**Topic 3: Aggregate Demand / Aggregate Supply**

**LVL 1: As you read, answer the following questions**

1. What is aggregate demand?
2. What happens to aggregate demand when interest rates go up?
3. What is aggregate supply?
4. What happens when aggregate demand increases with regard to GDP and price levels?
5. What happens when aggregate demand decreases with regard to GDP and price levels?
6. What happens when aggregate supply increases with regard to GDP and price levels?
7. What happens when aggregate supply decreases with regard to GDP and price levels?

**SSEMA1 Illustrate the means by which economic activity is measured.**

1. **Define unemployment rate, Consumer Price Index (CPI), inflation, real GDP, aggregate supply and aggregate demand and explain how each is used to evaluate the macroeconomic goals from SSEMA1a**

Economic activity derives from the sectors of the economy we explored in the fundamentals and microeconomics domains. Individuals, businesses, markets, and governments all interact to create a country’s economy. The degree of strength or weakness of all economic activity in an economy will affect the individual components of that economy. For this reason, public and private entities constantly measure specific types of economic activity and synthesize the data to create a picture of the economy’s health. The pictures drawn by the data inform policy makers who may choose to intervene in the economy to meet economic goals.

**Aggregate Demand** refers to the total quantity of all goods and services consumers are willing and able to purchase at each price level in a given period of time. The aggregate demand curve (AD) is downward-sloping showing an inverse relationship between price level and real GDP. Three effects explain the downward-sloping Aggregate Demand curve: the interest rate effect, the wealth effect (real balances), and the foreign purchases effect (net exports effect). The interest rate effect causes the downward slope of the aggregate demand curve because as price level rises, interest rates (the price of borrowing money) rises resulting in consumers and businesses spending less on interest sensitive purchases like cars, new homes, and physical capital. The wealth effect occurs when a rising price level reduces the purchasing power of consumers thus lowering the amount of consumption spending due to higher prices. Finally, the foreign purchases effect occurs when a higher price level in a country makes the relative price of the country’s exports higher, reducing demand for the country’s exports in other countries.

**Aggregate Supply** is the total quantity of final goods and services producers in an economy are willing and able to supply at each price level. Aggregate supply has both a short-run and a long-run curve. Aggregate supply in the short-run is typically an upward-sloping curve. This illustrates a direct or positive relationship between price level and the quantity of real GDP output supplied in the economy. It is upward-sloping in the short-run because wages and prices are slow to change due to contracts. Economists called this “sticky” wages and prices. In the long-run, economists generally view wages and prices as completely flexible. Therefore, the long-run aggregate supply curve is vertical at the full employment level of real GDP (real output or real national income). The long-run curve illustrates that, in the long-run, changes in price level have no effect on the long-run quantity of final goods and services the economy can produce.

**Change in Aggregate Demand**

**Increase in Aggregate Demand –** Increases in aggregate demand can occur when changes in the economy lead households, businesses, governments, or foreign consumers of domestic exports to purchase a greater number of final goods and services at all price levels.

**Real GDP increases –** The change from Y1 to Y2 means more employment in the short-run. This change indicates economic growth only if the percent change in Real GDP is greater than the percent change in price level.

**Price Level Increases –** Price level increased from PL1 to PL2. This indicates an increase in the inflation rate. The amount of the increase would determine how well the country’s is meeting its price stability goals.

**Decrease in Aggregate Demand –** Decreases in aggregate demand can occur when changes in the economy lead households, businesses, governments, or foreign consumers of domestic exports to purchase a smaller number of final goods and services at price levels.

**Real GDP decreases –** The change from Y1 to Y2 means less employment in the short-run. This change indicates the economy is contracting rather than growing.

**Price Level decreases –** Price level decreased from PL1 to PL2. This indicates a decrease in the price level or deflation. Deflation is generally not desirable when it occurs because of a decrease in economic activity. When the price level falls, businesses are unable to sell their products at a price high enough to cover costs they have already incurred, putting producers at risk of failure.

**Increase in Aggregate Supply** – Increases in aggregate supply can occur when changes in the economy reduce the costs of production or increase productivity for industries throughout the country, allowing producers to supply a greater number of final goods and services at all price levels.

**Real GDP increases** – The change from Y1 to Y2 means more employment in the short-run. This change indicates economic growth in the short-run because the price level is lower.

**Price Level decreases –** Price level decreased from PL1 to PL2. A price level decrease caused by decreased production costs or increased productivity do not usually cause the problems associated with deflation from demand shifts since producers have a lower cost of production.

**Decrease in Aggregate Supply** – Decreases in aggregate supply can occur when changes in the economy increase the costs of production or decrease productivity for industries throughout the country, forcing producers to supply a fewer number of final goods and services at all price levels.

**Real GDP decrease** – The change from Y1 to Y2 means more less employment in the short-run. This change indicates the economy is contracting in the short-run.

**Price Level increases –** Price level increased from PL1 to PL2. This economic condition when an increase in the price level occurs with a decrease in Real GDP and employment is stagflation. It is difficult to recover because prices are high at the same time as incomes are falling. There is little incentive to spend and high incentive to save.

**LVL II Consider the following questions**

1. Define unemployment rate?
2. Define inflation?
3. How would an increase in aggregate demand affect the unemployment rate?
4. How would a decrease in aggregate demand affect inflation?

**LVL III Do the Following:**

1. Create a graph of Aggregate Demand and Aggregate Supply. Show a shift in Aggregate Demand, explaining how that shift will impact unemployment and inflation.