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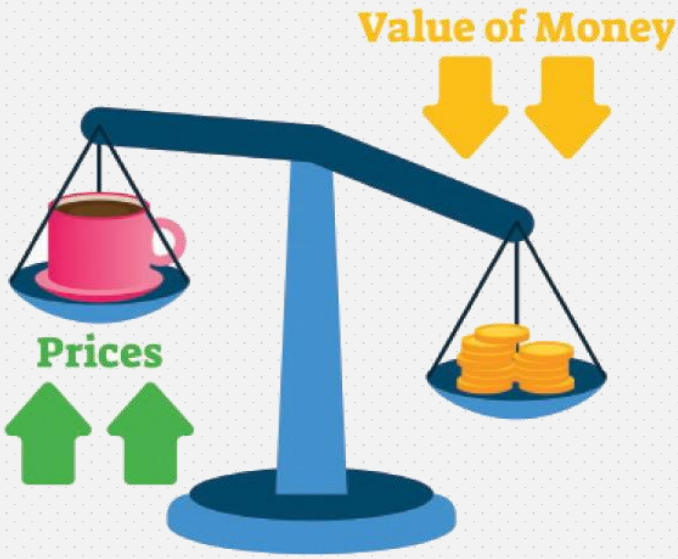
Inflation, what does it really mean?

Inflation is the *persistent* rise in the *general* price level of goods and services over a period. Sounds mouthful, it's the textbook definition, that's ECN101.

In plain English: it's when the average price of most/all goods and services keeps going up.

Example: If bottled water sells for ₦100 today and, due to higher production costs or booming demand, all manufacturers and retailers start selling it for ₦150, that's inflation. But if one retailer in Lekki suddenly decides bottled water is now ₦500 because he's serving "NEPO babies", well, that's not inflation. That's just price madness.

Inflation happens when prices across the board rise, not just when a single seller feels bougie. It needs to be "persistent" and "general".



What causes inflation?

There are two major causes of inflation: *increased demand* and *increased cost of production.*

Increased Demand (Demand-Pull Inflation, you can call it "demand-caused inflation"): When there is increased demand of a good than what's available, prices tend to rise. Sometimes sellers raise prices because demand is high. Other times, buyers themselves push prices up by offering more money just to get their hands on the goods. Just like an auction, but for everyday commodity.

Increased Cost of Production (Cost-Push Inflation): When the cost of producing a good increases, producers can decide to reduce their profit and bear the extra cost while the buyers continue to pay the same price. However, what is more practical is that producers passes some/all the additional cost to buyers, leading to higher prices of the commodity. Simply put, when it becomes more expensive to produce a product, say raw materials get pricier, wages go up, or energy costs spike. Producers have two options:

- Absorb the extra cost and make less profit.
- Pass some or all of that cost on to buyers by raising.

The second option is what usually happens, and that's how higher production costs ripple out into higher prices across the economy. The producers simply "push" the increased cost of production to the buyers.

How does inflation affect me?

Inflation's effect on your purchasing power

Simply put, when there is inflation, price increases, meaning you can only buy less with same amount of money. For instance, assume you earn ₦100k a month and spend it on 2 bags of rice (₦40k each) plus 1 gallon of oil (₦20k). Life is good. Now, if rice jumps from ₦40k to ₦60k per bag, with the same salary, you will be able to buy only 1 and half bags of rice with one gallon of oil. You're spending the same money but walking away with fewer goods. That's inflation stealing from you in plain sight.

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Inflation's effect on your investments

One major objective of investing is to preserve (and grow) the value of your money. If N100 could buy a bread today, and you decide to invest the N100 instead of buying a bread. you want your investment returns to ensure that ₦100 (plus gains) can still buy at least that same loaf in the future. All things being equal, when the investment matures in one year, the investment proceed should at least still be able to purchase the same bread.

So, let's create a scenario where you invest N100 (instead of buying a load of bread for N100).

Scenario: You invest ₦100 at 20% per year. After a year, you have ₦120. But if bread prices rose 30% in the same period (now ₦130 per loaf), your ₦120 can't even buy that loaf anymore. This means you've earned a negative real return. Your investment grew, but not enough to keep up with inflation.

If inflation outpaces your investment returns, your money's real value is shrinking, even if the numbers in your account are going up. This means a negative real return on investment for you, because your investment + inflation rate is lower than your investment + return. In a nutshell, if your inflation rate is moving higher than investment return, value is not absolutely preserved.

Are the numbers correct?

Over the years, I have heard so many people say the numbers from NBS are wrong, and the inflation rate at 22.22% doesn't reflect economic reality. Well, the numbers are right based on their method, but the underlying assumptions may not reflect your personal spending.

First, let's understand how they arrive at the numbers. The NBS uses a "basket" of goods and services to compute inflation. Each item is assigned a weight that reflects its share in average household spending. At month end, statisticians measure the price change in each item, multiply it by its weight, and sum them up to get the official rate.

This basket contains representative items that should reflect the general price level in the country. So, the statistician would select these goods, allocate weight to each item. At the end of the month, the increase on each good is multiplied by the weight in the basket to arrive at the average rate.

That still looks complicated, let's play around with some numbers.

Items/Category	Weight	Price Increase	Contribution to Inflation
Food & Non-Alcoholic Beverages	45%	30%	13.500%
Restaurants & Accommodation Services	13%	5%	0.650%
Housing, Water, Electricity, Gas, Other Fuels	8%	10%	0.800%
Household Maintenance	5%	10%	0.500%
Education Services	7%	5%	0.350%
Health	10%	10%	1.000%
Transport	12%	15%	1.800%
		Inflation Rate for the Period	**18.600%**

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In summary, the concerns are not really around the accuracy of the numbers, rather on if the underlying assumptions fully reflect the spendings of an average Nigeria. I am not sure an average Nigerian spends up to 12% of his income on Restaurant and Hotels, or spends less than 50% on food and non-alcoholics. That's why everyone has their own personal effective inflation rate, depending on their spending pattern. Different individuals are expected to have different personal effective inflation rates, which is influenced by what proportion of your income is spent on each category and the price increase in that category.

Let's say you earn N100k a month, and you spend 80% on food and 20% on transportation, with my example above your personal effective inflation rate would be around 27%.
Food: 80% × 30% = 24.00%
Transport: 20% × 15% = 3.00%
Total = 27.00%

Notice that while my general inflation rate is 18.60%, yours is 27.00% because you spend most of your income on food (which has seen sharper price increase). If you spend all your income on potatoes, and price of potatoes goes up by 100%, your effective personal inflation rate is 100%. It doesn't mean the general inflation published by the statistician is wrong, their assumptions don't just reflect your own spending.

In a nutshell, NBS figures are not necessarily wrong, it just means their basket doesn't match your basket.