Aggregate Demand and Aggregate Supply

First: Aggregate Demand

Aggregate demand shows the amounts of real output (real GDP) that buyers collectively desire to purchase at each possible price level. The relationship between the price level (as measured by the GDP price index) and the amount of real GDP demanded is inverse or negative: When the price level rises, the quantity of real GDP demanded decreases; when the price level falls, the quantity of real GDP demanded increases.

Aggregate demand curve: The down sloping aggregate demand curve AD indicates an inverse (or negative) relationship between the price level and the amount of real output purchased.

The explanation of the inverse relationship is not the same as for demand of a single product.

The explanations rest on three effects of a price level change as following:
1. **Real balances effect**: when price level falls, purchasing power of existing financial assets rises, which can increase spending. People feel wealthier when price level falls and will be encouraged to buy more goods and services.

2. **Interest-rate effect**: When we draw an aggregate demand curve, we assume that the supply of money in the economy is fixed. But when the price level rises, consumers need more money for purchases and businesses need more money to meet their payrolls and to buy other resources. So, given a fixed supply of money, an increase in money demand will drive up the price paid for its use. That price is the interest rate.

3. **Foreign purchases effect**: when price level falls, other things being equal, domestic prices will fall relative to foreign prices, which will tend to increase spending on domestic exports and also decrease import spending in favor of domestic products that compete with imports.

**Changes in Aggregate Demand:**

![Diagram of changes in aggregate demand](image)
Change in one or more of the listed determinants of aggregate demand (the price level is fixed) will shift the aggregate demand curve. The rightward shift from AD1 to AD2 represents an increase in aggregate demand; the leftward shift from AD1 to AD3 shows a decrease in aggregate demand.