17.1 Aggregate Demand

1. Aggregate demand (AD) refers to the total demand for all goods and services in an economy at all given price levels in a given period of time.

2. The total quantity of output demanded is the sum of private consumption expenditure, investment expenditure, government expenditure and net exports at a given price level.

3. The AD curve is downward sloping. Other factors being constant, a decrease in the general price level results in *(an increase / a decrease)* in the total quantity of output demanded.

4. The AD curve is downward sloping for the following three reasons:

- Wealth effect (Real balance effect)

People's assets are denominated in nominal value. When the price level decreases, the purchasing power of money *(increases / decreases)*. The real value of the wealth of the economy will *(increase / decrease)*. Households and firms will *(increase / decrease)* their purchases of goods and services. Therefore, the total quantity demanded of goods and services (i.e. the real output) will *(increase / decrease)*.

- Interest rate effect

When the price level decreases, people will hold *(more / less)* money to finance their transactions and will keep more money in banks. Given that the supply of money is fixed, the amount of money available for lending will *(increase / decrease)* and the interest rate will *(increase / decrease)*. Consumption and investment expenditures will *(increase / decrease)* and the total quantity demanded of goods and services (i.e. the real output) will *(increase / decrease)*.

- Net exports effect (Exchange rate effect)

When the domestic price level decreases, imported goods become relatively more expensive, so the quantity demanded of imports will *(increase / decrease)*. The decrease in the domestic price level also makes domestic-made exported goods relatively cheaper to foreign buyers. Thus, the quantity demanded of exports will *(increase / decrease)*. With the *(increase / decrease)* in net exports, the total quantity demanded of goods and services (i.e. the real output) will *(increase / decrease)*.

17.2 Factors Affecting Aggregate Demand

5. When there is an increase in aggregate demand, the AD curve will shift to the *(right / left)*.

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6. State the effects of the following events on the aggregate demand.

	Aggregate demand
(a) a decrease in the salaries tax rate	*(increases / decreases)*
(b) an increase in desire to save	*(increases / decreases)*
(c) an increase in wealth	*(increases / decreases)*
(d) a decrease in the interest rate	*(increases / decreases)*
(e) an increase in consumer confidence	*(increases / decreases)*
(f) an increase in the profits tax rate	*(increases / decreases)*
(g) firms are optimistic about their business prospects	*(increases / decreases)*
(h) an increase in government expenditure	*(increases / decreases)*
(i) there is an economic recession in major trading partners of an economy	*(increases / decreases)*
(j) a depreciation of domestic currency	*(increases / decreases)*
(k) an imposition of a tariff on imported goods	*(increases / decreases)*

17.3 Aggregate Supply

7. Aggregate supply (AS) refers to the total amount of goods and services produced by firms in an economy at all given price levels in a given period of time.

8. In macroeconomics,

- the *(short run / long run)* refers to the situation in which at least some people in the economy do not fully recognise and adjust to changes in economic conditions.
- the *(short run / long run)* refers to the situation in which all people in the economy fully recognise and adjust to changes in economic conditions.

9. Reasons for an upward-sloping short run aggregate supply (SRAS) curve:

When the general price level increases, the adjustment of input prices is imperfect or slow (e.g. due to the long-term contracts of factors of production). Meanwhile, the adjustment of output prices is more flexible in comparison. As a result, output prices will increase faster than input prices, making it profitable for firms to produce *(more / less)* output. At the same time, the imperfect adjustment of input prices leads to a fall in the real cost of production. Firms will increase their inputs to produce more output. Therefore, the SRAS curve is upward sloping, i.e. a higher price level will result in *(a higher / a lower)* output level.

10. In the long run, there is perfect information and all people in the economy fully recognise and adjust to changes in economic conditions. Prices are fully adjustable. A change in the price level *(affects / does not affect)* the aggregate output supplied. The LRAS curve is vertical, located at the full-employment output level or potential output level.

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17.4 Factors Affecting Aggregate Supply

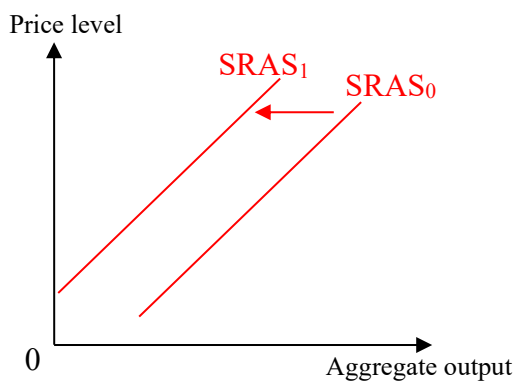
11. When there is an increase in short run aggregate supply, the SRAS curve shifts to the *(right / left)*. When there is an increase in long run aggregate supply, the LRAS curve shifts to the *(right / left)*.

12. State the effects of the following events on the short run aggregate supply and the long run aggregate supply.

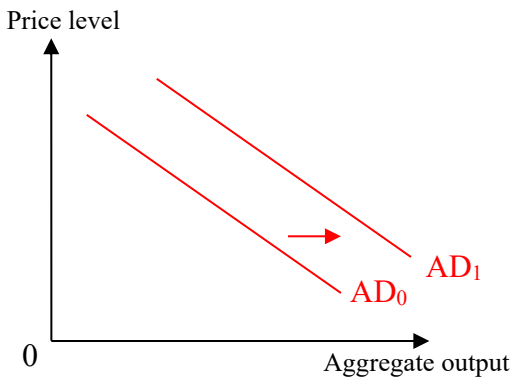
	Short run aggregate supply	**Long run aggregate supply**
(a) an increase in production cost	*(increases / decreases / does not change)*	*(increases / decreases / does not change)*
(b) an increase in production subsidies	*(increases / decreases / does not change)*	*(increases / decreases / does not change)*
(c) firms expect the price level to decrease in the future	*(increases / decreases / does not change)*	*(increases / decreases / does not change)*
(d) labour strikes	*(increases / decreases / does not change)*	*(increases / decreases / does not change)*
(e) a decrease in working population	*(increases / decreases / does not change)*	*(increases / decreases / does not change)*
(f) a technological improvement in production	*(increases / decreases / does not change)*	*(increases / decreases / does not change)*

13. Illustrate the effect of each of the following events on the aggregate demand or the short run aggregate supply of an economy.

(a) an increase in the oil price



(b) an increase in government spending on medical services



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