CLUTCH

CLUTCH

www.clutchprep.com

CONCEPT: AGGREGATE DEMAND

● The **aggregate demand and aggregate supply model (AD-AS Model)** explains short-run fluctuations in GDP and price

    ☐ **Aggregate Demand** is closely related to our calculation for GDP

        > Recall, that GDP = _____

        > Aggregate demand follows the same rule as demand in a single market: _____

            - As price levels fall, the quantity of real GDP demanded _____

Aggregate Demand Curve

● We are dealing with the economy as a whole, so we need *macroeconomic* explanations for the "DD"

    ☐ In a single market, Q_d falls as P increases because customers _____ their demand to other goods

        > Example: Apples and Oranges

    ☐ The **wealth effect** describes how price levels affect _____

You have $1. Candy costs $1. → _____	You have $1. Candy costs $0.50. → _____
As price levels decrease, the **real value** of money _____, allowing you to purchase more goods (Q_d _____)	

    ☐ The **interest-rate effect** describes how price levels affect _____

        > Prices decrease → Households save more → Interest rates _____ → Investment spending _____

   ☐ For now, we will assume that *government spending stays constant*

    ☐ The **exchange-rate effect** describes how price levels affect _____

        > Prices decrease → Foreign Demand _____ → Exports _____

CONCEPT: AGGREGATE DEMAND AND THE AGGREGATE EXPENDITURES MODEL

● The aggregate expenditures model can be used to derive the ***aggregate demand curve***

   □ Price levels are a determinant of consumption (lower prices, more consumption) → shift AE curve

   □ Price levels are the y-axis of the aggregate demand graph → movement along AD curve
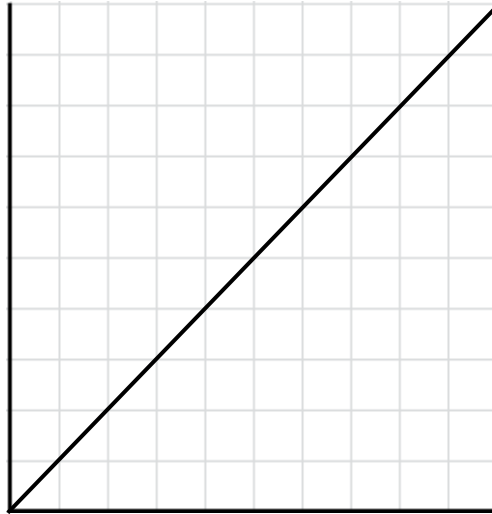
Aggregate Expenditures Model
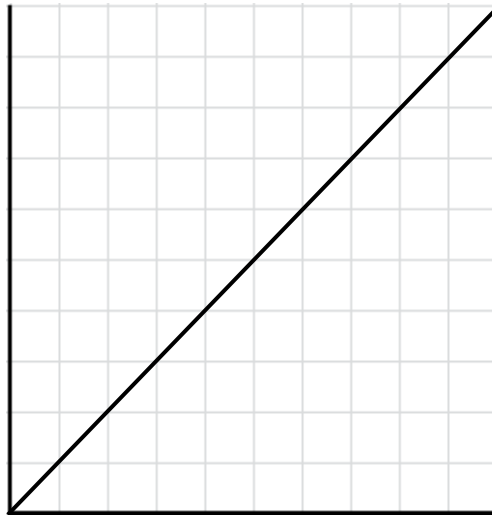
Aggregate Demand Curve

□ The derivation is reinforced when we shift the AE curve due to a change in a determinant of AE:

> Example: Investment spending increases leading to an overall increase in aggregate expenditures

Aggregate Expenditures Model

Aggregate Demand Curve

CONCEPT: SHIFTING AGGREGATE DEMAND

● When factors other than the price level change, the aggregate demand curve will either shift left or right

    □ **Aggregate Demand** is closely related to our calculation for GDP

        > Recall, that GDP = _____

        > When we shifted market demand, we used the idea of "good" and "bad"

            - "Good" for demand   → _____

            - "Bad" for demand   → _____

● Factors that affect **consumption**:

    □ _Interest Rates_: Interest Rate ↑ → Consumption _____ → Aggregate Demand _____

    □ _Income Taxes_: Income Taxes ↑ → Consumption _____ → Aggregate Demand _____

    □ _Expected Income_: Expected Income ↑ → Consumption _____ → Aggregate Demand _____

● Factors that affect **investment**:

    □ _Interest Rates_: Interest Rate ↑ → Investment _____ → Aggregate Demand _____

    □ _Business Taxes_: Business Taxes ↑ → Investment _____ → Aggregate Demand _____

    □ _Expected Profit_: Expected Profit ↑ → Investment _____ → Aggregate Demand _____

● Factors that affect **government purchases**:

    □ _Amount_: Amount of Government Purchases ↑ → Aggregate Demand _____

    □ Note: the government also affects aggregate demand through _monetary policy_ and _fiscal policy_

● Factors that affect **net exports**:

    □ _Relative GDP Growth_: USA Growth ↑ → Net Exports _____ → Aggregate Demand _____

        > US Consumers have more income leading imports to increase

    □ _Exchange Rates_: USD Value ↑ → Net Exports _____ → Aggregate Demand _____

        > Each USD has more buying power abroad leading imports to increase

CONCEPT: LONG RUN AGGREGATE SUPPLY

● The *aggregate demand and aggregate supply model (AD-AS Model)* explains short-run fluctuations in GDP and price

    □ *Aggregate Supply* is different in the short-run and the long-run

        > Long Run: The quantity of _____ depends on availability of _____

            - Real GDP = goods and services produced

            - Factors of production = labor, capital, natural resources, and available technology

      > The current price level _____ affect Real GDP in the long run

           - Real GDP is calculated using _____ prices

      > Only the availability of factors of production affects the position of LRAS

Long Run Aggregate Supply Curve

● LRAS will shift when there is a change in one of the underlying factors of production:

Factor of Production	"Good" Example → Shift _____	"Bad" Example → Shift _____
Labor		
Physical Capital		
Human Capital		
Natural Resources		
Technology		

CONCEPT: SHORT RUN AGGREGATE SUPPLY

● The *aggregate demand and aggregate supply model (AD-AS Model)* explains short-run fluctuations in GDP and price

  □ *Aggregate Supply* is different in the short-run and the long-run

  > Short Run: The quantity of Real GDP is affected by current price levels

  - Real GDP = goods and services produced

  > In the short run, an increase in the price level will lead to _____ production of goods (and vice versa)

<u>Short Run Aggregate Supply Curve</u>

● There are three explanations why we can expect the SRAS to slope upwards:

  □ *Sticky Wage Theory* says that wages (cost of labor) do not increase as quickly as the price level

  > Profit = Selling Price – Cost

  > Example: Union wages are set in contracts lasting several years; if economy booms, wages don't boom

  □ *Sticky Price Theory* says that some prices do not increase in line with the price level because of *menu costs*

  > *Menu Costs* – the costs businesses face from changing prices

  > Example: Price level increases but a restaurant does not want to take the cost of printing new menus

  - This restaurant will have lower prices, increasing their sales quantity, leading to higher output

  □ *Misperceptions Theory* says that increases in general price levels cause firms to respond with increased output

CONCEPT: SHIFTING SHORT RUN AGGREGATE SUPPLY

● When factors other than the price level change, the aggregate supply curve will either shift left or right

　　□ **Aggregate Supply** is different in the short-run and the long-run

　　　　> Short Run: The quantity of Real GDP is affected by current price levels

　　　　　　- Real GDP = goods and services produced

　　　　　　- Factors of production = labor, capital, natural resources, and available technology

　　　　> The SRAS will shift based on short-term fluctuations in the availability of factors of production

● SRAS will shift when there is a change in one of the underlying factors of production:

Factor of Production	"Good" Example → Shift _____	"Bad" Example → Shift _____
Labor		
Physical and Human Capital		
Natural Resources		
Technology		

● SRAS will also shift when there is a change in expectations:

Expectation	"Good" Example → Shift _____	"Bad" Example → Shift _____
Future Price Level		
Supply Shock (unexpected event)		
Adjustment for Past Expectations		

CONCEPT: EQUILIBRIUM IN THE AD-AS MODEL

● The *aggregate demand and aggregate supply model (AD-AS Model)* explains short-run fluctuations in GDP and price

  □ The long run equilibrium occurs at the point where AD and SRAS intersect with the LRAS curve.

    > In a market supply and demand graph, we noted an _____ shaped equilibrium

    > In the AD-AS model, the long-run equilibrium is _____ shaped

AD-AS Long-Run Equilibrium

    > In the AD-AS model, the short-run equilibrium can exist away from the long-run equilibrium

AD-AS Short-Run Equilibrium

CONCEPT: EQUILIBRIUM IN THE AD-AS MODEL – SHIFTS IN AGGREGATE DEMAND

● A shift in AD will always follow a three step process:

  □ First, a shift occurs in AD ("Good" or "Bad"?)

  □ Second, a new short-run equilibrium is found (Intersection of AD_2 and $SRAS_1$)

  □ Third, an opposite shift occurs in SRAS leading to a new long-run equilibrium → *SRAS finds LR equilibrium*

    > Note that this third step takes time; it does not immediately follow the first shift

● A *decrease in AD* leads to a *recession and cyclical unemployment*

EXAMPLE: A decrease in expected future profit has led to decreased investment spending:

Decrease in Aggregate Demand

● An *increase in AD* is referred to as *demand-pull inflation* because the shift leads to a higher long-run equilibrium price

EXAMPLE: An increase in defense spending by the government:

Increase in Aggregate Demand