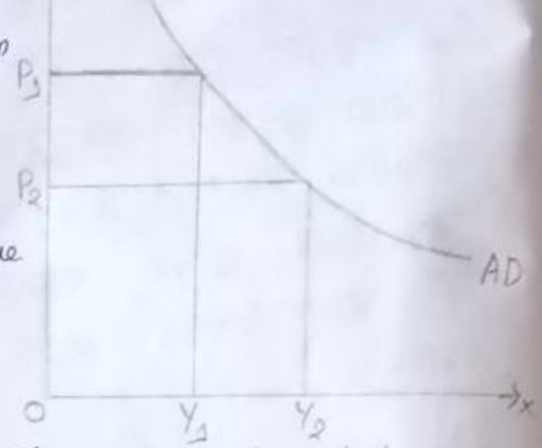
Aggregate Demand:-

Aggregate demand is the total quantity of goods and services that are bought by consumers, households, private investors, government and foreigners. Thus aggregate demand is a whole schedule of total output demanded at various price levels. The aggregate demand has four components consumption demand, private investment demand, government purchases of goods and services and net exports. Thus aggregate demand curve shows the relationship between the total quantity demanded of goods and services and general Price level. Aggregate demand curve AD slopes downward from left to right.



Why does Aggregate Demand Curve slopes downward?

1. Real Balance Effect:- With the rise in the general Price level, the real value of these monetary assets are making people feel poorer than before. This induces them to consumer less and therefore leads to the decline in quantity of output purchased by them.

2. Rate of Interest Effect:- Secondly another important reason for the downward sloping nature of aggregate demand curve is the effect of change in general price level on the rate of interest. At a higher price level, the people will require more money for conducting a given amount of transactions. This will lead to the

increases in the demand for money for making transaction given the money supply, the increase in demand for money will cause the rate of interest to go up. At a higher rate of interest, demand for investment in new capital goods (i.e plant, machenery and equipment) will decrease. To conclude, the investment demand and the general price level are also inversely related

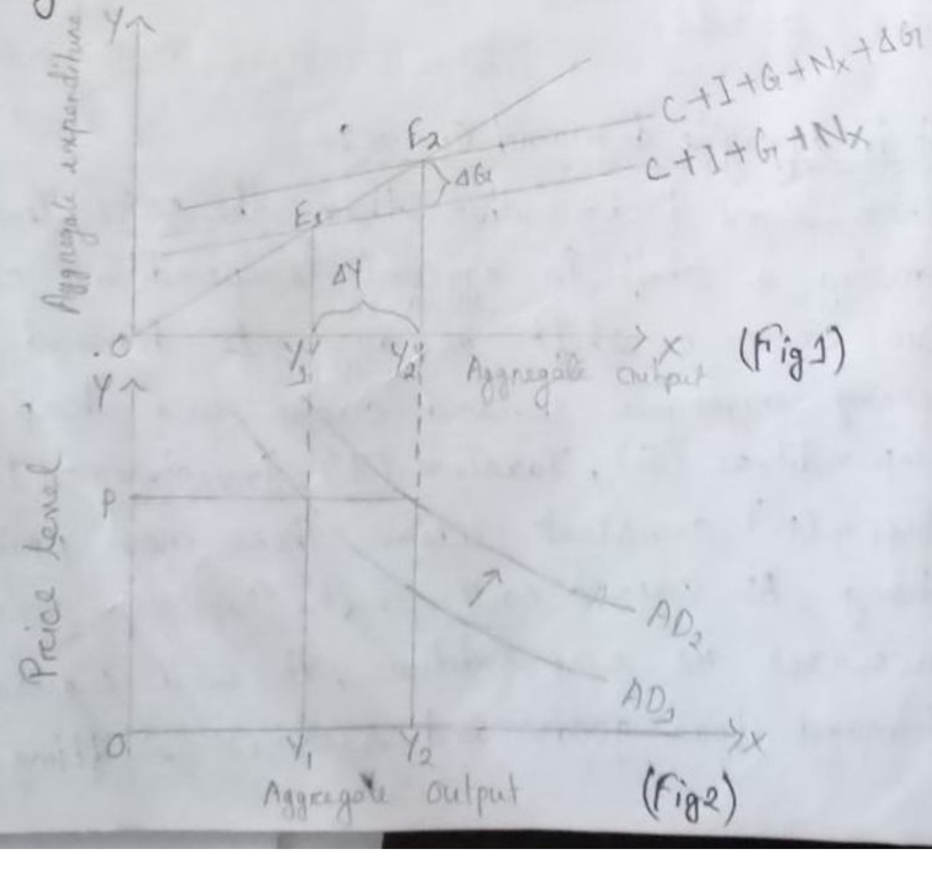
3. Foreign Trade Effect:- Thirdly changes in the price levels also causes a change in foreign demand for goods. This is called foreign trade effect of the change in Price level. If a general price level in India falls, its exports will become cheaper leading to their inverse. On the other hand, the lower price level in India will induce Indian people to buy Indian goods instead of ones. Thus, fall in general price level in India will lead to more exports and lesser imports causing expansion in aggregate demand for Indian goods.

Derivation of aggregate Demand Curve

23/09/22

Shift in aggregate demand Curve:-

When some factor other than the price level change, Causing a shift in aggregate expenditure curve, this will cause a shift in aggregate demand curve. In deriving aggregate demand curve, wee keep government expenditure (G), Taxation (T), Investment (I) and money supply (M) constant. When these non price factors Change, AD curve will shift. Suppose government increases its expenditure, it will cause more demand for goods and services shifting the Aggregate expenditure curve upward. As a result, equilibrium level of output will increase at given price level. Similarly reduction in taxes will also increase aggregate output demanded and will therefore cause a shift in aggregate demand curve. Again increase in money supply (M) will cause a rightward shift in AD (aggregate Demand) curve. At a given price level, if money supply is increased, the interest rate will fall. The fall in interest rate will cause investment demand to increase. Aggregate output demanded will be greater. Thus, expansion in money supply brings shift in AD curve to the right.



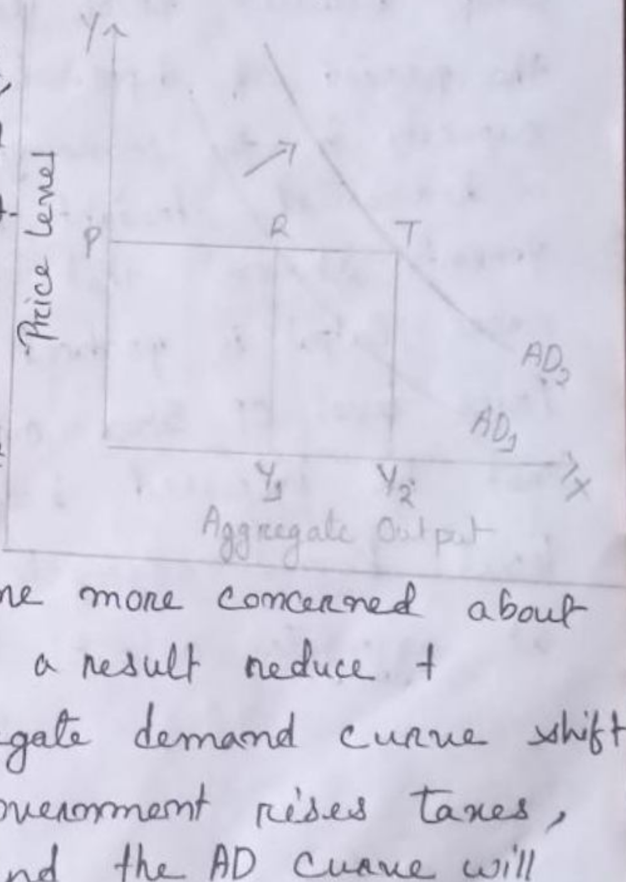
(Fig 1)

(Fig2)

In Fig) increase in government expenditure has a multiplier effect on aggregate output. Increase in government expenditure ΔG has caused aggregate expenditure to shift from $C+I+G+N_x$ to $C+I+G+N_x+\Delta G$. It will cause aggregate output to increase by $Y_1 Y_2$ shifting aggregate demand curve to the right from AD_1 to AD_2.

24/9/22 Likewise, changes in foreign demand for our goods also influence aggregate demand curve. For example if foreign exchange rate of rupee falls, i.e if rupee depreciates against US dollar, this will encourage exports and will lead to the increase in net exports (N_x). Therefore, the AD curve will shift to the right.

Due to expension in net export, aggregate demand curve shifts right from AD_1 to AD_2 and aggregate output at given price P increases from Y_1 to Y_2



Leftward Shift in Aggregate demand Curve:

Suppose people suddenly become more concerned about saving for retirement and as a result reduce current consumption, the aggregate demand curve shift to the left again when the government rises taxes, People cut their spending and the AD curve will shift to the left. Suppose Reserve Bank adopps tight moneytary policy and contracts money supply. It causes a leftward shift in AD curve.

The aggregate demand curve shifts left from AD_2 to AD_1 at given price P where smaller aggregate quantity Y_1 is demanded