LECTURE NOTE ON CHAPTER 12

Aggregate Expenditure and demand -side equilibrium

If we assume there is no capital depreciation and no business saving, then each dollar spent on production translates directly into a Dollar of aggregate income.
Consumption function: is the linear relationship between how many households are planning to consume at various levels of disposable income.
Saving function: the relationship between how many households are planning to save at various levels of disposable income.
Even you can relate income to consumption and saving.
Income (Y) = Consumption(C) + Saving (S)
Therefore, Saving = Income – Consumption.
Autonomous consumption is the part of consumption that is not related to current disposable income.
The 45degree line is the line by which income and consumption are equal. That is all the points on that line are the same distance in terms of vertical and horizontal axis.
Break-even income point is where income equals consumption and therefore, saving equals zero.
Dissaving is where spending total spending exceeds income.
Marginal propensity to consume (MPPC): changes in consumption / changes in income. The fraction of the income increase that will go to consumption and the rest of the income increase will go to saving.
Marginal propensity to save (MPS) changes in saving / changes in income. (See the lecture class note or the handed sheet). Note that MPC + MPS = 1.
Average Propensity to consume (APC) level of consumption / level of income and so does saving.
Multiplier effect = the change in equilibrium level of real income / a change in autonomous Expenditures (see the multiplier process in the textbook).
Aggregate expenditure and income: the relationship between aggregate spending and aggregate income or real GDP.
The sum of consumption, Planned investment (I), Government expenditure (G), and net exports (X-M) is shown in column9, as planned aggregate expenditure, which is the amount that Households (HH), firms, governments and the rest of the world plan to spend on U.S. output at each level of income.

Aggregate-expenditure model:
The equilibrium quantity of aggregate output demanded is achieved when the amount that people plan to spend equals the amount produced. Ye(real GDP), which is the equilibrium quantity of real GDP, is achieved when aggregate expenditure = real GDP.

The relationship between aggregate expenditure and real GDP:
- Real GDP is measured along the horizontal axis
- Real GDP can be looked at 2 different ways: as the value of aggregate output and as the aggregate income generated by level of output.
Income -expenditure model: a relationship between aggregate income and aggregate spending that determines for a given price level (income = spending).
Aggregate expenditure model: a relationship between the amount of spending for each level on income and total spending for each level on income.
When output and planned spending differ: At E, Aggregate Expenditure (AE)= Aggregate income or output
At J, AE is greater than output. That is what households (HHS), firms , Governments and the rest of the world plans to spend > the output. That is there is a shortage in inventories which implies that firms have to increase output, which means income will increase. This will continue until AE = Aggregate output.
At K, AE is less than aggregate output (AO) which implies that there is surplus (inventories pile up).
This implies that firms cut output and therefore income declines. This will continue until AE = AO.
Shifts in the aggregate expenditure: changes in the price level.
A rise in the domestic price level lowers the real value of the total wealth, which leads to a fall in desired consumption, this, in turn implies a downward shift in the desired aggregate expenditure curve. A fall in the domestic price level leads to a rise in wealth and desired consumption and thus to an upward shift in the desired aggregate expenditure curve.

Changes in net exports: A rise in the domestic price level shifts the net export function downward, which means a downward shift in the desired aggregate expenditure curve. A fall in the domestic price level shifts the net export function downward, which means a downward shift in the desired aggregate expenditure curve. A fall in the domestic price level shifts the net export function and the desired aggregate expenditure curve upward. Since a fall in the domestic price level causes the aggregate expenditure curve to shift upward, it increases equilibrium income. Each combination of equilibrium income and its associated price level becomes a particular point on the aggregate curve. It is also true that a rise in the domestic price level causes the aggregate expenditure curve to shift downward, it reduces the equilibrium real income. Any change in the price level leads to a new aggregate expenditure (AE) curve and hence to a new level of equilibrium income. Each combination of equilibrium income and its associated price level becomes a particular point on the aggregate curve.

IS Schedule: the combination of interest rate and income that generates goods market equilibrium. A fall in interest rate will cause aggregate expenditure to increase (AE curve shifts up to the left), and equilibrium income will increase. A rise in interest rate will cause aggregate expenditure to decrease (AE curve shifts down to the right), and equilibrium income will decrease.