6. Distinguish between Demand-pull and cost-push inflation? (Group-B — 50)

or

(Group-C — 40)
(a) How do you differentiate between demand-pull and cost-push inflation?
(b) Is it true that it is very difficult to separate demand-pull and cost-push inflation practice? Give reasons.

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Distiction between DPI and CPI :—

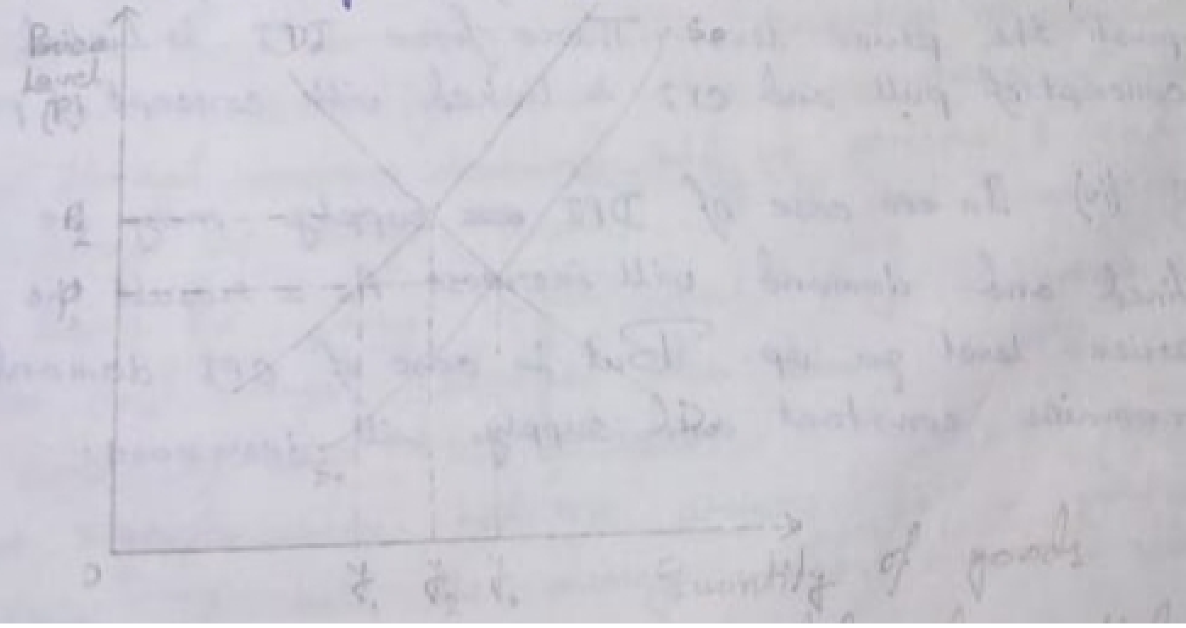
By inflation we mean time of generally rising the prices of good and factors of production. There are various types of inflation. Among them demand pull inflation (DPI) and Cost-push inflation (CPI) are very important.

Demand pull inflation (DPI) :—

Demand pull or excess demand inflation is a situation offen described as "too much money chasing to few goods" According to this theory, an excess of ~~agg~~ aggregate demand over aggregate supply will generate inflationary rise in prices. It's earliest explanation is to be found in the simple quantity theory of money. The theory states that price rise in proportion to the increase in the money supply. [Given the full employment level will the new demand curve is D_1D_1. Here at price level OP_0 the quantity demanded will be OY_1, but quantity ~~supply~~ supplied will be OY_0. Therefore, Y_0Y_1 is the excess demand. ~~Dut~~ Due to this excess demand the price level may increases from OP_0 to OP_2. This is called demand price inflation.

Cost push Inflation (CPI) :—

Cost push Inflation (CPI) is caused by wage increases enforced by unions and profit increases by employers. ~~This~~ The basic cause of C.P.I is the rises in money wages more rapidly than productivity of labour. In advanced countries trade unions are very powerful ; they press employers to grant wage increases ~~considera~~ considerably in ~~excess~~ of excess of increases in the productivity of labour, thereby raising the cost of prodn of ~~a commodity~~ commodities.
Employers interm, raise prices of their product. Higher wages enable workers to buy as much as before inspite of higher prices. The increase in prices induced unions to demand still higher wages. In this way, the wage-cost spiral continues, thereby leading to cost-push or wage push inflation. The concept of cost inflation is illustrated graphically below :—

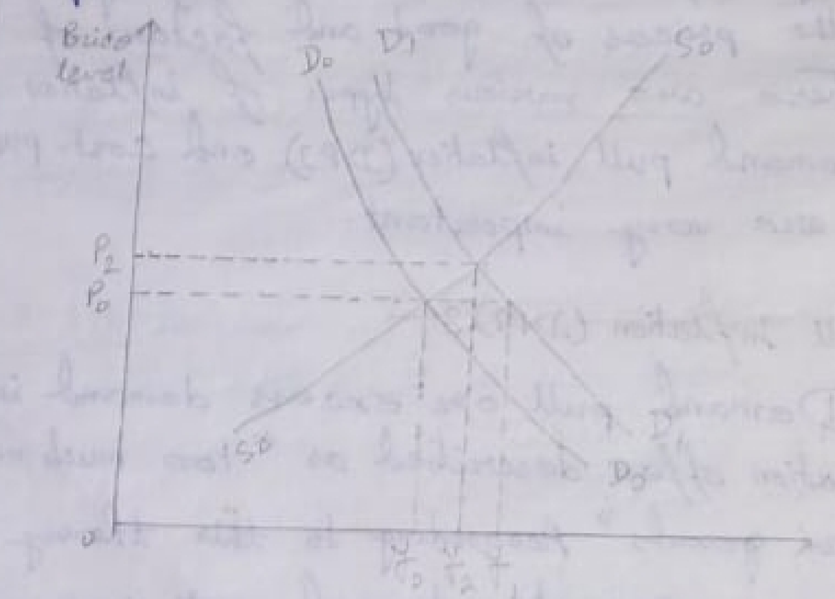


double the price level. So inflation proceeds at the same rate at ~~wich~~ which money supply expands.

Modern quantity theory led by Milton Friedman hold that "Inflation is ~~alawa~~ alaways and every where a monetary phenomenon". The higher the growth rate of the nominal money supply the higher the rate of inflation. Inflation arises when the nominal money supply increases more than the rises in the real money demanded.

The Keynesian theory of DPI is based on the argument that if the multiplier is relatively stable changes in income can be produced from change in investment.

The concepet of demand pull inflation can be explained with the help of following — diagream —



Here S_0-S_0 is the initial supply curve and D_0D_0 is the initial demand curve and OP_0 is the equ^m price level. Now suppose that there is an ~~utomomus~~ autonomus increase in demand and the

In the above digram D_0D_0 and S_0S_0 are the initial demand and supply curve respectively. Here OP_0 is the equ^m price level. Due to decrease in supply, the supply curve will be S_1S_1. Here at OP_0 price level excess demand will be Y_0Y_1. As a result price will increase. Due to increase in price demand will some what decrease ~~and~~ supply will some what increase. Finally when price level will be OP_2 demand will be OY_2 and supply will ~~as~~ also be OY_2. There fore OP_2 is the equ^n price. This is called cost push inflation (C.P.I).

From the above analysis let us now enumerate some important distinction between DPI and CPI ——

(i) In case of DPI the price level may increase due to increase in demand. But in case of CPI price level may increase due to increase in cost. Therefore, DPI arises from demand side and CPI arises from supply side.

(ii) The classical economists looked the problem of a country from the supply side. But Keynes looked this problem from demand side. Therefore, we can ~~stay~~ say that DPI is associated with Keynesian thinkings and the CPI is associated with classical thinkings.

(iii) In case of DPI excess demand may pull the price level, but in case of CPI cost of prod^n. may push the price level. There fore DPI is linked with concept of pull and CPI is linked with concept of push.

(iv) In ~~as~~ case of DPI ~~ex~~ supply may be ed and demand will increase. As a result the ice level go up. But in case of CPI demand emains constant and supply will decrease.

(v) DPI creats an expansionary effect in the economy here production, employment investment, income etc. increases. On the other hand, CPI creates a contractionary effect in the economy because here all the above variable decrease.

(vi) DPI affect prodⁿ directly and income distribution indirectly. But CPI effect income distribution directly and prodⁿ indirectly.

(b)

In a situation of demand pull inflation (DPI) ~~price~~ prices rise due to excess demand in the market for ~~produtt~~ in a situation of full employment. But in a ~~situato~~ situation of of cost push inflation (CPI) price rise ~~dul~~ due to increase in the money wage rate in a situation of less than full employment. In case of demand pull inflation excess demand pulls prices upward but in ~~case of cost p cost push~~ case of cost push inflation money wages rise without increase in demand. As a result prices rise.

There are several reasons why it is difficult in practice to distinguish between these two situation In the first place, above distinction has to do with the direction of causeation and not necessarily with time sequence of events. Even though excess demand bid up prices lead to bidding up wage rates, it is not necessary that there be any significant ~~lag~~ lag between price and wage changes. Nor ~~it is~~ in the the cost inflation case ~~of cost~~, here wages rise significantly before prices. In a period of time if both the money wages and prices is blamed for granting them. But trade unions reject the wage push theory because they would not like to lie blame for inflation. They also reject the demand pull view because that would prevent the use of monetary and ~~fis~~ fiscal measure to increase employment. Thus they hold only big firms respon-sable for inflationary rise price through adminis-tative price. But their is no conclusive proof that the profit margin and profit rate of firm have been increasing year after year.

Maclup further points out that their is a group of economist who holds that cost push is no - cause of inflation. On the other hand their is another group of economist who belives that demand pull is no cause of inflation, its take ~~a~~ cost push to produce it.

According to 'Ackley' the principlerea why the distinction between demand and cost inflation is difficult in practice is that wages are not set by impersonal market forces. In a modern world they are changed at infrequent intervals by an administative process and reflecting many ~~criteria~~ crit other than supply and demand. For some ~~farms~~ farm product and raw materials ~~is~~ prices do response directly and ~~almost~~ allmost daily to supply and demand conside-ration. But for most manifacture goods price rise and fall as a result of ~~a~~ some managers decission using some rule or formula or using his own judgement.

~~For~~ From the above considaration we an say that it is difficult to seperate demand pull om cost push inflation.
