1. WHAT IS INFLATION AND WHY MUST THE CENTRAL BANK FIGHT HARD TO SUBDUE THIS MONSTER? HOW DOES INFLATION AFFECT THE ORDINARY MAN

A. WHAT IS INFLATION

Inflation is one of the most frequently used terms in economic discussions, yet the concept is variously misconstrued. There are various schools of thought on inflation, but there is a consensus among economists that inflation is a continuous rise in the prices. Simply put, inflation depicts an economic situation where there is a general rise in the prices of goods and services, continuously. It could be defined as 'a continuing rise in prices as measured by an index such as the consumer price index (CPI) or by the implicit price deflator for Gross National Product (GNP)'. Inflation is frequently described as a state where "too much money is chasing too few goods". When there is inflation, the currency loses purchasing power. The purchasing power of a given amount of naira will be smaller over time when there is inflation in the economy. For instance, assuming that ₦10.00 can purchase 10 shirts in the current period, if the price of shirts double in the next period, the same ₦10.00 can only afford 5 shirts.

In the definition of inflation, two key words must be borne in mind. First, is aggregate or general, which implies that the rise in prices that constitutes inflation must cover the entire basket of goods in the economy as distinct from an isolated rise in the prices of a single commodity or group of commodities. The implication here is that changes in the individual prices or any combination of the prices cannot be considered as the occurrence of inflation. However, a situation may arise such that a change in an individual price could cause the other prices to rise. An example is petroleum product prices in Nigeria. This again does not signal inflation unless the price adjustment in the basket is such that the aggregate price level is induced to rise. Second, the rise in the aggregate level of prices must be continuous for inflation to be said to have occurred. The aggregate price level must show a tendency of a sustained and continuous rise over different time periods. This must be separated from a situation of a one-off rise in the price level.

Broadly, inflation can be grouped into four types, according to its magnitude.

1. **Creeping Inflation:** This occurs when the rise in price is very slow. A sustained annual rise in prices of less than 3 per cent per annum falls under this category. Such an increase in prices is regarded safe and essential for economic growth.
2. **Walking Inflation:** Walking inflation occurs when prices rise moderately and annual inflation rate is a single digit. This occurs when the rate of rise in prices is in the intermediate range of 3 to less than 10 per cent. Inflation of this rate is a warning signal for the government to control it before it turns into running inflation.
3. **Running Inflation:** When prices rise rapidly at the rate of 10 to 20 per cent per annum, it is called running inflation. This type of inflation has tremendous adverse effects on the poor and middle class. Its control requires strong monetary and fiscal measures.
4. **Hyperinflation:** Hyperinflation occurs when prices rise very fast at double or triple digit rates. This could get to a situation where the inflation rate can no longer be measurable and absolutely uncontrollable. Prices could rise many times every day. Such a situation brings a total collapse of the monetary system because of the continuous fall in the purchasing power of money.

Basically, two causes of inflation have been identified, namely, demand-pull and cost-push.

i. Demand-pull inflation is caused by an increase in the conditions of demand. These could either be an increase in the ability to buy goods or an increase in the willingness to do so.

ii. Cost-push inflation arises from anything that causes the conditions of supply to decrease. Some of these factors include a rise in the cost of production, an increase in government taxation and a decrease in quantity of goods produced.

B. WHY MUST THE CENTRAL BANK FIGHT INFLATION?

Central banks the worlds over are obsessed about inflation and, therefore, devote a significant amount of resources at their disposal to fight inflation. Hence, the primary objective of monetary policy is to ensure price stability. The focus on price stability derives from the overwhelming empirical evidence that it is only in the midst of price stability that sustainable growth can be achieved. Price stability does not connote constant (or unchanging) price level, but it simply means that the rate of change of the general price level is such that economic agents do not worry about it. Inflationary conditions imply that the general price level keeps increasing over time. To appreciate the need to fight inflation, it is imperative to understand the implications of frequent price increases in the system. Some of these implications include:

- Discouragement of long term planning;
- Reduction of savings and capital accumulation;
- Reduction of investment;
- Shift in the distribution of real income and consequent misallocation of resources; and
- Creating uncertainty and distortions in the economy.

To avoid any of the situations above, central banks ensure that the price level remains stable. This is achieved by implementing policies that guard against inflation. Indeed, instability in the general price level undermines the function of money as a store of value and discourages investment and growth.

C. <u>HOW DOES INFLATION AFFECT THE ORDINARY MAN?</u>

Inflation affects different people or economic agents differently. Broadly, there are two economic groups in every society, the fixed income group and the flexible income group. During inflation, those in the first group lose while those in the second group gain. The reason is that the price movement of different goods and services are not uniform. During inflation, most prices rise, but the rate of increase of individual prices differ. Prices of some goods and services rise faster than others while some may even remain unchanged. The poor and the middle classes suffer because their wages and salaries are more or less fixed but the prices of commodities continue to rise. On the other hand, the businessmen, industrialists, traders, real estate holders, speculators and others with variable incomes gain during rising prices. The latter category of persons becomes rich at the cost of the former group. There is transfer of income and wealth from the poor to the rich.

More generally, which income group of the society gains or loses from inflation depends on who anticipates inflation and who does not. Those who correctly anticipate inflation can adjust their present earnings, buying, borrowing and lending activities against the loss of income and wealth as a result of inflation.

To further determine the effect of inflation on individuals, it will be necessary to discuss the effect of inflation on different groups.

a) **Creditors and Debtors:** When there is inflation, creditors are generally worse off because, the real value of their future claims is reduced to the extent of the rate of inflation. On the other hand, when inflation occurs, debtors tend to pay less in real terms than they had borrowed. Therefore, it could be said that inflation favours debtors at the detriment of creditors.
b) **Salaried Persons:** Those with white-collar jobs lose during inflation because their salaries are slow to adjust when prices are rising.
c) **Wage Earners:** Wage earners may gain or lose depending on the speed with which their wages adjust to rising prices. If their union is strong, they may get their wages linked to the cost of living index. In this way, they may be able to protect themselves from the negative effects of inflation. Most often in real life there is a time lag between the rise in the wages of employees and the rise in price.
d) **Fixed Income Group:** These are recipients of transfer payments such as pensions, unemployment insurance, social security, etc. Recipients of interest and rent also live on fixed incomes. These people lose because they receive fixed payments while the value of money continues to fall with rising prices.
e) **Equity Holders and Investors:** These group of people gain during inflation as the rising prices expand the business activities of the companies and, consequently, increase profit. Thus, dividends on equities also increase. However, those who invest in debentures, bonds, etc, which carry fixed interest

rates, lose during inflation because, they receive fixed sum while purchasing power is falling.

f) **Businessmen:** Producers, traders, and real estate holders gain during periods of rising prices. On the contrary, their costs do not rise to the extent of the rise in prices of their goods. When prices rise, the value of the producer's inventories rise in the same proportion. The same goes for traders in the short run. The holders of real estates also make profit during inflation because the prices of landed property increase much faster than the general price level. However, business decisions are difficult in an environment of unstable price. In the long-run, there could be an increase in wages which will reduce profit thereby, having an adverse effect on future investment.

g) **Agriculturalists:** Agriculturalists are of three types, namely, landlords, peasant proprietors and landless agricultural workers. Landlords lose during rising prices because they get fixed rents. Peasant proprietors who own and cultivate their farms gain. Prices of farm products increase more than the cost of production. Prices of inputs and land revenue do not rise to the same extent as the rise in the prices of farm products. On the other hand, the wages of the landless agricultural workers are not raised by the farm owners, because trade unionism is absent among them. But the prices of consumer goods rise rapidly. So landless agricultural workers are losers.

h) **Government:** Inflation will have both positive and negative effects on the government. The government as a debtor gains at the expense of households who are its principal creditors. This is because interest rates on government bonds are fixed and are not raised to offset expected rise in prices. The government in turn levies less tax to service and retire its debt. With inflation, even the real value of taxes is reduced. Inflation helps the government in financing its activities through inflationary finance. As the money income of people increases, government collects that in the form of taxes on incomes and commodities. So the revenue of the government increases during rising prices.

2. CAN WE HAVE A STRONG NAIRA AND A LOW INTEREST RATE AT THE SAME TIME, WHEN INFLATION IS HIGH AND RISING?

Exchange, interest and inflation rates are fundamental macroeconomic variables, capable of changing the direction and growth pattern of a country's economic development and stability. The strength of a country's currency, including the Nigerian naira, is determined by its purchasing power vis-à-vis other currencies of the world. Several factors determine the value of any country's currency. These include, speculations; trade and current account balances; the relative price level; the productivity growth of the economy both at home and abroad; the growth in spending decision; the export base of the economy; the relative cost of credit (interest rate) in the economy; and foreign decisions[1]. All these factors can be reduced to the demand and supply maxim. The higher the demand for a naira relative to other currencies, the stronger the naira will be and vice versa. The above factors depict that the exchange rate channel sometimes moves in surprising directions by amplifying the effects of policies thereby complicating monetary policy.

The relationship between exchange rate[2] and inflation rate is not a one-to-one relation. However, sustained inflation induces depreciation of the exchange rate but not as much as the destabilizing speculation's effect on exchange rate stability. Likewise, the currency value of a country would, therefore, be more responsive to the expected pattern of domestic and foreign interest rates than to the current short-term rates. This is because of the inverse relationship between inflation and real interest rates. A high and rising inflation rate reduces the domestic real rate of interest and currency value.

Consequently, achieving a strong naira value and low interest rate at the same time in the face of high and rising inflationary trend may, however, be untenable both in economic theory and practice in a fairly deregulated economy like Nigeria. This is because a high and rising inflation depicts hyperinflation which leads to soaring exchange and interest rates.

[1] These are taken in the economics of the country's trading partners.

[2] Currency value of a country