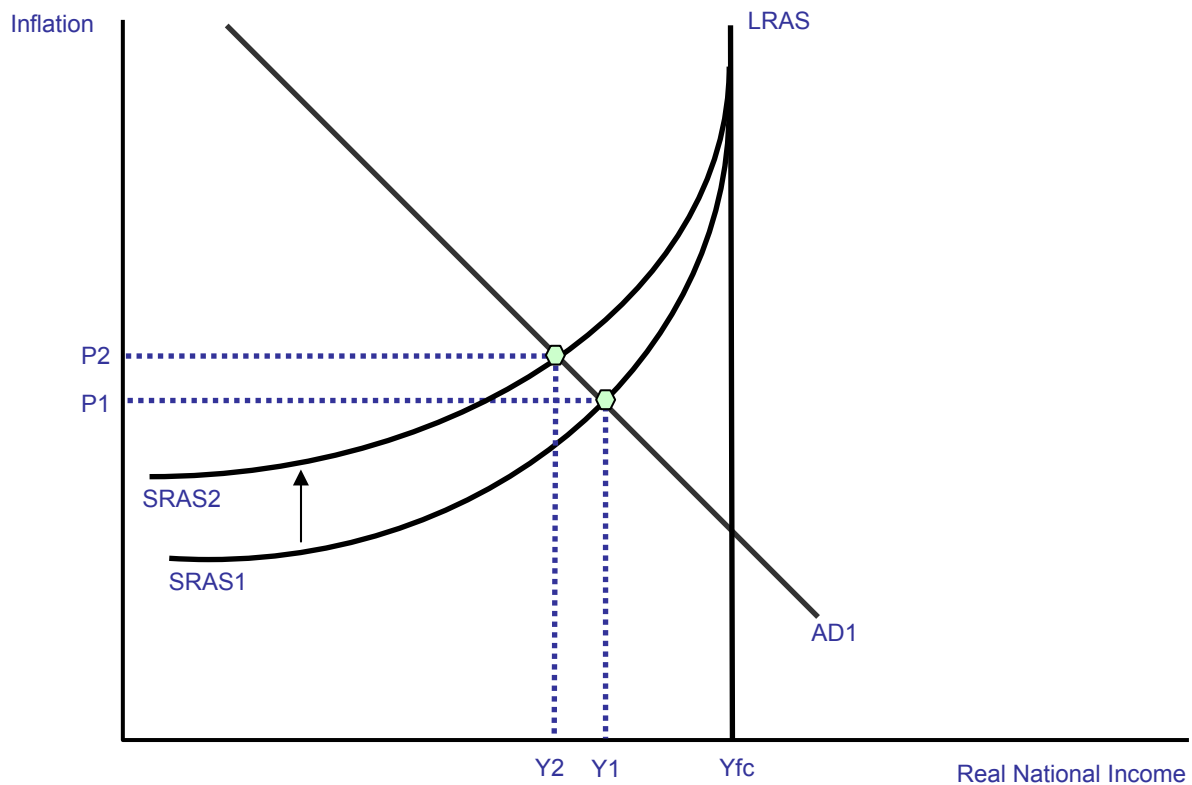


Cost push and demand pull inflation

This revision note considers two of the main causes of inflation – namely cost-push and demand-pull factors. It is designed for AS economists preparing for Unit 2 but is also useful revision for students revising for unit 6.

Inflation is a **sustained increase in the general price level** leading to a fall in the purchasing power of money. Inflationary pressures can come from **domestic and external sources** and from both the supply and demand side of the economy.

Cost push inflation



Cost-push inflation occurs when businesses respond to **rising costs**, by increasing their prices to protect profit margins. There are many reasons why costs might rise:

1. **Component costs:** e.g. an increase in the prices of raw materials and components. This might be because of a rise in global commodity prices such as oil, gas copper and agricultural products used in food processing – a good recent example is the surge in the world price of wheat.
2. **Rising labour costs** - caused by wage increases that exceed improvements in productivity. Wage and salary costs often rise when unemployment is low (creating labour shortages) and when people expect inflation so they bid for higher pay in order to protect their real incomes.
3. **Higher indirect taxes imposed by the government** – for example a rise in the duty on alcohol, cigarettes and petrol/diesel or a rise in the standard rate of Value Added Tax. Depending on the price elasticity of demand and supply, suppliers may pass on the burden of the tax onto consumers.

4. **A fall in the exchange rate** – this can cause cost push inflation because it normally leads to an increase in the prices of imported products. For example during 2007-08 the pound fell heavily against the Euro leading to a jump in the prices of imported materials from Euro Zone countries.

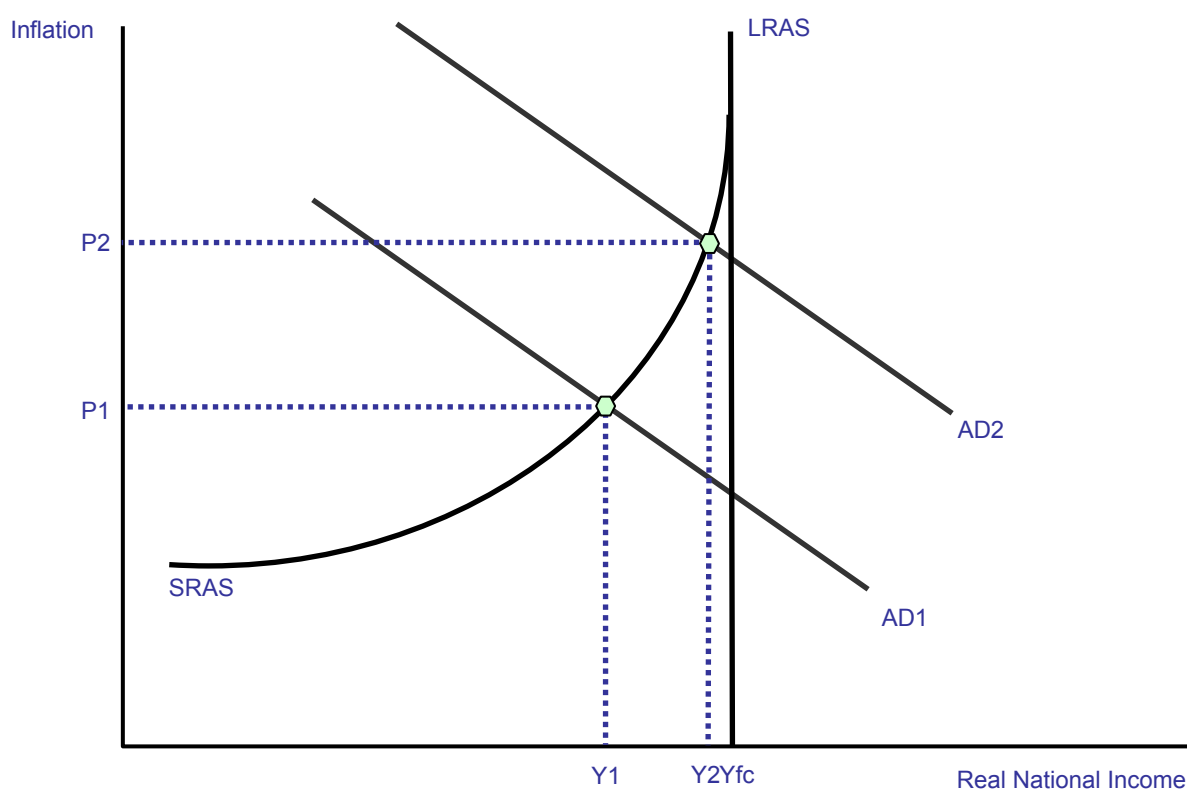
Cost-push inflation can be illustrated by an **inward shift of the short run aggregate supply curve**. The fall in SRAS causes a contraction of GDP together with a rise in the level of prices. One of the risks of cost-push inflation is that it can lead to **stagflation**.

Important note: Many of the causes of cost-push inflation come from **external economic shocks** – e.g. unexpected volatility in the prices of internationally traded commodities and large-scale movements in variables such as the exchange rate. A country can also import cost-push inflation from another country that is suffering from rising inflation of its own.

Demand pull inflation

Demand pull inflation occurs when aggregate demand and output is growing at an unsustainable rate leading to increased pressure on scarce resources and a **positive output gap**. When there is **excess demand** in the economy, producers are able to raise prices and achieve bigger profit margins because they know that demand is running ahead of supply. Typically, demand-pull inflation becomes a threat when an economy has experienced a strong boom with GDP rising faster than the long run trend growth of potential GDP. The last time this happened to any great extent in the UK economy was in the late 1980s.

Demand pull inflation can be shown in a diagram such as the one below.



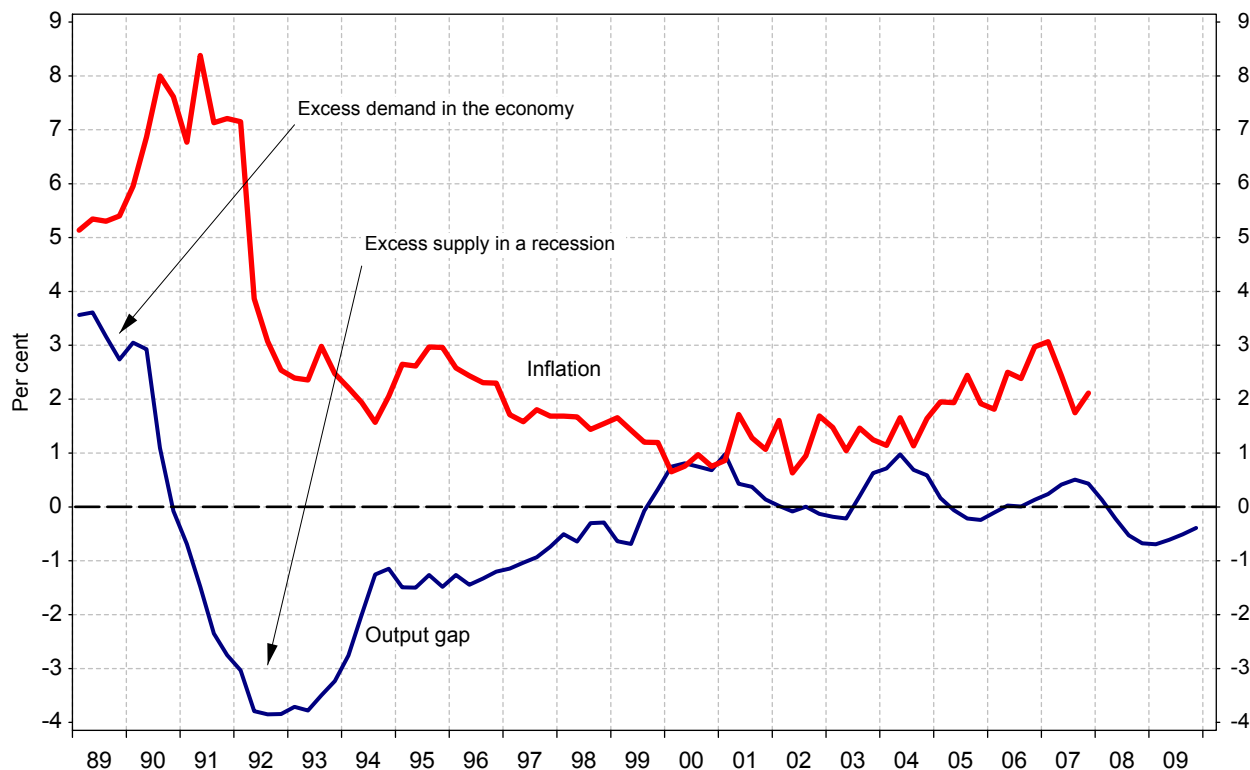
Possible causes of demand pull inflation

1. **A depreciation of the exchange rate** which makes exports more competitive in overseas markets leading to an injection of fresh demand into the circular flow and a rise in national and demand for factor resources – there may also be a positive multiplier effect on the level of demand and output arising from the initial boost to export sales.
2. **Higher demand from a government (fiscal) stimulus** e.g. via a reduction in direct or indirect taxation or higher government spending and borrowing. If direct taxes are reduced, consumers will have more disposable income causing demand to rise. Higher government spending and increased borrowing feeds through directly into extra demand in the circular flow.
3. **Monetary stimulus to the economy:** A fall in interest rates may stimulate too much demand – for example in raising demand for loans or in causing rise in house price inflation.
4. **Faster economic growth in other countries** – providing a boost to UK exports overseas.
5. **Improved business confidence** which prompts firms to raise prices and achieve better profit margins

Demand pull inflation is most likely to occur when an economy is becoming stretched and is said to be danger of over-heating. This is often seen towards the end of a boom when output is expanding beyond the economy's usual capacity to supply, the result being higher prices and also a larger trade deficit (imports act as a kind of [safety valve](#) to take away some of the excess AD).

The Output Gap and Consumer Price Inflation

Output Gap = Actual GDP - Potential GDP. CPI inflation - annual % change in prices



Source: Reuters EcoWin

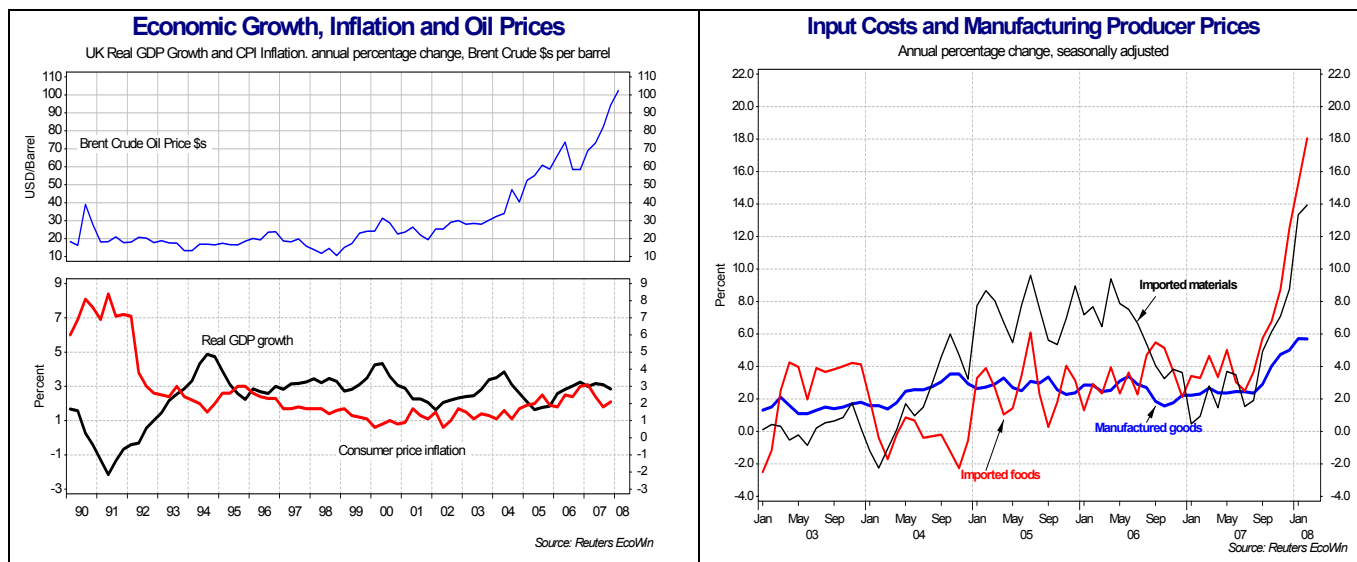
What should we look out for as evidence for cost-push and demand-pull inflation?

Cost-push inflation

1. The rate at which wages and salaries are rising
2. Data on producer prices and input costs such as the prices of raw materials
3. Trends in international commodity prices
4. The effects of changes in indirect taxes on prices

Demand-pull inflation

1. How fast is aggregate demand growing (and the component parts I.e. $C+I+G+X-M$)
2. Estimated size of the output gap
3. Profitability of businesses in different sectors of the economy
4. Growth of the money supply and credit / consumer borrowing
5. Trends in the values of assets such as property prices
6. Indicators of consumer and business confidence
7. Whether a firm's prices are rising faster than their costs (tells you what is happening to profit margins)



Check your understanding

Online multiple choice test on inflation

<http://vle.tutor2u.net/mod/quiz/view.php?id=1476>