Quadrant II – Transcript and Related Materials

Programme: Bachelor of Commerce (S.Y.B.Com)

Subject: Economics

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Paper Title: Macroeconomics (GE 4)

Unit: I

Module Name: Determination of Aggregate Demand; Shifts in Aggregate Demand

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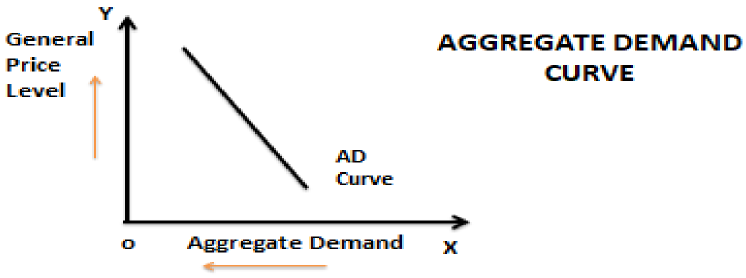
Transcript

DETERMINANTS OF AGGREGATE DEMAND AND SHIFTS IN AGGREGATE DEMAND

We are familiar with the concept of Demand and Supply in micro economics. Demand here would mean the demand for a particular commodity at a given price. The relationship between the quantity demanded of the commodity and the price is inverse. At a higher price, the consumer will demand less of the commodity and at a lower price the consumer will purchase more of the product. This relationship between price and quantity of the commodity demanded is depicted by a downward sloping demand curve. In the case of microeconomics, the term demand is used in reference to a single product and its given price.

On the other hand Aggregate demand is a macroeconomic concept and it implies the overall or total demand in the economy. The AD curve is also downward sloping. On the X and Y axis however is measured total output and the general price level in the economy.



On the X and Y axis are measured output and the general price level respectively. The Aggregate Demand Curve i.e AD Curve is downward sloping. It has a negative slope an inverse relationship between the general price level and the total demand for output. When the general price level increases, the total demand for output decreases and vice – versa.

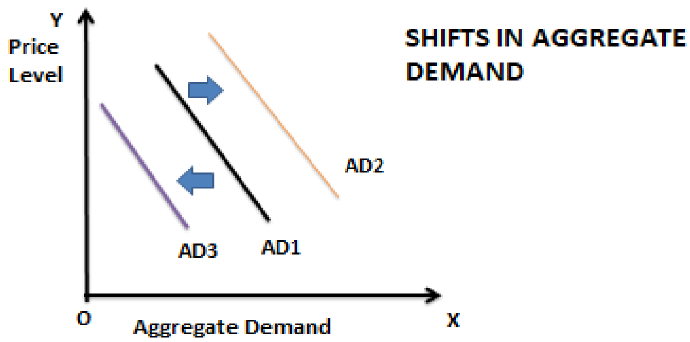
Causes of the shifts in the AD Curve

- ✓ **Private Consumption:** Ceteres Paribus, if price levels fall, then the people will automatically have the capacity to buy more goods. This will lead to an increase in the total output. This will lead to a outward shift in the AD Curve. All other things being equal, if prices rise, then people will be able to buy less quantity of goods with the same amount of money. Aggregate demand will automatically fall and the AD Curve will shift inwards.
- ✓ **Private Investment:** Other things being equal, if prices rise, people will be exhausting their money on existing consumption and their savings will automatically decrease. And the financial sector will now receive less savings which will reduce the supply of loanable funds and make loans now costlier. Interest rates will increase and the firms at large will now borrow less for the purpose of investment. When investment declines, total demand will decline leading to an inward shift in the AD Curve. On the other hand if prices decline, people will have a greater propensity to save. The savings in the financial system will increase leading to more supply of funds at lower costs. With a fall in the interest rates, more investment will take place leading to larger output/Real GDP. This will cause the AD Curve to shift outwards.

- ✓ **Government Consumption**: The Government is the single largest consumer of goods and services. Any increase in Government demand will lead to a shift in the AD Curve to the right. On the other hand, if government demand falls, the AD Curve will shift inwards.

  Furthermore, any increase in government spending will automatically lead to an expansion in money supply in the economy, augment peoples purchasing power and have a positive impact on AD. An increase or decrease in Government spending will therefore lead to shifts in the AD curve.
- ✓ **Net Receipts from abroad:** likewise with an increase in the inflows of net receipts from abroad, the AD Curve will shift to the right. If net receipts(X-M) decline, the AD Curve will shift to the left.

  In the words of **Lipsey and Chrystal**, *"A rise in the amount of desired private consumption, investment, government consumption or net export expenditure that is associated with each level of GDP, shifts the AD Curve to the right. A fall in any of these expenditures shifts the AD Curve to the left".*



AD1 is the original Aggregate Demand Curve. If for example there is a decline in the price level or firms invest more or if there is an increase in government spending, these factors will lead to an increase in aggregate demand and a consequent shift of the AD Curve to AD2. On the other hand, if the general price level increases or investment demand declines or there is a contraction in money supply due to reduction in government expenditure, this will result in a decrease in aggregate demand causing the AD Curve to shift to AD3.

Thus if there is an increase in Aggregate Demand, the AD Curve will shift outwards whereas if there is a decrease in Aggregate Demand, the AD Curve will shift inwards.