Big Question: Evaluate (prioritize) the most important causes of inflation.

Webnote 231

Syllabus Reference 2.3: Inflation

1. **Demand Pull**
2. **Cost Push**
3. **Money supply (see web 313)**
   HL should also see web 319.

3 Causes of Inflation[1]

- Devaluation/ depreciation
- Inflation Psychology
- Fiscal Policy (policy conflict)
- Imported (cost push)

1 demand pull
If there is too much money chasing too few goods we have demand pull

2 cost push
Rising costs will eventually push up prices, resulting in cost push inflation

3. money supply
quantity of money in economy main determinant of inflation

1. **Demand Pull Inflation: Excess Demand**

In an economy there may be a surplus of money relative to the amount of goods and services being produced. If this is the case, the excess demand is likely to pull up prices in its wake. Hence we get the term, **demand pull inflation.** It is really a situation where there is too much money chasing too few goods.

Possible Causes of Excess Demand

- Increases in bank lending.
- increases in government expenditure.
- Wage claims granted in excess of productivity.
- See factors that shift AD in webnote 310 item (A)

2. **Cost Push Inflation: Rising Production Costs**

If a firm suffers an increase in its costs, the natural reaction will be to pass on that increase to the buying public in the form of higher retail prices. When this happens, we may say that costs are pushing up prices, i.e. **cost push inflation.**

Possible Causes of Rising Costs (factor costs)

- Increased charges for raw materials.
- Higher taxation.
- High interest rates.
- Rising levels of social insurance contributions for firms
- Increases in wages etc.

3. **Money supply – monetarist view that quantity of money influences inflation**

This theory is considered in webnote 319. This theory of inflation draws on the *Quantity Theory of Money* to suggest that if the amount of money in the economy grows faster than the growth in the level of potential output, then this will feed through to prices. In other words if the money supply grows too fast there will be inflation.

[1] Reading: Andrew Holder, "The benefits of low inflation", 21(1), September 2003 Reading: John Power, "Price stability and inflation targeting", 19(3), February 2002 Reading: Peter Smith, "The case of the missing Phillips curve", 17(4), April 2000

Cost push
Weak domestic currency higher import prices

LDC's

Expectations of inflation can be high

Cost push
Higher import prices leading to higher input prices

demand pull
Taxation increases can stimulate inflation

cost push
A devaluation OR depreciation makes imports more expensive

Webnote 231

Other points to note about inflation:

- **Currency Devaluation / depreciation**

There is always a possibility that the government or the market may decide to decrease the value of the currency. This effectively revalues upward the other currencies that we must buy to pay for imported resources, thus making those resources more expensive. In turn, this may force firms to increase their prices. Recent fluctuations in the euro/ dollar rates with 50 % swings over a 3 year period affect costs of importing firms.

- **Inflation Psychology**

In LDC'S living with inflation is often a way of life; constantly rising prices is often normal. Manufacturers and retailers, aware that this is the case, are tempted on occasions to increase prices that little bit further, knowing that the public at large accept increased prices as a fact of economic life. Where inflation is rampant this is a valid argument and it does occur in LDC's. However in DC's inflation is generally stable and inflation psychology is less important.

- **Imported Inflation**

Many raw materials used in production processes come from abroad. If these raw materials were to rise in price, domestic firms facing inflation increased costs would have to raise the prices of finished goods. In this instance the increases in price may be said to be caused externally - our inflation is **imported.**

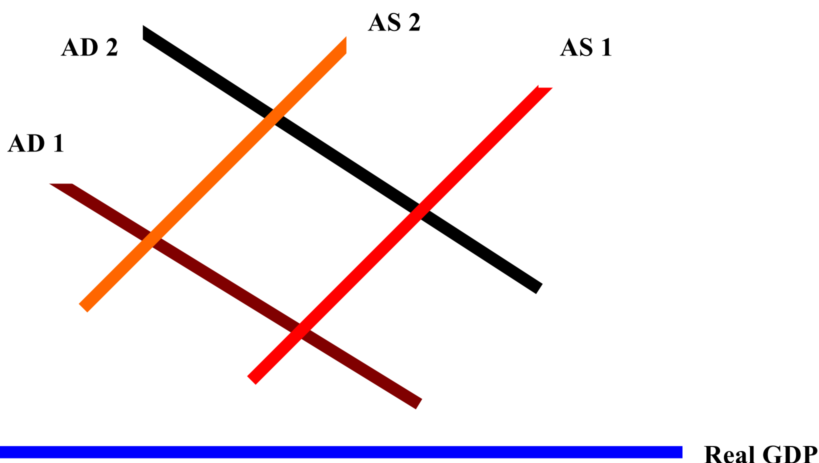
- **Fiscal Policy – policy conflicts can result as a result of the fiscal change**

In its annual budget – fiscal policy- a government may affect inflation by changing the rates of direct. It dropped the highest rate of income tax from 65% to 60%. This was done to stimulate consumption spending and therefore aggregate demand.

Note: this approach also assisted in keeping inflation under control using lower indirect tax rates.

Task: show effects of 1-6 on the aggregate supply and demand diagram below

Using the AS/ AD model to show cost push and demand pull inflation



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Question 4:
Use an Aggregate demand/aggregate supply diagram to explain how cost push inflation may occur, and outline two ways in which it might be controlled.