I. Aggregate Supply

- Aggregate supply is the total quantity of goods and services produced by all sellers at various price levels.
- Firms will enter into contracts with suppliers and workers to predict and control future resource prices and wage rates with some certainty. Firms thus can increase production without an associated rise in the cost of resources.
- The higher the price levels, the greater the aggregate quantity supplied (to a maximum), while the lower the price level, the smaller the aggregate quantity supplied.
- The curve is upward sloping but unlikely to be a straight line because the increase in production as a result of an increase in the price level is dependent on the condition of the economy.
- Short-run aggregate supply is the quantity of goods & services produced at various price levels assuming that factor prices are constant. Since factor prices remain fixed, a higher price for the goods or services they sell will mean higher profits and will induce firms to produce more. Therefore, the short-run aggregate supply curve is upward-sloping.
  - An increase in production during a recession can be achieved more easily since idle machines and laid-off workers can be put to use to produce more output.
  - Increase in production can be achieved with little impact on the per-unit cost.
  - The price level only has to increase a bit to induce firms to produce more.
- Long-run aggregate supply shows the quantity of goods and services that would be produced at various price levels assuming that wage rates and all other factor prices have adjusted to changing conditions. Therefore, the long-run aggregate supply is not affected greatly by changes in the price level or by changes in nominal wages.
  - An increase in production when the economy is working nearer to full capacity (i.e. close to full-employment) is more difficult, since firms must use older and less efficient machines as well as hire less experienced labour (thus resulting in lower productivity per machine/worker).
  - The price level will have to increase considerably in order to induce firms to produce more.

II. Aggregate Demand

- Aggregate demand consists of consumption expenditures, investment spending, government purchases of goods and services, and net exports.
- In other words, it is refers to spending by all four sectors of the economy: consumers, firms, government, and the international sector.
- It is the total demand for all goods and services produced in an economy (i.e. the aggregate quantity of goods and services demanded by all buyers at various different price levels)
- As price levels rise, total real output (or aggregate quantity demanded) falls.
- Aggregate demand at each price level is equivalent to the GDP that would occur at that price level.
- For real economic growth to occur, aggregate quantity demanded at each price must increase.
- Contrasting with the microeconomic view of demand, it is not correct to say that the aggregate demand slope is downward sloping because as the price level rise, people will buy less due to the
substitution effect. In microeconomics, consumers will substitute cheaper products, but with aggregate demand, a rise in the price level means that prices of all products have increased, and there are no substitutes for all goods.

- Also contrasting with the microeconomic view of demand, it is not correct to say that as prices rise, consumers are able to afford less due to the income effect. In microeconomics, a rise in prices effects consumers’ real income, so they buy less with the same income. However, our study of GDP tells us that incomes and expenditures must be equal. If prices rise, then so too should income since someone must be receiving as a higher income that which others are spending as a higher expense.

- It is downward-sloping for three reasons:
  - The first is the wealth effect of a change in the aggregate price level—a higher aggregate price level reduces the purchasing power of households’ wealth and reduces consumer spending. A higher price level leads to lower real wealth (i.e. lower real value of savings), lower consumption, and lower aggregate expenditures. There will therefore be a lower level of real GDP produced.
  - The second is the interest rate effect of a change in aggregate the price level—a higher aggregate price level reduces the purchasing power of households’ money holdings, leading to a rise in interest rates and a fall in investment spending and consumer spending. In other words, a higher price level tends to push up interest rates, which in turn causes a reduction in investment spending and, therefore, in aggregate expenditures. There will therefore be a lower level of real GDP produced.
  - The third is the exchange rate effect of a change in the aggregate price level – a higher aggregate price level increases the costs of goods and services that are exported, reducing the demand for Canadian exports. As higher Canadian prices make our exports less attractive, they also make imports more appealing to Canadians. Thus, real GDP declines.