IMPACT OF INFLATION
ON CONSUMERS' SPENDING PATTERN

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ABSTRACT

Inflation affects the standard of living of most households, especially the lower income group. This paper sheds light on the effect of the current inflation on the urban poor household spending pattern and how they cope with the increasing cost of living. There were 219 respondents in ten areas in Kuching City and Samarahan surveyed in this study. The majority (69.4%) of the poor households were private sector employees and self-employed households. The findings revealed that inflation had seriously affected the consumer's expenditure on food (68.9%), utility (42.0%), education (35.2%), housing (30.1%), and the least affected was vacation expenses (4.6%). The consumers coped with the rising food prices by buying cheaper products (87.2%), cutting expenditure on other items (82.6%), rationing on food expenditure (72.2%) and replacing certain food with other alternative (53.0%).

Keywords: inflation, consumer spending pattern, low income group.

CHAPTER 1

INTRODUCTION

This research provides empirical evidence of the effect of the 2008 inflation on the spending pattern of low income urban dwellers in Kuching and Kota Samarahan districts. In June, 2008, Malaysia's inflation rate hit a 27-year high of 7.7%, compared to 3.8% in May, 2008. It almost doubled within a period of one month, due mostly to the increase in petrol prices. A high inflation like this had reverberating effects over the following few months, resulting in other effects like increase in interest rates. Consequently, it may have devastating effects on the people and all sectors in the economy.

Inflation creates problems and introduces disturbances in the functioning of the economy and this would eventually affect economic growth. To the people, inflation affects their standard of living because they have to pay more for the same goods and services. If their real income does not increase at the same rate as the rate of inflation, they will find their standard of living declining even though they are making more money. Besides that, inflation has adverse effects on retirement planning because you have to revise your target savings to maintain the same quality of life. In other words, as your real savings decline, you will need to save more. The problem is everything you buy today costs more, so it will reduce your excess income, if any at all, that can be saved.

Inflation may affect the people's expectations, especially when it persists over an extended period. It will create a fear of paying much more in the future, hence people tend to spend now rather than later. This consumer spending may potentially heat up the economy further, and this may lead to higher inflation. Consequently, it may sustain inflation over longer

CHAPTER 2

LITERATURE REVIEW

Increased in the price of oil and thereafter, rice, in May 2008 affected the general price level of most goods and services in Malaysia. Bank Negara Malaysia reported an increase in the inflation rate from the usual 3.4-3.6% to 6% in June, 2008, and 7% the following month. The people of Malaysia now faced an increasing cost of living, which has weakened their purchasing power as the same amount of money can only buy less goods and services. Undeniably, people at various income levels would react differently to increasing inflation. According to Feenstra (1986), an increase in the inflation rate causes people to economise on their money balances. From the conventional perspective, welfare is directly related to the quantity of consumption goods. Hence, welfare will be negatively affected when inflation rate goes up. This is supported by Freeman and Huffman (1991) who find that an increase in the inflation rate reduces people's welfare in their models. They also find that all money-holders suffer when inflation rate rises because the returns to their money are reduced. With lower real returns, less savings will be available to acquire consumption goods.

Later studies, such as Romer and Romer (1999) and Easterly and Fischer (2001) provide evidence that inflation affects the welfare of the poorest groups in society. Focusing on the transaction patterns of heterogeneous households, Erosa and Ventura (2002) find that inflation is effectively a regressive consumption tax. It has redistributive effects as the detrimental impact on the welfare of low income households is larger than the impact on high income households who find it less costly to substitute credit for money in transactions. Doepke and Schneider (2006) calculate the effects of an unanticipated shock to the wealth distribution. Contrary to the earlier findings, they find the shock to be zero sum, yet households react asymmetrically, mainly