of expansionary monetary policy.
   2. Increasing government expenditure.
   3. Reducing direct taxes/ reducing direct taxes on incomes.
   4. Providing subsidies to consumers.
   5. Increasing wages of workers.

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HOW INFLATION MAY LEAD TO (CAUSE) UNEMPLOYMENT.

N.B: The existence of inflation and the measures adopted to reduce or fight it may result into unemployment in an economy as explained below:

- High **taxes imposed on incomes to cure inflation reduce aggregate demand**. A fall in aggregate demand reduces investment levels and this leads to low job creation.
- High rates of ***inflation increase production costs***. Some firms close down thereby causing unemployment due to loss of jobs.
- ***High interest rates are charged on loans to reduce borrowing*** and fight inflation. This reduces investment because of the rise in the cost of borrowing. As investment levels fall, fewer units of labour are employed.
- ***Restrictive monetary policy is adopted to reduce or curb inflation*** by reducing money supply. This reduces aggregate demand. Investment is discouraged and fewer jobs are created or some workers are laid off hence causing unemployment.
- During periods of hyper inflation, ***trade unions demand for increase in wages*** of workers. This increases the wage bill. This may force some employers (producers) to use machines to replace manual workers hence creating technological unemployment.
- ***Government reduces her expenditure*** to curb inflation. This reduces public investment and fewer jobs are created in the public sector hence causing unemployment.
- The ***setting of maximum prices in an attempt to reduce inflation discourages investment and productio***n. This reduces the number of jobs created in an economy hence causing unemployment.
- During inflationary periods, ***government borrowing is reduced***. This limits investment in vital sectors thereby reducing employment of labour and other factors of production.
- Policies like privatization and trade liberalization are adopted to fight inflation. However, these ***may instead create unemployment in the short-run***. For example shortly after being privatized, firms down-size their workforce and some workers are laid off hence causing unemployment.
- Fighting inflation may ***involve a reduction in the export of essential goods***. This discourages production and employment of labour in the export sector or in those industries that produce for export hence unemployment is created.

RESEARCH WORK: Make short notes on the following ***Theories of Inflation:***

1. Cost-push inflation theory.
2. Demand- pull inflation theory.
3. Bottle-neck or Structural inflation theory.
4. Speculative inflationary theory.
5. Imported inflation theory
6. Profit- drive inflationary theory.

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7. Monetarist theory of inflation. According to this theory inflation is caused by the growth in money supply which consequently leads to increase in spending (aggregate demand). Therefore, if money supply is allowed to grow at a faster rate than the rate of increase in output of goods and services, the inevitable effect is inflation.

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END

THEME: ***Bridge Gaps for Excellence*.**
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