2. COST- PUSH INFLATION

The theory of cost - push inflation become popular after the mid 1950s. It attempts to explain the rise in prices when the economy is not at full employment. According to this theory, the prices, instead of being pulled up by excess demand, may also be pushed up as a result of rise in the cost of production. The basis of cost-push theory is that organised groups, both business and labour fix higher prices for their products or services than would prevail in perfectly competitive market. Cost- push inflation is characterised by insufficiency of aggregate demand, unemployment of resources and excess capacity.

The cost - push theory of inflation maintains

(a) that the true source of inflation is the increase in cost of production.

(b) that the increase in cost of production is autonomous of the demand conditions.

(c) that the push forces operate through important cost component, such as, wages, profits or material costs, so that cost-push inflation may take the form of wage push inflation, or profit-push inflation or material-push inflation.

(d) that the increase in cost of production is not absorbed by the producers but is passed to the buyers in the form of higher prices.

The cost-push inflation can be explain with the help of the following figure:2

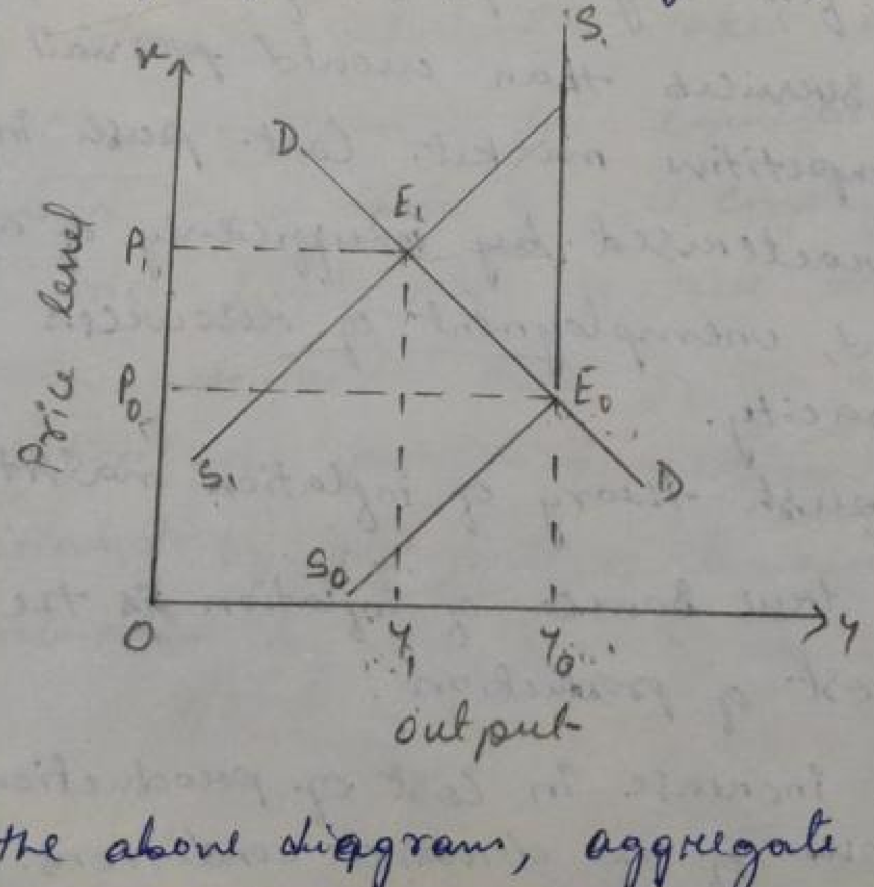

Fig:2

In the above diagram, aggregate demand curve (DD) intersect aggregate supply curve (S_0S) at point E_0, determining the price level OP_0 at full employment output OY_0. Now either due to wage rise or Profit rise, the Cost of production increases, shifting the aggregate Supply curve from S_0S to S_1S. It intersects the aggregate demand curve at point E_1. The price level rises from OP_0 to OP_1, and the output decreases from OM_0 to OM_1. It shows that the price level and unemployment increase simultaneously. If the government wants to maintain full employment under cost-push inflation, it is possible only at a higher price level.