

Chapter 9 - Aggregate Demand and Supply

9.1 - Aggregate Demand and the Aggregate Demand Curve

Aggregate Demand

- total quantity of aggregate output or real GDP that all buyers in an economy want to buy at different prices (ceteris paribus)

Aggregate Demand Curve

shows the relationship between the aggregate output buyers want to buy (real GDP demanded) and the economy's price level (ceteris paribus)

| Component | Definition | Determinants | Size/Stability |
|-----------|--|---|---|
| C | all purchases by households on durable and non durable goods | <ul style="list-style-type: none"> household wealth household income household confidence (disposable income) household debt real interest rates | 60% most stable component US : 70% China : 40% |
| I | spending by firms on capital goods | <ul style="list-style-type: none"> real interest rates expectations of firms | 15-20% |
| G | spending within a country by the government | <ul style="list-style-type: none"> fiscal policy : level of taxation & government spending government debt | stable fluctuations <ul style="list-style-type: none"> anti-cyclical 20+% in developing countries |
| X | exports : <ul style="list-style-type: none"> goods/services produced within a country | <ul style="list-style-type: none"> incomes of foreign consumers income of domestic consumer exchange rates | neutral component, depends on country |
| M | imports : <ul style="list-style-type: none"> spending on goods produced outside the country | <ul style="list-style-type: none"> incomes of foreign consumers income of domestic consumer exchange rates | neutral component, depends on country |

Wealth effect :

when price decreases, the real value of these assets increases
 when price increases, the consumption demand is stimulated
 low price level associated with a higher AD

Interest rate effect :

if price levels increases in order to main transactions, transactional money demand increases
 if money supply remains constant increasing money demand would raise interest rates (C and I would reduce, AD reduce)

The international trade effect :

when domestic price levels increase but other countries price levels remain, exports become more expensive (foreign buyers demand less)
 goods produced overseas become relatively cheaper, amount of exports bought increases
 overall fall in net exports - downward movement along the AD curve

Difference between micro and macroeconomic demand :

Microeconomics - reflects willingness & ability of **consumers** to buy a **single product** at difference possible prices and times

Macroeconomics - reflects willingness & ability of all **possible buyers (consumers/businesses/governments/foreigners)** to buy the economies **aggregate output or total real GDP** at difference possible prices and times

Determinants of aggregate demand (shifts in AD curve)

CHANGES IN CONSUMPTION SPENDING

1. *changes in consumer confidence*
2. *changes in interest rates*
3. *changes in wealth*
4. *changes in personal income taxes*
5. *changes in level of household indebtedness*

CHANGES IN INVESTMENT SPENDING

1. *changes in business confidence*
2. *changes in interest rates*
3. *changes in technology*
4. *changes in business taxes*
5. *the level of corporate*
6. *legal/institutional*

CHANGES IN GOVERNMENT SPENDING

1. *changes in political priorities*
2. *changes in economic priorities : deliberate efforts to influence aggregate demand*

CHANGES IN NET EXPORT SPENDING

1. *changes in national income abroad*
2. *changes in exchange rates*
3. *changes in the level of trade protection*

Movements along the aggregate demand curve are caused by :

- changes in the price level

Shifts in the aggregate demand curve are caused by :

- changes in consumer spending
- changes in investment spending
- changes in government spending
- change in foreigners' spending

9.2 - Short-run aggregate supply and short-run equilibrium in the AD - AS mode

Aggregate Supply

- the total quantity of goods and services produced in an economy (real GDP) over a particular time period at different price levels

Short run in macroeconomics

- the period of time when prices of resources are roughly constant (inflexible)
- applies especially to wages

Long run in macroeconomics

- the period of time when the prices of all resources including wages are flexible and change along with changes in the price level

What can shift the AS curve?

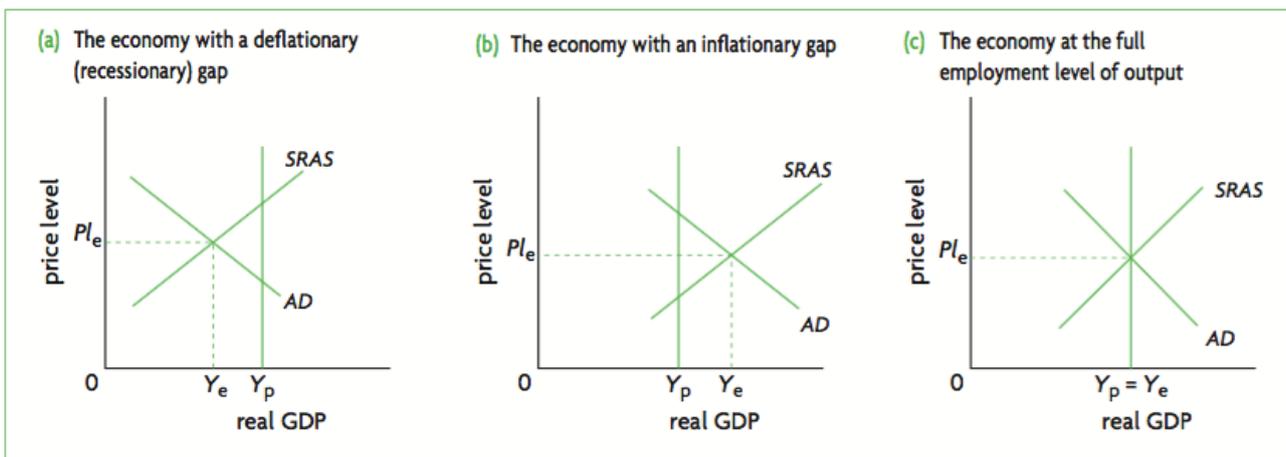
1. Changes in wages
2. Changes in non-labour resource prices
3. Changes in business taxes
4. Changes in subsidies offered to businesses
5. Supply shocks

Short-run equilibrium positions

- A. recessionary
- situation where real GDP < potential GDP
 - unemployment > natural unemployment rate, due to shortage aggregate demand
- B. inflationary
- situation where real GDP > potential GDP
 - unemployment < natural unemployment rate, due to excess aggregate demand
- C. full employment
- GDP at equilibrium
 - AD curve intersects SRAS curve at potential GDP level
 - no deflationary / inflationary gap
 - full employment level of output

Full Employment

- the level of **employment** rates where there is no cyclical or deficient-demand unemployment



9.3 and 9.4- The Monetary vs Keynesian model

Why is the LRAS vertical?

- as the price level increases or decreases with constant real costs, firms profits are also constant and firms no longer have any incentive to increase or decrease their output levels

Why is the price of wages sticky (unchanging)?

1. labour contracts fix wage rates for certain period of time
2. minimum wage legislation
3. work and labour unions resist wage cuts
4. wage cuts effect negatively on worker morale

3 sections of the Keynesian model

1. recessionary (deflationary)
2. inflationary
3. full employment

Difference between the 2 models

Monetary economics :

1. the economy will correct itself when equilibrium is not present
2. wages and prices are flexible
3. fiscal policy does not apply
4. the economy is in full natural employment

Keynesian economics :

1. the economy cannot correct itself
2. wages and prices are rigid
3. economy may become 'stuck' due to these rigidities
4. fiscal policy can be used to correct disequilibrium or inefficiency
5. in short run, full employment is unlikely

9.5- Shifting aggregate supply curves over the long term

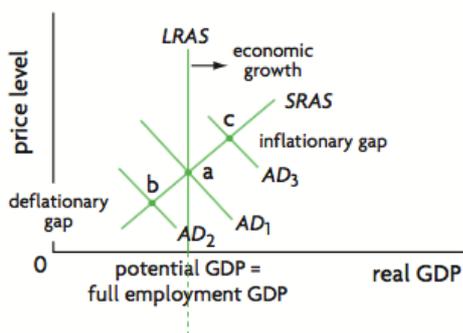
- Aggregate supply curves shifts in response to factors that change potential output
- increase in potential output signifies economic growth over the long term
- decrease signifies negative growth

Factors that increase potential output (on the PPC graph) or right shifts on the Monetary/ Keynesian graphs

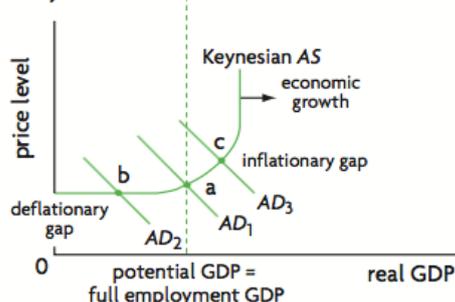
1. increase in quantities of the factors of production
2. improvements in the quality of factors of production (resources)
 - e.g. more highly skilled and educated works can produce more (higher output)
3. improvements in technology
 - technological innovations allow more output in same time
4. increases in efficiency
 - makes better use of scarce resources
5. institutional changes
 - e.g. the degree of private ownership as opposed to public ownership of resources
6. reductions in natural rate of unemployment

9.6 - Illustrating the monetarists / new classical Keynesian models

(a) The monetarist/new classical model



(b) The Keynesian AD-AS model



9.7 - The Keynesian multiplier

$$\text{multiplier} = \frac{1}{1-\text{MPC}}$$

OR

$$\text{multiplier} = \frac{1}{\text{MPS} + \text{MPT} + \text{MPM}}$$

MPC : marginal propensity to consumer

- change in consumption because of change in income

MPS : marginal propensity to save

- changes in savings because of change in income

MPT : marginal propensity to tax

MPM : marginal propensity to import

* marginal = change