



Aggregate Demand

- Aggregate Demand (AD) is total spending on economy's goods and services during certain time period.
- The components of Aggregate Demand are as follows:
 1. Consumption
 2. Investment
 3. Government Spending
 4. Exports and Imports

Aggregate Demand = $C + I + G + (X - M)$

- Aggregate Demand of an economy is inversely related to its general price level.

Factors affecting Consumption

- Total consumption of the economy is expected to be affected by following factors:
 - 1. Population:** higher the population obviously higher the aggregate consumption
 - 2. Average income level:** higher income levels increase citizens' purchasing power which in turn increases consumption
 - 3. Income tax:** higher income taxes leaves lower disposable

*incomes and so reduces
aggregate consumption*

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Factors affecting Consumption

4. **Interest Rates:** higher interest rates discourages consumers to borrow which reduces their consumption

5. **Expectations about future:** If overall citizens are optimistic about their future, aggregate consumption levels are expected to be higher

Factors affecting Investment

- Investment in the economy is expected to be affected by following factors:

1. Profit Margins: higher the profit margins of investment higher will be the investment levels in the economy

2. Interest Rates: being the cost of borrowing investment levels in an economy are very much determined by the interest rates and the relationship is inverse

Factors affecting Investment

3. **Government Policies and Regulations:** more investment friendly government policies like reduces corporate tax rates, other incentives for firms like subsidies and industrial zones will encourage investment in the economy and vice versa.

Factors affecting Government Expenditure

- Following factors are expected to be significant determinants of government expenditure:

1. Government Economic Objectives:

government economic objectives determine their expenditure to large extent for instance to create increased access to education and health care etc

Factors affecting Government Expenditure

2. *Government Political Objectives:*

though governments will never admit that any of their expenditure or project was intended to achieve political objectives but sometimes government spending is to get political popularity etc.

3. **Government Finances:** higher tax revenue and / or loan for different projects is expected to significantly increase government spending and vice versa.

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Factors affecting Net Exports ($X - M$)

- Following factors are expected to affect economy's net exports:

1. Depreciation of exchange rate: by making local products cheaper and imported goods expensive weaker exchange rates are expected to increase net exports

2. Competition from foreign

businesses: if foreign rival firms are improving in terms of product prices and quality then local exporters are expected to lose out hence reducing net exports

Factors affecting Net Exports ($X - M$)

- 3. Free Trade:** the more free trade an economy engages in the more likely it is to experience reduction in net exports at least temporarily and with protectionist policies since imports are reduced so it increases net exports at least temporarily.

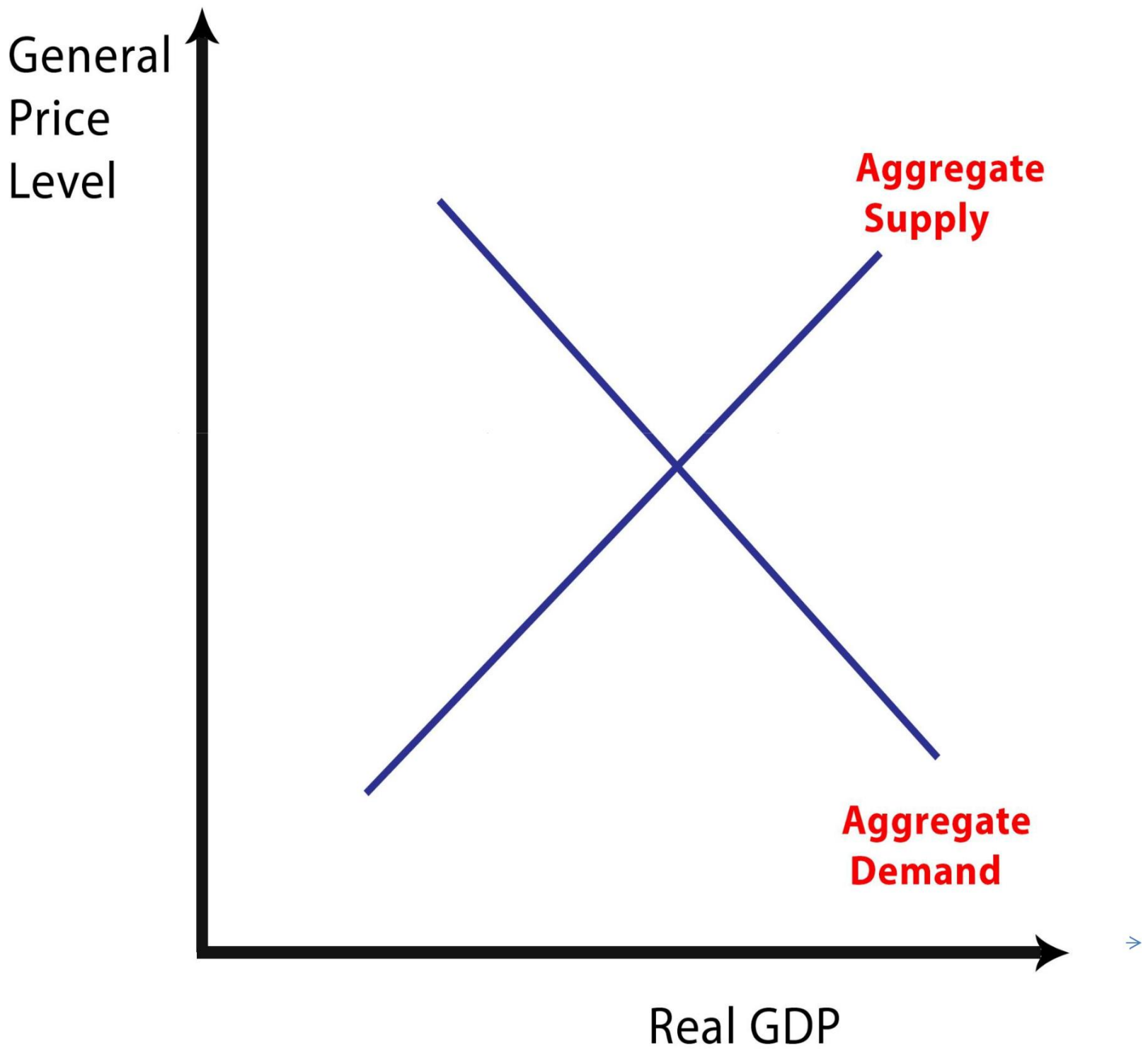
Aggregate Supply

- Aggregate Supply (AS) is total output of an economy's goods and services during certain time period.
- Aggregate Supply is positively related to economy's general price level. Therefore it is an upward sloping line with regards to general price level.

Aggregate Supply

- The equilibrium in macroeconomy exists where aggregate demand of an economy is equal to its aggregate supply. Changes in any of the two components results in formation of **new equilibrium**.

Macroeconomic Equilibrium



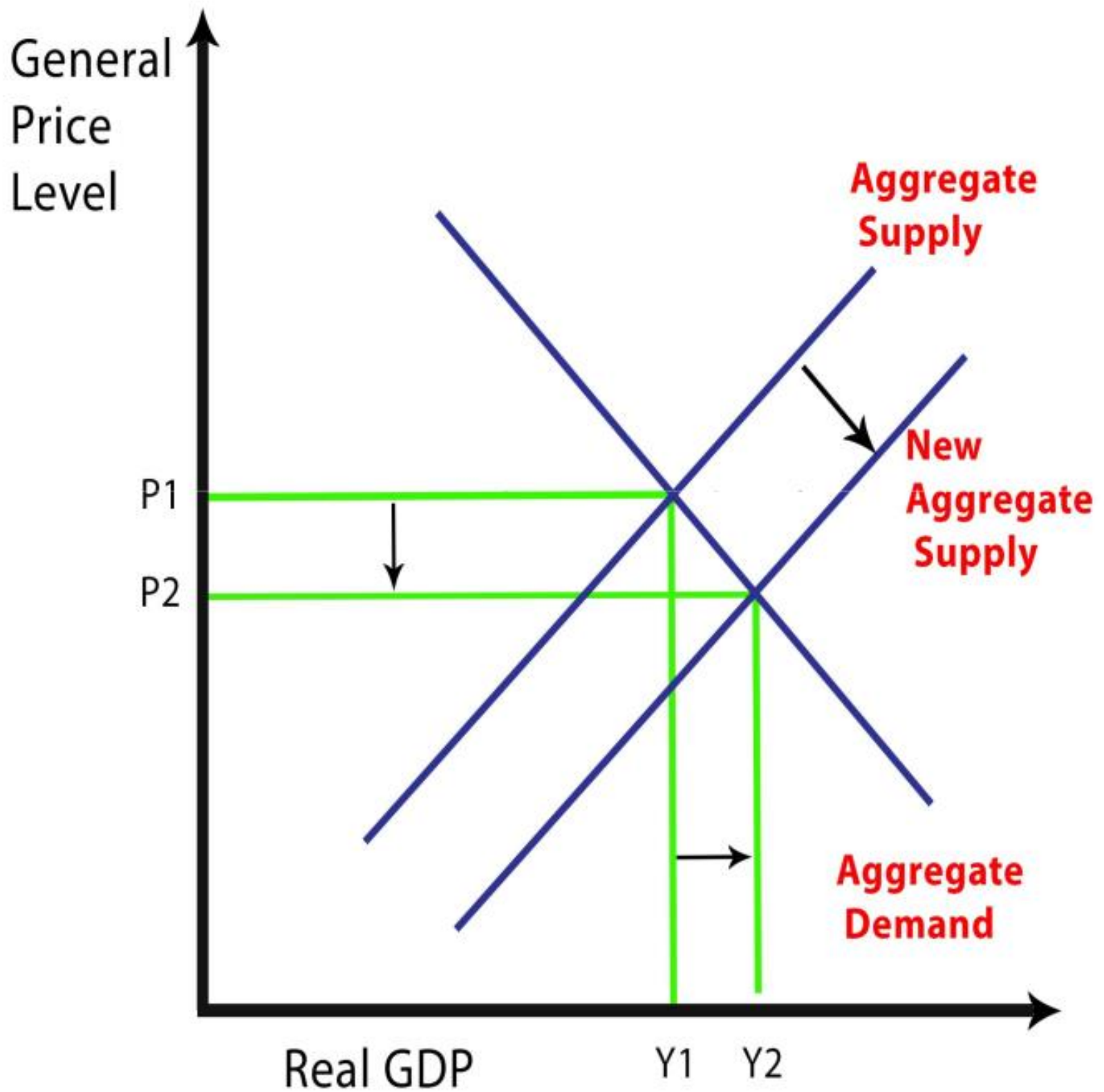
Changes in Macroeconomic Equilibrium

- Just like market supply curve, **aggregate supply (AS)** also reacts to changes in cost of **production and factor endowments** – factor endowments refer to the quantity and quality of resources available to an economy.
- 1. Decrease in costs of factors of production, due to any reason, will shift the AS rightwards and vice versa.

Changes in Macroeconomic Equilibrium

2. Moreover, any increase in quantity or quality of resources will also cause a rightward shift in AS and vice versa.

Changes in Macroeconomic Equilibrium



Changes in Macroeconomic Equilibrium

- Due to economic and / or non-economic variables changes in Aggregate Demand components result in **shifts in Aggregate Demand curve.**

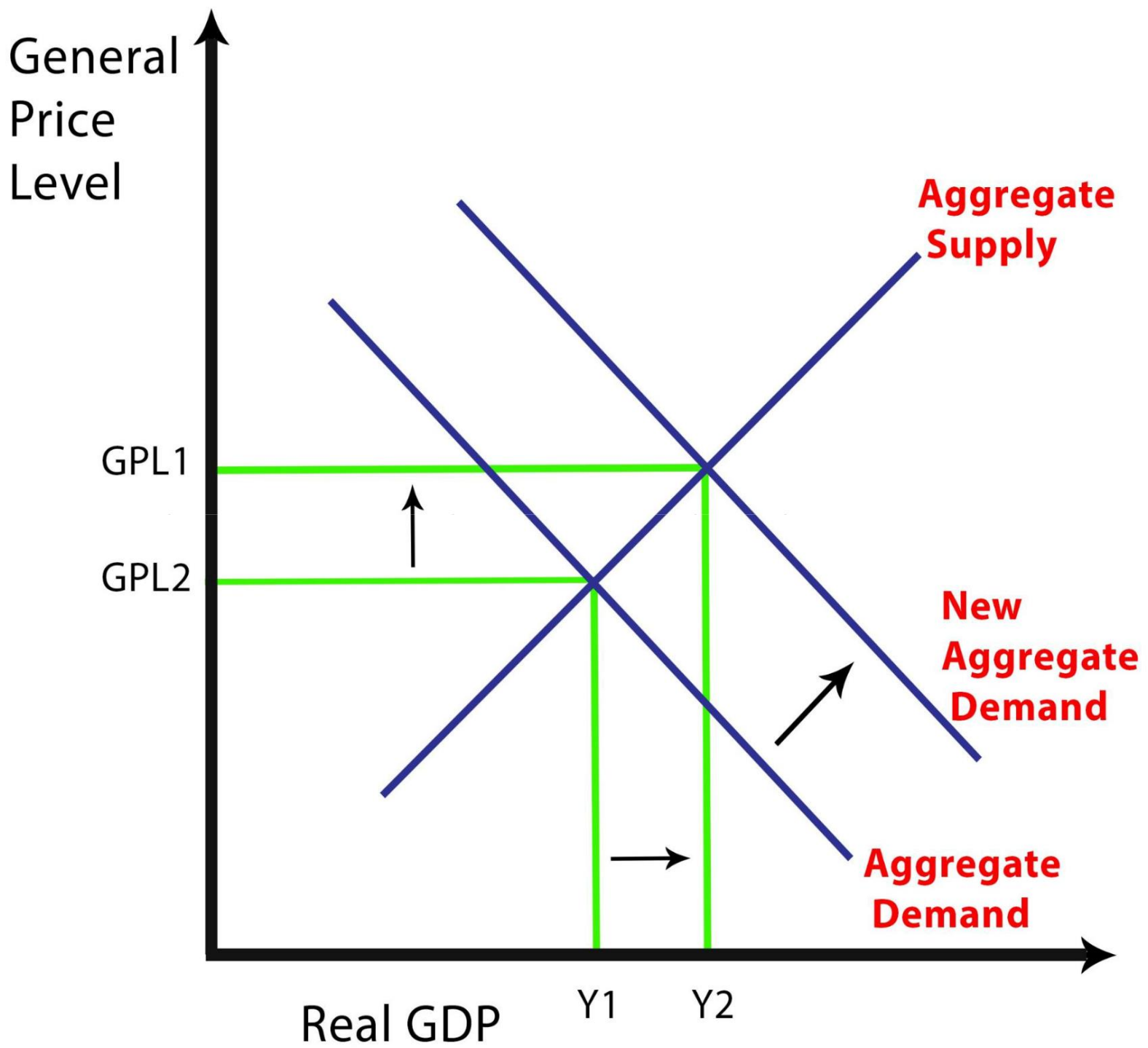
Changes in Macroeconomic Equilibrium

- Increased investment, government spending and higher net exports will result in rightward shift in economy's aggregate demand and similarly decrease in any of these components will cause the curve to shift leftwards.

Changes in Macroeconomic Equilibrium

- Changes in general price level results in movement along Aggregate Demand and Aggregate Supply Curves.

Changes in Macroeconomic Equilibrium



Difference between Short and Long Run Aggregate Supply Curves

- The upward sloping aggregate supply that we have seen so far is **Short Run Aggregate Supply (SRAS)** which is different from **Long Run Aggregate Supply (LRAS)**.

Difference between Short and Long Run Aggregate Supply Curves

- Unlike short run aggregate supply that is responsive to changes in economies' general price level and at higher prices producers are willing to produce more, LRAS can is a straight vertical line that does not depend on economy's price level meaning perfectly price inelastic demand.

Difference between Short and Long Run Aggregate Supply Curves

- *Short Run in economics is defined as certain time period during which at least one factor of production is fixed. Long Run is the time after short run in which all of economics factors of production are variable.*

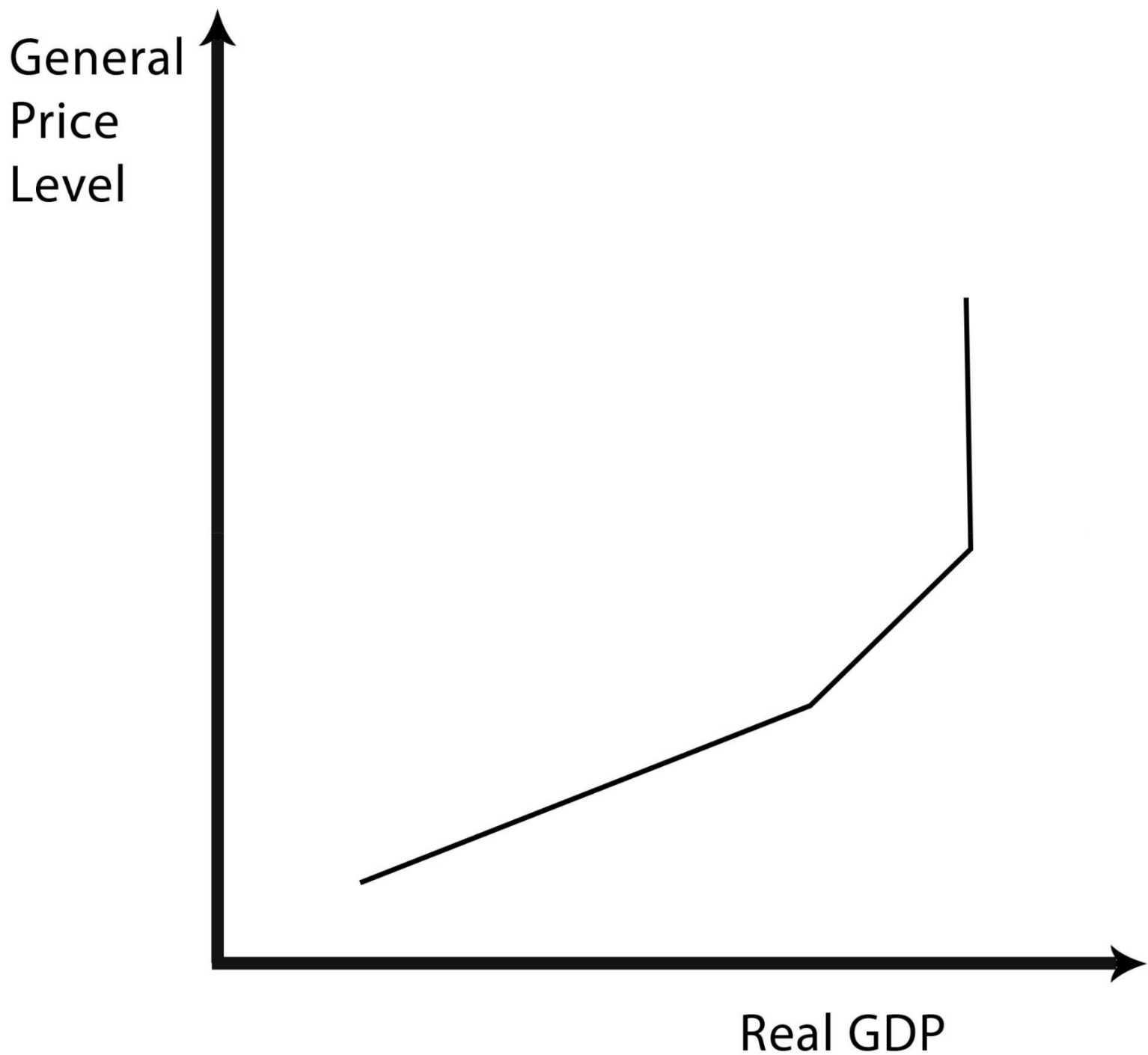
Difference between Short and Long Run Aggregate Supply Curves

- Therefore unlike short run, in the long run all economies have the ability to achieve **their full / maximum production potential** but economists have different opinion on whether economies will always be able to exploit their maximum production potential in Long Run or not.

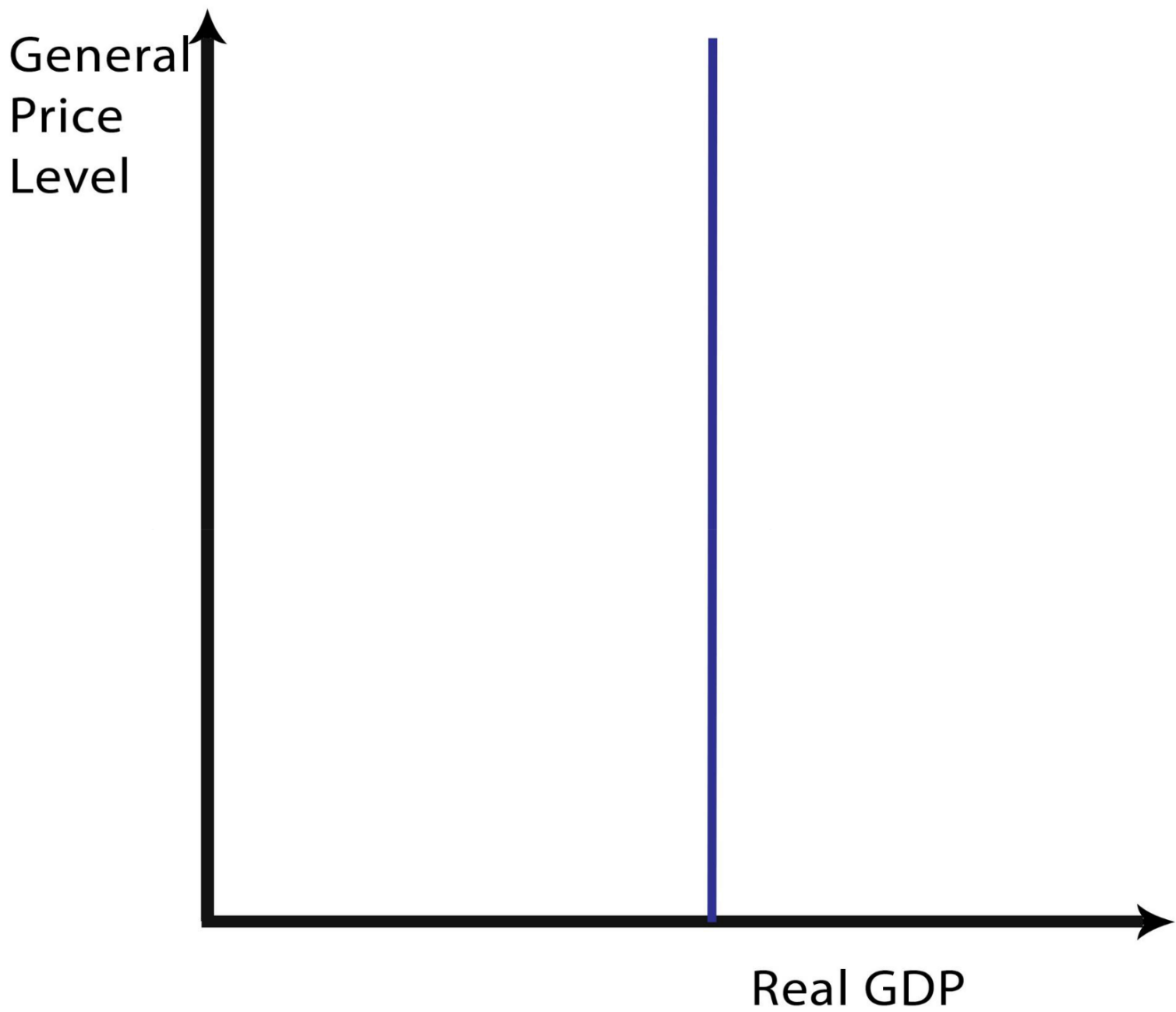
Different views about LRAS

- **Keynesian and Classical** are two major schools of economic thought that have over time made significant contributions to economics literature.
- These schools of economic thought have different opinions concerning the shape of economies Long Run Aggregate Supply Curve (LRAS).

Keynesian Long Run Aggregate Supply



Classical Long Run Aggregate Supply



Keynesian versus Classical School of Economic Thought

- Unlike **Keynesians** that claim that economies can stay out of equilibrium in long run, Classical school of economic thought argues that all economies will achieve long run equilibrium given there is no government intervention.

Keynesian versus Classical School of Economic Thought

- Based upon this major ideological difference, **Keynesians** advocate for active government involvement in market operations. But Classical economist do not advocate for government intervention in the market.

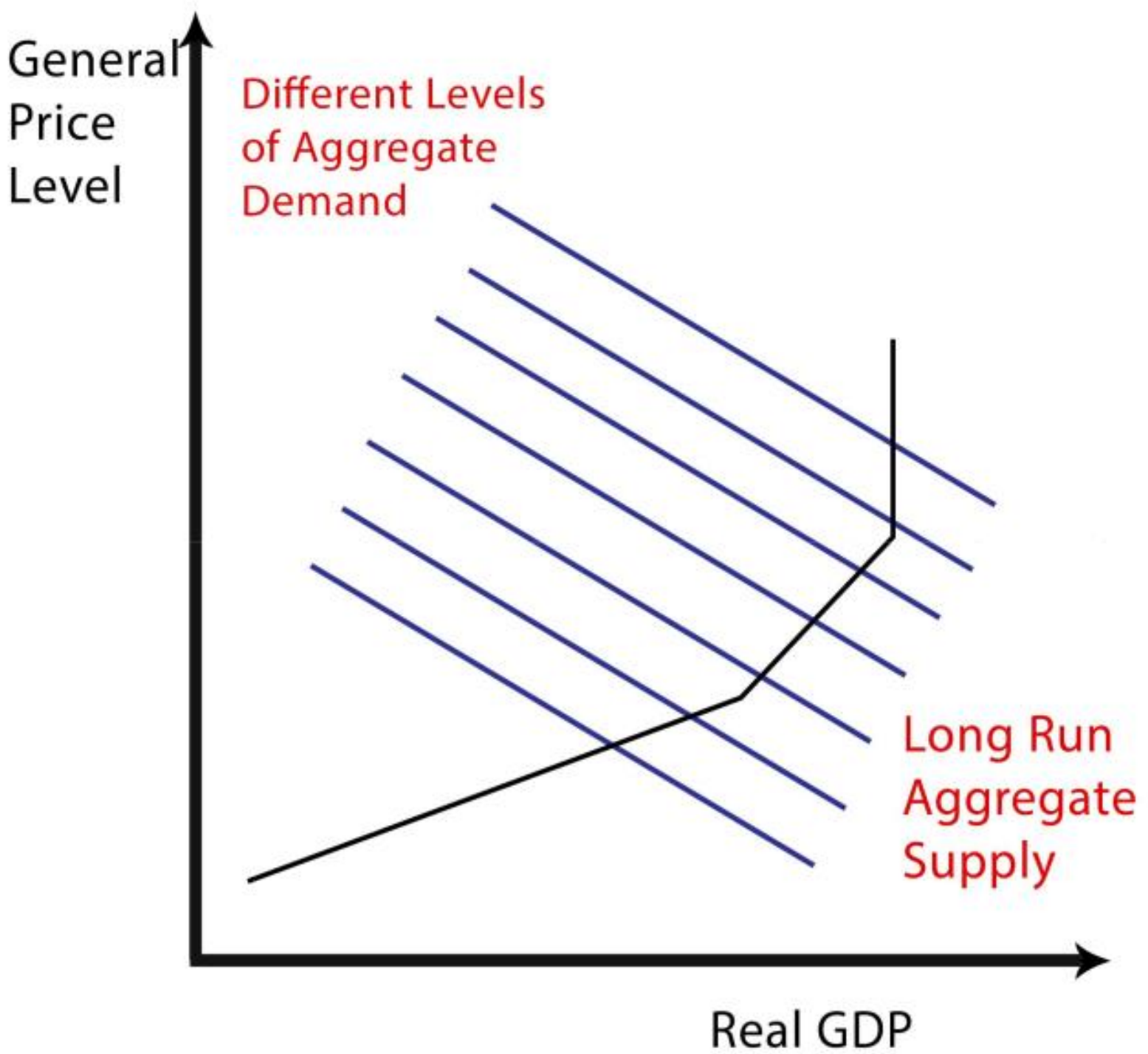
Keynesian versus Classical School of Economic Thought

- Hence according to Keynesian economists, an economy can operate at any part of its long run aggregate supply

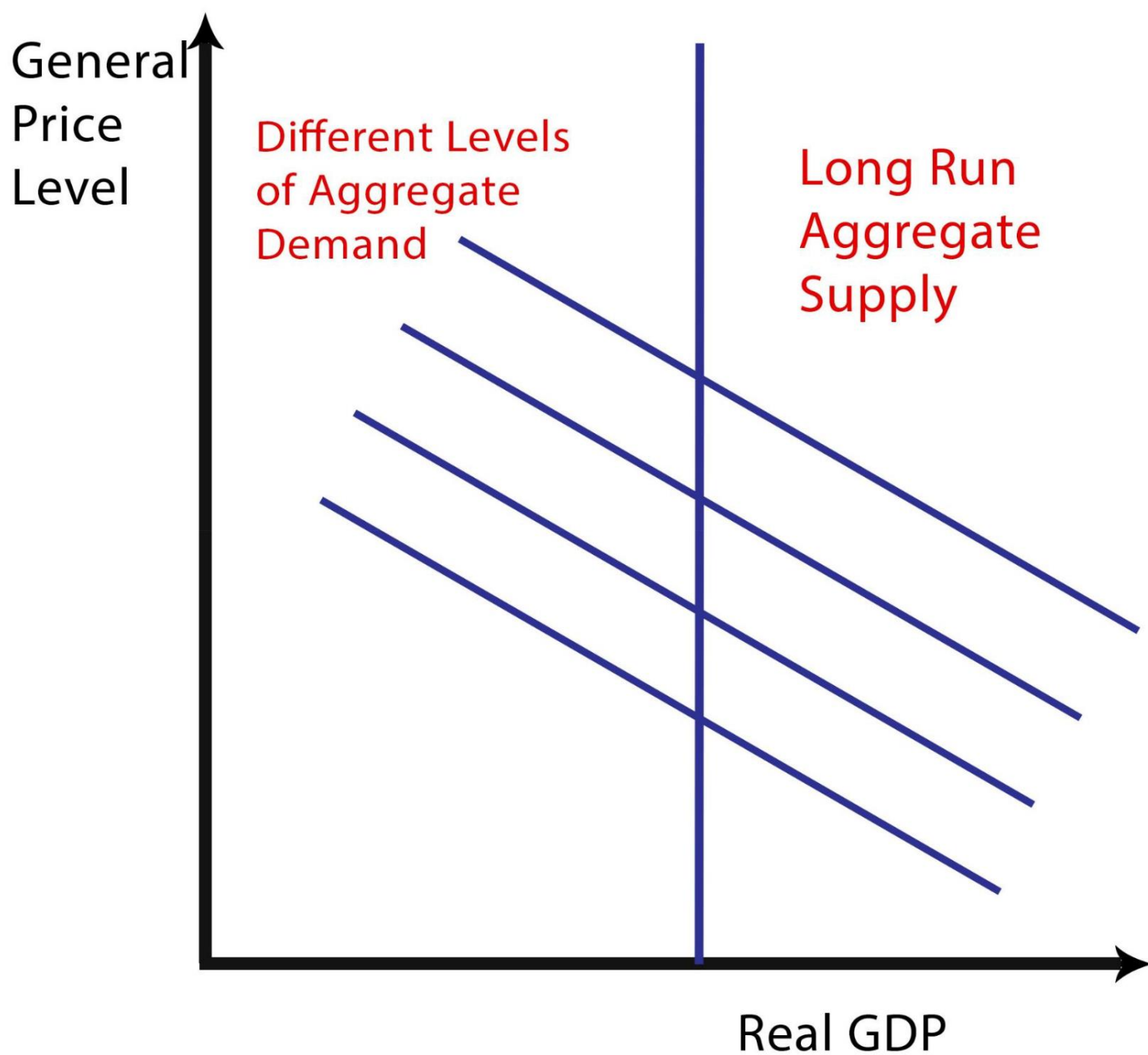
but according to Classical economists, all economies will operate at the **vertical part of their aggregate supply curves.**

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Keynesian Long Run Aggregate Supply



Classical Long Run Aggregate Supply



Changes in Economies' Long Run Aggregate Supply Curves (LRAS)

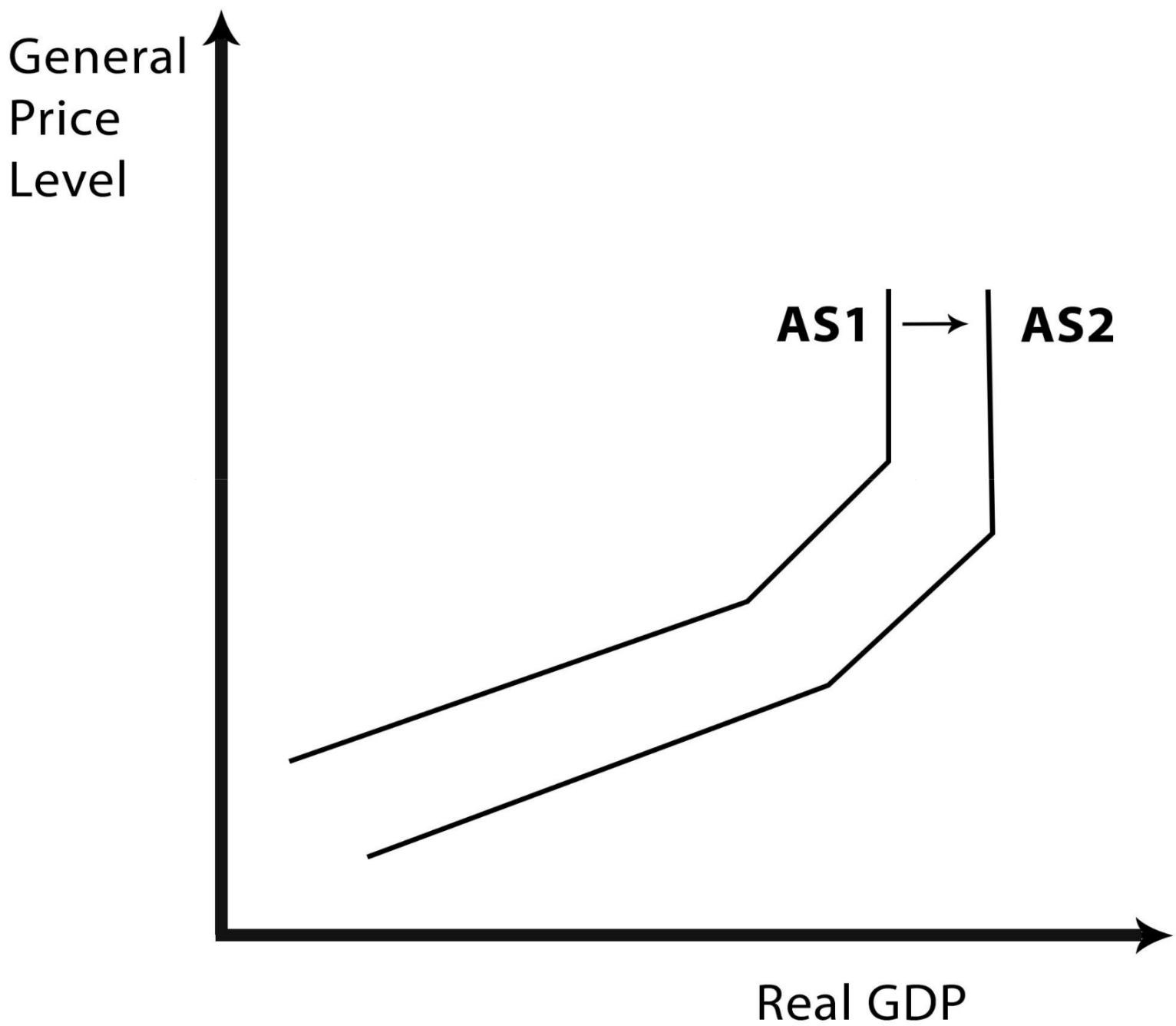
Changes in economies' long run production potential will cause shifts in their LRAS curves.

1. **Improvement in economies' factor endowments** meaning improvement in quality and / or quantity of resources will cause their **LRAS to shift forward** and vice versa.

Changes in Economies' Long Run Aggregate Supply Curves (LRAS)

- Note: Unlike SRAS that is affected by 2 factors namely changes in cost of production and changes in factor endowments, LRAS is ONLY affected by changes in factor endowments and not by costs of production.

Keynesian Long Run Aggregate Supply



Keynesian Long Run Aggregate Supply

