

## Aggregate Demand

AGGREGATE DEMAND,  
AGGREGATE SUPPLY, AND  
MODERN MACROECONOMICS  
Part 1

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## Laughter Curve

We adults do have something in common with today's teenagers.  
They listen to rock groups and we listen to economists.  
None of us understands a word they're saying.

Jean Stapleton

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## The AS/AD Model

- The AS/AD model consists of three curves:
  - The short-run aggregate supply curve.
  - The aggregate demand curve.
  - The long-run aggregate supply curve.

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### The AS/AD Model

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

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### The AS/AD Model

- Microeconomic supply/demand curves concern the price and quantity of a single good.
  - Price is measured on the vertical axis and quantity is measured on the horizontal axis.
  - The shapes are based on the concepts of substitution and opportunity cost.

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### 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.

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### The AS/AD Model

- The AS/AD model is an historical model that starts at a point in time and says what will happen when changes affect the economy.

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### 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.

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### The Slope of the AD Curve

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

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

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## The Slope of the AD Curve

- The slope of the AD curve is determined by the wealth effect, the interest rate effect, the international effect, and the multiplier effect.

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## The Wealth Effect

- **Wealth 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.

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## 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.

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### 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*

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### The International Effect

- **International effect** – as the price level falls (assuming exchange rates do not change), net exports will rise.

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### The International Effect

- The international effect works as follows:

*a decrease in the price level in the U.S. ⇒  
the fall in price of U.S. goods relative to  
foreign goods ⇒  
U.S. goods become more competitive  
internationally ⇒  
U.S. exports rise and U.S. imports fall*

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### The Multiplier Effect

- Initial changes in expenditures set in motion a process in the economy that amplifies the initial effects.
- **Multiplier effect** – the amplification of initial changes in expenditures.

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### The Multiplier Effect

- The multiplier effect works as follows:  
  
an increase in the price level in the U.S. ⇒  
U.S. exports fall and U.S. imports rise ⇒  
U.S. firms lose sales and cut output ⇒  
U.S. incomes fall ⇒  
U.S. households buy less ⇒  
U.S. firms cut back again ⇒ *and so on*

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### The Multiplier Effect

- The multiplier effect amplifies the initial wealth, interest rate, and international effects, making the AD curve flatter than it would have been.

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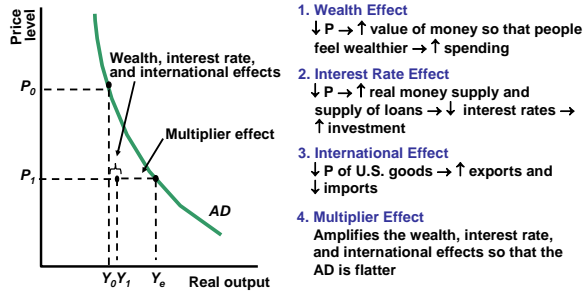
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## The AD Curve is Downward Sloping for 4 Reasons




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## How Steep Is the AD Curve

- Most economists agree that small changes in the price level result in relatively small changes in expenditures.
- This gives the AD curve a very steep slope.

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## The AD Curve Shifts for 5 Reasons

- 1. Foreign Income**  
 $\uparrow$  Foreign income  $\rightarrow \uparrow$  exports  $\rightarrow \uparrow$  AD
- 2. Exchange Rates**  
 Depreciation of the \$  $\rightarrow \uparrow$  exports  $\rightarrow \uparrow$  AD
- 3. Expectations**  
 Optimism and expectations of  $\uparrow$  future prices  $\rightarrow \uparrow$  AD

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## The AD Curve Shifts for 5 Reasons

### 4. Distribution of Income

↑ Wage portion of income → ↑ AD

### 5. Government AD management policies

- **Fiscal policy**

↓ Tax and/or ↑ government spending → ↑ AD

- **Monetary policy**

Federal Reserve ↑ money supply → ↓ interest rates  
↑ spending → ↑ AD

### Multiplier Effects

Magnify the initial shift of AD

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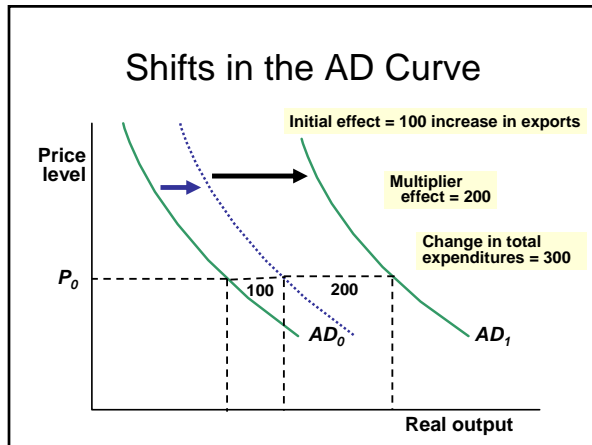
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