

An Introduction to Aggregate Demand

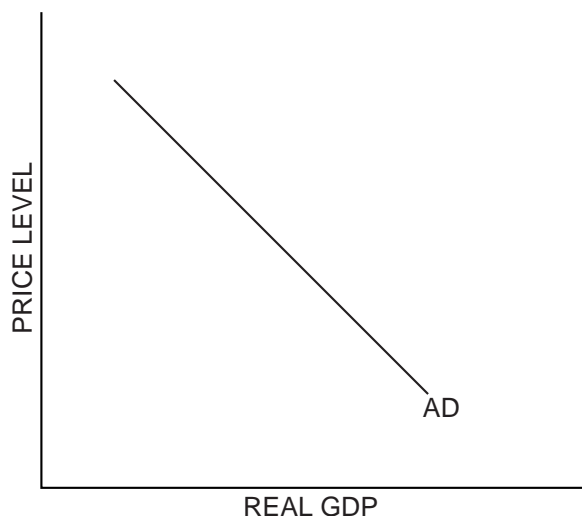
Part A

Why Is the Aggregate Demand Curve Downward Sloping?



Figure 23.1

Aggregate Demand Curve



1. According to the AD curve, what is the relationship between the price level and real GDP?
There is an inverse relationship: the lower the price level, the higher the real GDP or real national output.
2. Explain how each of the following effects helps explain why the AD curve is downward sloping.
 - (A) Interest rate effect *A lower price level decreases the demand for money, which decreases the equilibrium interest rate and increases investment and interest-sensitive components of consumption and, therefore, the real output.*
 - (B) Wealth effect or real-balance effect *As the price level falls, cash balances will buy more so people will spend more, thus increasing the real output.*
 - (C) Net export effect *A lower U.S. price level means prices for goods produced in the United States are lower relative to the prices in foreign countries. Thus, people will buy more U.S.-produced goods and fewer foreign produced goods. This increases net exports, a component of real GDP.*

3. In what ways do the reasons that explain the downward slope of the AD curve differ from the reasons that explain the downward slope of the demand curve for a single product? *The demand curve for a single product is downward sloping because of diminishing marginal utility and income and substitution effects for the individual at a specified level of income. For macro aggregate demand, the reasons are the interest rate effect, the wealth effect and the net export effect.*

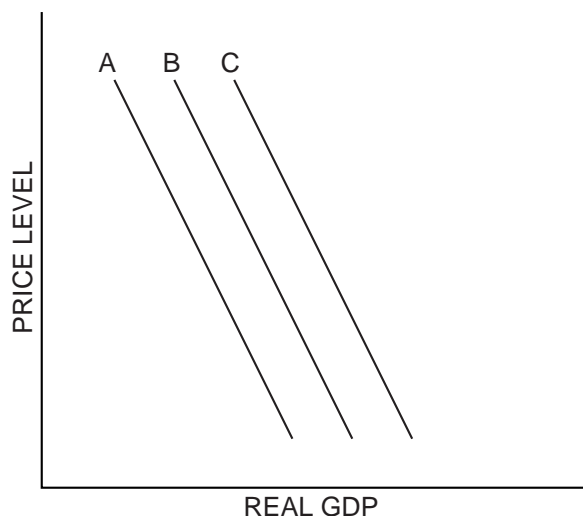
Part B

What Shifts the Aggregate Demand Curve?



Figure 23.2

Shifts in Aggregate Demand



4. Using Figure 23.2, determine whether each situation below will cause an increase, decrease or no change in AD. Always start at curve B. If the situation would cause an increase in AD, draw an up arrow in column 1. If it causes a decrease, draw a down arrow. If there is no change, write NC. For each situation that causes a change in aggregate demand, write the letter of the new demand curve in column 2. Move only one curve.

Situation	1. Change in AD	2. New AD Curve
(A) Congress cuts taxes.	↑	C
(B) Autonomous investment spending decreased.	↓	A
(C) Government spending to increase next fiscal year; president promises no increase in taxes.	↑	C
(D) Survey shows consumer confidence jumps.	↑	C
(E) Stock market collapses; investors lose billions.	↓	A
(F) Productivity rises for fourth straight year.	NC	
(G) President cuts defense spending by 20 percent; no increase in domestic spending.	↓	A

Note: (F) does not shift the aggregate demand curve. We will see that productivity changes affect the aggregate supply curve.