

# Aggregate Supply and Demand

# AS-AD

- Aggregate demand is the sum of all individual's demand curves in the economy.
- Since income is used to buy production, income equals quantity.
- Economic policies that affect aggregate demand are called demand-side policies.
- Fiscal and monetary policies are demand-side policies.

# AS-AD

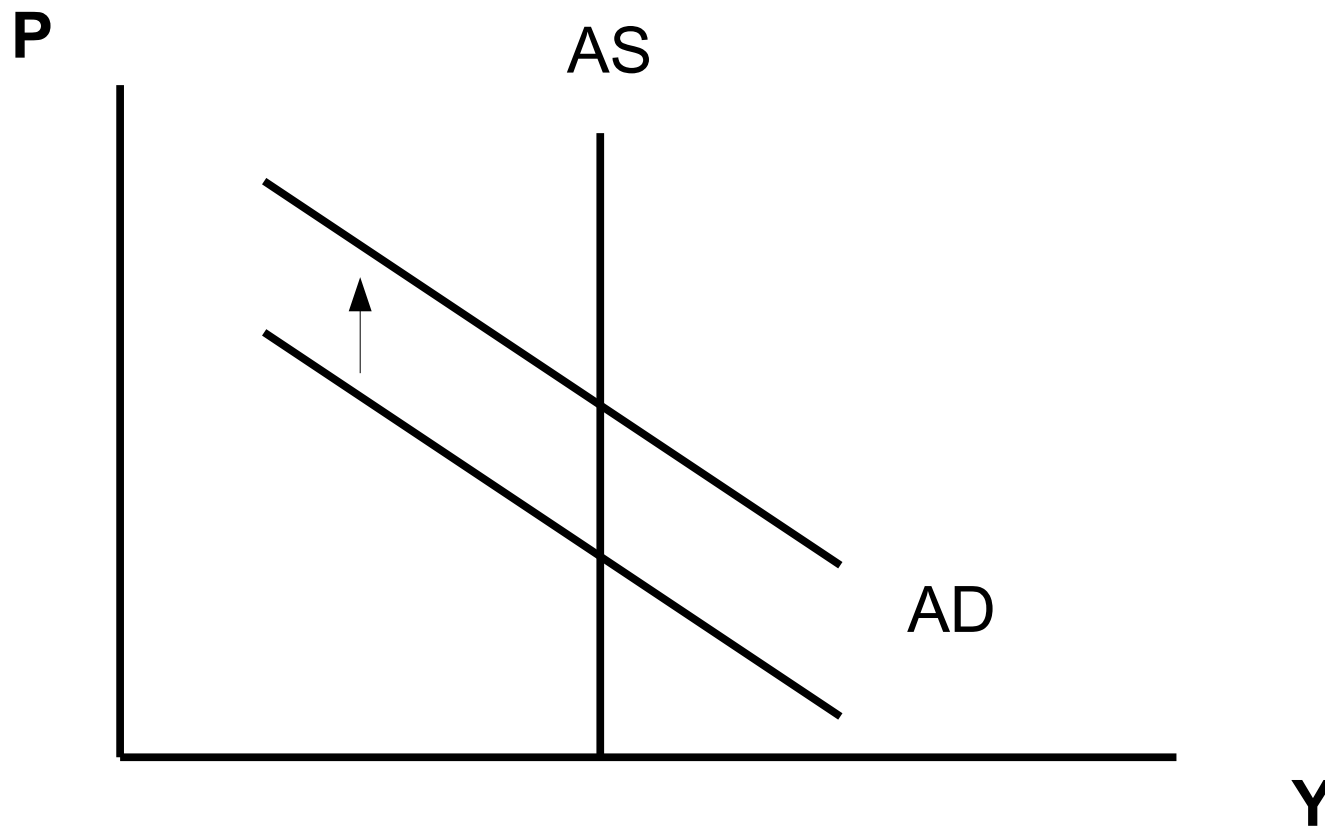
- Expansionary (contractionary) fiscal or monetary policy increase (decrease) aggregate demand.
- The interaction of aggregate supply and demand determines economic equilibrium: price and output.

# Effects of Expansionary Fiscal Policy

## Flexible Wages – Full Employment

- Expansionary fiscal policy expands economic activities through increased government spending and/or reduced taxation which increases aggregate demand in the short run.
- As aggregate demand increase, prices increase, wages also increase but real income remains unchanged so output remains constant. Consequently, employment does not change.

# Effects of Expansionary Fiscal Policy

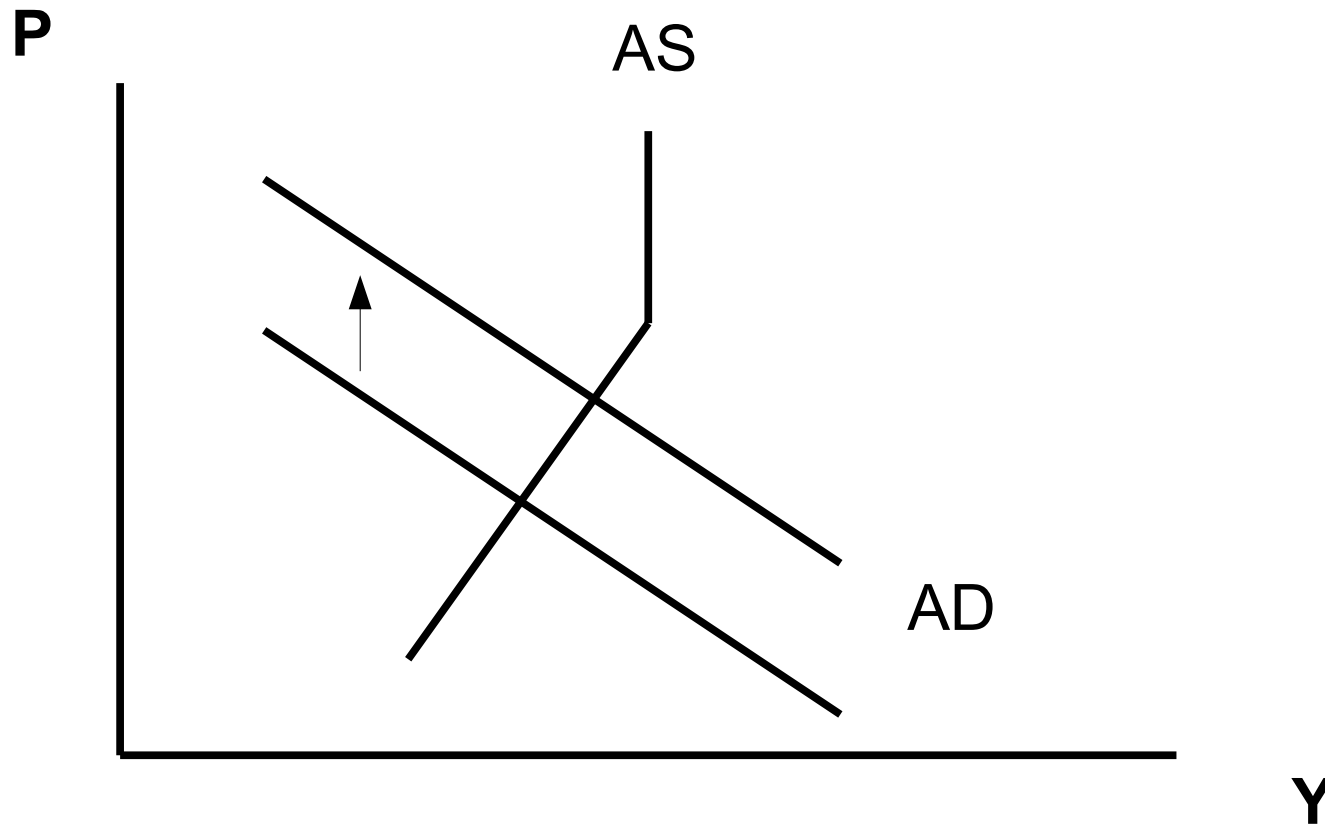


# Effects of Expansionary Fiscal Policy

## Sticky Wages – Unemployment Exists

- Expansionary fiscal policy expands economic activities through increased government spending and/or reduced taxation which increases aggregate demand in the short run.
- As aggregate demand increases, firms hire to increase output. Prices increase, wages do not increase (or do not increase as fast) so real income may decrease at first.

# Effects of Expansionary Fiscal Policy

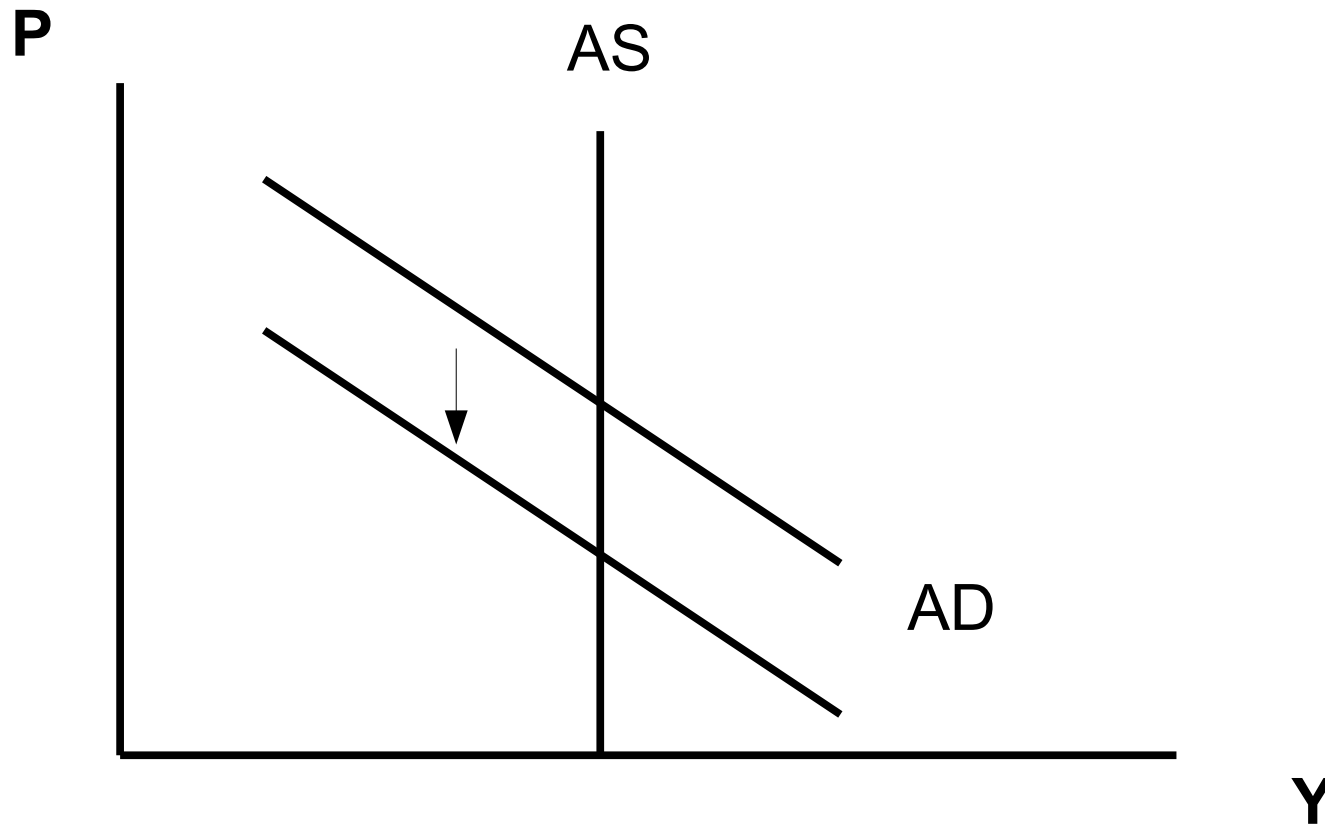


# Effects of Contractionary Fiscal Policy

## Flexible Wages – Full Employment

- Contractionary fiscal policy restricts economic activities through reduced spending and/or increased taxation which decreases aggregate demand in the short run.
- As aggregate demand decreases, prices decrease, wages also decrease but real income remains unchanged so output remains constant. Consequently, employment does not change.

# Effects of Contractionary Fiscal Policy

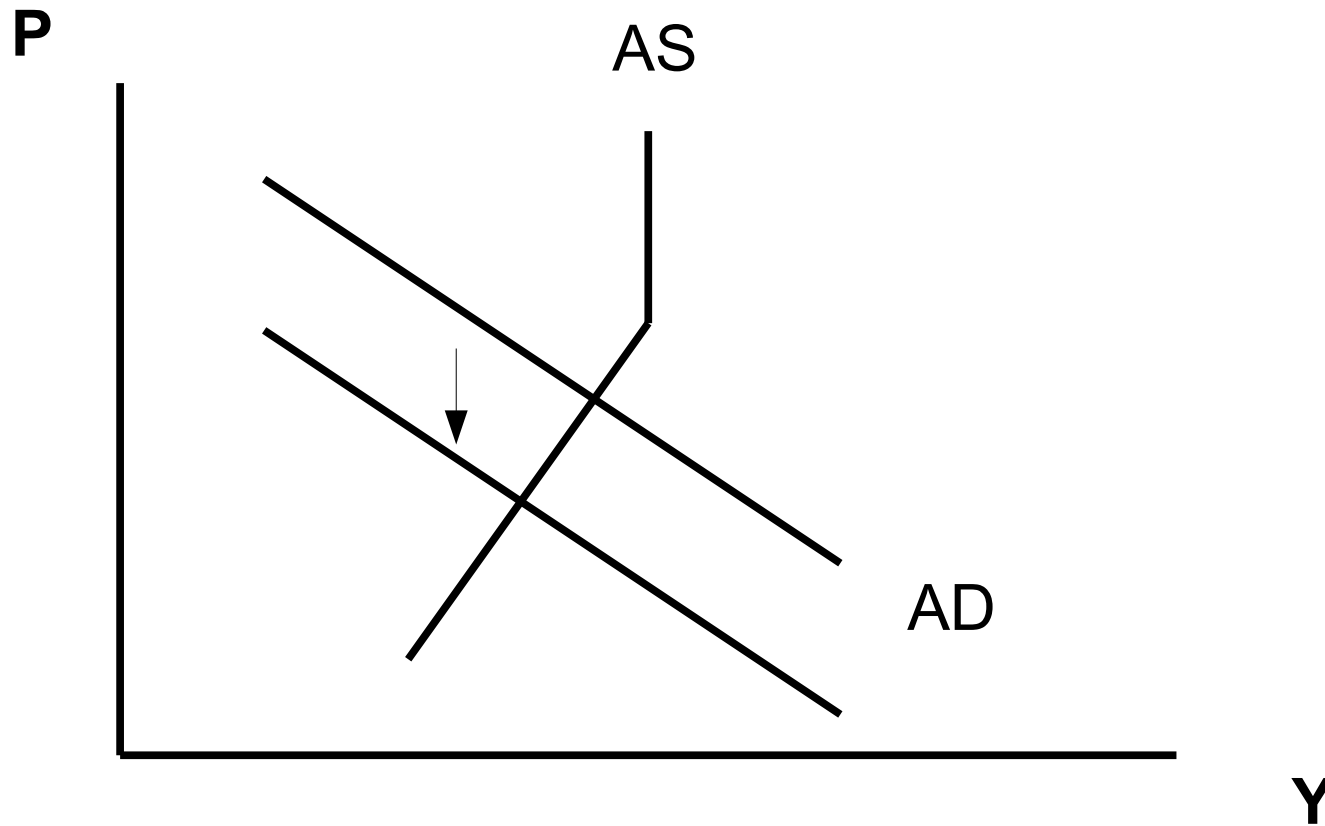


# Effects of Contractionary Fiscal Policy

## Sticky Wages – Unemployment Exists

- Contractionary fiscal policy restricts economic activities through reduced spending and/or increased taxation which decreases aggregate demand in the short run.
- As aggregate demand drops, output drops and prices drop. Workers refuse to drop nominal wages thus increasing real wages. Consequently, employment will drop as firms face higher costs.

# Effects of Contractionary Fiscal Policy

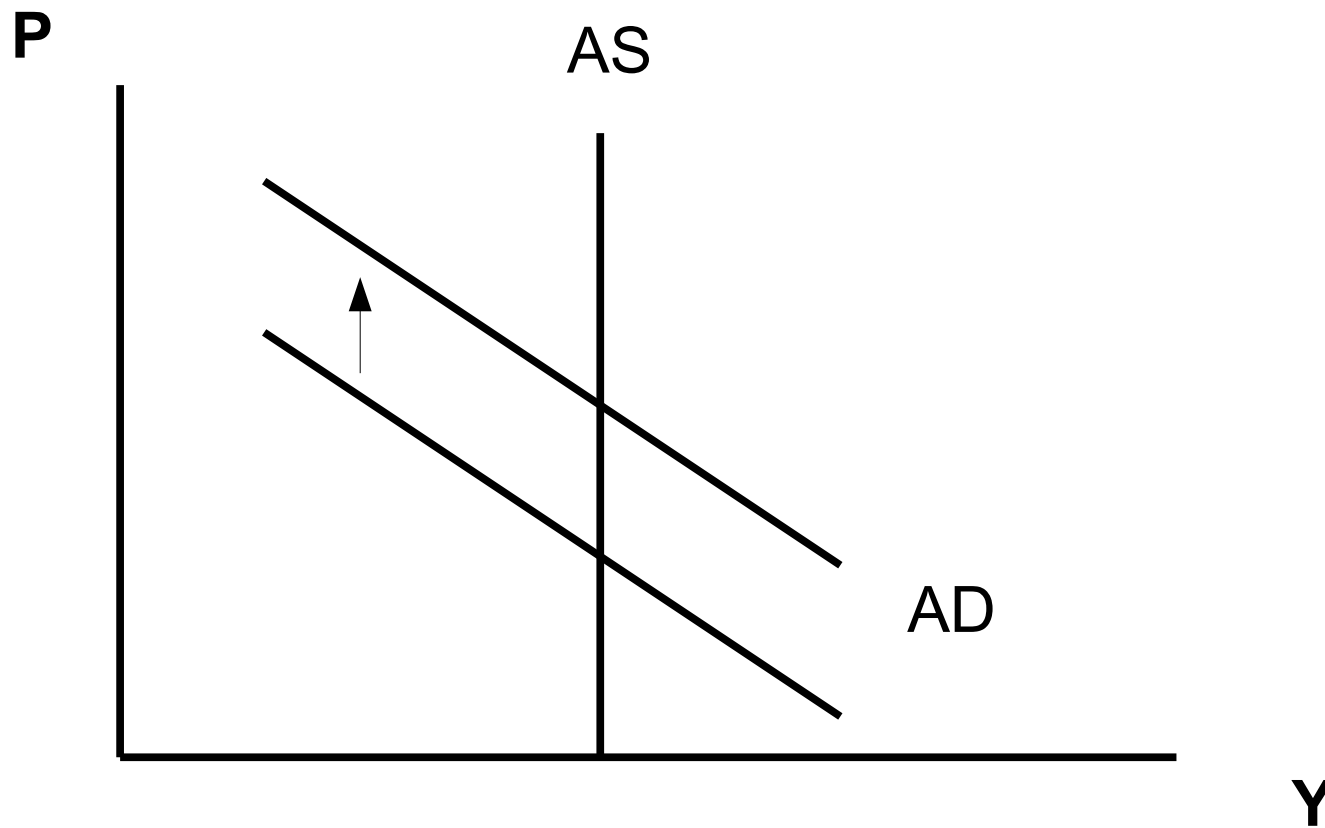


# Effects of Expansionary Monetary Policy

## Flexible Wages – Full Employment

- Expansionary monetary policy expands economic activities through banking and credit, primarily focusing on increasing investment, which increases short run aggregate demand.
- As aggregate demand increases, prices increase, wages also increase but real income remains unchanged so output remains constant. Consequently, employment does not change.

# Effects of Expansionary Monetary Policy

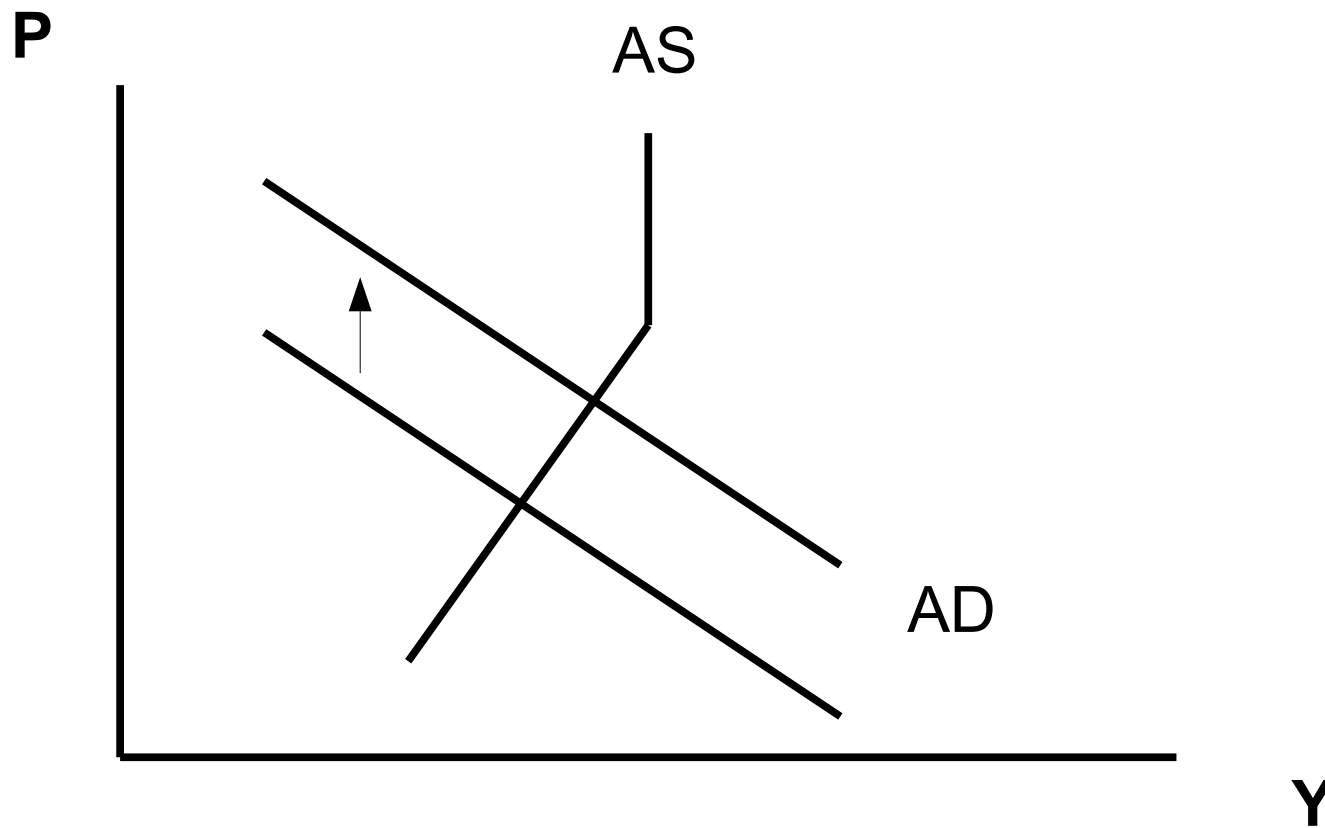


# Effects of Expansionary Monetary Policy

## Sticky Wages – Unemployment Exists

- Expansionary monetary policy expands economic activities through banking and credit, primarily focusing on increasing investment, which increases short run aggregate demand.
- As aggregate demand increases, firms hire to increase output. Prices increase, nominal wages do not increase initially, so real wages decrease. This lowers the cost of production encouraging firms to expand output.

# Effects of Expansionary Monetary Policy

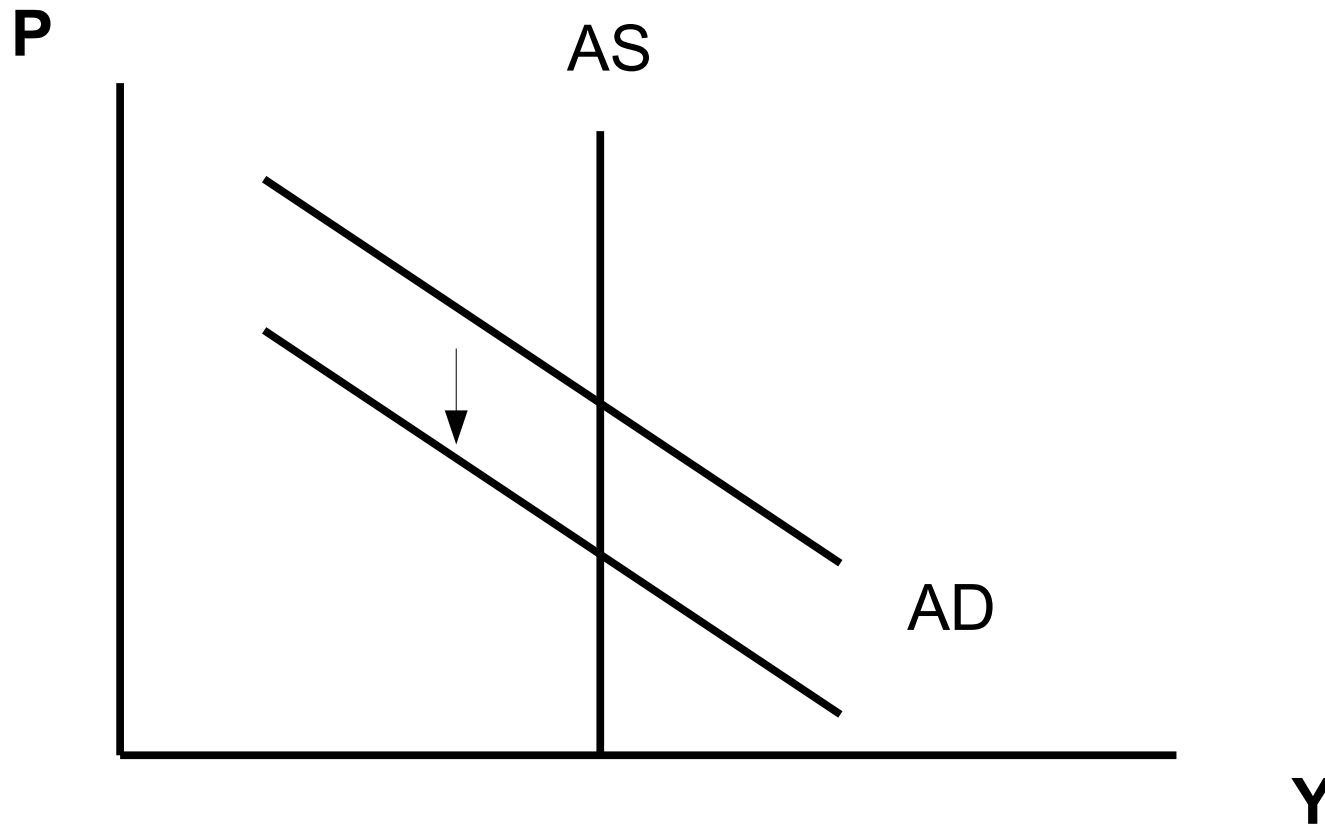


# Effects of Contractionary Monetary Policy

## Flexible Wages – Full Employment

- Contractionary monetary policy restricts economic activities through banking and credit, decreasing investment, thereby decreasing aggregate demand.
- As aggregate demand drops, prices drop, nominal wages drop but real wages remain unchanged so output remains constant. Consequently, employment does not drop.

# Effects of Contractionary Monetary Policy

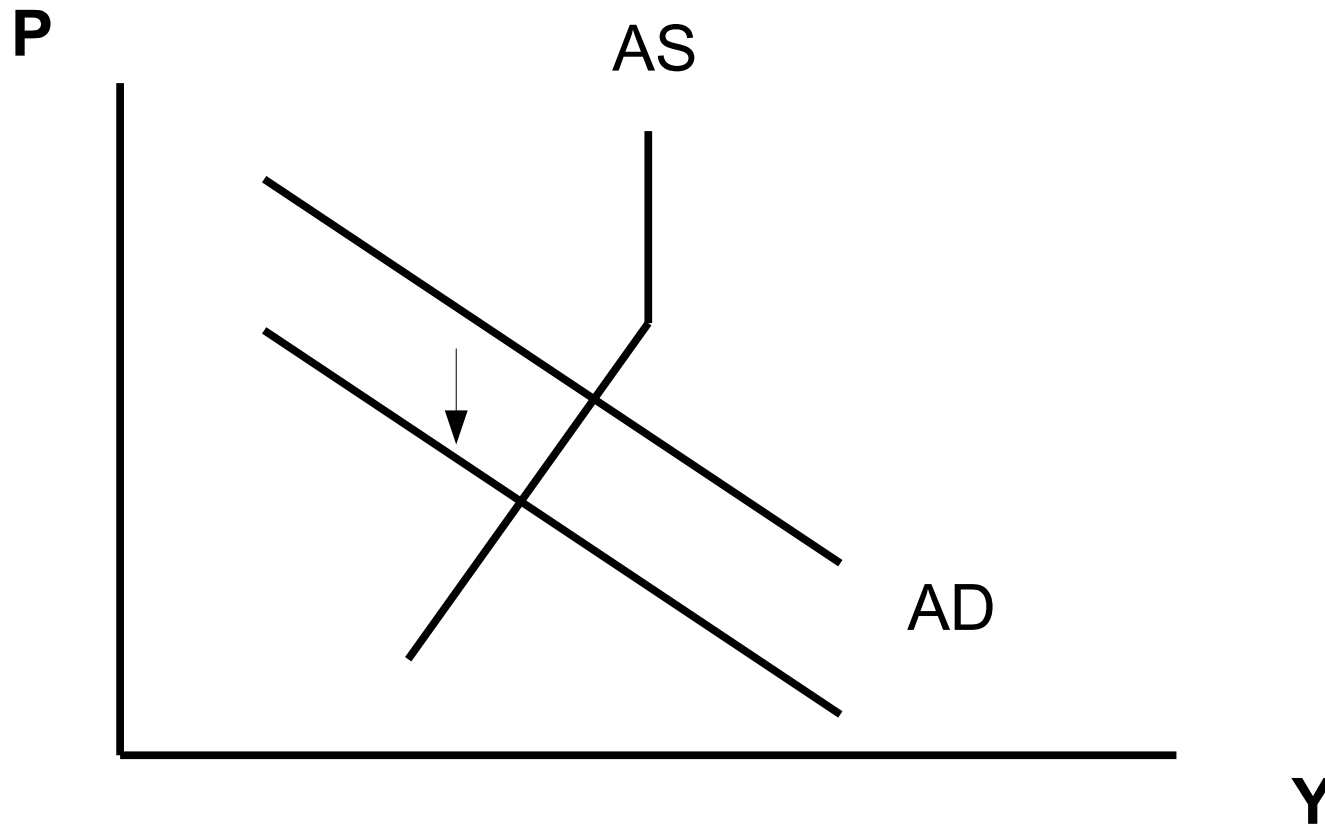


# Effects of Contractionary Monetary Policy

## Sticky Wages – Unemployment

- Contractionary monetary policy restricts economic activities through banking and credit, decreasing investment, thereby decreasing aggregate demand.
- As aggregate demand drops, output drops and prices drop. Workers maintain nominal wages thus causing real wages to increase. This causes production costs to increase, consequently, employment drops.

# Effects of Contractionary Monetary Policy



**The End**