HOME ASSIGNMENT

3rd SEMESTER

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MACROECONOMICS

NAME : PREETI DAS

ROLLNO : UA-201-340-0106

Head
Department of Economics
Mayang Anchalik College
Date.....

Question No. 1 What is Inflation? What are the types of inflation?

Ans:- To the neo-classicals and their followers at the university of Chicago, inflation is fundamentally a monetary phenomenon. In the words of Friedman, "Inflation is always and everywhere a monetary phenomenon.. and can be produced only by a more rapid increase in the quantity of money than output."[3] But economists do not agree that money supply alone is the cause of inflation. As pointed out by Hicks, "our present troubles are not of a monetary character." Economists, therefore, define inflation in terms of a continous rise in prices. Johnson defines "inflation as a sustained rise"[4] in price. Brooman defines it as "a continuting increase in the general price level."[5] Shapiro also defines inflation in a similar vein "as a presistent and appreciable rise in the general level of prices."[6] Deemberg and McDougall are more explict when they write that "the term ~~inflation~~ usually refers to a continuing rise in prices as measured by an index such as the consumer price index (CPI) or by the implicit price deflator for gross national product."[7]

However, it is essential to understand that a sustained rise in price may be of various magnitudes.

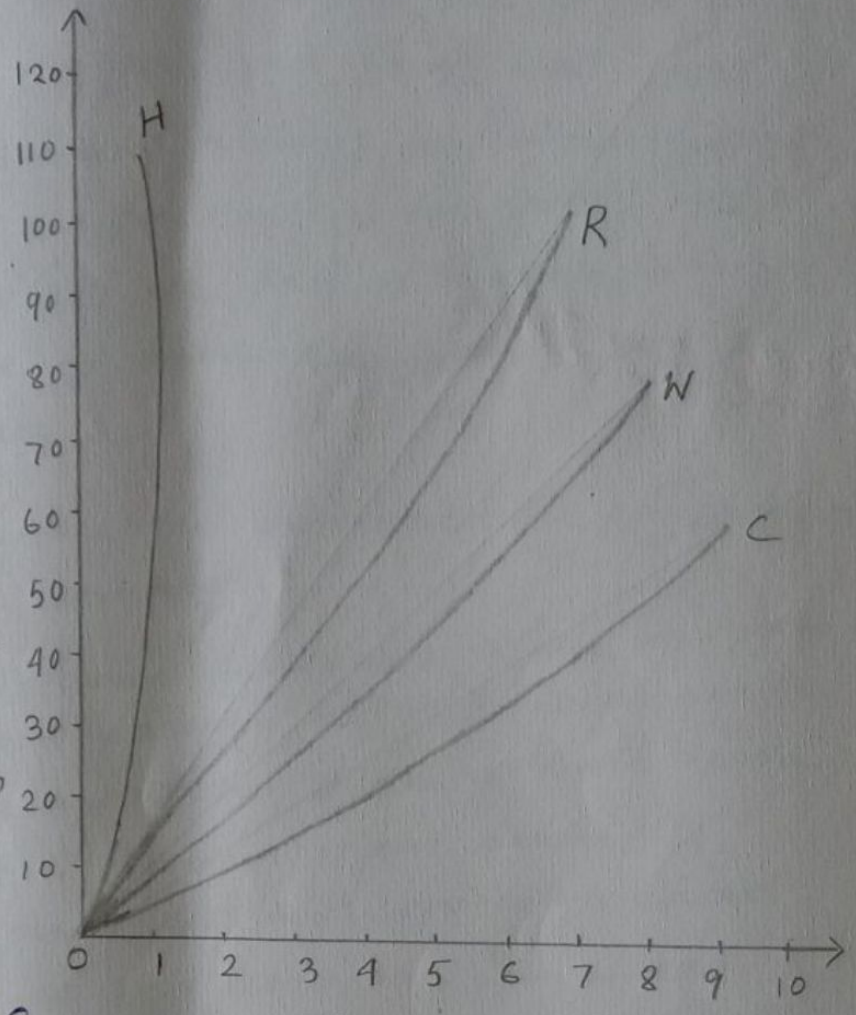
Accordingly, different names have been given to inflation upon the rate of rise in prices.

1. Creeping Inflation. when the rise in prices is very slow like that of a snail or creeper, it is called creeping inflation. In terms of speed, a sustained rise in price of annual increase of less than 3 per cent per annum is characterised as creeping inflation. Such an increase in price is regarded safe and essential for economic growth.

2. walking or trotting inflation. When prices rise moderately and annual inflation rate is a single digit. In other words, the rate of prise in price is in the intermediate range of 3 to 7 per cent annum or less than 10 per cent. Inflation at this rate is warning ~~sing~~ signal for the government to control it before it turns into runing in inflation.

3. Running inflation. When prices rise rapidly like the running of a horse at a rate of speed of 10 to 20 per cent per annum, it is called running inflation. Such an inflation affects the poor and middle classes adversely. It control requires strong monetary and fiscal measures, otherwise it leads to hyperinflation.

4. Hyperinflation.



when prices rise very fast at double or triple digit rates from more than 20 to 100 per cent per annum or more it is usually called runaway or galloping inflation. It is also characterised as hyperinflation by a certain economists. In reality, hyperinflation is a situation when the rate of inflation becomes immeasurable and absolutely uncontrollable. prices rise many times every day. Such a situation brings a total collapse of monetary system because of the continuous fall in the purchasing power of money.

The speed with which prices tend to rise is ~~illustrated~~ illustrated in the above figure. The curve C shows creeping inflation within a period of ten years the price level has been shown to have risen by about 30 per cent. The curve W

depicts walking inflation when the price rose by more than 50 per cent during ten years. The curve R illustrates running inflation showing a rise of about 100 per cent in ten years. The steep curve H shows the path of hyperinflation when prices rose by more than 120 per cent in less than one year.

Question No. 2 Explain the determination of National income in open economy.

Ans:- The main difference between a closed and open economy is that open economy allows foreign trade whereas closed economy doesnot. Foreign trade is the trade of goods and services across barders. A country has to exported goods and services to abroad and imported goods and services from abroad and there is financial capital mobility in between nations in terms of borrowing and lending. For determination of national income in open economy economy we begin our discussion by assuming that the nation is small. The main ag argument for making this assumption is that, it makes simple our analysis and will give more clarity of our thinking. Students should be note that an assumption for building an economic model need not be realistic to be useful. Again, for simplicity we assume that there is no government sector and the economy is operating at less than full equilibrium.

In an open economy the national identity can be written as

$$Y = C_d + I_d + X \quad \text{..... (3.1)}$$

In equation (3.1) output (Y) is divided into three components, consumption on domestic goods and services (C_d) investment in domestic goods and services (I_d) and export of domestic goods and services to other nation (X). We can also term 'X' as foreign spending on domestic goods and services. It should be noted that 'X' doesnot appear in a closed economy national income identity. The term consumption on domestic goods and services (C_f) from total consumption (C). Like wise investment in domestic goods and services (I_d) can be obtain from deducting investment in foreign goods and services (I_f) from total investment (I). Thus we can write in equation as

$$C_d = C - C_f \text{ or } C = C_d + C_f$$

$$I_d = I - I_f \text{ or } I = I_d + I_f$$

Now putting the value of C_d and I_d, we can rewrite in equation (3.1) as

$$Y = C - C_f + I - I_f + X$$

$$\Rightarrow Y = C + I + X - (C_f + I_f)$$

The sum of expenditure on foriegn goods and services and investment expenditure is nothing but the expenditure on imports, which we termed as capital letter 'M'. Now the national

income indentity can be written as

$$\Rightarrow Y = C + I + X - M \quad \ldots\ldots \quad (3.2)$$

Defining Net expant as expant minus impant $NX = (X - M)$ we get national income as sum of consumption expenditure, investment expenditure and net expant. We incorparated the net expant in national income identity as because of impant of goods and services from abroad cannot be recognized as countries autput. Thus, the identity becomes

$$Y = C + I + NX \quad \ldots\ldots\ldots \quad (3.3)$$

In a closed economy model, national income or autput always equal to expenditure, on goods and services, it may be consumption expenditure or investment expenditure. However, in an economy model autput need not to be equal to the goods and services. In the equation (3.4), a country only expant when autput exceeds the expenditure on goods and services. That is, when net expant is pasitive. Again, if autput falls shaut of expenditure, the country will impant the difference. Then the country' net expants will be negative.

$$NX = Y - (C + I) \quad \ldots\ldots \quad (3.4)$$