UNIVERSITY OF THE PEOPLE

BUS 2203-01 Principles of Finance 1 – AY2024-T2

Learning Journal Unit 8

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Chapter 23: Aggregate supply and demand, the growth diamond, and financial shock

23.1 Aggregate demand

“Aggregate demand is a measurement of the total amount of demand for all finished goods and services produced in an economy. Aggregate demand is commonly expressed as the total amount of money exchanged for those goods and services at a specific price level and point in time” (Kenton, 2023). The aggregate demand (AD) curve shows the total quantity of final goods and services demanded at different price levels. It slopes downward because a lower price level leads to higher real money balances, lower interest rates, more investment spending, and increased net exports due to a weaker domestic currency. The AD curve shifts outwards when the money supply, consumption spending, investment spending, government spending, or net exports increase.

23.2 Aggregate supply

“Aggregate supply, also known as total output, is the total supply of goods and services produced within an economy at a given overall price in a given period. It is represented by the aggregate supply curve, which describes the relationship between price levels and the quantity of output that firms are willing to provide. Typically, there is a positive relationship between aggregate supply and the price level” (Kenton, 2022). The short-run aggregate supply (AS) curve shows the total quantity of final goods and services supplied at different price levels. It slopes upwards because sticky wages and input prices mean higher market prices increase business profits and hence production. The AS curve shifts left when output rises above potential GDP due to tightening of the labor market or higher inflation expectations. It shifts right when output is below potential GDP. Supply shocks also shift the AS curve.

23.3 Equilibrium analysis

In the short run, the economy moves to the point where the AD and short run AS curves intersect to determine equilibrium income and the price level. In the long run, the vertical aggregate supply (ASL) curve determines the economy's potential GDP level, with shifts in short run AS allowing temporary deviations from this level. Views differ on how long it takes for the economy to revert to its long-term equilibrium.

23.4 The growth diamond

The growth diamond model suggests economic growth depends on having:

(1) good governance/institutions (home plate); (2) efficient financial systems (first base); (3) entrepreneurs (second base); and (4) modern business management practices (third base). Countries/regions must develop each base in sequence to achieve sustainable growth.

23.5 Financial shock

"A financial shock is an unexpected disturbance which originates from the financial sector and has a significant effect on an economy (e.g. national, regional, or global). The term is largely used to refer to events which have negative impacts" (Hubrich et al., 2013). Financial stocks like higher uncertainty, rising interest rates, balance sheet deterioration, and banking crises increase problems associated with asymmetric information. This constrains lending, investment, and consumption, reducing economic activity. Central banks try to counter financial shocks by acting as lenders of last resort. If too severe, recessions can turn into depressions.

Chapter 24: Monetary policy transmission mechanisms

24.1 Modeling reality

Structural models that trace the specific mechanisms linking monetary policy changes to economic variables are superior to reduced-form models that just link the two directly. Structure models help confirm causal relationships and identify breakdowns.

24.2 How important is monetary policy?

Milton Friedman provided timing, statistical and historical evidence that money supply changes influence later changes in economic activity. Historical evidence on exogenous money supply changes was most persuasive. This convinced early Keynesians that money does matter for GDP.

24.3 Transmission mechanisms

Specific monetary policy transmission mechanisms describe how interest rates, asset prices, credit conditions and asymmetric information link changes in monetary policy to economic activity. Identifying these mechanisms helps central banks understand the impact of their policies.

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