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.

\[ \text{Expenditures} = C + I + G + (X - M) \]

The Aggregate Demand Curve

- Aggregate Demand is the total value of real GDP that all sectors of the economy (C + I + G + Xn) 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.

**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 ⇒
  - increase of real cash ⇒
  - banks have more money to lend ⇒
  - interest rates fall ⇒
  - 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**
  \[\downarrow \text{Tax and/or } \uparrow \text{government spending} \rightarrow \uparrow \text{AD}\]

- **Monetary policy**
  Federal Reserve \[\uparrow \text{money supply} \rightarrow \downarrow \text{interest rates} \rightarrow \uparrow \text{spending} \rightarrow \uparrow \text{AD}\]