# **DEMAND PULL AND COST PUSH INFLATION**

## According to the modern economist inflation is caused from two ways, which are the demand side factors and the supply side factors. So, on the basis of how it is caused inflation can by classified into

* Demand pull inflation
* Cost push inflation

DEMAND PULL INFlATION

When the price of the commodities of a country increases continuously because of the increase in demand for the commodities while the supply remains unchanged, this situation is called demand pull inflation. When the supply cannot increase, we have reached to a level of full employment level beyond which there can be no production and we have a vertical supply curve. Such a situation shows the country’s expenditure is more than country’s production at a full employment level.

The following diagram illustrates and explains the demand-pull inflation.

D1

P

E

E1

Q\*

D

D1

P1

D

P

Q

S

0

Let’s say the initial equilibrium is at point E where the demand curve (DD) and supply curve intersect. Here we have full employment hence the supply curve is vertical. At the initial equilibrium point where the demand for commodity is equal to the supply of commodity, we have price level as P and the quantity as Q\*. Now as the people keep demanding more and more of the good the demand will increase which will cause a rightward shift of the demand curve from DD to D1D1.With the new demand curve the equilibrium point will shift from E to E1. The new intersection of demand and supply cure will give us the new price. Since the amount of quantity cannot change due to the full employment level, only the price increases from P to P1. This increase is caused solely by the demand side factor and hence is called demand pull inflation.

COST PUSH INFLATION

This inflation occurs when we focus on the supply side factor. When the price level of the country is increasing continuously because of the increase in the cost of production due to the increase in the prices of the factors of production then the situation is called cost push inflation. When we say price of the factor of production we mainly talk and focus on the wages. Trade unions have power to influence the wages greatly. When the increase the wages that increases the cost of production. However, if the increase in wages is higher than the increase in productivity of the workers it causes an increase in the cost of production and increasing the price further.

The following diagram illustrates and explains the cost push inflation.

S2

S1

S0

B

A

E1

E2

Q2

Q1

P1

D

D

P2

0

P

Q

The vertical line shows the supply level when the country is in full employment level, before that the supply curve is upward sloping. The total demand curve is given by the downward sloping curve DD. Let the initial equilibrium be at point E1, where the demand curve intersects the supply curve (S1AS0). The point of intersection gives the price P1 and quantity Q1. When the trade unions influence the wage rate and it increases more than the increase in the productivity of the work it results in the increase in the cost of production. This is illustrated by the leftward shift of the supply curve from S1AS0 to S2BS0. Now the equilibrium is at E2 where we have a higher price level at P2 and lower quantity at Q2. This rise in price is solely caused by the supply side factor hence is called cost push inflation. Therefore, before the full employment level when the demand doesn’t change, an increase in the cost of production increases the price. Since the trade unions increase the wages to meet their interest this inflation is also called administered price inflation.

There are criticisms regarding the cost push inflation-

1. This theory is based on the assumption that the trade unions influence the price, but if there is perfectly competitive labor market then the wages increase when the demand for labor increases. In such a market structure there will be no cost push inflation.
2. If the money supply and the government expenditure remain constant, then the increase in price due to the increase in the cost of production won’t last for long. If the money supply isn’t increased, then they will not have extra purchasing power to demand more. This results in lower demand and lower production which increases the unemployment level. With higher unemployment the wages decreases and there will be no cost push inflation.