

Aggregate Demand Curve

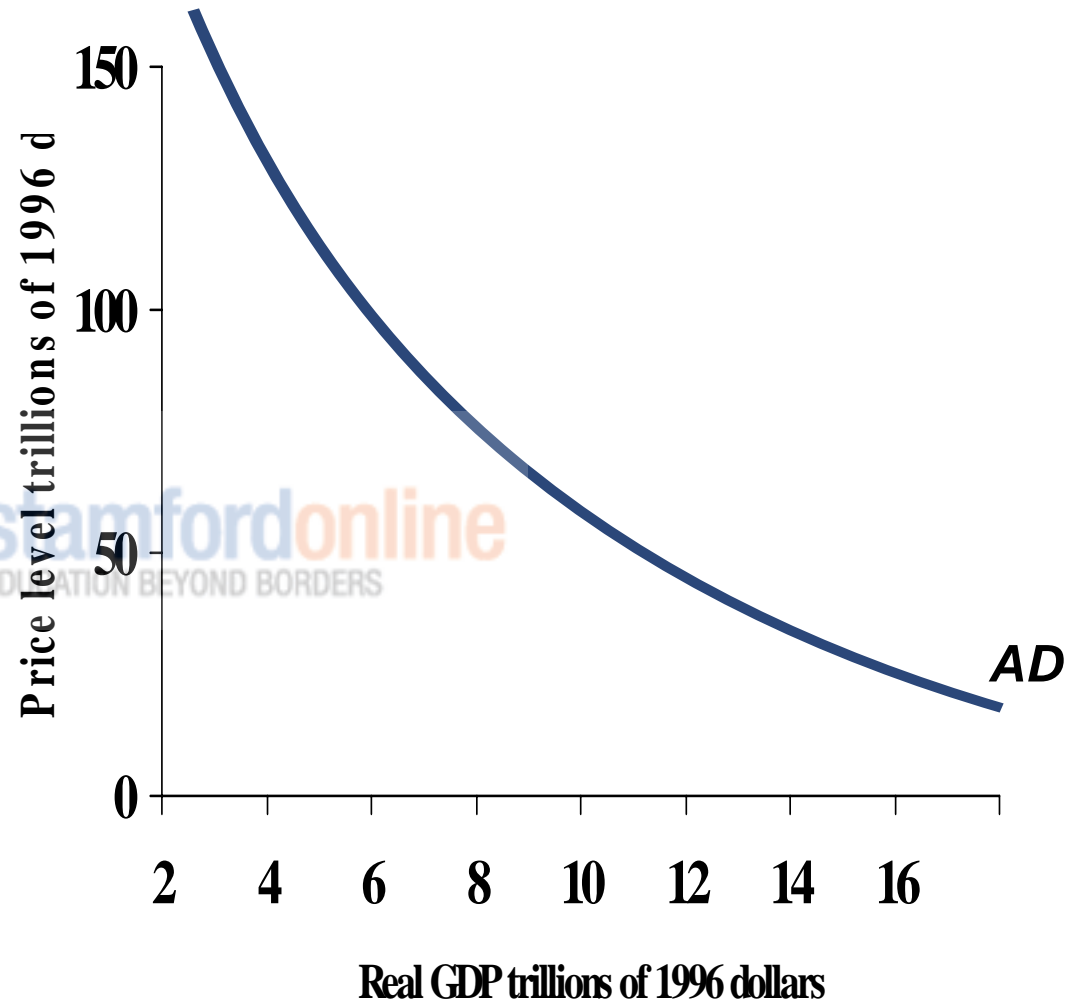
- **Aggregate demand curve shows the relationship between the price level in the economy and the real GDP demanded, other things constant**
- **Sums demands of the four economic decision makers: households, firms, governments, and the rest of the world**

Exhibit 1: Aggregate Demand Curve

The vertical axis measures a price index of the economy relative to a 1996 base year price level of 100.

The horizontal axis shows real GDP, which measures output in dollars of constant purchasing power, using 1996 prices

The inverse relationship depicted by the aggregate demand curve reflects the fact that as the price level increases, other things constant, the purchases of the four major decision makers decline



Aggregate Supply Curve

- Aggregate supply curve shows how much output producers are willing and able to supply at each price level, other things constant
- Assumed constant along an aggregate supply curve are
 - Resource prices, including wage rates
 - The technology level
 - The rules of the game that provide production incentives

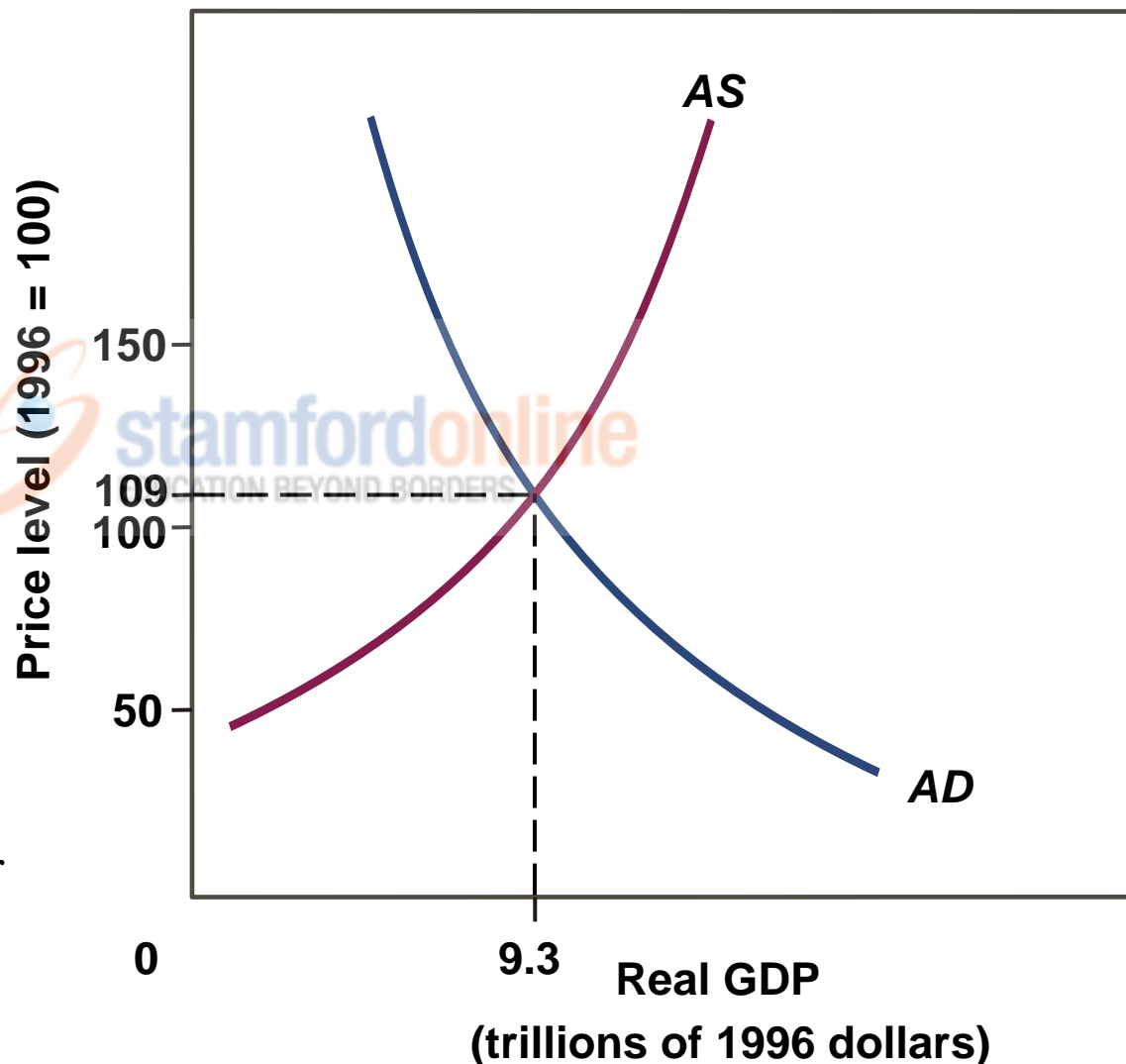


Exhibit 2: Aggregate Demand & Supply

Wage rates are typically assumed to be constant along the aggregate supply curve
→ firms find a higher price level more profitable so they increase real GDP supplied.

Equilibrium occurs where the AD and AS curves intersect.

From graph, equilibrium real GDP is about \$9.3 trillion at a price level of 109. At any other price level, quantity demanded would not match quantity supplied.



Equilibrium

- Although employment is not measured directly along the horizontal axis in Exhibit 2
- Firms usually must hire more workers to produce more output → higher levels of real GDP can be beneficial because
 - More goods and services are available in the economy
 - More people are employed



Trade Cycle

EDUCATION BEYOND BORDERS

Economic Fluctuations

- Economic fluctuations
 - The rise and fall of economic activity relative to the long-term growth trend of the economy
 - Business cycles
 - Vary in length and intensity but have some features in common
- Easiest way to understand economic fluctuations is to examine their components



Components of Business Cycles

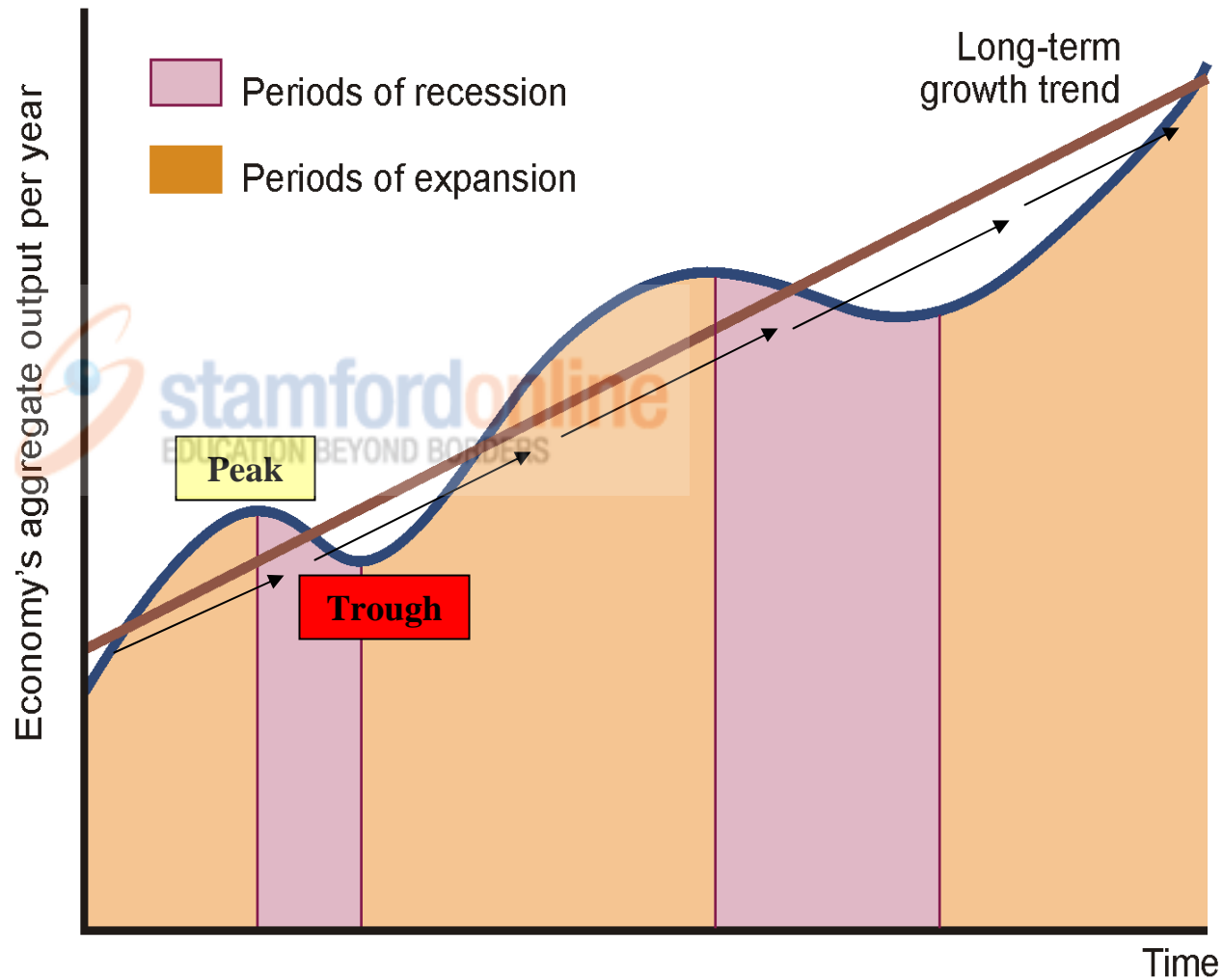
- Two phases
 - Periods of expansion
 - Periods of contraction
- Depression
 - Severe contraction
 - Lasting longer than one year and accompanied by high unemployment
- Recession
 - Milder contraction
 - Decline in total output lasting at least two consecutive quarters

Exhibit 3: Hypothetical Business Fluctuations

The long-term growth trend is shown by the upward sloping straight line. Economic fluctuations reflect movements along this growth trend.

A recession begins after the previous expansion has reached its peak, or high point and continues until the economy reaches a trough, or low point.

Period between a peak and a trough is a recession and the period between a trough and subsequent peak is an expansion.



Increases in Production

- Production tends to increase over the long run because of:
 - 1. Increases in the amount and quality of resources, especially labour and capital
 - 2. Better technology
 - 3. Improvements in the rules of the game that facilitate production and exchange

Business Cycle

- Turning points – peaks and troughs
- Since a recession means that output declines for at least two consecutive quarters,
 - a recession is not so designated until six months after it begins
 - recovery is officially underway after two consecutive quarters of growth