CAUSES OF INFLATION:

Inflation can be caused by two main factors: too much demand in the economy or rising costs.

Demand-pull inflation: In the market for oil, a significant rise in demand for oil with no increase in supply will lead to a rise in the prices of oil. The same occurs at a macroeconomic level. It aggregate or total demand rises and there is no increase in aggregate supply, then DEMAND-PULL INFLATION is likely to occur. **Demand-pull inflation is caused by excessive demand in the economy**. When there is too much demand, the price level, (or average level of prices in the economy) will rise. Excessive increases in aggregate demand in the UK can come about for a variety of reasons.

• Consumer spending may rise excessively. Interest rates could be low and consumers are spending large amounts on their credit cards, or consumer confidence could be rising because house prices are rising.

• Firms may substantially increase their spending. Perhaps they are responding to large increases in demand from consumer and need extra capacity to satisfy that demand.

• The government might be increasing its spending substantially, or it could be cutting taxes.

• World demand for UK exports may be rising because of a boom in the world economy.

Cost-push inflation: Inflation may also occur because of changes in the supply side of the economy.

Cost-push inflation occurs because of rising costs. There are four major sources of increased costs:

• Wages and salaries account for about 70 per cent of national income and hence increases in wages are normally the single most important cause of increases in costs of production.

• Imports can rise in price. An increase in the price of finished manufactured imports, such as television sets or cars, will lead directly to an increase in the price level. An increase in the price of imported semi-manufactured goods and raw materials, used as component parts of domestically produced manufactured goods, will feed through indirectly via an increase in the price of domestically produced goods.

• Profits can be increased by firms when they raise price to improve profit margins. The more price inelastic the demand for their goods, the less will such behavior result in a fall in demand for their products.

• Government can raise indirect tax rates or reduce subsidies, thus increasing prices.

Firms will try to pass on increases in their costs to customers. For example, if a firm gives a 5 per cent pay rise to its workers, and wages account for 80 per cent of its costs, then it will need to increase prices by 4 per cent (80 per cent of 5 per cent) to maintain its profit margins. Competition in the market may mean that it finds it difficult to pass on these price rises and maintain sales. However, if costs are rising over time, firms will have to increase their prices and this leads to inflation.