

Topic: Inflation and its causes

Subject: Planning and Economic Development

Paper: BCH 3.5

Class: B.com semester three

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Inflation and its causes

Inflation exists when money supply exceeds available goods and services I.e. a situation when too much money chasing too few goods.

According to J **Keynes** '**Inflation** is the result if excess aggregate demand over the aggregate supply and the true **inflation** starts after full employment. ' According to him, the rise in price level before full employment is semi-**inflation**.

We can say that inflation creates when aggregate demand over the aggregate supply

Inflation= aggregate demand- aggregate supply----- increases price

Causes of Inflation:

Inflation is mainly caused by excess demand/ or decline in aggregate supply or output. Former leads to a rightward shift of the aggregate demand curve while the latter causes aggregate supply curve to shift left-ward. Former is called demand-pull inflation (DPI), and the latter is called cost-push inflation (CPI).

1. Demand-pull inflation

An increase in aggregate demand over the available output leads to a rise in the price level. Such inflation is called demand-pull inflation (henceforth DPI). Classical economists attribute this rise in aggregate demand to money supply. If the supply of money in an economy exceeds the available goods and services, DPI appears. It has been described by Coulborn as a situation of “too much money chasing too few goods.”

If the economy is at or close to full employment, then an increase in aggregate demand (AD) leads to an increase in the price level (PL). As firms reach full capacity, they respond by putting up prices leading to inflation. Also, near full employment with labor shortages, workers can get higher wages which increase their spending power.

DPI originates in the monetary sector. Monetarists' argument that “only money matters” is based on the assumption that at or near full employment excessive money supply will increase aggregate demand and will, thus, cause inflation.

An increase in nominal money supply shifts aggregate demand curve rightward. This enables people to hold excess cash balances. Spending of excess cash balances by them causes price level to rise. Price level will continue to rise until aggregate demand equals aggregate supply

2. Cost-push inflation

If there is an increase in the costs of firms, then businesses will pass this on to consumers. There will be a shift to the left in the AS.

Cost-push inflation can be caused by following factors

1. Rising wages

If trades unions can present a united front then they can bargain for higher wages. Rising wages are a key cause of cost push inflation because wages are the most significant cost for many firms. (higher wages may also contribute to rising demand)

2. Import prices

One-third of all goods are imported in the UK. If there is a devaluation, then import prices will become more expensive leading to an increase in inflation. A devaluation / depreciation means the Pound is worth less. Therefore, we have to pay more to buy the same imported goods.

In 2011/12, the UK experienced a rise in cost-push inflation, partly due to the depreciation of the Pound against the Euro. (also due to higher taxes)

3. Raw material prices

The best example is the price of oil. If the oil price increase by 20% then this will have a significant impact on most goods in the economy and this will lead to cost-push inflation. E.g., in 1974 there was a spike in the price of oil causing a period of high inflation around the world.

4. Profit push inflation

When firms push up prices to get higher rates of inflation. This is more likely to occur during strong economic growth.

5. Declining productivity

If firms become less productive and allow costs to rise, this invariably leads to higher prices.

6. Higher taxes

If the government put up taxes, such as GST this will lead to higher prices, and therefore CPI will increase. However, these tax rises are likely to be one-off increases. There is even a measure of inflation (CPI-CT) which ignores the effect of temporary tax rises/decreases'-CT is less volatile because it ignores the effect of taxes. In 2010, some of the UK CPI inflation was due to rising taxes.