Inflation: Causes and Consequences - Part 2 - By Laurel Theresa Bain

Inflation is the persistent increase in the general price level. It reduces the amount of goods and services that consumers could purchase with their existing fixed income, described as reducing the purchasing power of money. It erodes the value of money with adverse socio-economic impact on consumers. The previous article focused on the current inflationary period and explained what inflation is and how it is determined. In this article, the causes and consequences of inflation are examined, and some policy options are outlined for mitigating the impact of inflation.

In Grenada, similar to the other countries in the Eastern Caribbean Currency Union [ECCU], inflation is mainly imported; due to the high influence of increases in the costs of imported raw material, services and other imported products used by economic agents. This imported inflation could be combined with or lead to domestically induced inflation. There are numerous causes of inflation, whether imported or domestically induced, and these are categorized into supply push inflation or demand-pull inflation. Supply push inflation occurs due to increases in the cost of production. This is normally associated with higher wages and increases in the cost of raw materials and capital goods, which are more pronounced during periods of shortages. These increases in the cost of inputs into production are passed on to consumers through higher prices for the finished goods and for services. Demand pull inflation occurs when consumer demand for goods and services outpaces the available supply of these goods and services. It is often referred to as 'too much money chasing too few goods', thereby forcing an overall increase in prices. Demand pull inflation is generally associated with economic booms brought about by sharp increases in export earnings, excessive government spending, and growth in the money supply due to increased credit and other expansionary monetary policies by the central bank.

In the Covid-19 Pandemic period, both supply and demand factors have been influencing inflation. On the supply side, production cost has increased due to soaring energy costs, demands for higher wages due to labour shortages, reductions in the supply of goods and services associated with lockdowns and restrictions, and disruptions in the supply chain. There were elements of demand-pull inflation as financial resources were available to individuals and companies through the provision of income support by many governments. In addition, the expansionary monetary policies by central banks, through low interest rates and the purchasing of financial assets, increased the supply of money. The development during the pandemic is now aggravated by the Russia/Ukraine war, triggering high energy cost and disruption in production and supply chain. The impact of both types of inflation, supply push or demand pull, is the same, that is, an increase in the general price level; but their resolution requires different policy responses.

The current inflation rate in Grenada, recorded at less than ten (10) percent, is classified as moderate. However, its impact is still adverse particularly if it persists for a long period. In inflationary periods, workers may successfully demand higher wages to offset the rising cost of living, and if this cycle of wage push and higher prices continues, it would lead to spiralling inflation. The negative effects of inflation on the economy outweigh the positive impact. Fundamentally, inflation reduces the value of money and its purchasing power; and the inflation rate could be equated to a tax that reduces disposable income. Fixed and low-income

earners, the unemployed and the poor suffer the most from inflation resulting in increased income inequality. In Grenada, inflation would place a greater financial burden on the vulnerable groups such as the unemployed youths and women, the working poor, those on low and fixed income, and the poor and other vulnerable groups.

During inflationary periods, the wealth of economic agents, held in the form of savings, diminishes due to reduction in the purchasing power of money. Also, inflation reduces the return on savings, particularly if the rate of inflation is higher than the rate of interest on deposits. Grenada's published inflation rate approximates two (2) percent. Therefore, for deposits with interest rates of two (2) percent or less, there is no real return on savings. Inflation therefore discourages savings and suppresses the availability of resources for investment. The higher prices lead to increases in the cost of production and contribute to the loss of competitiveness of the economy and reduced inflows from export earnings. If inflation persists, the social and economic impact becomes severe, and it could destroy the economy.

During inflationary periods, there are some beneficiaries. Individuals who have already invested in assets that appreciate in value such as real estate or have contracted loans to purchase such assets benefit during inflationary periods. Businesses that could determine price and those that provide essential services could register increased profits. Government collects more revenue from the higher values on which taxes are applied and from the higher profits from some businesses.

Mitigating the impact of inflation could be addressed by individuals, the Government, and the Monetary Authority. Individuals should practice the slogan: 'grow what you eat and eat what you grow'; restrict their purchases, as far as possible, to necessities; and they should use available financial resources to invest. The financial market is not well developed and the avenues for investment beyond savings in the financial system would be limited. However, it is an opportune time to invest in real estate and to purchase equity in companies that are profitable during both normal times and inflationary periods. The surge in the digital economy provides an avenue for investment in businesses that could be profitable, even in inflationary periods.

Government has an important role to play in light of the limited availability of alternative investments available to individuals. The primary focus of economic policies, at all times, should be to reduce unemployment and poverty. This would give the population economic space to absorb the shocks of intermittent inflationary periods. Also, the focus of policy should be to increase domestic production, particularly of food, to reduce imports of goods and services.

During persistent inflation, the Government has to use its redistributive role and adjust its taxes and expenditure to reduce the burden on the poor and vulnerable groups. In Grenada, where taxes on international trade and transactions are budgeted at almost fifty (50) percent of tax revenue [349.5 M], higher import prices would boost Government revenues.

Specifically, the tax base [the value on which the tax rate is applied] is already increasing due to the high freight cost. Then, the tax base is compounded, particularly for the Value Added Tax [VAT], as the tax base includes the customs service charge and import duty. Government revenues would therefore be increasing during inflationary periods. The additional revenue as a result of inflation is referred to as an 'inflation tax'. The burden of this 'inflation tax' on the population could be reduced by redistributing some of the additional revenues gained from

taxes at the port. This could be achieved by lowering the customs service charge and re-examining the goods that are zero rated and exempt under the VAT for the inclusion of some goods commonly purchased by consumers, particularly in the categories of laundry and cleaning products, hygiene products and building materials. Additionally, income support should be well targeted, particularly to cushion the effects on the vulnerable groups, and those in extreme poverty.

With the soaring fuel price, the price of gas at the pump comes under scrutiny. Grenada price of gas, capped at $15 per gallon, is comparable with its neighbouring countries of Saint Lucia where the price per gallon of gas is $14.95, in Dominica it is $14.89, and in St Vincent and the Grenadines $14.69. The price per gallon of gas approximates $16 in St Kitts and Nevis [$15.93] and Antigua and Barbuda [$15.70]. [Information from Ministry Officials on 29th March 2022] Some countries, such as, Saint Lucia have used the model of adjusting the taxes on gas to maintain the price at a targeted level. Gas is a commodity for which the governments of the Eastern Caribbean Currency Union [ECCU] could use its pool of expertise and adopt a common approach to the method of pricing.

With the pronounced inflation rate of two (2) percent and interest rates of less than two (2) percent on deposits in some financial institutions, the return on savings is negative. If the inflationary period continues, the two (2) percent Minimum Savings Rate [MSR] on savings deposits at commercial banks, as stipulated by the Eastern Caribbean Central Bank [ECCB], would need to be revisited. The policy decision would be based on the objective of the two (2) percent administered Minimum Savings Rate, and the independent assessment of the economies of the ECCU by the Eastern Caribbean Central Bank [ECCB].

In this inflationary period, the trend in prices should be monitored and appropriate policies adopted to mitigate the adverse impact of inflation. Inflationary periods would emerge. The best option for mitigating the impact of inflation is to develop a productive and competitive economy with low unemployment and poverty, and with wages that allow individuals to live above the poverty line.

Knowledge is power and experience is the greatest teacher.

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