Aggregate Supply & Aggregate Demand

Chapter 11-2 Aggregate Demand

The AS/AD Model

- The AS/AD model is fundamentally different from the microeconomic supply/demand model.

The AS/AD Model

- Microeconomic supply/demand curves concern the price and quantity of a single good.

  Price of a single good is measured on the vertical axis and quantity of a single good is measured on the horizontal axis.
  The shapes are based on the concepts of substitution and opportunity cost.

The AS/AD Model

- In the AS/AD model the price of everything is on the vertical axis and aggregate output is on the horizontal axis.
- So there is no substitution

Aggregate Demand

- The **aggregate demand curve** shows the relationship between the aggregate price level and the quantity of aggregate output demanded by households, businesses, and the government

The Aggregate Demand Curve

- The *aggregate demand* (*AD*) *curve* shows how a change in the price level changes aggregate expenditures on all goods and services in an economy.
- It shows the level of expenditures that would take place at every price level in the economy.
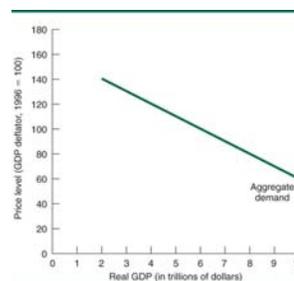
The Slope of the AD Curve

- The AD is a downward sloping curve.
- Aggregate demand is composed of the sum of aggregate expenditures.

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

The Aggregate Demand Curve

- **Aggregate Demand** is the total value of <u>real</u> GDP that all sectors of the economy (C + I + G + X_n) are willing to purchase at various price levels.

When the price level increases, (inflation), people purchase less output.

Three Reasons why the AD Curve Slopes Down

- **Real Balance Effect**
  - You feel poorer, so you spend less.
  - Purchasing power declines with inflation.
- **Interest Rate Effect**
  - Rising prices push up interest rates.
  - Lenders need higher interest rates to compensate for eroding purchasing power of money.
- **Foreign Purchases Effect**
  - If prices rise in the US, exports decrease and imports increase, so X_n decreases.

The Aggregate Demand Curve
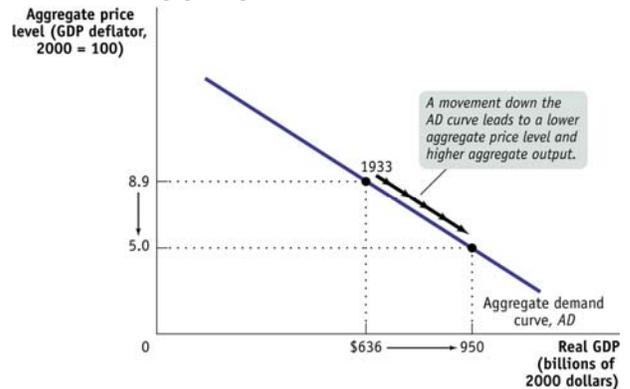
Downward Sloping

- It is downward-sloping for two reasons:
  - The first is the **Real Balance Effect of a change in the aggregate price level**—a higher aggregate price level reduces the purchasing power of households' wealth and reduces consumer spending.
  - The second is the **interest rate effect of a change in aggregate the price level**—a higher aggregate price level reduces the purchasing power of households' money holdings, leading to a rise in interest rates and a fall in investment spending and consumer spending

The **Real Balance Effect**

- **Real Balance Effect**– a fall in the price level will make the holders of money and other financial assets richer, so they buy more.
- Most economists accept the logic of the wealth effect, however, they do not see the effect as strong.

The Interest Rate Effect

- *Interest rate effect* – the effect a lower price level has on investment expenditures through the effect that a change in the price level has on interest rates.

The Interest Rate Effect

- The interest rate effect works as follows:

a decrease in the price level $\Rightarrow$
increase of real cash $\Rightarrow$
banks have more money to lend $\Rightarrow$
interest rates fall $\Rightarrow$
investment expenditures increase

Shift Factors

- The aggregate demand curve shifts because of
  - *Changes in expectations*
  - *Changes in wealth*
  - *Changes in the stock of physical capital*

- Policy makers can use **fiscal policy** and **monetary policy** to shift the aggregate demand curve

Coming Soon

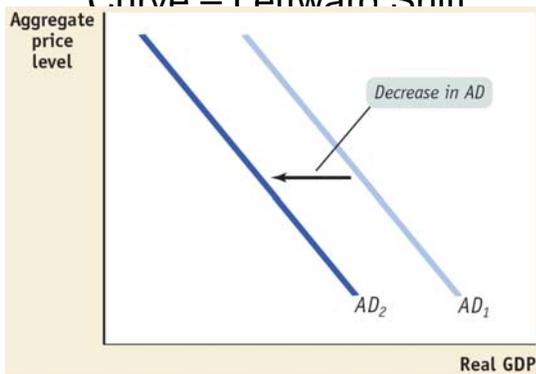In the next few chapters you will see the following patterns

Government policies

- **Fiscal policy**
  ↓ Tax and/or ↑ government spending → ↑ AD

- **Monetary policy**
  Federal Reserve ↑ money supply → ↓ interest rates ↑ spending → ↑ AD

Shifts of the Aggregate Demand Curve – Rightward Shift
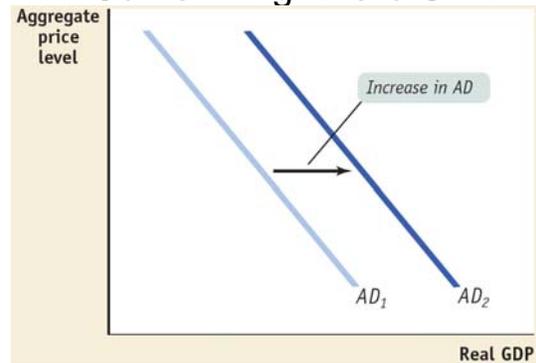
Shifts of the Aggregate Demand Curve – Leftward Shift

Shifts in the AD Curve