Lecture 3 Notes

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1. Aggregate Expenditure (AE)
   (a) John Maynard Keynes analyzed the short run relationship between the aggregate expenditure and GDP in his book, "*The General Theory of Employment, Interest, and Money*" (1936)
   (b) There is a fall in spending and production during a recession
   (c) To explain the business cycle including recession, we must understand the components of aggregate expenditure
   (d) The aggregate expenditure equation consists of four components:
      i. $AE = C + I + G + NX$
      ii. Aggregate expenditure is composed of expenditure by households (C), expenditure by firms (I), expenditure by government (G), and expenditure by foreigners minus domestic consumers (NX)
   (e) The Components in Detail:
      i. Consumption (C)
         A. An expenditure on goods and services by households and is the highest part of aggregate expenditure (70%)
         B. Consists of spending on nondurables, durables, and services
         C. Factors that influence consumption:
            - Disposable personal income (current income)
              - DPI is the amount of income that is available for consumption after tax (adjustable income)
              - $DPI = PI - T$, where PI is personal income, and T is the income tax
              - Personal income = GDP + transfer payments + interest payments - retained earnings
              - Transfer payments are government spending on social welfare to households (ex. unemployment insurance, social security, disability insurance, etc.)

  - Interest payments are households' interest income from holding government bonds
  - Retained earnings are the earnings from stocks that are reinvested to firms instead of paying back to stockholders as dividends
  - There is a positive relationship between DPI and consumption, ceteris paribus
  - The positive relationship between the two is shown as positive marginal propensity to consume
  - The marginal propensity to consume (MPC) is the increase in consumption as a result of increase in DPI by $1, and ranges between 0 and 1
- Wealth
  - The value of assets minus the value of liabilities
  - Asset is anything of value owned by a person (ex. saving account, stocks, bonds, real estate, etc.)
  - Liability is anything of value owed by a person (ex. mortgage loans, car loans, credit card debts)
  - There is a positive relationship between wealth and consumption, ceteris paribus (with higher savings, households tend to consume more)
- Expected income (future income)
- Price level
- Interest rate