AGGREGATE DEMAND AND SUPPLY

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What goes on the X axis is Real GDP.
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The Y axis has nominal prices, harder to think about than the price of french fries.
AGGREGATE DEMAND

• **Aggregate Demand**: the amounts of real domestic output which domestic consumers, businesses, governments, and foreign buyers collectively will desire to purchase at each possible price level
WHY AGGREGATE DEMAND IS DOWNWARD SLOPING

- **Real Balances Effect**
  - Because higher prices reduce real spending power, prices and output are negatively related.
  - If you go to bed with $20 and when you wake up prices are higher, then you buy more stuff.

- **Foreign Purchases Effect**
  - When domestic prices are high, we will export less to foreign buyers and we will import more from foreign producers.
  - This is the standard effect that when prices go up you switch to a substitute.
**Interest Rate Effect**

- higher prices mean I need to hold more money to buy the same amount of stuff
- This leads me to transfer money from my savings account to checking account (or things like savings to things like checking)
- As a result savings declines relative to borrowing which leads to increases in interest rates
- Increase in interest rates lead people to spend less today
VARIABLES THAT SHIFT AGGREGATE DEMAND

- Taxes
- Interest Rates
- Confidence
- Strength of the Dollar
- Government Spending
## Determinants of Aggregate Demand

<table>
<thead>
<tr>
<th>Variable</th>
<th>GDP Components</th>
<th>Effect of an Increase on AD</th>
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- It is also hard to summarize all of the discussion succinctly
- I am going to do things a bit differently than the book, but it will make similar points
Most economists believe the aggregate supply curve is vertical in the long run.
WHY IS LONG RUN SUPPLY INELASTIC?
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- In the long run prices and wages will adjust and there will be no change in real output
Most economists believe the aggregate supply curve is upward sloping in the short run.
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  - Firms sign contracts with workers that set wages for a while.
  - Due to concerns of fairness, firms cannot cut nominal wages.
IF WAGES COULD ADJUST IMMEDIATELY

Price Index

Real GDP

We Start Here
IF WAGES COULD ADJUST IMMEDIATELY

Price Index

Real GDP

We Start Here

Now Suppose there is a shift down in Aggregate Demand
If wages could adjust immediately

Now suppose there is a shift down in Aggregate Demand.

Prices fall but wages adjust and nothing happens to Real GDP.
WITH STICKY WAGES
WITH STICKY WAGES

Now Suppose there is the same shift down in Aggregate Demand
Now suppose there is the same shift down in Aggregate Demand. Firms can’t lower wages and are losing money so they lay workers off decreasing output.
VARIABLES THAT SHIFT AGGREGATE SUPPLY

- Input Prices
- Productivity
- Government Regulation
## DETERMINANTS OF AS

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INCREASE IN AGGREGATE SUPPLY

![Graph showing the relationship between Price Index and Real GDP](image-url)
INCREASE IN AGGREGATE SUPPLY

Monday, November 7, 11
INCREASE IN AGGREGATE SUPPLY

Now Suppose there is the same shift up in Aggregate Supply

Monday, November 7, 11
INCREASE IN AGGREGATE SUPPLY

Now Suppose there is the same shift up in Aggregate Supply

GDP Increases
Prices Fall

Real GDP

Price Index

Monday, November 7, 11
CAUSES OF INFLATION

• **Demand Pull Inflation:** inflation caused by an increase in aggregate demand

• **Cost Push Inflation:** inflation caused by a decrease in aggregate supply
GOVERNMENT INFLUENCE: AGGREGATE DEMAND

- Government can influence economic activity with aggregate demand side policies affecting:
  - Taxes
  - Government Spending
  - Interest Rates
GOVERNMENT INFLUENCE: AGGREGATE SUPPLY

• Government can influence economic activity with aggregate supply side policies affecting
  • input costs (labor and wage)
  • reducing regulation
  • Increase incentives to
    • Work
    • Take Risks

• The actions are sometimes called Supply Side Economics