Q: What are the causes of Inflation? Explain.

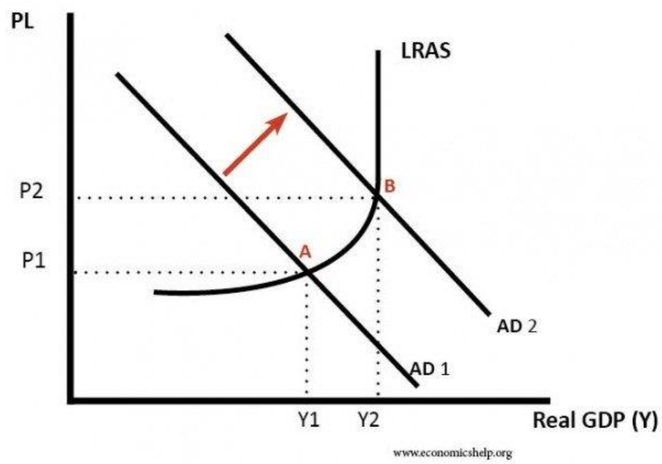
Ans: There are two main causes of inflation:

- Demand-Pull Inflation
- Cost-Push Inflation

Demand-Pull Inflation: The most common cause of rising prices is the demand pull inflation which occurs when the consumer demand of goods and services exceeds the supply. As demand for a particular good or service increases, the available supply decreases. When fewer items are available, consumers are willing to pay more to obtain the item—as outlined in the economic principle of supply and demand. The result is higher prices due to demand-pull inflation.

For example, the housing market has seen its ups and downs over the years. If homes are in demand because the economy is experiencing an expansion, home prices will rise.

Diagrammatically



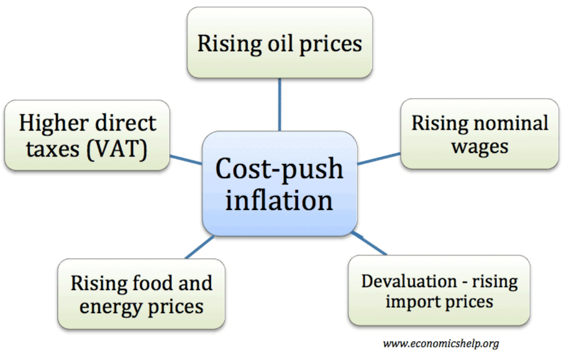
If the economy is at or close to full employment, then an increase in aggregate demand (AD) leads to an increase in the price level (PL). As firms reach full capacity, they respond by putting up prices leading to inflation. Also, near full employment with labour shortages, workers can get higher wages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

AD can increase due to an increase in any of its components C+I+G+X-M

We tend to get demand-pull inflation if economic growth is above the long-run trend rate of growth. The long-run trend rate of economic growth is the average sustainable rate of growth and is determined by the growth in productivity.

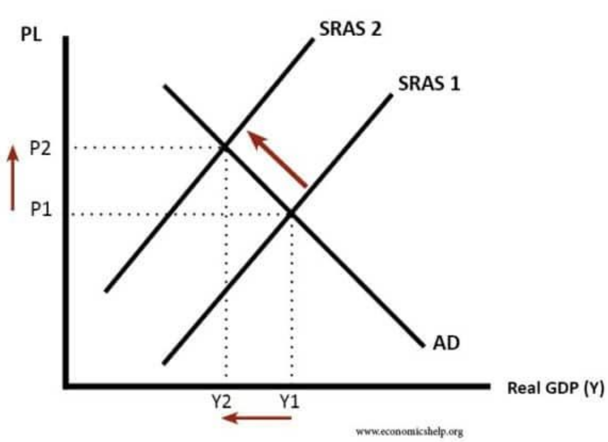
Cost-Pull Inflation:

Cost-push inflation occurs when prices increase due to increases in production costs, such as raw materials and wages. The demand for goods is unchanged while the supply of goods declines due to the higher costs of production. As a result, the added costs of production are passed onto consumers in the form of higher prices for the finished goods.



Wages also affect the cost of production and are typically the single biggest expense for businesses. When the economy is performing well, and the unemployment rate is low, shortages in labor or workers can occur. Companies, in turn, increase wages to attract qualified candidates, causing production costs to rise for the company. If the company raises prices due to the rise in employee wages, cost-push inflation occurs.

Diagrammatically



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