Learning Objectives

Upon completion of this unit, students should be able to:

1. Explain the role of consumption.
2. Discuss gross private domestic investment.
3. Analyze the effects of government purchases of goods and services.
4. Explain how net exports affect aggregate expenditure.
5. Examine aggregate spending as a whole.
6. Discuss how the simple spending multiplier accounts for changes in spending plans.
7. Describe the aggregate demand curve.
8. Explain how aggregate supply operates in the short run.
9. Discuss short-run aggregate supply in relation to the long run.
10. Analyze shifts of the aggregate supply curve.

Unit Summary

Unit V examines the macroeconomic aggregate models of expenditure, supply, and demand. Aggregate expenditure is used to determine an economy's demand. Aggregate demand and supply together are a function of GDP and the price level.

In previous units, the connection between a nation's output and income was made. In Unit IV, gross domestic product was introduced as a way to measure national income. In Unit V, the relationship between income and consumption is analyzed, as consumption is a large part of aggregate expenditure. A nation's aggregate expenditure is composed of consumption, investment, government purchases, and net exports. Each of these four components is discussed in Chapter 9.

Consumption is simply the purchase of goods and services in an economy by its citizens. One of the most important measures of consumption is the consumption function, which compares income to consumption. In general, people receiving income have two options: spending or saving. Marginal propensity to consume (MPC) and the marginal propensity to save (MPS) are both used to measure the percentage of income that is used each of these ways. Because MPC and MPS are fractions of total consumption, the following equation is true:

\[ MPC + MPS = 1 \]
The graphical representation of the consumption function models various levels of income and the resulting level of consumption. However, changes to the consumption function are not always movements along the curve. In other words, several factors can cause the consumption function to shift. Changes in wealth, price level fluctuations, interest rate hikes, or changing expectations for consumers will shift the consumption curve upward or downward depending on the specific change.

Investment, the second component of aggregate expenditure, is determined by interest rates and expectations for business success. This component of GDP includes a business and household sector. Investment for households refers mostly to the purchase of new housing units, as this is one of the most common forms of personal investment. Business investment in general is the purchase of new capital stock. Though investment is a small portion of GDP, its ability to indicate macroeconomic activity is strong.

The government's purchase of goods and services is also a contributing factor for determining aggregate expenditure. The government acquires revenue through taxes, and this income is used to purchase various goods in the economy. Some commonly purchased goods by the government are military vehicles, public school textbooks, or traffic lights. Government spending may be done at several levels including the state, city, and national government levels. Government spending, though a small contributor, adds to the aggregate expenditure model.

The final component of GDP, and the final element of aggregate expenditure, is net exports. Net exports, by calculation, are simply the dollar amount of exports minus imports. When a nation purchases final goods and services from a foreign nation, the money spent contributes to the foreign nation's GDP. Conversely, when a nation exports a good abroad, the sale contributes to the domestic GDP of the producing nation. By subtracting the total cost of imports from the revenue received from exports, one can determine the total impact to national GDP.

The aggregate expenditure model is useful in determining aggregate demand for a nation. Real GDP demanded at a given price level is equal to the point where the aggregate expenditure curve intersects the aggregate output curve. (The supplemental material may be referenced for interpreting this section.) This data is used to derive the aggregate demand curve, which shows the relationship between price levels and gross domestic product. Because consumption is such a large fraction of aggregate expenditure, it can be assumed that changes which shift the consumption function will also shift the aggregate demand curve.

Occasionally, unforeseen substantial increases in supply can occur. Such a change can be positive or negative, but its impact on the aggregate model is substantial. Instead of steady long term growth or reduction in supply, the short run aggregate supply curve abruptly shifts with a supply shock. The figures below detail the effects of beneficial and adverse supply shocks.

(Unit Summary continued on page 3)
Aggregate supply is determined by how many goods and services firms are willing and able to supply at given price levels. Fiscal policy decisions have a strong impact on business decisions regarding output.