Aggregate Demand

Figure 6.6 shows an AD curve. The AD curve slopes downward for two reasons:

- A wealth effect
- Substitution effects
Aggregate Demand

Wealth effect A rise in the price level, other things remaining the same, decreases the quantity of real wealth (money, bonds, stocks, etc.).

To restore their real wealth, people increase saving and decrease spending, so the quantity of real GDP demanded decreases.

Similarly, a fall in the price level, other things remaining the same, increases the quantity of real wealth.

With more real wealth, people decrease saving and increase spending, so the quantity of real GDP demanded increases.
What causes AD to be flat?

- Strong wealth effects
- Strong substitution effects
  - Related to real rate of interest
  - Related to real exchange rate
* To understand the next transparency we need to do Chapter 10: Expenditure Multipliers.

. I will skip a detailed explanation of the Wealth Effect until we get to Chapter 10 (which in our next chapter according to the syllabus)
- Economics
- Models of markets
- The commodity market
- Keynesian approach

Real wealth: \( \frac{\text{Net Worth}}{\text{P}} \)

\[ \text{AD} = f \left( \text{RGDP}, \frac{\text{NW}}{\text{P}} \right) \]

\[ \text{AD} = f \left( \text{RGDP}, \frac{\text{NW}}{\text{P}_0} \right) \]

\( P_0 > P_1 \)
- A decrease in \( P \)
- Increases real wealth
- Shifts AD up

Note: A decrease in \( P \) increases RGDP ex.
- economic models of markets
- commodity market
- keynesian approach

AD: \( f(RGDP, \frac{NW}{P}) \)

\( AD = f(RGDP, \frac{NW}{P_0}) \)

\( P_0 > P_1 \)

Monetary emphasis

Ch. 8

\( AD = f(\bar{I}, \bar{G}, \bar{E}, \bar{i}, \bar{\bar{P}}, \bar{NW}) \)

\( NW = net\, worth \)

\( i = int.\, rate \)

\( E = real\, exchange\, rate \)

\( \bar{e} = tax\, rate \)

etc.
Text

Net worth ≡ "money"

"money" ≡ "cash balances"

"cash balances" ≡ "checkable deposits"

↑

a very narrow definition.

"Wealth" = "checkable deposits"
# Households (the ultimate owners of all property)

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Care</td>
<td>Consumer credit</td>
</tr>
<tr>
<td>homes</td>
<td>mortgages</td>
</tr>
<tr>
<td>Stocks</td>
<td>student loans</td>
</tr>
<tr>
<td>Bonds</td>
<td>net worth</td>
</tr>
<tr>
<td>Checking accounts</td>
<td></td>
</tr>
<tr>
<td><strong>Sum</strong></td>
<td><strong>Net Worth</strong></td>
</tr>
</tbody>
</table>

**Assumption:**

- your checking account = net worth
expenditure: \( C \)

- how do I pay for \( C \)
  - out of current income
  - out of future savings
    (repayment of current borrowings + interest)
  - out of currently available past savings

\( \text{asset} - \text{liability} = \text{net worth} \)

\[ C = C(Y, NW) \]

"income" \[\uparrow\]

"net worth" \[\uparrow\]
\[ C_t = f \left( Y_t, \hat{Y}_{t+1} \right) \]

- Current income
- Expected future income
- Current cons.

Keys: Yes

- A stock market crash
  - \( \Delta Y_{t+1} < 0 \), \( \Delta NN_t < 0 \)

- What happened to RGDP?

Did this cause the great depression?
**Households**

(\textit{the ultimate owners of all property})

<table>
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<td>sum</td>
</tr>
<tr>
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<td>sum</td>
</tr>
</tbody>
</table>

Scenario: a decrease in the price of stocks (\$S + P_{500})

\[
\Delta \text{ net worth} < 0 \quad (\text{no change in CPI})
\]

\[ AD \text{ with low } S + P_{500} \]

\[ AD \text{ with high } S + P_{500} \]