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Demand-Pull Inflation

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What Is Demand-Pull Inflation?

Demand-pull inflation is the upward pressure on prices that follows a shortage in supply, a condition that economists describe as "too many dollars chasing too few goods."

KEY TAKEAWAYS

- When demand surpasses supply, higher prices are the result. This is demand-pull inflation.
- A low unemployment rate is unquestionably good in general, but it can cause inflation because more people have more disposable income.
- Increased government spending is good for the economy, too, but it can lead to scarcity in some goods and inflation will follow.

Demand-Pull Inflation

Understanding Demand-Pull Inflation

The term demand-pull inflation usually describes a widespread phenomenon. That is, when consumer demand outpaces the available supply of many types of consumer goods, demand-pull inflation sets in, forcing an overall increase in the cost of living.

Demand-pull inflation is a tenet of Keynesian economics that describes the effects of an imbalance in aggregate supply and demand. When the aggregate demand in an economy strongly outweighs the aggregate supply, prices go up. This is the most common cause of inflation.

In Keynesian economic theory, an increase in employment leads to an increase in aggregate demand for consumer goods. In response to the demand, companies hire more people so that they can increase their output. The more people firms hire, the more employment increases. Eventually, the demand for consumer goods outpaces the ability of manufacturers to supply them.

There are five causes for demand-pull inflation:

1. **A growing economy**: When consumers feel confident, they spend more and take on more debt. This leads to a steady increase in demand, which means higher prices.
2. **Increasing export demand**: A sudden rise in exports forces an undervaluation of the currencies involved.
3. **Government spending**: When the government spends more freely, prices go up.
4. **Inflation expectations**: Companies may increase their prices in expectation of inflation in the near future.
5. **More money in the system**: An expansion of the money supply with too few goods to buy makes prices increase.

Demand-Pull Inflation vs. Cost-Push Inflation

Cost-push inflation occurs when money is transferred from one economic sector to another. Specifically, an increase in production costs such as raw materials and wages inevitably is passed on to consumers in the form of higher prices for finished goods.

Demand-pull and cost-push inflation move in practically the same way but they work on different aspects of the system. Demand-pull inflation demonstrates the causes of price increases. Cost-push inflation shows how inflation, once it begins, is difficult to stop.

In good times, companies hire more. But, eventually, higher consumer demand may outpace production capacity, causing inflation.

Demand-Pull Inflation Example

Say the economy is in a boom period, and the unemployment rate falls to a new low. Interest rates are at a low point, too. The federal government, seeking to get more gas-guzzling cars off the road, initiates a special tax credit for buyers of fuel-efficient cars. The big auto companies are thrilled, although they didn't anticipate such a confluence of upbeat factors all at once.

Demand for many models of cars goes through the roof, but the manufacturers literally can't make them fast enough. The prices of the most popular models rise, and bargains are rare. The result is an increase in the average price of a new car.

It's not just cars that are affected, though. With almost everyone gainfully employed and borrowing rates at a low, consumer spending on many goods increases beyond the available supply. That's demand-pull inflation in action.

Related Terms

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