

Chapter 29: Aggregate Demand and Aggregate Supply

Just as supply and demand helped us to understand how prices and quantities change for individual products or in specific industries, aggregate supply and aggregate demand help to explain how and why real GDP and price levels change in the national economy. Chapter 29 explores the Aggregate Supply-Aggregate Demand (AS-AD) model, bringing together the concepts of real GDP, inflation, unemployment, and inflationary and recessionary gaps that have been discussed throughout the preceding macroeconomics chapters.

Aggregate demand illustrates the total amount of demand for American products at each price level. The aggregate demand curve slopes downward for three reasons. The real balances effect explains that higher price levels reduce the real value of assets, so households reduce spending. The interest rate effect shows that when higher prices and the resulting demand for money cause interest rates to rise, households and firms are less likely to borrow, reducing spending and investment. With the foreign purchases effect, an increase in U.S. price levels (compared to foreign price levels) leads Americans and foreigners to buy fewer U.S. products in favor of the now relatively less expensive foreign products. On the other hand, all three effects serve to increase the quantity demanded when price levels fall.

Aggregate demand shifts in response to changes in all four sectors of the economy. Consumer spending can change as a result of changes in consumer wealth, expectations about the economy, household borrowing, and personal taxes. Investment spending changes in response to fluctuations in real interest rates and expected returns on investment, caused by changes in expected business conditions, technology, excess capacity, and business taxes. The government sector affects aggregate demand through changes in spending, and net exports affect aggregate demand as a result of changes in national incomes and exchange rates.

Aggregate supply illustrates the relationship between the price level and the quantity of products produced by all firms in the economy. In the immediate short run, the aggregate supply curve is horizontal because both input and output prices are fixed. In the short run, the aggregate supply curve is upward sloping because while input prices are fixed, output prices are flexible. The increased profit at higher prices can entice firms to increase production. The long-run aggregate supply curve is vertical, because when both input and output prices are fully flexible, firms will produce at full employment output. Unless otherwise specified, aggregate supply generally refers to the upward-sloping curve.

The aggregate supply curve shifts as a result of changes in input prices, worker productivity, taxes, subsidies, and government regulation. Equilibrium output and equilibrium price are established at the point where aggregate supply equals aggregate demand.

If the economy is producing at full-employment output, an increase in aggregate demand causes demand-pull inflation; both prices and output increase, and an inflationary gap illustrates the amount by which current output exceeds full-employment output. The multiplier effect of the increase in demand is reduced by the increase in price level. A decrease in aggregate demand causes a recessionary gap and an increase in cyclical unemployment. But because prices and wages are downwardly

“sticky,” the multiplier works at full strength, so the entire effect of the decreased demand accrues to output and employment.

Decreases in aggregate supply cause cost-push inflation. As costs of production rise, firms reduce output and pass those increased costs on to consumers in the form of higher prices. An increase in aggregate supply increases national output without causing an increase in the price level.

Material from Chapter 29 consistently appears in a significant number of multiple-choice questions on the AP Macroeconomics Exam. In addition, free-response questions involving the AS-AD model have appeared on nearly every AP Macroeconomics Exam. It is very important to understand all of the factors that can cause changes in aggregate supply and aggregate demand. It is critical to be able to correctly graph the AS-AD model, to identify and illustrate changes in aggregate supply or aggregate demand, and to correctly explain the effects of such changes on national output, employment, and price levels. An understanding of this model is crucial for properly prescribing fiscal and monetary policies to address recessionary and inflationary gaps in coming chapters.