# Aggregate demand

In macroeconomics, aggregate demand (AD) is the total demand / spending for goods and services in an economy at a given time.

Aggregate = totaled all together.
So we are not looking at the demand for a specific product as we were when studying microeconomics, but the demand for everything!

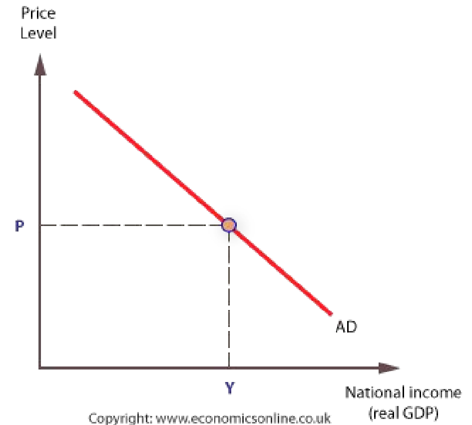
# What are the four components of AD?

C = Consumer spending

I = Investment spending / Business spending

G = Government spending

X-M=Net exports (exports minus imports)




- Think of it like this AD measures spending of all goods and services in an economy. So its basically the demand for the GDP of a country!!!

*Example, a car produced by Nakamura Motors can only be purchased by consumers, a business, the government or another country*

## 2.1 What is aggregate demand?

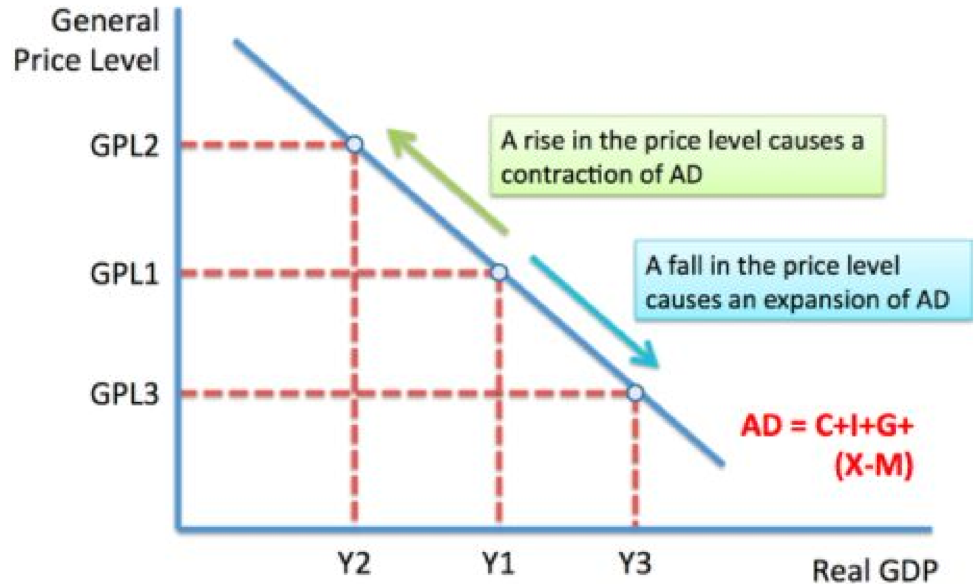
GDP (Y) is made up of four components: consumption (C), investment (I), government expenditure (G), and net exports (NX). Each of the four components is a part of aggregate demand (AD). Then we have:

$$Y = C + I + G + NX$$

# What is the aggregate demand curve?

The AD curve shows the relationship between price and the quantity of output (real GDP) demanded by the households, firms, the government and foreign sectors.

- A change in price level will result in a movement along the AD curve
- AD curve is downwards sloping
- Y-Axis - General Price Level
- X-Axis - Real GDP



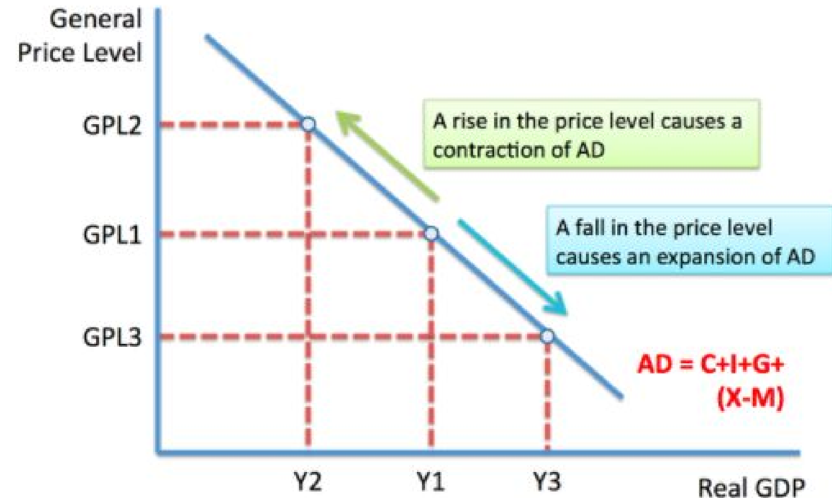
# How does a change in price affect C, I and X-M

***Wealth Effect: The Price Level and Consumption***

When the price goes up and there is inflation people have less purchasing power and so buy less. When prices go down the opposite occurs

***Interest-Rate Effect: The Price Level and Investment***

Interest rates go up when prices go up as people need to borrow more money. As banks have less money to lend out, they raise their interest rates. People will buy more when interest rates go down




***The Exchange-Rate Effect: The Price Level and Net Exports***

As discussed, a lower price level decreases interest rate. Suppose a fall in the price level in the United States lowers the U.S. interest rate. American investors will gain higher returns by investing abroad. Increasing U.S. capital outflow raises the supply of U.S. dollars in the foreign exchange market. U.S. dollars will then depreciate (i.e. price of U.S. dollars decreases).U.S. then goods become relatively cheaper than foreign goods. Exports rise and imports fall.

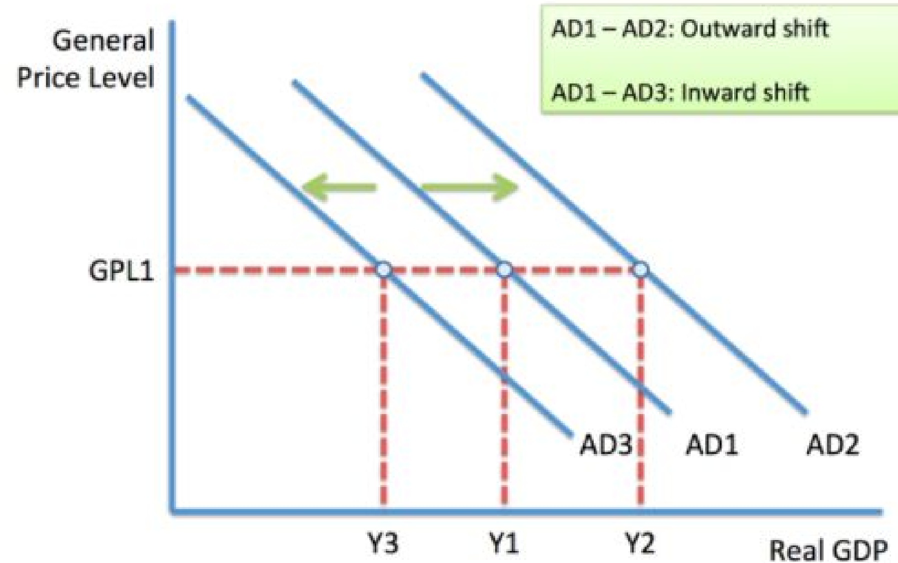
# What about government spending?

Government expenditure is assumed to be fixed by policy, not by price level. Thus it is not included in the analysis at this stage.

# What causes a shift in aggregate demand curve?

An increase or decrease in any of the components of aggregate demand will result in a shift in the AD curve.

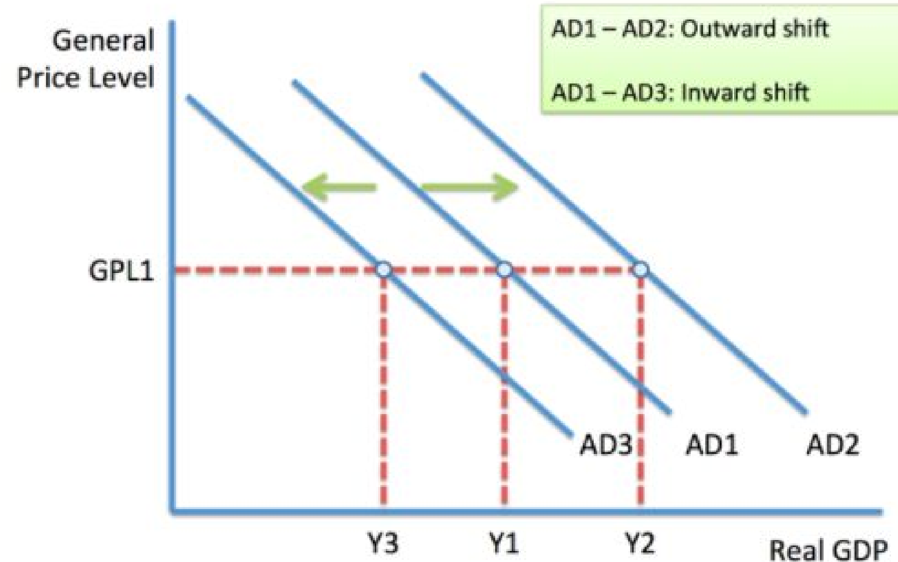
- Consumer spending (+/-)
- Investment (+/-)
- Government spending (+/-)
- Net exports (+/-)



# What causes a shift in aggregate demand curve?

Will the following cause the AD to shift outward or inward?

- A significant boom in the stock market
- A decrease in government spending
- Widespread fear of recession
- Increase in incomes of close trading partners



# What causes a shift in aggregate demand curve?

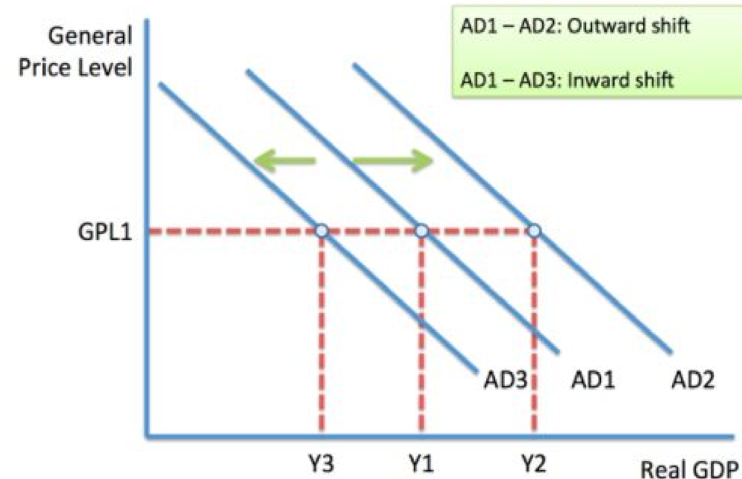
**Will the following cause the AD to shift outward or inward?**

A significant boom in the stock market - Shift right. Confidence is high as people © see more return on investments and spend more

A decrease in government spending - Shift left. This is a decrease of government spending (G) on goods and services as well as military spending, etc.

Widespread fear of recession - Shift left. People save rather than spend. Businesses also would invest less (I) as consumers are buying less

Increase in incomes of close trading partners - Shift right. Those people would have more money so our exports (X-M) would increase.

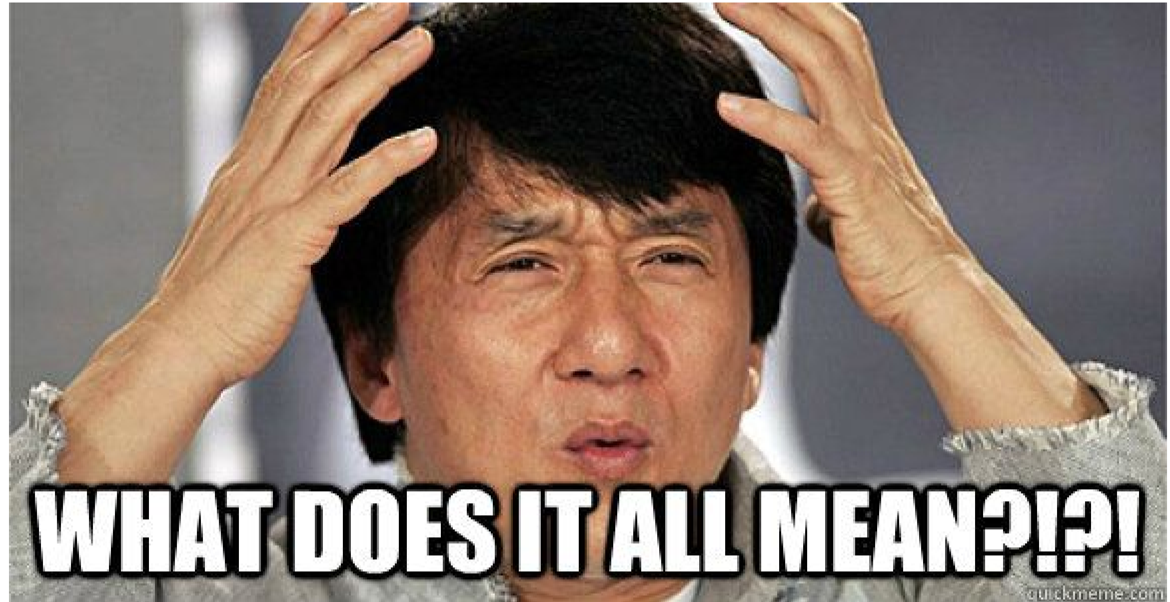


# So what does it all mean?

Basically……….

An increase in AD means economic growth

- More output
- More jobs
- More spending
- ……etc



# Fiscal policy

Fiscal policy is defined as the set of government’s policies relating to its spending and taxation rates.

**Contractionary fiscal policy**

Cut public spending

Raise taxes

**Contractionary fiscal policy**

Cut public spending

Raise taxes

# Some problems with fiscal policy

- **Too much public spending can cause inflation**
- **Increases in taxes on incomes and profits can reduce incentives to work and enterprise**
- **Public spending can crowd out private spending**

Public sector

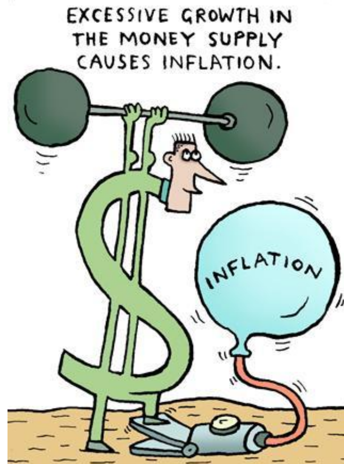
Public spending has to be financed:

- by raising taxes from household and corporate incomes, or
- by government borrowing from the private sector (an increas borrowing will raise interest rates

Private sector

# Monetary policy

Monetary policy is defined as the set of official policies governing the supply of money in the economy and the levels of interest rates




## Contractionary monetary policy

**Increase interest rates to reduce consumer borrowing and increase savings**

Higher interest rates can also increase the exchange rate and reduce prices of imported products

## Expansionary monetary policy

**Reduce interest rates to increase consumer borrowing and reduce saving**

Lower interest rates can also reduce the exchange rate and reduce prices of exported products