

Mona  
Assistant Professor  
Department of Economics  
Maharaja College  
Veer Kunwar Singh University, Ara  
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Topic : Cost Push Inflation

### **Cost Push Inflation**

We can visualise situations where even though there is no increase in aggregate demand, prices may still rise. This may happen if there is increase in costs independent of any increase in aggregate demand.

Three such autonomous increases in costs which generate cost-push inflation have been suggested. They are:

1. Wage-push inflation
2. Profit push inflation
3. Increase in prices raw materials, especially energy inputs such as rise in crude oil prices.

It may be noted that rise in prices of raw materials, especially of energy inputs (petroleum products) which have a cost push effect are also called supply shocks.

We discuss these below:

#### **Wage-Push Inflation:**

It has been suggested that the growth of powerful trade union is responsible for the spread of inflation, especially in the industrialized countries. When trade unions push for higher wages which are not justifiable either on grounds of a prior rise in productivity or of cost of living they produce a cost-push effect.

The employers in a situation of high demand and employment are more agreeable to concede to these wage claims because they hope to pass on these rises in costs to the consumers in the form of hike in prices. If this happens we have cost-push inflation. It may be noted that as a result of cost-push effect of higher wages, aggregate supply curve of output shifts to the left and, given the aggregate demand curve, this results in higher price of output.

#### **Profit-Push Inflation:**

Besides the increase in wages of labour without any increase in its productivity, there is another factor responsible for cost-push inflation. This is the increase in the profit margin by the firms working under monopolistic or oligopolistic conditions and as a result charging higher prices from the consumers.

In the former case when the cause of cost-push inflation is the rise in wages it is called wage-push inflation and in the latter case when the cause of cost-push inflation is the rise in profit margins, it is called profit-push inflation. The increase in profit margins also produces a cost-push effect and results in shift in the aggregate supply curve to the left.

### **Rise in Raw material Prices or Oil Price Shock:**

In addition to the rise in wage rate of labour increase in profit margins, in the seventies the other supply-shocks causing increase in marginal cost of production became more prominent in bringing about cost-push inflation. During the seventies in prices of raw materials, especially energy inputs (hike in crude oil price made by OPEC resulting in rise in prices of petroleum products). The sharp rise in world oil prices during 1973-75 and again in 1979-80 produced significant supply shocks resulting in cost-push inflation.

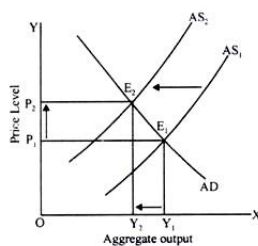


Fig. 23.3. Cost-Push Inflation

The cost-push inflation can also be illustrated with the aggregate demand and supply curves. Consider Fig. 23.3, where aggregate supply and demand are measured along the X-axis and price level along the Y-axis. AD is the aggregate demand curve and AS1 and AS2 curves are aggregate supply curves.

Now, when wages increase, and as a result cost of production rises, the aggregate supply curve would shift upward to the left. As will be seen in Fig. 23.3 when there is an upward shift in the aggregate supply curve from AS1 to AS2 due to the rise in wages, price level rises from OP1 to OP2.

Thus, in this case when aggregate demand curve remains the same, price level rises due to rise wages which has caused leftward shift in the supply curve. An important feature of cost-push inflation is that this causes not only rise in price level but brings about a fall in aggregate output. Thus in Fig. 23.3 when price level rises from OP1 to OP2 aggregate output falls from OY1 to OY2.

Indirect Effect of Increase in oil prices or other raw material prices. In addition to the direct effect of oil price shocks and increase in other raw material prices, there are indirect effects

of such supply shocks which cause further rise in rate of inflation. It may be noted that an aggregate supply curve is drawn assuming given price level expectations over time.

When a certain event occurs, the workers will revise their price expectations. Now, when due to increase in raw material prices or oil price shock price level of output has risen as a result of cost-push effect, the workers would revise upward their expectations of price level.

With this, the expected real wage rate ( $W/P$ ) will decline and therefore less labour will be supplied at a given money wage rate. Thus, with the increase in expected price level, aggregate supply curve will further shift to the left as a result of this indirect effect through the upward revision of expected price level.

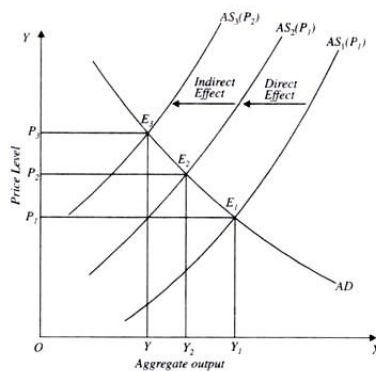


Fig. 23.4. Cost-Push Inflation: Accounting for both Direct and Indirect Effects of Oil Price Shock

This indirect effect is illustrated in 23.4. Initially, aggregate demand curve AD and aggregate supply curve AS1 (with  $P_1$  as the expected price level) determine price level and  $P_1$  output  $Y_1$ . Now, due to oil price shock, aggregate supply curve shifts to the left to AS2 ( $P_1$ ) and price level rises to  $P_2$ . Since price level has risen, workers will adjust the expected price level upward say to  $P_2$ . The causes a further shift in the aggregate supply curve to AS3 ( $P_2$ ) and further in price level to  $P_3$ .