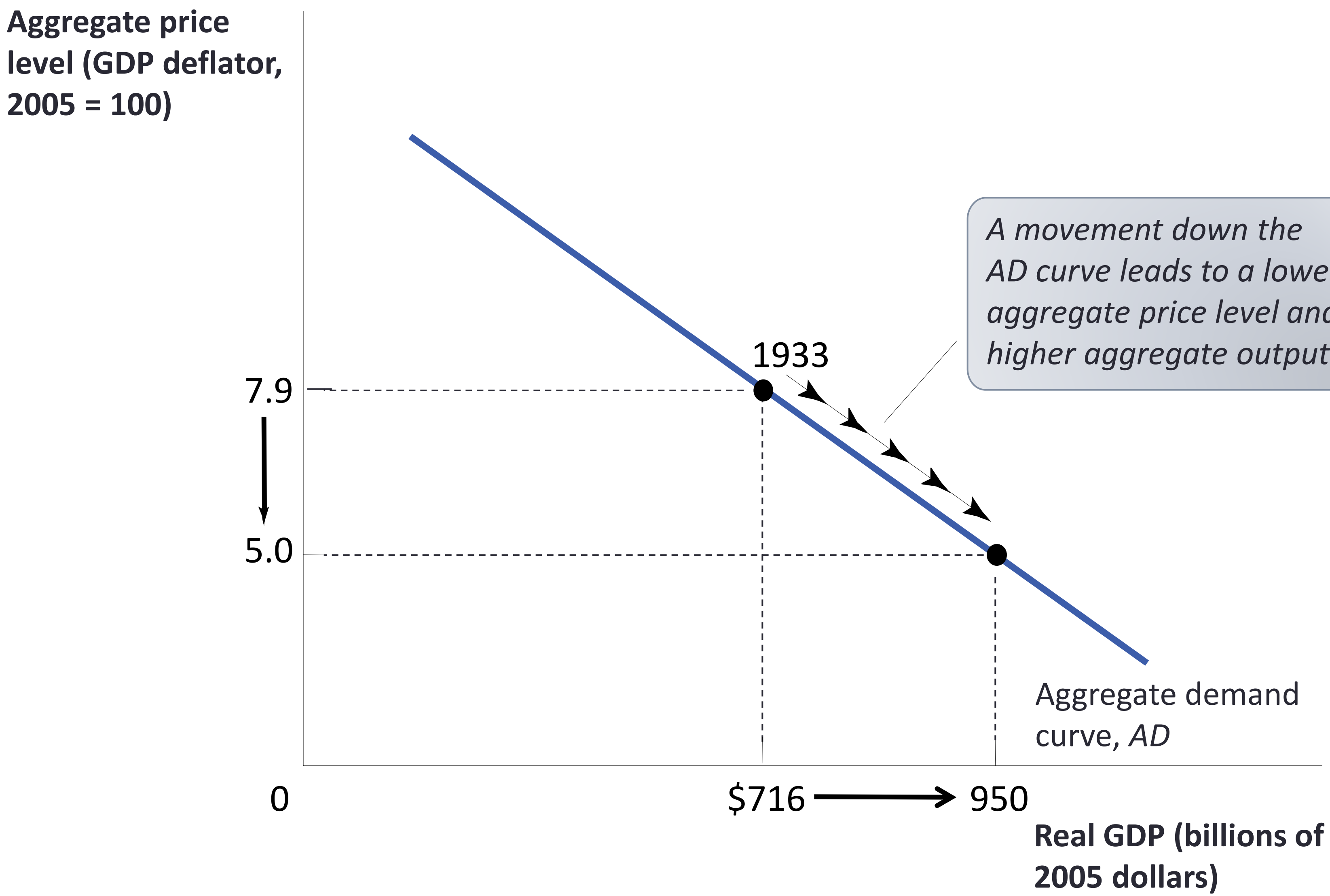
27 Aggregate Demand

MODULE 27

The Aggregate Demand Curve

- The **aggregate demand curve** shows the relationship between the aggregate price level (P) and the quantity of aggregate output (Y) demanded by households, businesses, the government and the rest of the world.

The Aggregate Demand Curve



Why Does the AD Curve Slope Downward?

- With the aggregate demand curve, remember we are considering a change in the prices of *all* final goods and services.

- It is downward-sloping for two reasons:

1) **Wealth effect of a change in the aggregate price level**—a higher aggregate price level reduces the purchasing power of households' wealth and reduces consumer spending.

Why Does the AD Curve Slope Downward?

- It is downward-sloping for two reasons:

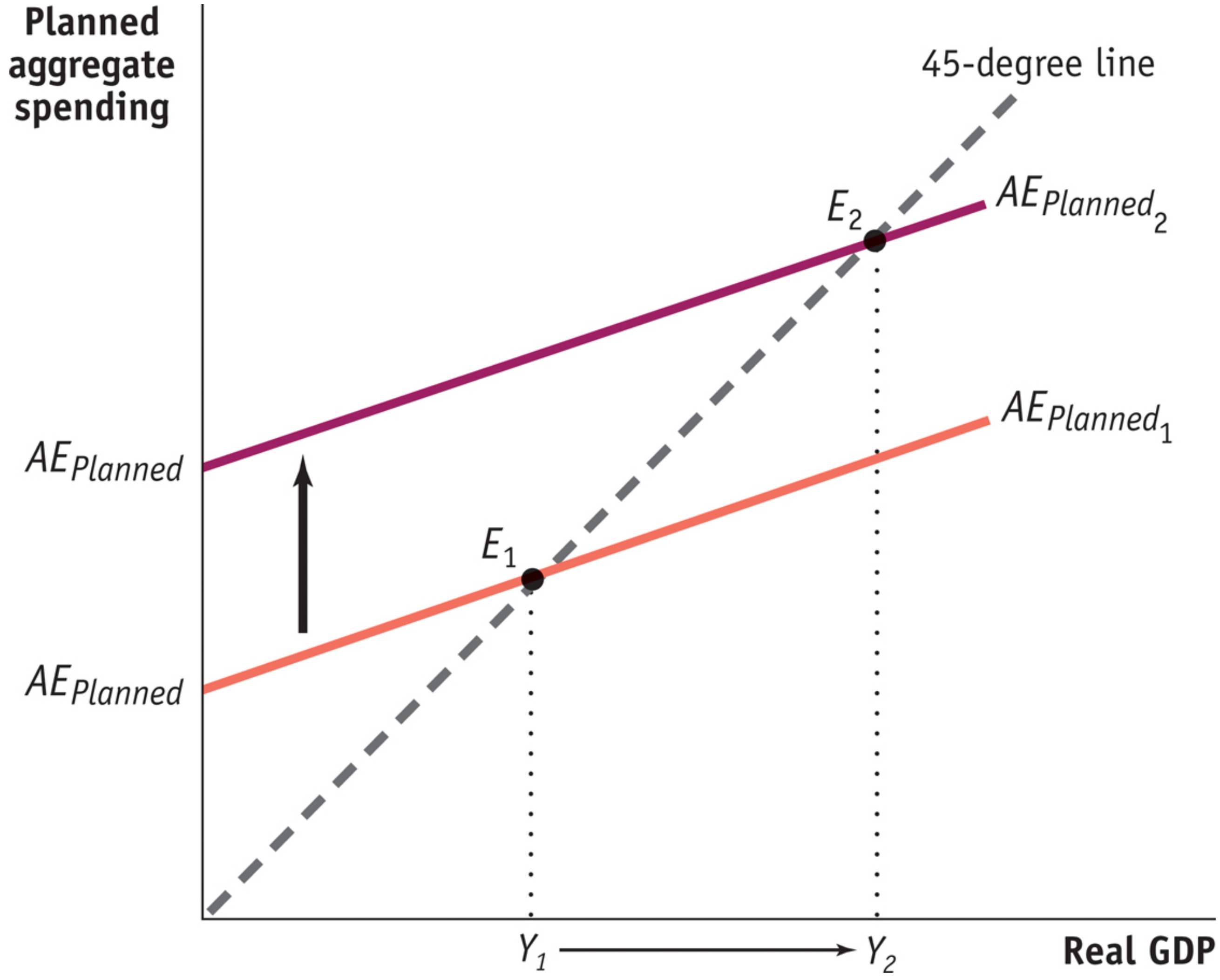
  2) **Interest rate effect of a change in aggregate the price level**—a higher aggregate price level reduces the purchasing power of households' money holdings, leading to a rise in interest rates and a fall in investment spending and consumer spending.

The AD Curve and the Income-Expenditure Model

- The aggregate demand curve shows what aggregate spending would be at any given aggregate price level (P).

- Changes in the aggregate price level change the level of planned aggregate spending at any given level of real GDP, so the $AE_{Planned}$ curve shifts when P falls.

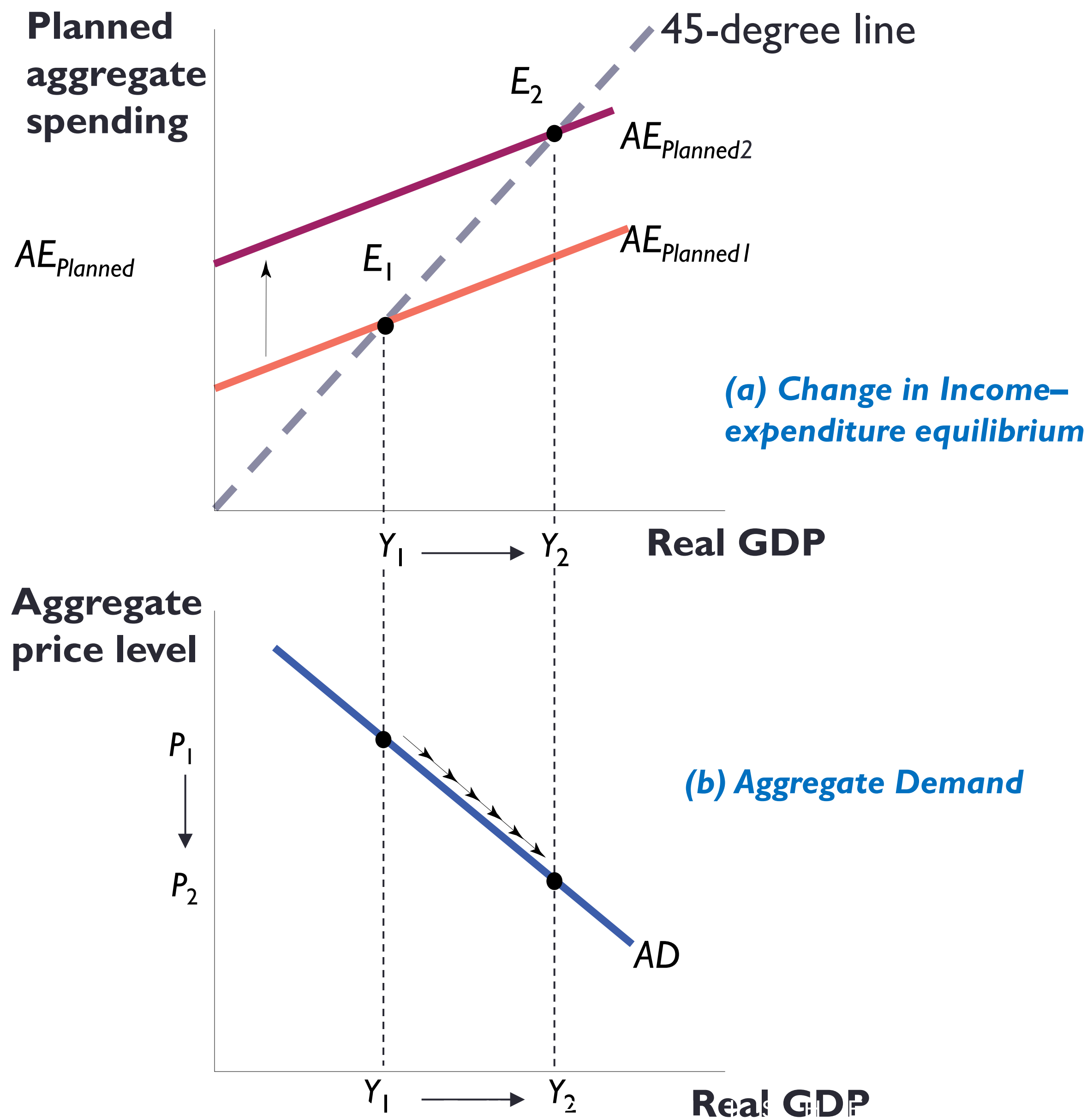
The AD Curve and the Income-Expenditure Model



The AD Curve & the Income–Expenditure Model

If the price level drops, planned spending rises at all output levels (from the wealth and interest-rate effects).

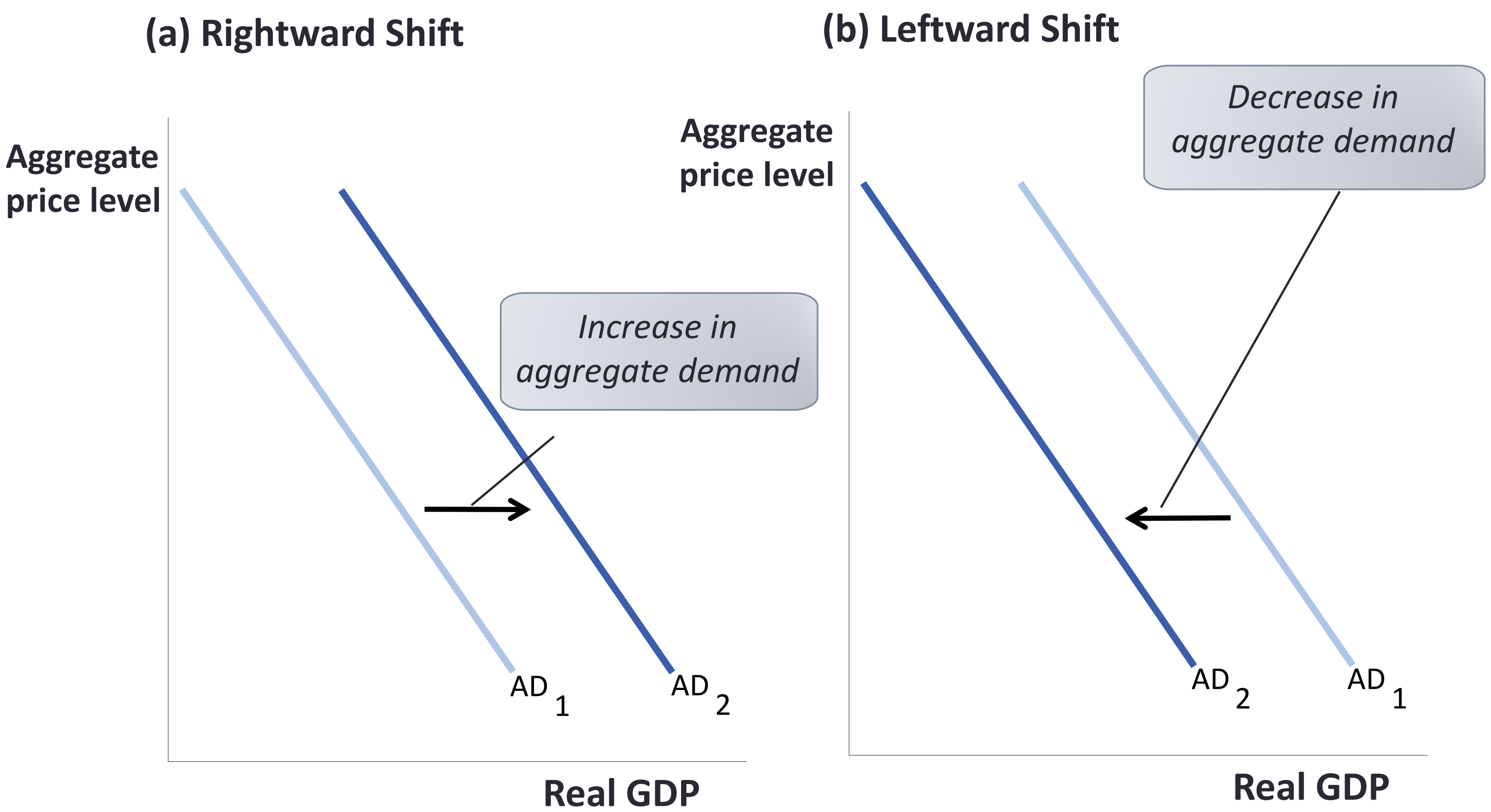
This leads to a multiplier process that moves the income–expenditure equilibrium from E_1 to E_2 and raises real GDP from Y_1 to Y_2.



Shifts of the Aggregate Demand Curve

- The aggregate demand curve shifts because of:
  - changes in expectations
  - wealth
  - government policies
    - fiscal policy
    - monetary policy

Shifts of the Aggregate Demand Curve



Economics in Action

Moving Along the Aggregate Demand Curve, 1979-1980

- It is often hard to distinguish between changes in spending that represent *movements along the AD curve* and *shifts of the AD curve*
- In March, 1980, the rate of consumer price inflation rate reached 14.8%, but the Federal Reserve was increasing the quantity of money slowly
- Purchasing power of money in circulation fell
- This led to an increase in the demand for borrowing and an increase in interest rates
- High interest rates caused consumer spending and investment to fall