Aggregate Demand

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AP MACROECONOMICS

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Aggregate Demand (AD)

- Shows the amount of Real GDP that the private, public and foreign sector collectively desire to purchase at each possible price level
- The relationship between the price level and the level of Real GDP is inverse
  - See graph →

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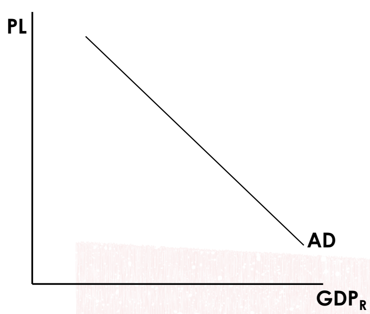
Aggregate Demand Curve



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Three Reasons AD is downward sloping

- Real-Balances Effect
  - When the price-level is high households and businesses cannot afford to purchase as much output.
  - When the price-level is low households and businesses can afford to purchase more output.
- Interest-Rate Effect
  - A higher price-level increases the interest rate which tends to discourage investment
  - A lower price-level decreases the interest rate which tends to encourage investment
- Foreign Purchases Effect
  - A higher price-level increases the demand for relatively cheaper imports
  - A lower price-level increases the foreign demand for relatively cheaper U.S. exports

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Shifts in Aggregate Demand (AD)

- There are two parts to a shift in AD:
  - A change in C, I_G, G and/or X_N
  - A multiplier effect that produces a greater change than the original change in the 4 components
- Increases in AD = AD →
- Decreases in AD = AD ←

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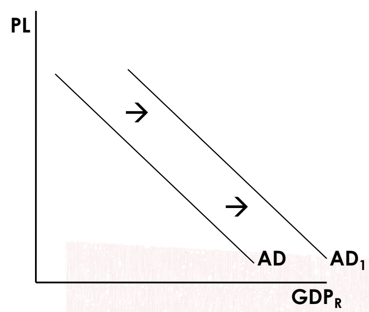
Increase in Aggregate Demand



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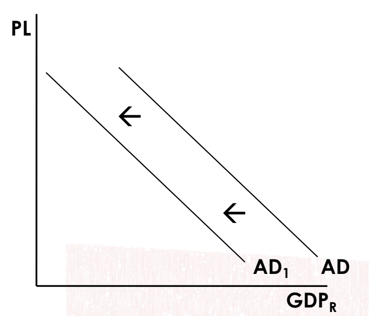
Decrease in Aggregate Demand



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Determinants of AD

- Consumption (C)
- Gross Private Investment (I_G)
- Government Spending (G)
- Net Exports (X_N) = Exports - Imports (X – M)

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Consumption (C)

- Household spending is affected by:
  - Consumer wealth
    - More wealth = more spending (AD shifts →)
    - Less wealth = less spending (AD shifts ←)
  - Consumer expectations
    - Positive expectations = more spending (AD shifts →)
    - Negative expectations = less spending (AD shifts ←)
  - Household indebtedness
    - Less debt = more spending (AD shifts →)
    - More debt = less spending (AD shifts ←)
  - Taxes
    - Less taxes = more spending (AD shifts →)
    - More taxes = less spending (AD shifts ←)

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Gross Private Investment (I_G)

- Investment Spending is sensitive to:
  - The Real Interest Rate
    - Lower Real Interest Rate = More Investment (AD→)
    - Higher Real Interest Rate = Less Investment (AD←)
  - Expected Returns
    - Higher Expected Returns = More Investment (AD→)
    - Lower Expected Returns = Less Investment (AD←)
    - Expected Returns are influenced by
      - Expectations of future profitability
      - Technology
      - Degree of Excess Capacity (Existing Stock of Capital)
      - Business Taxes

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Government Spending

- More Government Spending (AD→)
- Less Government Spending (AD←)
- Remember: Government transfer payments do not count toward GDP.
  - Social Security
  - Welfare
  - Etc.

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Net Exports (X_N)

- Net Exports are sensitive to:
  - Exchange Rates (International value of $)
    - Strong $ = More Imports and Fewer Exports = (AD ←)
    - Weak $ = Fewer Imports and More Exports = (AD →)
  - Relative Income
    - Strong Foreign Economies = More Exports = (AD →)
    - Weak Foreign Economies = Less Exports = (AD ←)

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Summary

- AD reflects an inverse relationship between PL and GDP_R
- Δ in PL creates real-balance, interest-rate, and foreign purchase effects that explain AD's downward slope
- Δ in C, I_G, G, and/or X_N cause Δ in GDP_R because they Δ AD.
- Increase in AD = AD →
- Decrease in AD = AD ←