AD & AS Analysis Project

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Period 1 (Increase in inflation):

One period in American history where inflation increased was 1965 to 1980. It became an era in economics known as the 'Great Inflation.' There are two ways in inflation occurs. The first is demand pull inflation, the second is cost push inflation. The inflation in this period was caused due to a combination of both.

Demand pull inflation occurs when there is an increase in aggregate demand, for example due to an increasing wages. The increase in aggregate demand causes the aggregate demand curve to shift to the right. This results in the aggregate demand curve intersecting the aggregate supply curve at a higher price level. Cost push inflation occurs when the supply decreases at every given price level. The aggregate supply curve shifts leftward and intersects the demand curve at a higher price level.

Aggregate demand includes consumer spending, investment, net exports and government spending. One main cause of an increase in government spending was due to the Vietnam War (Tucker). In addition, Lyndon Johnson ran large deficits, due to his social programs such as the Large Society. Nixon entered office in 1969. He expanded Social Security, further increasing the deficit (Kramer, 2019). In addition, he also installed a Fed Chief that would lower interest rates (Kramer, 2019). With interest rates reduced, people were more likely to spend rather than save, further fueling inflation.

Aggregate supply was reduced due to a hike in the price of oil, administered by OPEC (Tucker). This caused the price level to increase, thereby resulting in inflation.

This inflation caused a recession and therefore an increase in unemployment in the early 1970s. In order to rein in inflation, the Fed had to increase interest rates to upto 20 percent (Kramer, 2019).

In conclusion, we can say that large spending along with low interest rates and rising costs of essential supplies like oil led to inflation as seen in the 1960s and 1970s.

Period 2 (Increase in unemployment):

The highest unemployment rate ever recorded in United States history was during the height of the Great Depression in 1933. It was 24.9 percent (cit). The unemployment rate can be defined as the percentage of people in the civilian labor force who are without jobs and are actively seeking one (Tucker).

The cause of the Great Depression is an ongoing debate among many economists. Milton Friedman and Anna Schwartz in their book, "A monetary history of the United States: 1867-1960," argue that the Great Depression was a result of a decline in the quantity of money, or a restricted money supply. This caused deflation. Due to falling income, prices, etc. people hoarded money. This led to decreased consumer spending, which in turn stopped production and caused workers to lose their jobs. This can be referred to as cyclical unemployment.

In addition to the causes of the Great Depression, there are many theories as to what should be done in the event of a recession or a depression. One such theory is presented by late British economist John Maynard Keynes.

Keynes believed that increased government spending would lead to a GDP growth in a recession or a depression, since the aggregate supply curve, according to him was horizontal. Therefore, if government spending was increased, it would intersect the aggregate supply curve at a point where the price level would remain the same, but at the same time increase the GDP.

The unemployment rate did indeed fall with the onset of World War 2, during which government spending increased for the war effort. This led to many economists and politicians to adopt the Keynesian school of thought.

References:

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Tucker, I. B. (2019). *Survey of economics*. Boston MA: Cengage Learning.