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Topic : Demand-Pull Inflation

Demand-Pull Inflation

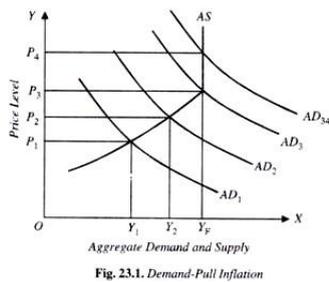
In an Aggregate Demand and Aggregate Supply diagram, an increase in the aggregate demand curve leads to an increase in the rate of inflation, i.e., when the aggregate demand for goods and services is greater than the aggregate supply. Demand Pull Inflation is defined as [an increase in the rate of inflation caused by the Aggregate Demand curve. It is the most common cause of inflation.](#)

Demand Pull Inflation involves inflation rising as real Gross Domestic Product rises and unemployment falls, as the economy moves along the Phillips Curve. Demand Pull Inflation is commonly described as “**too much money chasing too few goods**”.

More accurately, it should be described as involving “too much money spent chasing too few goods,” since only money that is spent on goods and services can cause inflation. This rise in price level is not expected to happen unless the economy is already at a full-employment level. The term demand-pull inflation is mostly associated with **Keynesian economics**.

For example, if aggregate demand is rising at 3%, but the productive capacity is only rising at 2%. Thus, firms will see that demand is outstripping supply and will respond by increasing prices. As firms produce more, they will hire more workers. This hiring spree will cause a fall in unemployment. This increased demand for workers puts upward pressure on wages, leading to wage-push inflation. Finally, higher wages increase the disposable income of employees, leading to a rise in consumer spending.

Graph



Demand-pull inflation can be illustrated with aggregate demand and supply curves. Consider Fig. 23.1 in which aggregate demand and aggregate supply are measured along the X-axis and general price level along the Y-axis. Curve AS represents the aggregate supply which rises upward in the beginning but when full-employment level of aggregate supply OY_F is reached, aggregate supply curve AS takes a vertical shape.

This is because after the level of full employment, supply of output cannot be increased. When aggregate demand curve is AD_1 the equilibrium is at less than full-employment level where price level OP_1 is determined. Now, if the aggregate demand increases to AD_2 , price level rises to OP_2 due to the emergence of excess demand at price level OP_1 .

It will be noticed that here the rise in price level has also brought about an increase in aggregate output supplied from OY_1 to OY_2 . If the aggregate demand further increases to AD_3 , the price level rises to OP_3 under the pressure of more demand.

But since the aggregate supply curve is still sloping upward, the increase in aggregate demand from AD_2 to AD_3 has used the increase in output from OY_2 to OY_F . If aggregate demand further increases, say to AD_4 only, the price level rises to OP_4 with output remaining constant at Y_F . OY_F is the full-employment level or output and aggregate supply curve is perfectly inelastic at Y_F .