



LIMPOPO
PROVINCIAL GOVERNMENT
REPUBLIC OF SOUTH AFRICA

DEPARTMENT OF
EDUCATION

SEKHUKHUNE EAST RRT MATERIALS

INFLATION

1. DEFINITION:

Inflation is a sustained and a significant increase in the general price level over a period of time with a simultaneous decrease in

the buying power of money,
(It is a process, significant, general price level, non-monetary factors also contribute to inflation; vice versa is a decrease in the buying power of money)

TYPES AND CHARACTERISTICS

Demand-Pull inflation:

- ☐ Demand increase more than production - lead to price increases Groups responsible: consumers, businesses and government
- ☐ Foreigners contribution - further increase in demand for goods and services
- ☐ Relative increase in total demand components: C(consumer spending), I (investment spending), G (government spending) and X (export earnings).

Cost-push inflation

- ☐ Increase in labour cost - aggressive trade union bargaining
- ☐ Producers increase profits - price increase more than increase in cost
- ☐ Contribution of government - VAT
- ☐ Expensive imported products - intermediate goods - prices of final goods increase
- ☐ Lower productivity at the same remuneration - cost of production increase
- ☐ Natural disasters - floods, droughts, HIV/Aids - causes cost of production to increase.

KINDS OF INFLATION

Consumer inflation

- **Headline inflation** - measured by CPI - represent cost of typical basket of consumer goods and services of a typical SA household - Stats SA identify 1 500 different consumer goods/services, assign weights to each, decides on base year, decides on formula, decides on collection of prices - unadjusted CPI = headline inflation.
- **CPIX-** calculate inflation rate excluding effect of mortgage bond (housing loan) interest rates - interest rates are the main monetary instrument used by SARB to fight inflation - target 3% - 6%

- **Core inflation** - published by Stats SA - excludes items from CPI basket with highly volatile prices and items with prices that are affected by government intervention and policy (fresh and frozen meat, fish, vegetables and fresh fruit and nuts, interest rates and mortgage bonds, VAT, and assessment rates)
- **Administered prices inflation** - prices set by government and controlled by government - price changes must stay between inflation target as prescribed by Minister of Finance -since 2004 the price moved above the inflation target of 6% (included in CPI basket with a weight of 20%)

Producers inflation:

Uses:

- Measure cost of production
- Distinguish between goods produced in SA and imported goods
- Eg. Depreciation of the rand are immediately reflected in PPI

Differences between CPI and PPI:**CPI:**

- Pertains to cost of living
- Basket consists of consumer goods and services.
- Capital and intermediate goods are excluded.
- ¹⁸Prices include VAT
- Interest rates are taken into account
- Prices of imported goods are not shown explicitly

PPI:

- Pertains to cost of production
- Basket consists of goods only (no services)
- Capital and intermediate goods are included
- ^a Prices exclude VAT
- ⁸ Interest rates are excluded
- Prices of imported goods are shown explicitly.

All-inclusive inflation:

Economists check what happened to the prices of all final goods and services produced in a particular year .

- They use the implicit GDP deflator.

$$\text{How to calculate inflation} = \frac{\text{GDP deflator of next year (2005)} \times \frac{\text{GDP deflator of previous year (2004)}}{100} \times 1$$

Hyperinflation:

- A very high rate of inflation (50% +)
- ^H Price levels are rising rapidly - people lose confidence in value of money
- Become difficult for economy to operate.
- Barter makes a comeback with people exchanging goods for goods.

Stagflation:

- Low growth, high unemployment and high rates of inflation

CAUSES OF INFLATION**Demand-pull inflation**

- Caused by any component of total demand (C;I;G;X)
- Disposable income of households increase at faster rate than supply-

- prices pulled up
- Public not in savings mode - spend all consumer income - demand greater than growth
- Not enough savings to finance important capital investments - supply decrease
- Expenditure pattern outrageous - luxury hotels, holidays - expenditure move from goods to services.
- Increase in public expenditure without increase in productivity - surplus demand
- Infrastructure (roads and housing) Consumption spending (education and health) Social spending (public works programs)
- Increase in money supply without increase in production - surplus demand
- **Easy credit** - causes demand-pull inflation

- High exports without increase in domestic production
- **Reduction in taxes** (personal income tax)
- **Investment spending** - lower interest rates - higher profit expectation - invests more demand increase more than supply - higher prices

Cost-push inflation

Cost of production influenced by pressure of power groups - monopolies, trade agreements, consumer organisations - prices not determined by only demand and supply

- Workers requires higher wages without increase in productivity - cost covered by increase in prices
- Causes a cycle, higher wages, higher prices, higher living cost
- Systematic decrease in productivity while employment and wages stay constant - produce less while demand stay constant
- Strikes and stay away actions decrease production output - supply decrease - prices increase
- Increase in direct tax - producers and workers adapt income - products more expensive.
- **Key Inputs** - Import prices increase - cost of production increase - lower profits not an option.
- **Increase in prices of administered goods (controlled by government)** - trade unions bargain for higher wages and producers add cost to prices of final product eg. Fuel, postage, electricity, water.
- **Exchange rate depreciation.** Indirect taxation (VAT) eg. Customs and excise as extra cost on imports which lead to increase in prices.
- **Price increases aimed for profit margins** without surplus demand. Theft and losses caused by workers can be estimated in advance - added to prices of all products
- High prices of agricultural products due to high input cost eg. Diesel and fertilizer - high food prices
- **High interest rates** lead to more savings - cost items for businesses - included in prices
- **Natural disasters.** Droughts, floods and earth warming have an impact on cost of producers and consumers.

Increase in money supply

- Inflation caused by increase in money supply at a rate faster than production capacity of economy - sustained high growth rate of money supply cause high inflation rate.

Monetary policy measures causes increase in total quantity of money - main cause of inflation (SARB cause inflation by greater money supply) - they base their opinion on quantity theory of money ($MV=PT$) - where MV = amount of money in use in period and PT = money value of all transactions in a period.

CONSEQUENCES OF INFLATION

- **Purchasing power of money** decrease - eg. Income increase by 10% and inflation by 15% - purchasing power decrease by 5% - monetary unit loses its function as a valuable measure of value.
- **Creditors** suffer due to price increases while debtors benefit from price increases.
- **Fixed income earners** - People whose incomes remain constant or do not increase at the same rate as prices are negatively influenced - income remain constant.
- **investors**: assets with fixed nominal values - their real value decreases;
- Assets with flexible market values - gain by price increases because the nominal values tend to increase at least proportionately to rate of inflation - market values are flexible.
- **Savings** - decrease real value of money
- **Balance of payments** - SA loses international competitiveness because of higher price increases than major trading partners - decreasing exports and increasing imports result in depreciation of a country's currency against foreign currencies.
- **Government** - SA has a progressive personal income tax system which leads to **bracket creep** - as a result of combination of inflation and progressive income tax.

- **Industrial and social unrest** - Wage bargaining is often accompanied by strikes and mass action.
- **Economic growth are negatively influenced** - increase in economic uncertainties - discourage savings and investments - tend to be speculative and in the short term **Undermine believe in the economy and create negative climate for economic activities**
- Negative for free market - prices are no longer a correct indication of scarcity value of goods and services.

INFLATION IN SOUTH AFRICA

1960s	3.5%
1970s	10.3%
1980s	14.8%
1990s	8.75%
2000s	5.3%

INFLATION PROBLEMS OVER SHORT-TERM:

DEMAND PROBLEMS

- Production capacity does not increase but prices increase.
- Borrowing - ratio of household debt as percentage to disposable income increase
- Sales of durable goods - domestic motorcar sales increase and houses prices increase at a similar rate - show very strong domestic demand.
- Money supply and credit - M3 increase more than target of 10% - Bank loans to private sector grew

COST PROBLEMS:

- World inflation - higher rates puts pressure on domestic prices.
- Labour - Wage settlements below productivity increases.
- Key inputs - crude oil price increases.
- Administered prices - cost of education above upper rate level.
- Market prices - food, clothing and medical services continuously mentioned By MPC.
- Exchange rates - \$/R exchange rate unstable.

INFLATION PROBLEMS OVER LONGER-TERM:

LOGISTICAL INFRASTRUCTURE:

- ASgisa announced R372 billion to be spent on physical infrastructure by 2011.
- Inflation pressures caused by inadequate port capacity, airport limitation, rail cargo inefficiencies and congested road transport

ENERGY PROBLEMS:

- **Liquid fuels** - increase in crude oil prices is a direct cost item for businesses and consumers - domestic petrol and diesel producers (Sasol and PetroSA) apply import parity pricing (IPP) Fuel stocks - local refineries operate at full

capacity - increases in consumption will have to be directly imported - unavailability adds to costs and results in inflation .

- **Electricity** - Eskom has inadequate capacity to deliver uninterrupted supplies to a growing SA economy

SKILLED LABOUR:

- Shortage in private and public sector due to work permit red tape.

EXCHANGE RATE DEPRECIATION:

- Shortage on balance of current account increases - deficit was financed by means of portfolio investments from abroad

SOCIAL SPENDING:

- Pressure to increase social spending on cash grants.-
25% of population benefited from such expenditures -
increases in taxes fuel inflation

COMBATING MEASURES**FISCAL MEASURES:**

- These are measures used by Minister of Finance on taxation and spending.
- Increase in direct taxation - due to surplus demand (personal income tax)
- Increase in indirect taxation (VAT, customs and excise)
- Payments on loans to be increased.
- State cut on expenditure - cancel state projects (dams, roads)
- Payments on imported goods - price of imported goods increase - people buy less
- Supply side economy of Ronald Reagan (decrease personal income tax, company tax, tax on interest and dividends, government spending)

MONETARY MEASURES:

- These measures are used the SARB to combat inflation.
- Balance must be maintain between goods and services an money supply – change in the quantity of money according to needs of economy eg. Open market transaction policy.
- Bank rate of SARB influence interest rate in economy (repo rate) - can be increased to encourage savings.
- Extraordinary credit can be decreased by granting banks less credit
- Moral pressure on financial institutions to be more careful on granting of credit
- Relax exchange rate control.

OTHER NON MONETARY MEASURES:

- Increase in productivity is a long term measure (education and training)
- Price control - fixed prices on certain goods
- Wage policy - break inflation spiral of increasing wages – prices
- Stricter conditions for consumer credit - limit surplus demand
- Promote personal savings - unevenness between demand and supply must be rectified through increase in savings.
- Relax import control.
- Floating exchange rate - prices will automatically change to international standards
- Indexing - effect on inflation must be reduced - learn to live with inflation
- Inflation target - change policy measures to reach the target.

END OF TOPIC

