Spending, Output, and Fiscal Policy

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- The idea that a decline in aggregate spending may cause output to fall below potential output was one of Keynes's insights
- Too little spending leads to a recessionary output, too much creates an expansionary gap

The Keynesian Model's Crucial Assumption: Firms Meet Demand at Preset Prices

- In the short run, firms meet the demand for their products at preset prices
    - Firms do not respond to every change in the demand for their products by changing their prices
    - Instead, they set a price for some period and meet the demand at that price
        - By "meeting the demand" we mean that firms produce just enough to satisfy their customers at the prices that have been set
    - Fluctuations in spending will have powerful effects on the nation's real GDP
- Menu Costs: the costs of changing prices
    - Prices should be changed if the benefit of doing so outweighs the menu costs associated with making the change
- Planned Aggregate Expenditure (PAE): total planned spending on final goods and services - together, these four types of spending sum to aggregate spending
    - Consumption expenditure is spending by households on final goods and services
        - Largest component of PAE
        - The higher the private sector's disposable income, the higher the level of consumption spending
    - Investment is spending by domestic firms on new capital goods
        - Also spending on new houses and apartments and increases in inventories
    - Government purchases are purchases by federal, state, and local governments of final goods and services
    - Next exports equal exports minus imports
    - PAE = C + I + G + NX