# DEMAND - PULL AND COST - PUSH INFLATION

## 1. DEMAND - PULL INFLATION

According to the demand pull theory of inflation, the process of rising prices is initiated by the excess of demand over supply to goods and services in the economy. Later on further excess of demand over supply continues to exercise demand pull and the price level continues to move in the upward direction. If the economic system is initially in a state of full employment equilibrium. The aggregate supply of output becomes fixed or perfectly inelastic in such a situation. Now suppose the aggregate demand increases due to any of the factors such as —

(i) Increase in the quantity of money
(ii) Increase in the velocity of money
(iii) Increase in the flow of credit.
(iv) Increase in consumption.
(v) Increase in investment.
(vi) Increase in government expenditure.
(vii) Increase in foreign demand.

The excess of aggregate demand over aggregate supply causes the bidding up of prices. Thus the excess demand or demand pull initiates the increase in price level. As prices increase, consumer and producers expect that the prices will rise even in future. They start making purchases not only for the current period but also for the future. Thus there is further pull of demand and price level continues to increase. So long as the excess demand or the demand-pull continuous to exist, the process of inflation will persist in the economy.

Keynes' inflationary gap analysis is also a variant of the demand pull or excess demand inflation. The inflationary gap is the excess of anticipated expenditure over the available supply of output at base prices or the pre-inflationary prices.

The demand-pull inflation or excess demand inflation can be explained with the help of the following diagram

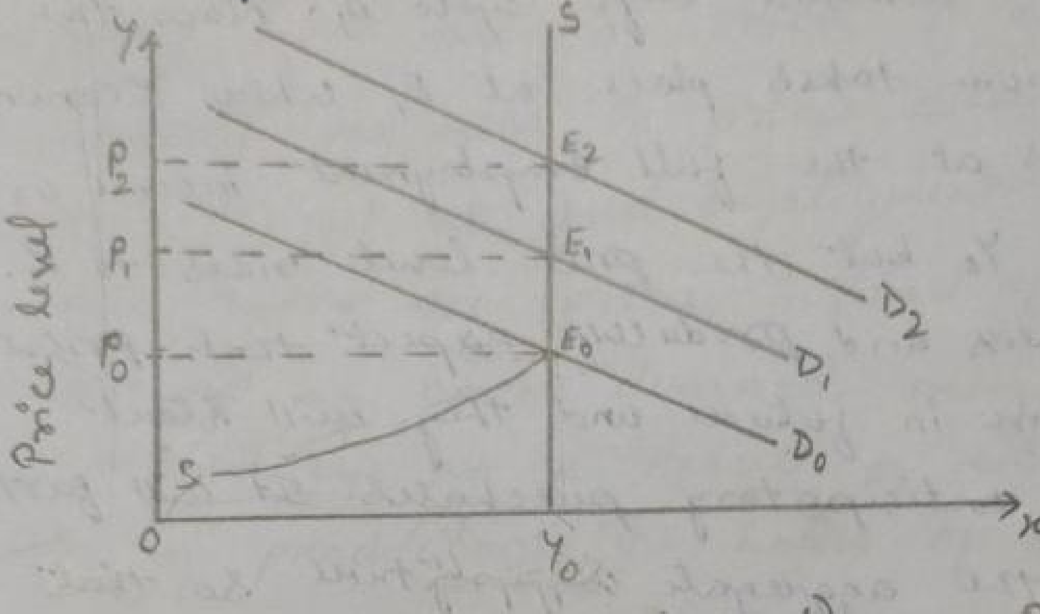


Fig-1

In Fig:1, income or output is measured along the horizontal scale. The price level is measured along the vertical scale. Originally SS is the aggregate supply function which is relatively more elastic before the full employment, income ~~or~~ output and becomes perfectly inelastic or a vertical straight line at the full employment i.e at $Y_0$. $D_0$ is the original aggregate demand function which slopes negatively. Initially, equilibrium income is $Y_0$ and the price level is $P_0$. In this situation, the economy is in equilibrium at full employment. If there is increase in money stock and credit, increase in consumption, investment or government expenditure, the aggregate demand shift upto $D_1$. Now the equilibrium takes place at $E_1$ where economy remains at the full employment income or output $Y_0$ but the price level rises to $P_1$. Consumers and producers expect that prices will rise in future and they will start making anticipatory purchases. It will further raise the aggregate expenditure so the aggregate demand function further shift upto $D_2$. Now the intersection takes place at $E_2$. The economy even in this equilibrium position remain in a state of full employment but the price level rises further to $P_2$. Thus in the demand - pull or the excess demand inflation, the process of rising prices is not initiated by the pull of demand but is also perpetuated by the pull of demand.