Topic 4: Aggregate Demand and Aggregate Supply

Need both models to get an equilibrium-

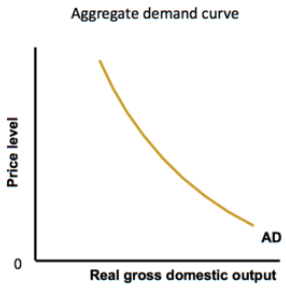
a. Aggregate expenditure gives equilibrium output
b. Aggregate demand and aggregate supply gives:
    i. Tells us if we are at full employment, recession or boom (i.e. which part of the business cycle we are in)
    ii. Gives a place for price → so we can talk about inflation

Aggregate demand (AD)

AD = aggregate expenditure (AE)

The difference: AD is drawn against prices

- Changes in AD mean that one or more elements of AE are effect (C, I, G, NX)
- Holding all other things constant: the lower the price, the higher the output



Curve represents the amount of goods and services that consumers, businesses, government and foreign buyer are willing and able to buy at various price levels- ***slopes downward to the right due to***:

1. ***Interest-rate effect***
    - Rising price level causes higher nominal interest rates → causes reduction in certain kinds of <u>consumption</u> and <u>investment</u> spending (most importantly)

2. ***Real-balances effect (wealth effect)***
    - At a higher price level the real value of purchasing power of the accumulated financial assets held by the public falls (real wealth falls) → leading to a fall in <u>consumption</u>
    - Wealth = assets = determinant of consumption

3. ***Foreign-purchases effect***
    - Higher domestic prices (local goods) cause the relative price of foreign goods to decrease
    - This causes increased imports and decreased exports, resulting in a fall in <u>net exports</u>

These are the factors because:

- It is not for one product → substitution effect not applicable
- Normally assume fixed income → as we move to higher price levels, it increases income → not necessarily a decline in the real purchasing power of the economy → if spent = same real domestic output

Rational for the demand of one product is not the same as the rational for aggregate demand

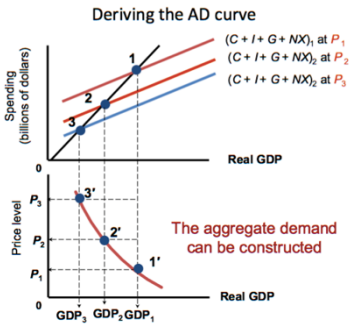
Deriving the aggregate demand curve

Aggregate expenditure model: assumes that increases/decreases in AE bring about increases/decreases in total output keeping price constant

- When price moves from P1 to P2, there was a shift down → price is not on axis

Aggregate demand model: various possible price levels and the corresponding equilibrium real GDP

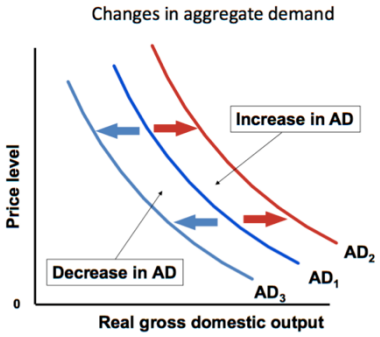
- When price moves from P1 to P2, it is not a shift because price is on the axis

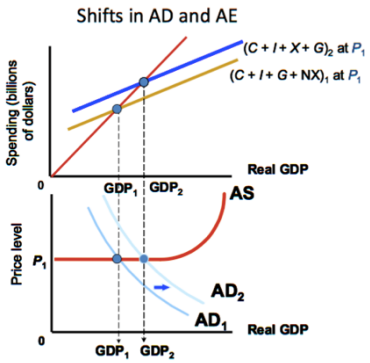


Determinants of aggregate demand

- Price determinants = movement along the AD curve
- Non-price determinants = shift in the AD curve (anything but price)

Consumer spending	- *Consumer wealth*: if real value of assets goes down → save more → left AD *aka real balances effect* - *Consumer expectations:* if expect income to rise → spend more of current income - *Consumer indebtedness:* those in debt will cut spending - *Taxes*: tax cut increases spending
Investment spending	- *Interest rates*: a decrease not from a change in price level → lowers investment - *Profit expectation on investment projects* - *Business taxes* - *Technology*: new improvement stimulate investment - *Degree of excess capacity*: a rise in capacity will delay investments
Government spending	Decided by the treasurer - If implementing an expansionary will increase government spending - Reduction in spending decreases AD
Net export spending	Independently of changes in out price level: - Growth in foreign GDP: rising income in Australia's trading partners = increase AD - The level of exchange rates: if AUD depreciates → exports rise/imports fall → overall increase in exports = increase in AD





Aggregate expenditure shifts and aggregate demand

- Shifts in the aggregate expenditure curve caused by changes in the non-price determinants of C, I, NX will shift the entire aggregate demand curves rightwards or leftwards
- Degree of shift affected by the multiplier
- Shift in AD = change in spending x the multiplier
- Will always have the same equilibrium GDP on both AE and AD