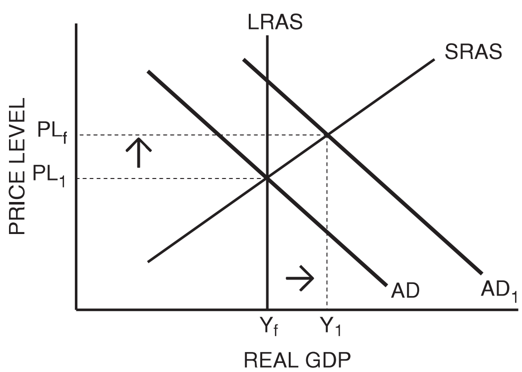
The Types of Inflation

The aggregate supply (AS) and aggregate demand (AD) model is used to determine changes in the price level and real gross domestic product (GDP). Changes in AS and AD lead to changes in the price level (inflation and deflation). Whether changes in the price level are due to changes in AS or AD determines the type of inflation experienced in the economy. Demand-pull inflation is caused by a shift in the AD curve. Cost-push inflation is caused by a shift in the AS curve.

Demand-pull inflation occurs because the demand for goods and services increases at a time when the production of goods and services is already high. The increase in AD causes real GDP to expand and the price level to increase. Demand-pull inflation is often described by the saying "too much money chasing too few goods."

Figure 3-7.1 illustrates demand-pull inflation. An increase in AD causes the AD curve to shift to the right. AD will increase as a result of a change in the determinants of AD: consumption (C), investment (I), government spending (G), and net exports (Xn). Notice that, in addition to the increase in the price level, the increase in AD leads to an increase in real GDP.

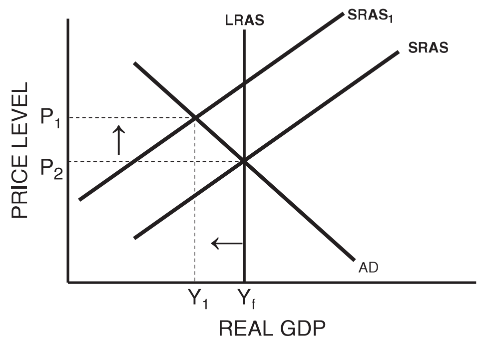
Figure 3-7.1
Changes in the Price Level Due to Aggregate Demand



Cost-push inflation is caused by an increase in the cost of an input with economy-wide importance. An increase in production costs throughout the economy will cause AS to decrease. For example, an increase in wages or the price of oil will increase input costs economy-wide.

Figure 3-7.2 illustrates cost-push inflation. A decrease in AS causes the AS curve to shift to the left. AS will decrease as a result of an increase in production costs throughout the economy. Notice that, in addition to the increase in the price level, the decrease in AS leads to a decrease in real GDP. *Stagflation* occurs when the economy experiences high inflation and high unemployment at the same time.

Figure 3-7.2
Changes in the Price Level Due to Aggregate Supply



For each situation described below, circle either demand-pull or cost-push inflation and explain.

1. In his 2020 State of the Union address, President Dodge calls for an increase in the U.S. military presence across the globe to combat what he deemed a "threat to the sovereignty of the U.S. economy and trade routes."

   Demand-Pull Inflation *Cost-Push Inflation*

   Explain:

2. The Arab Spring of 2010 disrupts oil production and supplies worldwide. This causes OPEC and commodities speculators to raise crude oil prices to record levels.

   Demand-Pull Inflation *Cost-Push Inflation*

   Explain:

3. During the election of 2100, Democratic presidential candidates all advocate the expansion of the Social Security and Medicare and Medicaid programs to include a greater number of American citizens. These campaign promises cause the United States to run a budget deficit in the year after the election, which in turn leads to increased government borrowing.

   Demand-Pull Inflation *Cost-Push Inflation*

   Explain:

4. The federal government raises the minimum wage to $12 an hour.

   Demand-Pull Inflation *Cost-Push Inflation*

   Explain: