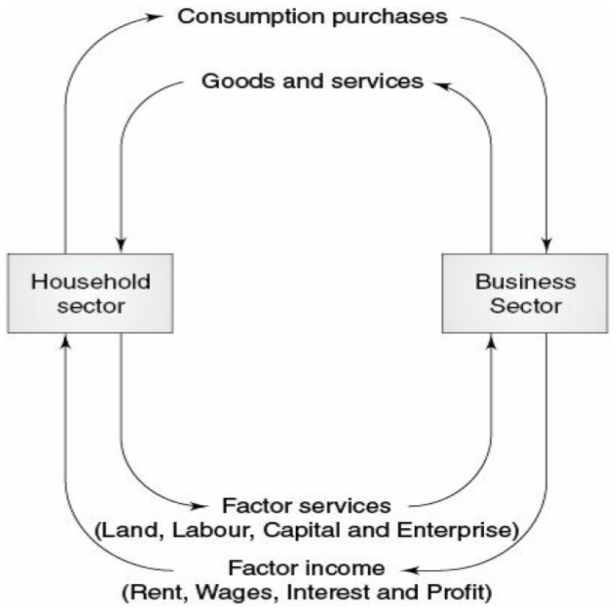
Macro Economics

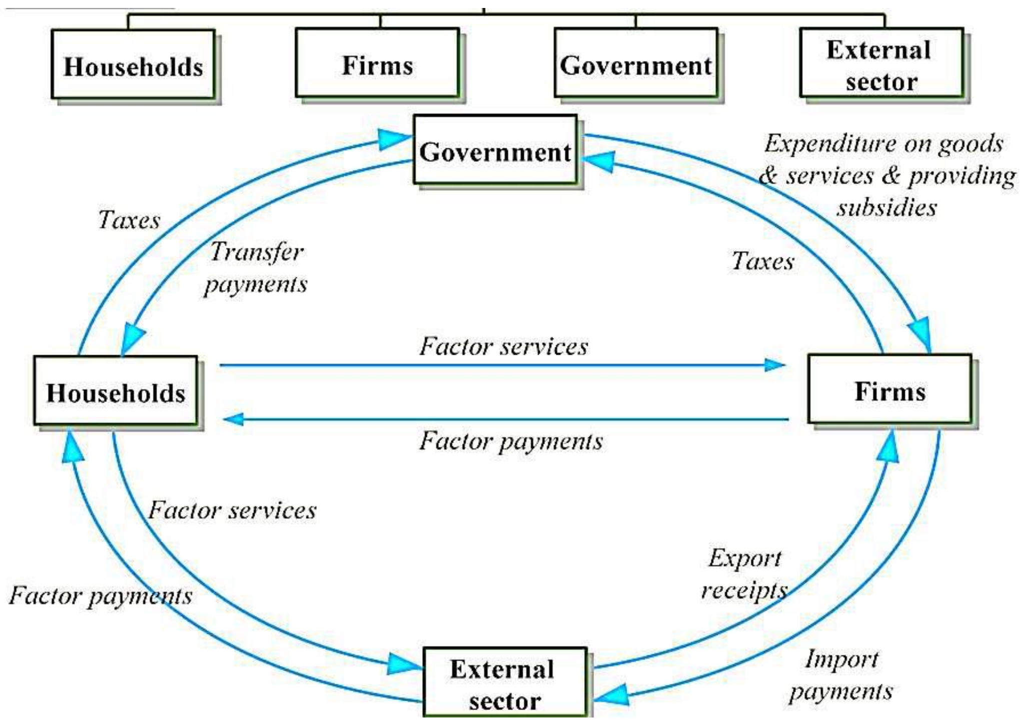
Money Moves in Circular Flow in an Economy

2 Sector Model:



4 Sector Model:

Sectors of Economy

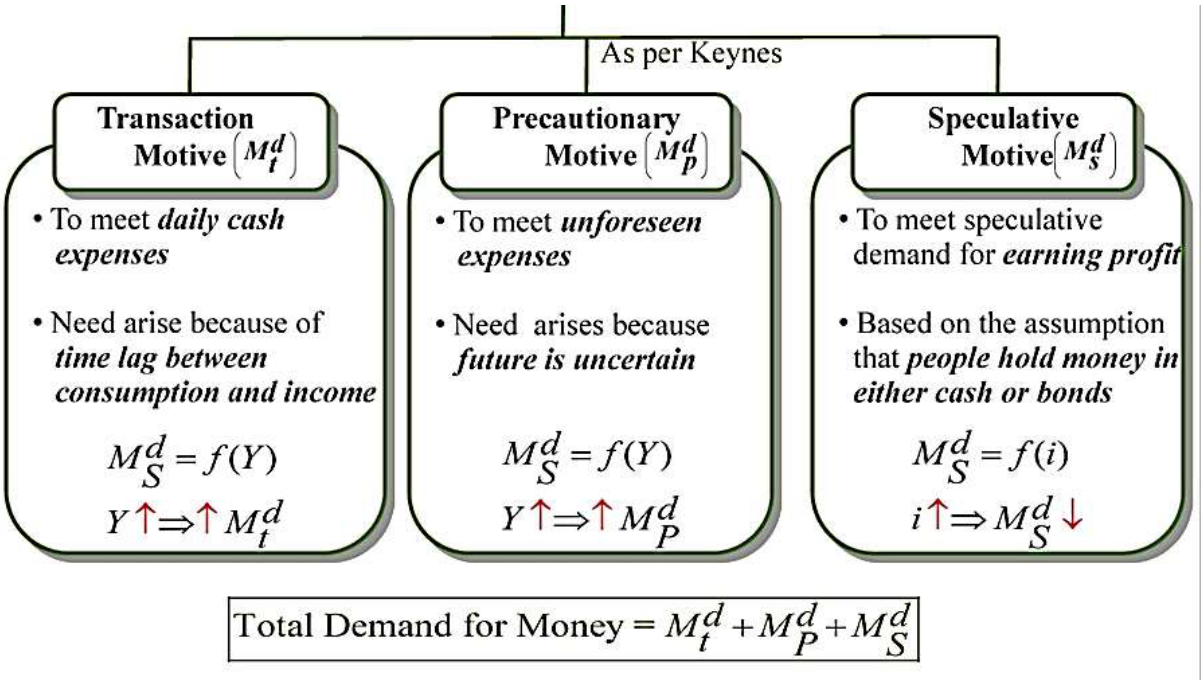


AD = C + I + G + (X-M)

AD= Aggregate Demand

C = Consumption, I= Investment, G= Government Expenditure, X = Export, I = Import, (X-M) = Net Export

Demand for Money



Inflation

- **Inflation refers to the situation when there is a persistent rise in the general price level in the economy.**
- **There are four main types of inflation, categorized by their speed.**
- **Creeping, walking, galloping, and hyperinflation.**
- **Causes of Inflation- demand-pull and cost-push inflation.**

Creeping or mild inflation is when prices rise 3% a year or less. According to the Federal Reserve, when prices increase by 2% or less, it benefits economic growth.

Walking or Trotting Inflation: When prices rise moderately and the annual inflation rate is a single digit (3% - 10%), it is called walking or trotting inflation. Inflation at this rate is a warning signal for the government to control it before it turns into running inflation.

Running Inflation: When prices rise rapidly like the running of a horse at a rate of speed of 10% - 20% per annum, it is called running inflation. Its control requires strong monetary and fiscal measures, otherwise, it leads to hyperinflation.

Galloping or Hyperinflation: When prices rise between 20% to 100% per annum or even more, it is called galloping or hyperinflation. Such a situation brings a total collapse of the monetary system because of the continuous fall in the purchasing power of money.

Stagflation is when economic growth is stagnant but still, there is price inflation. It happened in the 1970s when the United States abandoned the gold standard.

Deflation is the opposite of inflation. It's when prices fall.

Inflation is classified on the basis of cause as:

Demand-Pull Inflation

• Demand-Pull Inflation is mainly due to an increase in Aggregate demand. The increase in Aggregate demand mainly comes from either increase in Government Expenditure (Expansionary Fiscal Policy) or an increase in expenditure from Households and Firms.

• The root cause of demand-pull inflations is- Aggregate demand > Aggregate Supply.

Cost-Push Inflation

• There exists a situation in an economy where inflation is fueled up, not because of an increase in Aggregate Demand but mainly due to an increase in the cost of producing goods and services.

• The cost can be increased mainly due to three factors:

• An Increase in Wages or Wage Push Inflation.

• Increase in prices or Raw materials [Supply Shocks]

• Increase in Profits of Firms or Profit Push Inflation.

Stagflation

The most important difference between the Demand-Pull and Cost-Push

Inflation is that while in the case of Demand-Pull Inflation the overall output in the economy does not fall. Whereas, in the case of Cost-Push Inflation, along with an increase in prices the output level of the economy also falls.

The fall in output will cause employment to fall in the economy along with a fall in growth. The falling growth along with rising prices makes cost-push inflation more dangerous than demand-pull inflation. The situation of rising prices along with falling growth and employment is called stagflation.