**KEY CONCEPTS AND SKILLS: Unit 2.2 – Aggregate Supply and Demand**

**Definitions:**

* **Aggregate Demand**: The total amount of real output (real GDP) that consumers, firms, the government and foreigners want to buy at each possible price level
* **Aggregate Supply**: the total amount of real output (real GDP) that firms want to produce at each possible price level
* **Wealth**: the value of assets that people own (houses, cars, cash, etc.)
* **Consumer confidence**: a measure of the optimism of consumers regarding their future incomes and the future of the economy
* **Business confidence**: a measure of the optimism of firms regarding their future performance and the future of the economy
* **Disposable income**: the income of households that is left over after they have paid their taxes
* **Spare capacity**: physical capital (machines, equipment, etc.) that firms have available but do not use
* **Stagflation**: simultaneous high unemployment and high inflation

**Concepts and Applications:**

***A. Aggregate Demand***

1. Draw an aggregate demand (AD) curve.
2. Describe the components of aggregate demand and how changes to those components affect aggregate demand.
3. Explain how the AD curve can be shifted by changes in:
   * Consumption spending
   * Investment spending
   * Government spending
   * Export and import spending

***B. Short-Run Aggregate Supply***

1. Explain the difference between the short-run in microeconomics and the short-run in macroeconomics.
2. Explain how the SRAS curve can be shifted by changes in production costs, taxes or subsidies or supply shocks.

***C. Short Run Equilibrium***

1. Explain, using a diagram, how aggregate supply & demand equilibrium is determined in the short term.
2. Explain, using diagrams, the short run economic impacts of changes in the determinants of aggregate supply and demand.
3. Explain why full employment does not imply zero unemployment.
4. Explain, using diagrams, short run equilibrium assuming economies:
   * With a deflationary (recessionary) gap
   * With an inflationary gap
   * At full employment
5. Explain how shifts in AD and SRAS can be causes of the business cycle.
6. Explain how changes in consumer or business confidence could lead to a recession.
7. Using an AD/AS diagram, explain why aggregate supply shocks are considered a worse problem than aggregate demand shocks.

***D. Equilibrium in the Monetarist / New Classical (M/NC) Model***

1. Explain, using a diagram, the determination of long-run equilibrium in the M/NC model.
2. Explain why, in the M/NC approach, while there may be short-term fluctuations in output, the economy will always return to the full employment level of output in the long run.
3. Examine, using diagrams, the impacts of changes in the long-run equilibrium.
4. Assuming that the M/NC model is correct, recommend what a government should do in response to a demand shock that shifts the AD curve lower.

***E. Equilibrium in the Keynesian Model***

1. Explain, using a diagram, that the Keynesian AS curve has three sections because of wage/price downward inflexibility and different levels of spare capacity in the economy.
2. Discuss why, in contrast to the Monetarist/New Classical model, the economy can remain stuck in a deflationary (recessionary) gap in the Keynesian model.
3. Explain, using a diagram, that if AD increases in the vertical section of the AS curve, then there is an inflationary gap.
4. Discuss why, in contrast to the Monetarist/New Classical model, increases in aggregate demand in the Keynesian AD/AS model need not be inflationary unless the economy is operating close to its level of full employment.
5. Assuming that the Keynesian model is correct, recommend what a government should do in response to a demand shock that shifts the AD curve lower.

***F. Shifting Aggregate Supply Curves in the Long Run***

1. Explain how factors leading to changes in the quality and/or quantity of factors of production can shift the aggregate supply curve in the long run (in either the M/NC or Keynesian models)

***G. (HL) Keynesian Multiplier***

1. Explain what the Keynesian Multiple is and why it is important for policymakers.
2. Explain how the Keynesian Multiple is related to leakages in the circular model.
3. Calculate the Keynesian Multiple given MPC or MPS+MPT+MPM.
4. Use the multiple to calculate the effect on GDP of a change in investment, government spending or net exports.
5. Draw an AD/AS diagram showing how the Keynesian Multiple affects a shift in aggregate demand.