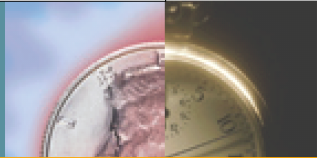


**Year 12 Teaching Points**  
**AE Model**  
**AD/AS Model**



## **The Aggregate Expenditure Model**

- This short-run macro model focuses on the importance of spending in explaining economic fluctuations
- It explains how changes in spending can cause changes in total output (GDP) and employment
- Usually we write GDP as  $C + I + G + (X-M)$
- and AE is also written as  $C + I + G + (X-M)$
- But this is ***NOT CORRECT***

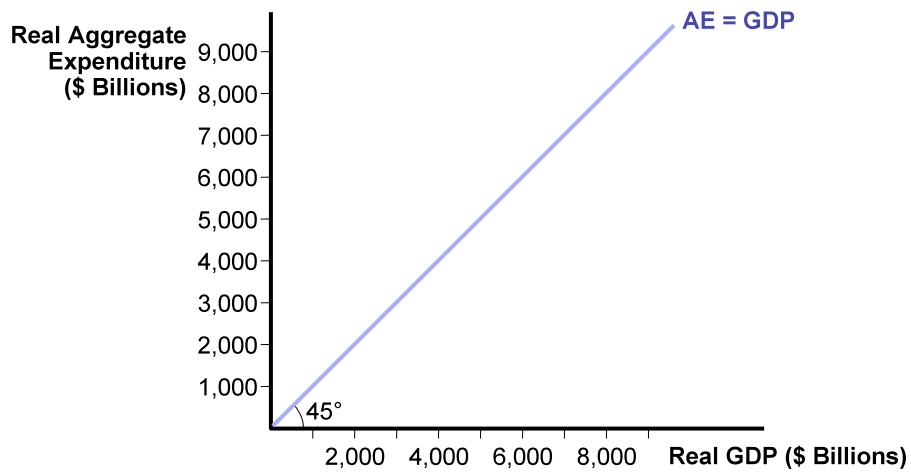
## The Aggregate Expenditure Model

- In GDP, *investment* consists of three components
  - Business spending on plant and equipment
  - Purchases of new homes
  - Accumulation of unsold inventories
- In AE, we define *investment spending* ( $I^P$ ) as
  - Plant and equipment purchases by business firms, and new home construction
  - *Inventory investment* is treated as unintentional – it is *excluded* from the definition of investment spending

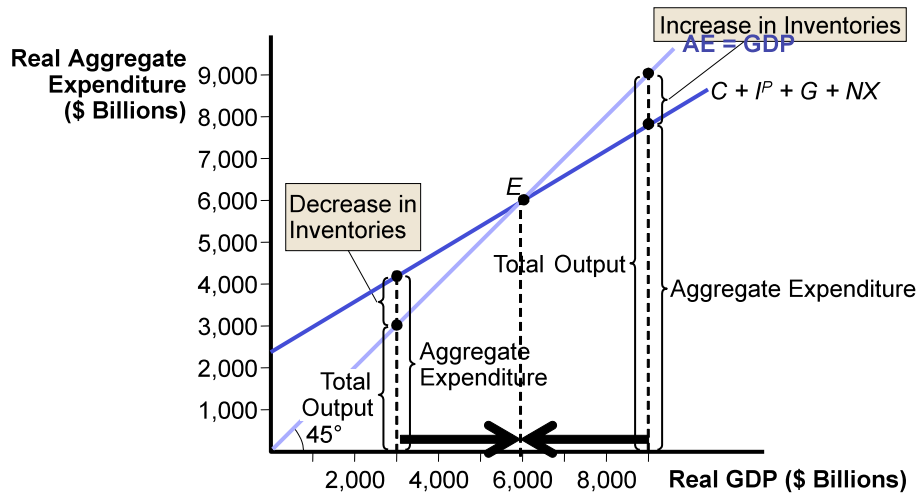
## The Aggregate Expenditure Model

- So
- $GDP = C + I + G + (X-M)$
- While
- $AE = C + I^P + G + (X-M)$
- AE will only equal GDP at equilibrium when inventories equal 0
- If  $AE < GDP$ , inventories increase & GDP ↓
- If  $AE > GDP$ , inventories decrease & GDP ↑

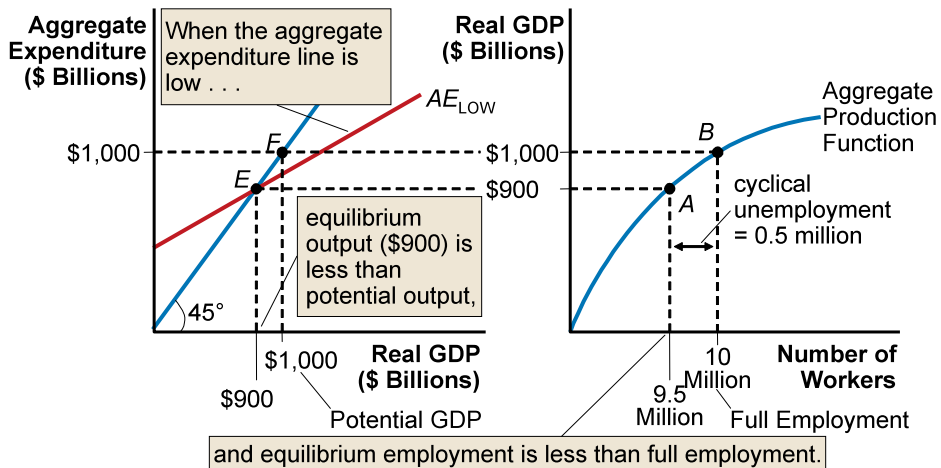
# Determining Equilibrium Real GDP



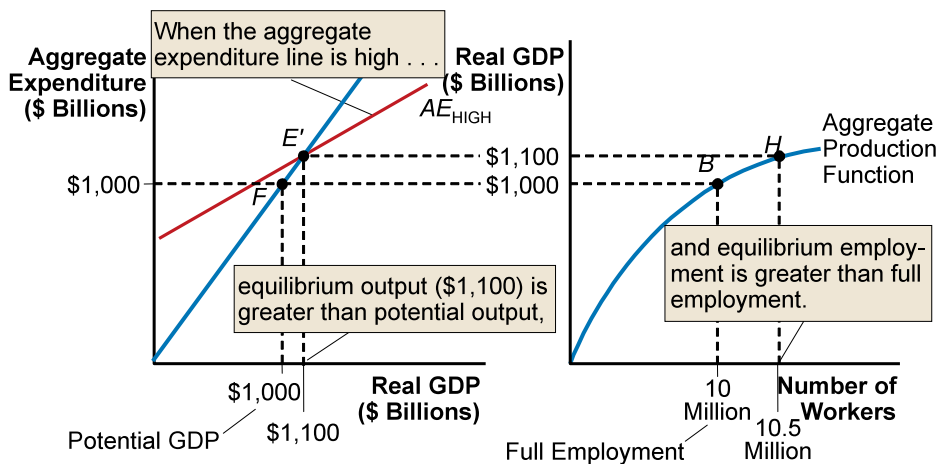
# Determining Equilibrium Real GDP



## Equilibrium GDP Can Be Less Than Full Employment GDP

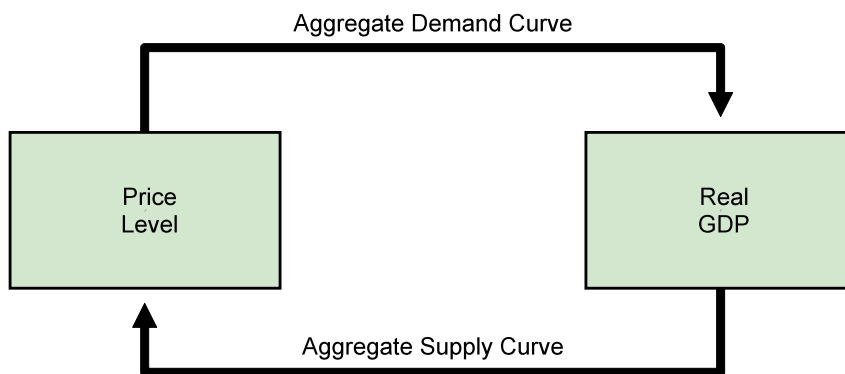


## Equilibrium GDP Can Be Greater Than Full-Employment GDP



# •The AD/AS Model

## The Two-Way Relationship Between Output and the Price Level



## Aggregate Demand

- The **Aggregate Demand** curve shows the equilibrium level of real GDP (where total spending = total output) for each price level.
- It is not simply a 'total spending' curve
- The AD curve is not to be confused with the microeconomic demand curve

## The AD Curve

- The *AD* curve slopes downward for 3 reasons:
  - Wealth effect
  - Interest rate effect
  - International trade effect

# Aggregate Demand

## 1. *Wealth effect*

- An increase in the price level will **decrease** the real value of household wealth & reduce consumption.

## 2. *Interest rate effect*

- An increase in the price level **raises interest rates (increases D for money)** which decreases investment (& C).

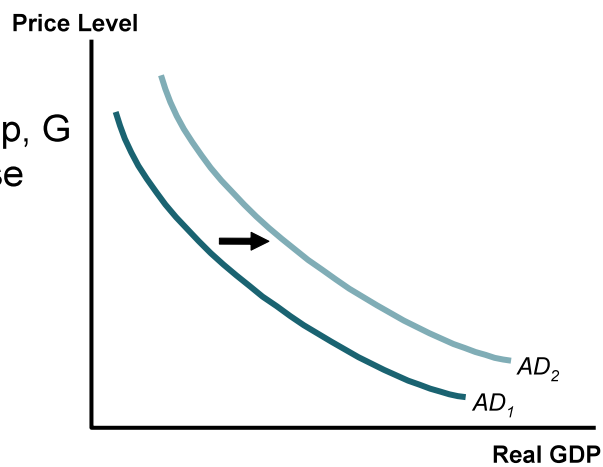
## 3. *International trade effect*

- An increase in the price level causes imports to become relatively cheaper & exports to be more expensive, thus decreasing net exports.

# Shifts of the AD curve

AD will increase if

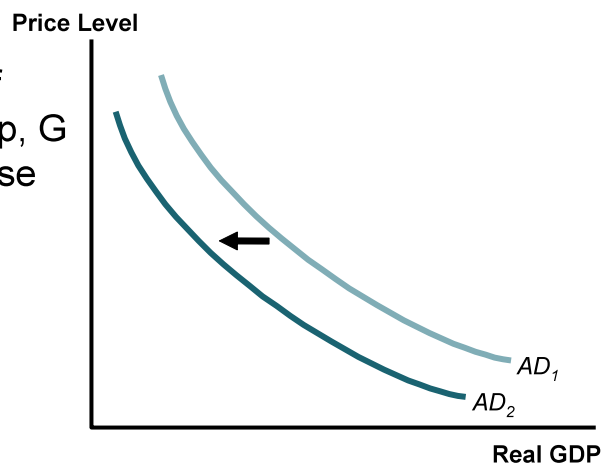
- Autonomous C, Ip, G or net Xs increase
- T is decreased
- RBA lowers i/rs
- \$A depreciates



## Shifts of the AD curve

AD will decrease if

- autonomous  $C$ ,  $I_p$ ,  $G$  or net  $X$ s decrease
- $T$  is increased
- RBA raises  $i/r_s$
- $\$A$  appreciates

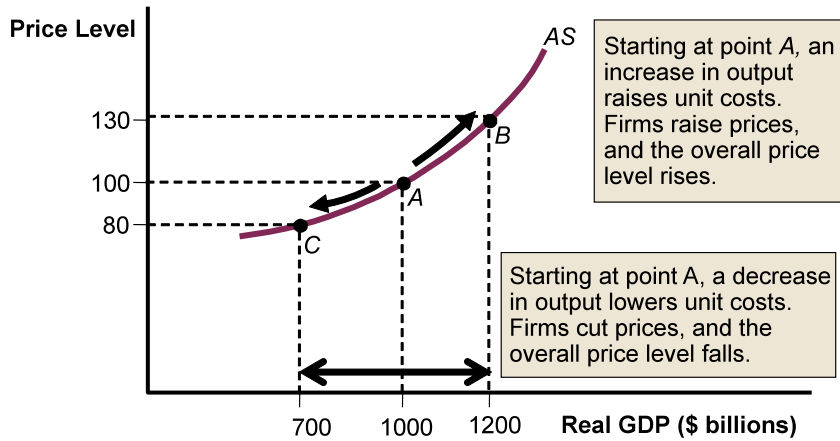


## Aggregate Supply

- The **aggregate supply curve** shows the effect of changes in total output or real GDP on the price level (via changes in unit costs)
- As total output increases
  - greater amounts of inputs may be needed to produce a unit of output
  - price of inputs will rise
- The AS curve should not to be confused with the micro supply curve

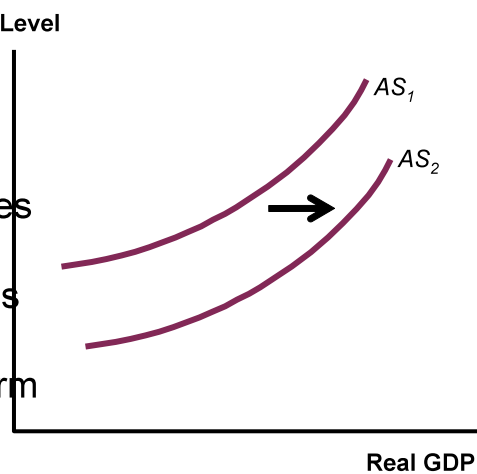


# The Aggregate Supply Curve



# Shifts of the AS Curve

- AS will increase if
- L or K increases
  - Productivity increases
  - Oil prices fall
  - Technology improves
  - Successful microeconomic reform



## Shifts of the AS Curve

AS will decrease if

- L or K decreases
- Productivity decreases
- Oil prices rise
- Drought

