



JAYOTI VIDYAPEETH WOMEN'S UNIVERSITY, JAIPUR

Government of Rajasthan established

[Through ACT No. 17 of 2008 as per UGC ACT 1956](#)

[NAAC Accredited University](#)

Faculty of Education and Methodology

Faculty Name- JV'n Dr. Md Meraj Alam

Program- BA (Hons) Economics 2nd Semester

Course – Macroeconomics II

Digital session name – Demand pull Inflation and Cost Push inflation

Demand pull Inflation.

Demand-Pull or excess demand inflation is a situation often described as “too much money chasing too few goods.” According to this theory, an excess of aggregate demand over aggregate supply will generate inflationary rise in prices. Its earliest explanation is to be found in the simple quantity theory of money.

The theory states that prices rise in proportion to the increase in the money supply. Given the full employment level of output, doubling the money supply will double the price level. So inflation proceeds at the same rate at which the money supply expands.

In this analysis, the aggregate supply is assumed to be fixed and there is always full employment in the economy. Naturally, when the money supply increases it creates more demand for goods but the supply of goods cannot be increased due to the full employment of resources. This leads to rise in prices.

Modern quantity theorists led by Friedman hold that “inflation is always and everywhere a monetary phenomenon. The higher the growth rate of the nominal money supply, the higher the rate of inflation. When the money supply increases, people spend more in relation to the available supply of goods and services. This bids prices up. Modern quantity theorists neither

assume full employment as a normal situation nor a stable velocity of money. Still they regard inflation as the result of excessive increase in the money supply.

The quantity theory version of the demand-pull inflation is illustrated in Figure 3. Suppose the money supply is increased at a given price level OP as determined by the demand and supply curves D and S_1 respectively. The initial full employment situation OY_F at this price level is shown by the interaction of these curves at point E . Now with the increase in the quantity of money, the aggregate demand increase which shifts the demand curve D to D_1 to the right. The aggregate supply being fixed, as shown by the vertical portion of the supply curve SS_1 the D_1 curve intersects it at point E_1 . This raises the price level to OP_1 .

The Keynesian theory on demand-pull inflation is based on the argument that so long as there are unemployed resources in the economy; an increase in investment expenditure will lead to increase in employment, income and output. Once full employment is reached and bottlenecks appear, further increase in expenditure will lead to excess demand because output ceases to rise, thereby leading to inflation.

The Keynesian theory of demand -pull inflation is explained diagrammatically in Figure 3. Suppose the economy is in equilibrium at E where the SS_1 and D curves intersect with full employment income level OY_F . The price level is OP . Now the government increases its expenditure. The increase in government expenditure implies an increase in aggregate demand which is shown by the upward shift of the D curve to D_1 in the figure. This tends to raise the price level to OP_1 , as aggregate supply of output cannot be increased after the full employment level.

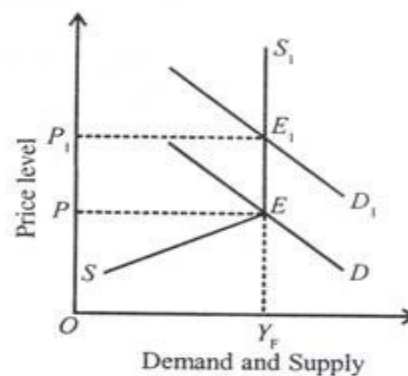


Fig. 3

Source: Internet

Cost-Push Inflation

Cost-push inflation is caused by wage increases enforced by unions and profit increases by employers. This type of inflation has not been a new phenomenon and was found even during the medieval period. But it was revived in the 1950s and again in the 1970s as the principal cause of inflation. It also came to be known as the “New Inflation.”

Cost-push inflation is caused by wage-push and profit-push to prices for the following reasons:

1. Rise in Wages:

The basis cause of cost-push inflation is the rise in money wages more rapidly than the productivity of labour. In advanced countries, trade unions are very powerful. They press employers to grant wage increases considerably in excess of increases in the productivity of labour, thereby raising the cost of production of commodities. Employers, in turn, raise prices of their products.

Higher wages enable workers to buy as much as before, in spite of higher prices. On the other hand, the increase in prices induces unions to demand still higher wages. In this way, the wage-cost spiral continues, thereby leading to cost-push or wage-push inflation. Cost-push inflation may be further aggravated by upward adjustment of wages to compensate for rise in the cost of living index.

2. Sectoral Rise in Prices:

Again, a few sectors of the economy may be affected by money wage increases and prices of their products may be rising. In many cases, their production such as steel, raw materials, etc. are used as inputs for the production of commodities in other sectors. As a result, the production cost of other sectors will rise and thereby push up the prices of their products. Thus wage- push inflation in a few sectors of the economy may soon lead to inflationary rise in prices in the entire economy.

3. Rise in Prices of Imported Raw Materials:

An increase in the prices of imported raw materials may lead to cost-push inflation. Since raw materials are used as inputs by the manufacturers of the finished goods, they enter into the cost of production of the latter. Thus a continuous rise in the prices of raw materials tends to set off a cost-price-wage spiral.

4. Profit-Push Inflation:

Oligopolist and monopolist firms raise the prices of their products to offset the rise in labour and production costs so as to earn higher profits. There being imperfect competition in the case of such firms, they are able to “administer prices” of their products. “In an economy in which so called administered prices abound there is at least the possibility that these prices may be administered upward faster than cost in an attempt to earn greater profits.

To the extent such a process is wide-spread profit-push inflation will result.” Profit-push inflation is, therefore, also called administered-price theory of inflation or price-push inflation or sellers’ inflation or market-power inflation. Cost-push inflation is illustrated in Figure 4. Where S_1 is the supply curve and D is the demand curve. Both intersect at E which is the full employment level OY_F , and the price level OP is determined. Given the demand, as shown by the D curve, the supply curve S_1 is shown to shift to S_2 as a result of cost-push factors. Consequently, it intersects the D curve at E_1 showing rise in the price level from OP to OP_1 and fall in aggregate output from OY_F to OY_1 level. Any further shift in the supply curve will shift and tend to raise the price level and decrease aggregate output further.

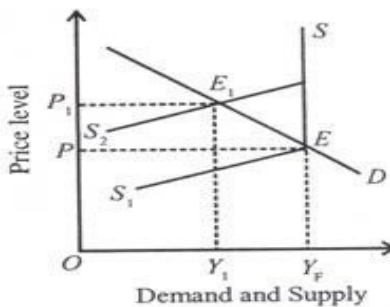


Fig. 4

Source: Internet

Course Outcome: The goal of this paper will be to expose the students to the basic principles of macroeconomics. The emphasis will be on thinking like an economist and course will illustrate how economic concepts can be applied to analyse real-life situations. In this course, the students are introduced to money and interest, theories of inflation, rate of interest, trade cycle and growth models.