5.5 Determinants of Aggregate Demand

Changes in consumption
- Changes in wealth: changes in nation’s wealth will cause an increase in aggregate demand (a rightward shift)
  - Stock market can have a big impact on consumers’ wealth
  - Age of consumer durables: greater the age of consumer durables, the more likely consumers will replace or repair these with new purchases, thus increasing consumer spending
  - Consumer expectations: as consumers gain confidence in the economy’s future, they are more willing to make present-day purchase

Changes in investment
- Rate of interest: if the cost of borrowing falls, firms will be more willing to borrow money for investment purposes (recall that investment refers to spending on capital assets), leading to an increase in investment and a rightward shift of the curve
- Purchase price and the installation, operating, and maintenance costs of the capital asset: if the cost of a capital asset goes down, firms will be more willing to invest in purchasing it, thus increasing investment spending
- Amount of spare capacity of the present capital stock: if a business has a lot of idle machinery, it is unlikely to increase investment; however, if a firm has little available production capacity with which to flexibly address potential increases in demand, it will need to increase its investment spending so as to increase its production capacity
- Business expectations: firms are more likely to invest when the future of the economy looks promising
  - Government policies and regulations: “red tape” or increased bureaucracy can make investing tedious, unattractive, and even costly

Change in net exports
- Value of the exchange rate: lower Canadian dollar makes our exports more attractive and imports less attractive, thereby increasing net exports, and in turn, aggregate demand
- Domestic rate of inflation: makes Canadian goods more expensive, reducing demand or exports, shifts curve left
- Relative levels of incomes abroad: increases will have the same positive effect on Canadian exports
- Price level of foreign goods: when the prices of competing foreign goods are raised, Canadian good appear more attractive, leading to increases in exports for our country
Changes in the role of the government
- Affected by social and cultural standards of people, expectations of people to the political philosophy of the governing party, and the amount of time left in its mandate
- Changes in revenue (through taxation)
  - Decrease in taxation (income tax, sales tax, corporate profit tax) will lead to an increase in aggregate demand
  - Increase in government spending (via both government-provided services and transfer payments) will lead to a rise in aggregate demand
  - An increase in the money supply will increase aggregate demand

Determinants of aggregate supply shift the curve and include factors other than a change in the price level
- Normally, a firm would want to produce more only if it could charge more for its product (i.e. the price level increased)
- What factors would lead firms to be willing and able to produce more despite the price level remaining constant?

An increase in aggregate supply can result from an increase in an economy’s productivity, which in turn comes from:
- An improvement in human capital (size and quality of labour force)
- An increase in the amount of capital
- Technological improvement
- An increase in natural resources

Better productivity means that the firm can produce its product at lower per-unit costs, thus increasing profit
- Increased profit incentivizes firms to produce more even in the absence of a price level increase
- In other words, the four factors of productivity increase potential GDP, thereby leading aggregate supply to increase also
- An increase in aggregate supply is shown by a rightward shift of the aggregate supply curve

Lower wage rates will also increase a firm’s profits and lead to increase in aggregate supply
- A fall in the prices of factor services (including resources like oil, steel, or wood) or in business taxes increases profits and thus aggregate supply
- Note that a change in factor prices does not affect potential GDP (like the other 4 elements of productivity do)
- When there is a decrease in factor prices, potential GDP remains unchanged while the aggregate supply curve shifts rightward