Sustained, Frequently Rapid, Price Increases.

Is zero inflation good for the economy?

Introduction

Inflation is a continuous and considerable rise in the general level of prices of goods and services in an economy over a period of time. A principal measure of inflation is the consumer price index (CPI), an annual percentage change in a general price index. CPI measures changes in the price level of a market basket of consumer goods and services purchased by households. It is an effect of the increase in aggregate demand and a contraction of aggregate supply. Inflation is caused by either an increasing demand of goods exceeding supply or by an increase in the cost of production. The CPI is a statistical estimate constructed using the prices of a sample of representative items referred to as a basket of goods whose prices are collected periodically. The Namibia Consumer Price Index (NCPI) includes all Namibian private households living in urban and rural areas and is compiled by comparing the prices of the goods and services with the prices prevailed in December 2001. It is based on the basket of goods derived from the 1993/1994 Namibia Household Income and Expenditure Survey.
It is crucial to monitor inflation because, when the price of goods and services increase, the purchasing power of income decreases. Thus, inflation provides an indication of the cost of living. While it is generally believed that high inflation rate is not good for the economy, zero inflation (deflation) is not good for the economy either since it indicates economic stagnation. Current research shows that low inflation is most beneficial to the economy than extremes. The importance of inflation as a measure of social and economic stability and an indicator of consumer welfare is apparent. Since the poor hold a large portion of their wealth in currency, they are usually the hardest hit by high variations in inflation rates. Price fluctuation results in increased uncertainty which makes economic decisions more difficult and makes the price signal role less efficient thereby resulting in lower levels of investment and growth. Therefore, a stable inflation rate is good both for investors as well as for the poor. Generally, high and variable inflation rate causes uncertainty. This increased uncertainty will make both individuals and firms reluctant about taking up new investments. This results from the fact that highly variable inflation is regarded as a signal of poor economic policy. Inflation information is commonly used when making monetary policy, fiscal policy, wages/rents and social security benefit adjustments.

**Trends in inflation rate since 2001**

**Figure 1: Inflation trend since 2001**

Since 2001 the inflation rate has averaged 6.4% reaching a high rate of 13.7% in November 2002 and a lower rate of 0.9% in May 2005. The peaks refer to the 2002 financial crisis and the 2008 economic crisis mainly driven by increase in the price of food and transport. In April 2013, inflation rate was recorded at 6.1%. Nevertheless the trend as depicted in Figure 1 has been relatively stable but high, hovering around 6% driven mainly by the increasing of global food and
frequent increases in fuel prices as well as domestic housing market conditions. The rate of 6.1% means that compared to April 2012, the purchasing power of the consumer’s dollar fell and could now buy fewer items by 6.1%. Thus, price increases or inflation erodes the real value of money. Generally, continued stability in inflation rates will lead to lower real interest rate which provides an important stimulus to domestic demand as well as investment.

Namibia being a member of the Common Monetary Area as well as a member of SACU, it imports about 70% of its products from South Africa. An analysis of the inflation trends between Namibia and South Africa (Figure 2) indicates that the inflation rate of Namibia followed a similar trend to that of South Africa. Comparing the Namibian and SACU average inflation trends reveals that there are similarities between the two trends. Furthermore, evidence has also indicated that the main components with the highest annual rates of inflation have been more or less the same amongst member states.

**Figure 2**: Inflation trends Namibia, South Africa and SACU 2001 - 2012

![Inflation trends graph](source: SACU, 2013)

**Main drivers of inflation**

Figure 3, depicts the three major CPI components. About 30% of the CPI basket consists of foods, while housing, water and electricity represent about 21% and transport about 15%. Thus, changes in the prices of food, housing and transport have a major impact on movements of the consumer price index. Figure 3 indicates that price movements in Namibia follow closely changes in the price of food and transport. Between 2006 and 2008 when the price of housing remained almost constant, average prices increases in response to increases in the price of food and transport.
Figure 3: NCPI changes by major categories

Food
Namibia depends heavily on South Africa in terms of imports. Changes in the cost of transport commonly resulting from fuel increases have an effect on the cost of food and beverages. Since this category consists of goods that are basic needs consumed by each and every Namibian, it thus has an adverse effect on the well-being of the general Namibian population, especially the poor and those who earn a fixed income. If for example, other things being the same, a consumer with a fixed income of say N$5,000 who spends 10% i.e. (N$500) of his/her income on food in 2001 would need to spend about 25% of his/her salary (which is N$1,200) today on the same bundle of goods. Though, this type of scenario is not a common occurrence, when it occurs it threatens food security and increases vulnerability in the country. This implies that with the same income, this consumer’s buying power has declined by more than 100%. It is important to note that droughts or floods in Namibia are some of the drivers of inflation as they raise the cost of production and constrains supply, as a result the price of agriculture and other related products will increase.

Fuel
Inflation of food and non-alcoholic beverages has been stimulated by the increasing fuel prices. Based on the figure below it can be observed that the oil prices have increased drastically in the last 20 years. With the increase of oil prices, the prices of most products have been increasing due to its impacts on transport and production cost. Thus, due to the increase in oil price since 1990, global food prices have been following the same trend as depicted in Figure 4 & 5. The two Figures indicate a positive relationship between fuel prices and food prices. When the oil prices peaked in 2008, dropped in 2009 and increased...
again in 2010 the global food prices followed the same trend.

**Figure 4: Global historic oil prices**

![Graph showing global historic oil prices]

Source: [www.inflationdata.com](http://www.inflationdata.com)

**Figure 5: Global Food Price Index**

![Graph showing global food price index]

Source: FAO

**Housing**

It is important to note that global price trends (oil and gas) can mask wide divergences in different parts of the world, more particularly in individual countries where local conditions, such as housing, can make such problems far more acute. Thus, for instance, the category of housing, water, electricity accounts for 21% of the weight of total consumption basket, making it the second highest category after food and non-alcoholic beverages. That means 21% of an average consumer’s expenditure is allocated on housing, water, electricity, gas and other fuels.

Housing price has been on a steep increase and currently remain high because the sector operates on market conditions which is driven by non-availability and scarcity, as a result of excessive demand which has led to increase in property prices. House prices in Namibia in general rose by more than
100% from 1993 to 2005. Even though the price continued to rise in the last 7 years, it increased at a much lower rate due to increase in developer activities in recent years. However, in order to eliminate the housing backlog by 2017 (end of NDP4), 24,000 housing units will need to be made available each year for the next five years. This is an ambitious target; however both private and public sector should collaborate effectively to bring the housing backlog under control. Thus, there is a need for a sustainable solution to address the current housing efforts to meet current demand.

The current housing backlog is estimated to be at least 100,000 units, growing between 3,000 and 4,000 per year and thus constituting one of the country’s main challenges. Sustainable land should be made available to ensure that those tasked with provision of affordable houses can effectively carry out their mandates. Furthermore, more resources should be availed to increase NHE’s annual provision of housing which currently stands at 700 units per year.

Higher and increasing housing prices affect both poor and non-poor households, young graduates and retired senior citizens. Young people cannot afford housing units to rent, let-alone buying a house and as a result they are unable to settle down and this slows down their social development. Those who manage to buy a house ends up spending too much on mortgage than they would have paid if prices were stable. Higher housing prices may also lead to an increase in household size, thereby leading to overcrowding, deterioration in the living standard and an increase in poverty. Thus, increasing house prices have a negative spill over effect on the rest of the economy through its effect on individuals.

**Inflation and other macroeconomic variables**

Inflation affects consumption, savings, investment, exchange rates and employment. High inflation rate reduces consumption as inflation distorts the buying power of the consumers. Saving becomes relatively harder over the periods of high inflation rates, thereby translating into a decrease in investments. Where fixed exchange rates are implemented, higher inflation than in trading partners’ economies will make exports more expensive and tend toward a weakening balance of trade. A reduction in aggregate demand (AD), where AD is defined as \( AD = C+I+G+X-M \), may result in a reduction in employment as well as GDP. Needless to say, \( GDP = C+I+G+X-M \), hence a reduction in C, I and X reduces GDP. For these reasons, many economists see moderate inflation as beneficial, hence the need to reduce high inflation. For countries that adopt flexible or managed exchange rate systems, they can rely on transmission channels, such as the exchange rate and asset price channels to control inflation levels. However, Namibia, due to its fixed exchange rate system, it only relies on the interest rate/repo rate
channel and, to a lesser extent, the asset price channel to influence domestically induced inflation. Below is a schematic illustration of how inflation in Namibia can be controlled.

**Figure 6: Monetary policy transmission mechanism for Namibia**

![Monetary Policy Transmission Mechanism](image)


Figure 6 looks at the monetary policy transmission mechanisms where channelling takes place when the Bank of Namibia embarks on a strict or expansionary monetary policy instruments for price stability. For example, if there is a negative shock on inflation, the Bank of Namibia would need to increase the repo rate which will have trickle-down effects on market rates consisting of commercial banks adjusting their interest rates. These interest rates adjustment may have negative effects on asset prices and therefore may influence consumers’ future expectations. Through these instruments, the Bank of Namibia is able to influence domestic demand (AD) and ultimately control domestic inflation.
Effects of Inflation

There are generally three effects of inflation. Firstly, given that the purchasing power of money falls when price increases inflation could benefit borrowers at the expenses of lenders thereby redistributing wealth from lenders to borrowers. Secondly, inflation can have an impact on productivity if entrepreneurs are involve in speculative practices instead of investing their money on productive assets such as machinery and equipment. Given that inflation reduces the purchasing power or real value of money it could discourage some forms of savings such as fixed deposits and life insurance. Furthermore, inflation could have an impact on competitiveness when prices in Namibia are higher than those of our main trading partners. Thirdly, inflation can cause conflicts and can lead to political instability which is not conducive for economic growth. This results from the fact that as price increases people becomes unhappy and starts blaming one another for increases in the cost of living thereby leading to a feeling of uncertainty and despair. Additionally, increases in the rate of inflation may lead people to expect that it will increase in the near future and will thus try to be compensated for the expected higher inflation. This happens often with trade unions and when it happens it results in an actual price increase. The other notable effect is that when prices are expected to increase, consumers will rush to buy goods now than in the future and this will put pressure on prices to increase. As food price increases, it undermines the ability of the poor to buy food while at the same time effort by government to protect the poor from price increases could lead to increases in the costs of the safety net programmes. High food prices affect the poor both as consumers and as producers. Given the percentage of total expenditure allocated to food by the poor, high food prices could reduce income available for other purposes or could lead to reduction in food consumption. However, it could also work as an incentive to produce local food thereby stimulating agricultural production. Figure 7 indicates that there is a direct relationship between inflation and interest rate with changes in inflation follows those in interest rate. Interest rate as a cost of borrowing could be used to stimulate consumption/ investment spending through availability of cheaper credit as a result of a drop in interest rate. The opposite is also true.

Figure 7: Annual Inflation rates and Prime lending rates trends, 2001-2012

Policy Implication and Recommendations

In Namibia inflation is mainly driven by prices of food, housing and transport, items which accounts for a high consumption expenditure of the poor. According to the Namibia Household Income and Expenditure Survey 2009/10, about a quarter of households with the lowest adjusted per capita income spend more than two thirds of their consumption on food and housing. Given this expenditure on basic commodities, they will find it hard to save and invest in assets that retain value despite increases in prices. As a result, poor households tend to suffer more than non-poor households as a result of continuous and considerable increases in prices. It is therefore conclusive that dependence on food imports threatens food security and exacerbates poverty in Namibia. It is recommended therefore to introduce food import substitution through green scheme projects. This will in turn moderate food induced inflation.

As stated above while it is generally believed that high inflation rate is not good for the economy, deflation is not good for the economy either since it indicates economic stagnation. It makes it difficult for firms to survive as by the time their goods reach the market, prices are too low to recover their cost of production. This will lead to reduction in total production, retrenchment, increasing unemployment, falling income and increases in poverty and inequality. Low inflation is thus desirable for Namibia, and in order to achieve this, supply constraints in fuel, housing and related amenities should be enhanced.

Even though maintaining sound fiscal discipline and keeping a strong control over inflation has turned out to be one of the primary objectives of the government, it is quite difficult maintaining stable food, gas and other fuel prices while the country imports most of these commodities. Namibia is a small open economy and thus does not have the power to influence global prices. Nevertheless monetary and fiscal authorities should continue to ensure price stability while ensuring preparedness for external shocks that could potentially affect domestic price stability. Government could also look at incentives for local farmers to produce locally consumed food products by buying local products for social programmes. Thus, there is need to increase food production to reach self-sufficient in staple food. There is also need for deliberate effort in redistribution of factors of production to increase production capacity.

Both government and private sector will need to play a critical role as far as the provision of housing is concerned. Government will need to facilitate the provision of housing by ensuring availability of serviced land, identifying and establishing new residential locations. There is a need to harmonise existing policy and legislative frameworks to eliminate bottlenecks and to improve access to serviced land and the use of alternative building materials. The private sector needs to look at other options such as urban/rural housing loans, and rural housing schemes.

It is crucial to measure inflation as accurately as possible since other economic variables such as wages, salaries, interest rate and rent are either directly or indirectly linked to price increases. The basket of goods for 1993/1994 NHIES are still being used for the calculation of NCPI. During that time, there was no much use of cellphones or ipads, (to mention but one example) this is evident in the 2009/2010 NHIES. It is therefore recommended that the NCPI is rebased using the current available information in accordance with good practices.


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