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Review on: Effect of Inflation on Economic Growth in Ethiopia

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ABSTRACT

One of the main objectives of macroeconomic policy of most developing countries like Ethiopia is to attain sustainable economic growth together with stable price level. Price stability is considered as a proxy for macroeconomic stability, the ongoing high level of inflation is not a good sign. Large fluctuations in inflation for firms, consumers and the public sector reduce the economy in the long run growth potential. The nations of the countries who are highly affected by the problem of inflation are those who have low level of income or fixed income and unemployed portion of the population. Higher average inflation has a negative impact on the steady state growth. This is because of the higher cost of transaction that inflation causes to the money market. It is generally accepted that instability in the general level of prices causes substantial economic distortions, leading to inefficiencies, both in aggregate employment and output. Due to different factors, the effects of inflation have significant effect on economic growth in Ethiopia.

INTRODUCTION

World economic growth and inflation rates have been fluctuating. Likewise, inflation rates have been dominating to compare with growth rates in virtually many years and relationship between inflation and the economic growth continued to be one of the most macroeconomic problems (Madhukar and Nagarjuna, 2011). One of the central macroeconomic policy objectives of most developing countries in the world is maintaining price stability together with economic growth. Ethiopia is one of the countries in Sub Saharan African with moderate economic growth in recent years. The country's economic progress is accompanied by sustained inflationary problems. Inflation's effects on an economy are various and can be simultaneously positive and negative in Ethiopia (Umaru and Zubairu, 2012). According to Abdurahman Mohammed's report, Ethiopia's inflation rate remains persistently high, reaching 33.6 percent in February 2022. The renewed conflict in the north and the most prolonged and severe droughts in recent years were the main reasons behind the high inflation, given the adverse impact on economic growth. A high or unpredictable inflation rate are regarded as harmful to an overall economy that add inefficiency in the market, and makes it difficult for companies to plan long term (Mankiw, N.Gregory, 2002).

Objective of the Review

To review the effect of inflation on economic growth in Ethiopia.

Overview of Inflation and Economic Growth in Ethiopia

Inflation is defined as the general rise in the price level of goods and services in the given economy. General rise in the price level indicates the net change in the price of all baskets of commodity produced and services provided in the economy. That means there may be an increase or decrease in the price of basket of some commodity in the economy. The net effect gives us the general rise in the price level or decrease in the price level. If the net change is a rise in the price level, we can call it inflation otherwise deflation (Teshome, 2011). It measures the change in average price level on a year on year basis-that is:

$$\text{Inflation}=\frac{Price\ t-Price\ t-1}{Price\ t-1}$$

where: t is a particular year in time; and t-1 is the year before (Gillepie, 2011).

Economic growth is the increase in the amount of goods and services produced by the economy overtime (Solow, 1995). It can be measured in real or nominal terms. Real terms have been adjusted for inflation and nominal terms are not adjusted for inflation. Economic growth is usually measured as the percentage rate of increase in real GDP (Swan, 1997). On the other hand, economic growth is a sustained increase in per capita national output or net national product over a long period of time. (Dwivedi, 2004).

Theories on Economic Growth and Inflation

Economists have been studying about inflation and its effect on economic growth starting from the appearance of classical economic theory to modern economic theories. The following table summarizes the statement of different theories on about inflation and economic growth.

The Effect of Inflation on Economic Growth in Ethiopia

Inflation's effects on an economy are various and can be simultaneously positive and negative. Inflation causes individuals to substitute out of money and into interest

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Table 1: Theories on Inflation and Economic Growth

No	Theories	Their statement on inflation
1	Classical theory	There is no direct explanation between inflation and its tax effect on profit level & output. But the relationship between the two variables is implicitly negative by the reduction in firms' profit level and saving through higher wage costs (Gokal and Hanif, 2004).
2	Keynesian theory	Excess demand is the major cause for the existence of inflation (Gokal V. and Hanif S, 2004).
3	Monetary theory	Inflation occurs when money supply rises faster than the rate of economic growth of national income (Richard Froyen, 1998).
4	Neo classical growth theory	Inflation increases output growth rate by stimulating capital accumulation, because in response to inflation households would hold less in money balance and more in other asset (Mudell, 1963).

Table 2: Source of Inflation

No	Source of inflation	
1	Demand Pull Inflation	It occurs when aggregated demand exceeds aggregate supply. This excess demand may occur due to increase in one or all components of aggregate demand which includes consumption, investment, government expenditure and net exports. The excess demand creates disequilibrium and pulls up prices until equilibrium is restored. This is because the increase in aggregate demand causes shortage of goods and services at old prices. This in turn leads to price increases until equilibrium is restored (Campbell R and L.Stanley, 1986).
2	Cost Push Inflation	It is a situation occurs when there is caused by an increase of one or more of the cost or supply side factors such as the rising wages, input price (domestic or imported), interest rate, taxes, and exchange rate (Campbell R and L.Stanley, 1986).
	Current Causes of Inflation in Ethiopia	
1	Outbreak of COVID-19	The impact of COVID 19 pandemic uncertainty shock on the macroeconomic stability in Ethiopia in the short run period.
2	Civil war	Ethiopia was embroiled in spiraling & soaring ethnic and a state-based large-scale armed conflict that has continued for more than a year.

earning assets, which leads to greater capital intensity and promotes economic growth. In effect, inflation exhibits a positive relationship to economic growth. Inflation initially motivates capital accumulation which will contribute to higher growth. But the effect of inflation on growth is only temporary since this works only until the return on capital falls (Tobin, 1965). High inflation increases the opportunity cost of holding cash balance and can induce people to hold greater portion of their assets in interest paying accounts. With high inflation, firms must change their prices often in order to keep up with economy. It can benefit the inflators (those responsible for the inflation) and it benefits early and first recipients of the inflated money. It can also benefits big cartels, destroys small sellers, and can use price control set by the cartels for their own benefits. (Mankiw, N, 2002). Optimal inflation ranging from 2–3% is good for economic growth. It increases the employment opportunities in the countries, increases the economic activities, and encourages investment and production by raising the rate of profit (Fischer, 1993).

Unpredictable inflation rate are regarded as harmful to an overall economy they add in efficiency in the market, and makes it difficult for companies to plan long term and also that inflation distorts price mechanism, and this will affect the efficiency of resource's allocation and hence influence economic growth negatively (Fischer, 1993). It can impose hidden tax increases as inflated earnings push tax payers in to higher income. With high inflation, purchasing power is redistributed from those on fixed nominal income. It also makes traders from an increased instability in currency exchange price caused by unpredictable inflation (Mankiw, N, 2002). Inflation and economic growth entitled that the channel through which inflation affect economic growth and inflation negatively affects growth by reducing investment, and by reducing rate of productivity growth (Fikirte, T, 2012).

High inflation can cause serious problems on the economic growth. It would bring a large distribution of income. Higher food price would hurt the urban poor who spend most of their income on food. Moreover, although it would have a positive effect on the rural food producers, it would have an adverse effect on the rural food buyers, which may consist of about half of population in the rural Ethiopia. Thus, higher inflation, particularly through higher food price, could worsen the economic inequality. High inflation would also increase of uncertainty about future inflation (Conrad and Karanasos, 2004).

Inflation can cause a number of problems for an economy. It may damage business confidence because of fears about the future impact on costs. This may reduce levels of investment. Uncertainty about future inflation rates will make it difficult to estimate future profits and therefore may deter many projects, damaging economic growth; if prices are increasing this creates costs for firms, because they may have to update their promotional material to list the higher prices; it erodes the purchasing power of individuals' earnings. If wages do not increase as much as prices, then, in real terms, wage earners are worse off. Their real income has fallen; if the prices of firms in Ethiopia are increasing faster than those of their trading partners, then this may make the Ethiopian products uncompetitive compared to those of foreign firms; Tax thresholds often do not increase in line with inflation. If employees gain a wage increase to match inflation, then they are not better off in real terms. However, with higher nominal wage, individuals may enter a higher tax bracket and therefore be worse off. This is called bracket creep. And also redistributes income from one individual to another. Debtors benefit during inflation moments at the expense of creditors and the government gains at the expense of the private sector; and Inflation creates inflation expectations and it actually feeds on these expectations. It is often said that the greatest cost of inflation is the one inflation causes itself. The effects of inflation will depend partly on whether it is anticipated or unanticipated inflation. If inflation levels are regularly unanticipated, then this will lead to high levels of uncertainty in the economy, which may deter investment and affect spending, and impact saving decisions (Arnold, 2008).

Table 3: Summary of Effect of Inflation on Economic Growth in Ethiopia

No	Author/s, Year of publication	Effect of Inflation on Economic Growth in Ethiopia
1	Barro (1995)	It reduces the level of investment and a reduction in investment adversely affects economic growth of the country due to sharp increase in the cost of their investment projects.
2	Dotsey and Sarte (2000)	Higher average inflation has a negative impact on the steady state growth. This is because of the higher cost of transaction that inflation causes to the money market.
3	Bruno and Easterly (1996)	A higher level of inflation harms the growth and lower inflation has less cost on the economy.
4	Fisher (1993)	Inflation negatively affects growth by reducing investment, and by reducing rate of productivity growth. Fisher also argues that inflation distorts price mechanism, and this will affect the efficiency of resource's allocation and hence influence economic growth negatively. He argued that inflation hampers the efficient allocation of resources due to harmful changes of relative prices.
5	Conrad and Karanasos, (2004)	High inflation can cause serious problems on the economic growth. It would bring a large distribution of income. Higher food price would hurt the urban poor who spend most of their income on food. Moreover, although it would have a positive effect on the rural food producers, it would have an adverse effect on the rural food buyers, which may consist of about half of population in the rural Ethiopia. Thus, higher inflation, particularly through higher food price, could worsen the economic inequality.
6	Fikirte, T, (2012)	Inflation and economic growth entitled that the channel through which inflation affect economic growth and inflation negatively affects growth by reducing investment, and by reducing rate of productivity growth.
7	Arnold, (2008)	If inflation levels are regularly unanticipated, then this will lead to high levels of uncertainty in the economy, which may deter investment and affect spending, and impact saving decisions.

CONCLUSION

One of the main objectives of macroeconomic policy of this country is to attain sustainable economic growth together with stable price level. As known, day to day increment of price of goods and services is a key problem of economic backwardness in Ethiopia. Sustained inflation has harmful effects on societal welfare and income inequality in such a way that the income distribution tends to be skewed and also decrease in the real value of money and other monetary items overtime, uncertainty over future inflation may discourage investment and savings, and high inflation leads to shortages of goods if consumers begin hoarding out of concern that prices will increases in the future. Therefore, to overcome this inflation problem on economic growth of the country, focus should be given on policies that will achieve price stability in the country, firms should produce more production to satisfy consumers and to reduce inflation, peoples who have low income should increase their income and reduce inflation by reorganizing their production system, e.g. using technology.

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