What is the aggregate demand-aggregate supply model?
Explores long-run growth and development

Tuesday, April 14, 2015 4:36 PM

Governments that impact the economy

Business
aggregate supply model
demand and supply of GDP

In an economy

What people believe that this spending is what drives the economy

Resource in the economy

Which constitute real GDP

Decreases in the quantity of aggregate demand
The Slope of the Aggregate Demand Curve

- All else being equal: increases in the economy's price level leads to decreases in the quantity of aggregate demand.
- Substitutions from one market to another have no effect on the total amount of output, or real GDP.
- Three reasons for this inverse relationship:
  - **The Wealth Effect**
    - **Wealth**: the value of one's accumulated assets
    - Wealth is the total value of everything you own, including the value of your labor
    - **Wealth effect**: is the change in the quantity of aggregate demand
    - A rise in prices all over the economy reduces real wealth in terms of purchasing power
    - If prices fall, real wealth increases, and then the quantity of aggregate demand increases
  - **The Interest Rate Effect**
    - If the price level rises and real wealth falls, people save less
    - When you cut back on groceries that shows the effect of the interest rate effect
    - When you cut back on your savings that shows the effect of the wealth effect
    - **Interest Rate Effect**: occurs when a change in the price level leads to a change in interest rates and therefore to a change in the quantity of aggregate demand
    - When savings declines, the quantity of investment must also decline
      - It’s a reduction in the supply of savings that makes the investment curve (horizontal axis)
  - **The International Trade Effect**
    - The price level and real GDP represent the domestic market
    - We must also consider the prices of the US relative to the prices of other countries
    - When the US price level rises, all else equal, US goods are relatively more expensive
    - **International Trade Effect**: a change in the price level leads to a change in the quantity of aggregate demand
  - All three reasons work together to influence the quantity of aggregate demand
    - Begins with a change in the price level
    - Consumption (C) decreases from the wealth effect
    - Investment (I) declines from the interest rate effect
The economy will tend to move to point at which aggregate demand is equal to aggregate supply. This is the output level that is sustainable for the long run in the economy. LRAS is a vertical line at Y* (full employment output).

The price level does not affect the long run of aggregate supply. The distinction between sticky input prices and flexible input prices affects the way firms react when prices do move.

Errors in past price expectations, changes in expected future prices, and if input prices don't fall with output prices, firms reduce output in response to general price increases. This explains the positive slope of the short run aggregate supply curve. Positive: reduce production costs. Negative: leads to firms not wanting to produce at any price level.

When you and other firms raise output, GDP rises. This begins with a change in the price level and leads to firms not wanting to produce at any price level. Positive: reduce production costs. Negative: leads to firms not wanting to produce at any price level.

The number of paper dollars we exchange for our goods and services does not impact our ability to produce. However, it makes it more expensive for other nations to purchase our exports. Countries with rampant inflation: individuals will spend their paychecks right away. Inflation is a determinate of people's spending habits.

The slope of the aggregate demand curve is inverse. Three reasons for this inverse relationship:
- On the AD curve, aggregate demand is the spending side of the economy.
- Business growth economics focus on longer time horizons.
- Input prices, like worker wages, affect the firm's costs.

Examine short run fluctuations, or business cycle. Determine of people's spending habits:
- Consumption (C) decreases from the wealth effect.
- Savings (S) decreases from changes in the price level.
- This occurs when a change in the price level leads to a change in interest rates and therefore in the quantity of aggregate demand. Wealth: it's a reduction in the supply of savings that makes the interest rate increase (vertical axis) and the quantity of aggregate demand decrease.

International Trade Effect: When the US price level rises, all else equal, US goods are relatively more expensive and so the quantity demanded for US goods declines. It's a reduction in the supply of savings that makes the interest rate increase (vertical axis) and the quantity of aggregate demand decrease.

Factors that affect aggregate demand:
- • Real GDP
- • Unemployment
- • Price Level
- • Value of the Dollar
- • Shifts in Aggregate Demand
- • The Slope of the Aggregate Demand Curve
- • Long Run Aggregate Supply Curve (LRAS)

The Aggregate Demand Model:
- AD  =  C  +  I  +  G  +  NX

Vertical axis: General price level of the whole economy. Horizontal axis: Real GDP. AD increases when people spend on goods and services and most people believe that this spending is what drives the economy.
The economy will tend to move to a point at which aggregate demand is equal to aggregate supply. The aggregate demand curve is downward sloping because an increase in the price level leads to a decrease in the quantity of aggregate demand. This inverse relationship is due to three reasons:

1. **Expected Income**: Higher expected future prices lead to a lower quantity of aggregate supply. In contrast, output prices tend to be more flexible.
2. **Exchange Rates**: Changes in exchange rates can shift the aggregate demand curve. When the income of people in foreign nations grows, their demand for US goods increases, shifting AD to the right.
3. **Net Exports**: Changes in net exports (NX) can also affect AD. An increase in NX, such as during a recession, will shift AD to the right.

On the AD curve, to determine aggregate demand we sum up spending from different sources in the economy. The function of a firm tells us about the willingness and ability of producers to supply GDP. Need to think from the perspective of those that produce and supply goods and services. Both study GDP growth, employment, and the people, firms, and governments that impact the economy, but they use different tools and methods.

In the short run, the aggregate supply model helps us understand the economy. The price level and real GDP represent the domestic market. Shifts in aggregate demand result from wealth changes due to price level changes. The Wealth Effect and the Interest Rate Effect are examples of how changes in wealth can affect AD.

- **Wealth Effect**: The negative slope means that increases in the price level lead to decreases in the quantity of aggregate demand. An increase in the price level makes goods and services more expensive, reducing the purchasing power of consumers and thus demand.
- **Interest Rate Effect**: Changes in the price level can affect interest rates, which in turn influence consumption and investment. Higher interest rates can reduce consumption and investment, affecting aggregate demand.

However, in the long run, the aggregate supply model helps us understand the economy. The long-run output of an economy depends on resources, technology, and institutions. The economy moves towards full employment (Y*) in the long run. The long-run output is sustainable for the long run in the economy. Higher expected future prices lead to a lower quantity of aggregate supply. Menu costs, inflexible input prices, and the distinction between sticky input prices and flexible input prices affect how firms react when prices do move. 

The price level does not affect the long run of aggregate supply. The economy moves towards full employment (Y*) in the long run, and the long-run output of an economy depends on resources, technology, and institutions. The influence of the price level on aggregate supply depends on the time frame we are considering. 

Shifts in aggregate demand can be caused by changes in consumer spending, investment, government spending, and net exports. The aggregate demand function is a tool for understanding how changes in these factors can affect the economy. The aggregate demand curve is downward sloping, indicating an inverse relationship between the price level and the quantity of aggregate demand. This relationship helps explain how changes in the price level can affect the economy, with an increase in the price level leading to a decrease in aggregate demand and a decrease in the price level leading to an increase in aggregate demand.