Aggregate demand and supply

Key terms:

Aggregate demand - the total spending in an economy consisting of consumption, investment, government expenditure and net exports. This is calculated by the formulae: *C+G+I+(X-M).*

Private consumption (C) - spending by households on domestic consumer goods and services over a period of time.

Government spending (G) - public sector spending whether by national or local governments. This includes spending on public services such as health, education, public transport, defence and infrastructure projects.

Investment (I) - expenditure by firms on capital equipment and is an injection into the economy.

Net exports (X-M) - the value of exports (ie export revenues) - value of import (ie import expenditures).

Aggregate supply - also known as total output, is the total supply of goods and services produced within an economy at a given time and at an overall price level.

Supply shock - an unexpected event that impacts on the supply of a product or commodity, resulting in a sudden change in price. Supply shocks are generally negative, resulting in a sudden fall in supply but can also sometimes be positive, leading to increased supply.

Price level / average price level - the average of current prices across the entire spectrum of goods and services produced in the economy.

Activity 1

Draw a normal demand and supply curve for a good or service. Now consider how this might look if you were drawing a demand and supply curve for the whole economy? Instead of price write average price and instead of quantity label the horizontal axis real GDP, real national output or real national income.

Now consider what determines the level of aggregate demand and supply within any economy?

Activity 2

Using the information contained of the short video answer the questions that follow:

(a) What is the formulae for calculating AD in the economy?

(b) Explain the inverse relationship between average price level and quantity demanded.

(c) Provide examples of durable and non-durable goods.

(d) Why are individuals 'investing' in the stock market or placing their savings in bank deposits not included under *investment* in AD calculations?

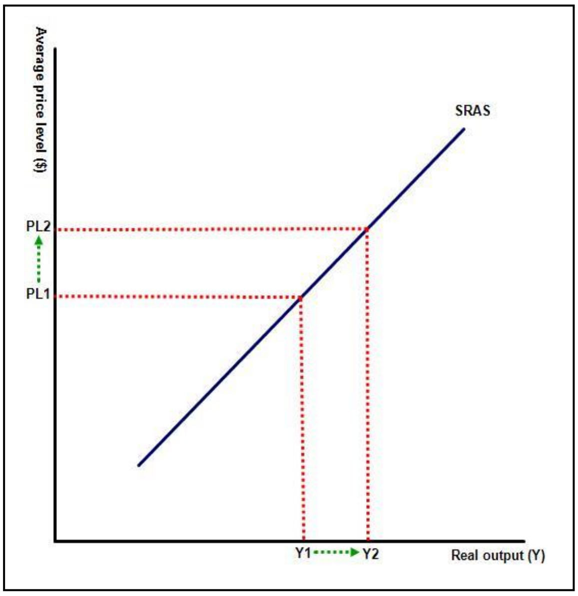
(e) What is net investment spending?

(f) How is the external balance (X-M) calculated?

(g) What is the opportunity cost of any investment decision.

(h) The government is forced to cut spending on services and public works. Outline the consequence of this for aggregate demand in the economy?

Activity 3: Aggregate supply



Use the information on the following short video to complete the questions that follow:

1. The diagram to the left illustrates a short run AS curve.

(a) Explain the relationship between average price level and the aggregate supply of goods and services in the economy?

(b) Explain what happens to SRAS when real output in the economy moves from Y1 to Y2.

Activity 4: Shifts in the AS curve

An economy is in equilibrium at PL1 and Y1. Calculate the new equilibrium as a result of the following supply shocks:

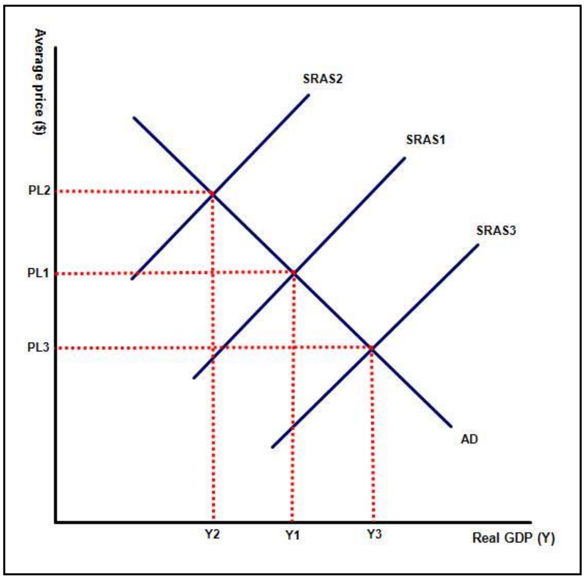
1. The government raises the level of minimum wage in the country, above the rate of productivity growth.

2. A sharp fall in oil prices, resulting from a glut in global supply.

3. A significant fall in the value of a nation's currency compared to its main trading partners.

4. A period of very low interest rates, over a sustained period of time.

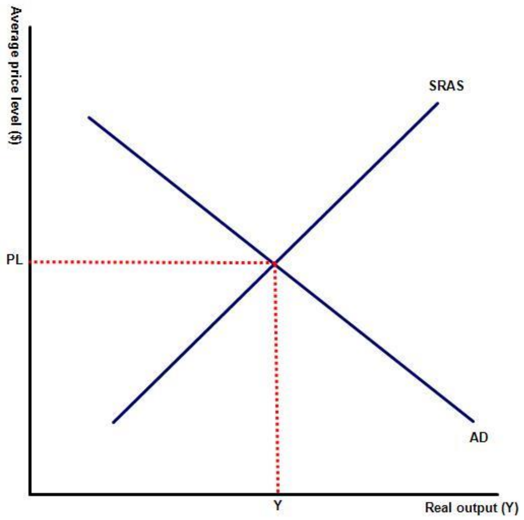
5. A rise in the rate of sales tax in the economy.



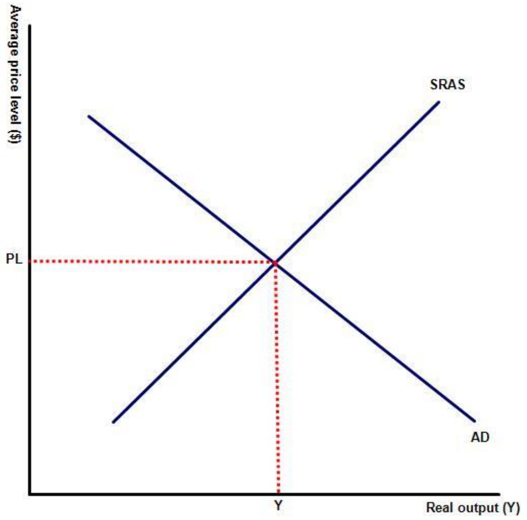
Activity 5

Illustrate the effect on either AS and / or AD of the following:

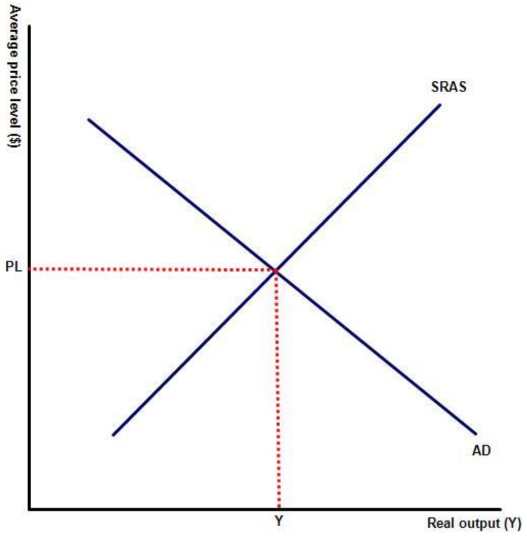
A rise in income tax rates in the economy



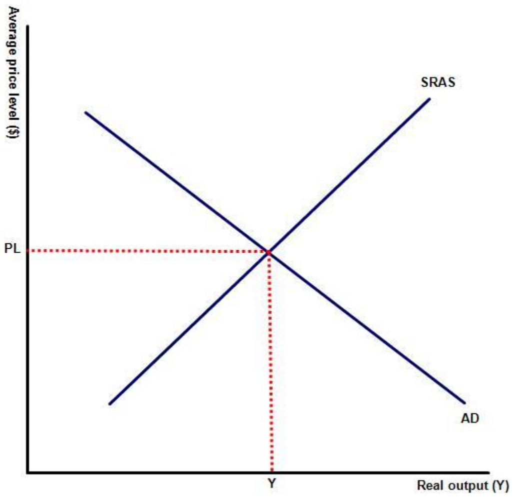
A fall in oil prices



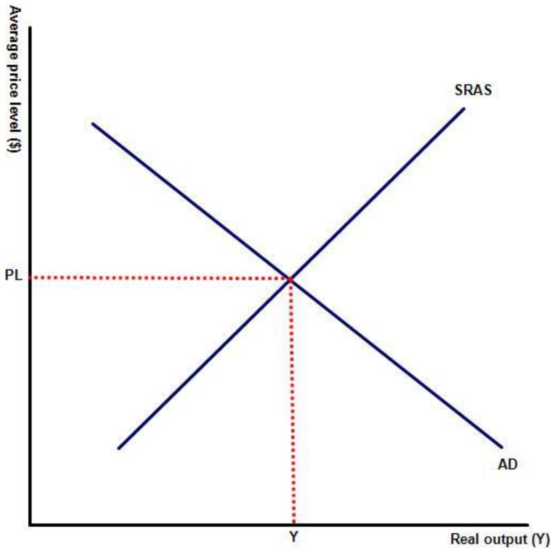
A rise in interest rates in the economy



A rise in minimum wage



A rise in the value of the currency



A fall in corporation tax rates