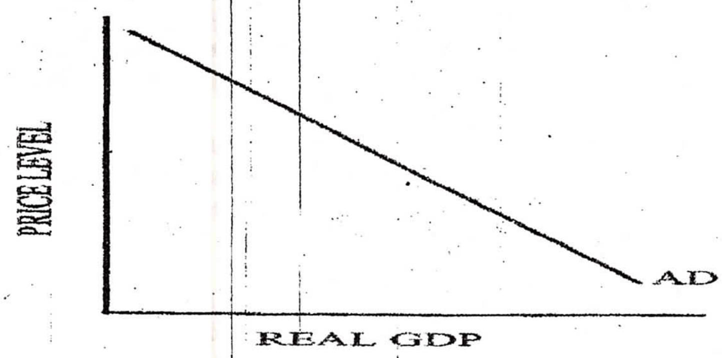
Aim: How does our macroeconomy operate and can we control it?
Topic: Aggregate Demand

Document #1: Introduction to Aggregate Demand



Aggregated Demand = total spending/total demand in the economy: Consumer Spending + Investment Spending + Government Spending + Net Exports C+I+G+X

Aggregate Demand function is an inverse function between the price level and output: as the price level rises, the level of output demanded decreases.

Factors that show why the demand curve is an inverse curve and that make movements along the demand curve:

1) **Interest Rate Effect:** When the price level increases, the real quantity of money (its purchasing power) decreases. People need more money even to continue their current consumption levels. This increases the demand for money in the form of loans, and decreases the supply of **loanable funds (funds from a bank)**. To reach equilibrium in the money market, the interest rate (which is effectively the price of money as we saw with Fisher's hypothesis) must increase. The higher interest rates leads to a decrease in real GDP as households and firms put off major purchases and investment until future periods when the interest rate might be lower. Likewise, a decrease in the price level decreases interest rates and increases real GDP.

2) **Wealth effect:** When the price level increases, the value of assets such as cash and checking-account balances falls. These assets will purchase fewer goods when prices are higher. The real value (or purchasing power) of the assets thus declines and people buy less. Likewise when the price level falls, the purchasing power of people's assets increase, and they buy more.

3) **Net export/foreign trade effect:** when the price level in one country increases, the prices of imports from other countries become relatively less expensive. At the same time, exports from the country whose price level rose become relatively more expensive. Thus, more imported goods and services are purchased and fewer exports are sold. Domestic firms will also find it relatively more profitable to invest abroad. The decrease in exports and the increase in imports resulting from a higher price level lead to a decrease in real GDP (and vice versa).

When the price level of one country increases, there is a decrease in exports as well as a demand for imports which decreases GDP. However, when our price level is low and another country's is high, we export more and import less -- increasing our GDP

1) Why must RGDP be the formula for Aggregate Demand ?

2) According to the Aggregate Demand curve, what is the relationship between the price level and real GDP?

3) For each factor of aggregate demand: explain why each factor makes the Aggregate Demand curve an inverse curve of Price Level to Real GDP?

a) Interest Rate Effect

b) Wealth effect or real-balance effect

c) Net export effect

Document #2: Shifting the Aggregate Demand Curve
Below are a list of factors that **Shift the aggregate Demand** curve right (aggregate demand increases) or left (aggregate demand decreases), and what effects each of the four factors of Aggregate Demand. When one of these occur; then at the same price level, production and spending will be different.

Decrease (Shift to the left)	**Increase (Shift to the right)**
Consumption decreases when: - expectations of decrease in inflation - decreased incomes or wealth - fear of jobs and income - lack of consumer confidence	**Consumption increases would result from:** - Expectations of inflation or shortages in the future - Increased incomes or wealth - Optimism about jobs and income - Consumer confidence
Investment decreases when: - investors lose optimism - Businesses expect less future sales - **Contractionary Monetary Policy** (policies the **Federal Reserve** enacts that affect the banking system but affect **investment demand**) which decrease money supply (amount of money banks have) by taking money out of the banking system/raising the interest rates)	**Investment increases when:** - Investors gain optimism - Businesses expect higher future sales - **Expansionary Monetary Policy** (policies the Federal Reserve System enacts that affect the banking system but affect investment demand) which increase in the money supply (amount of money banks have) by releasing more money into the banking system/decrease in interest rates)
Government spending decreases when: **- Government carries out <u>Contractionary Fiscal policies</u> (policies that Congress enacts that shrink the economy) such as:** - decrease in government spending - increase in taxes ***Note, these policies also affect consumer and investment spending**	**Government spending increases when:** **- Government carries out <u>Expansionary Fiscal Policies</u> (policies that Congress enacts that grow the economy) such as:** - increase in spending - decrease in taxes ***Note, these policies also affect consumer and investment spending**
Net exports decrease when: - foreigners lose preference for our products - increase in exchange rate	**Net exports increase when:** - foreigners develop preferences for our products - decrease in exchange rate

1) What is the difference between Monetary and Fiscal Policy?

2) What is the difference between expansionary and contractionary fiscal and monetary policies? How do these policies affect other aspects of C+I+G+Nx?

3) What non-government factors can influence the economy?

4) Why is it important to have a positive balance in Net Exports?

5) Why is Consumer spending important to the economy?

6) Why is business spending important to the economy? Even though stocks are not counted in GDP, why is it important to watch the stock market?

7) Why might economists agree that businesses generate the most spending?