

Aggregate Demand

BY RENEE HALTOM

What determines how much the economy produces in any given period? One way to think about it is through the concept of aggregate demand, along with a partner concept, aggregate supply.

An aggregate demand curve displays the quantity of goods and services that are demanded at every possible price level in the economy. The aggregate quantity of goods and services demanded generally is high when prices are low and low when prices are high (the opposite being true for aggregate supply, which slopes upward). Where the two intersect is, in theory, at the current level of gross domestic product (GDP).

This theoretical framework can help economists think through the causes of business cycles. For example, four components of aggregate demand cause the aggregate demand curve to shift outward when they increase: the amounts households want to consume, businesses want to invest, governments want to spend, or foreigners want to purchase (minus the amount we purchase from them) at any given price level. Each component is driven by different factors; consumption, for example, is affected by interest rates, disposable income, and expectations for the future.

Aggregate demand is easily confused with GDP, the broadest and most commonly used measure of economic activity. GDP in the United States is measured regularly by the Bureau of Economic Analysis as the sum of final spending on consumption, investment, government spending, and net exports. Thus, these four measures are both the accounting components of GDP and the causes of a shift in the theoretical concept of aggregate demand.

When the BEA reports that GDP has declined, that's what economists call a recession — which often ignites debates about whether the government should attempt to boost aggregate demand. This idea stems from the work of British economist John Maynard Keynes. In the throes of the Great Depression, he proposed that the government should counteract declines in aggregate demand by stepping in to spend itself.

Up to that point, the prevailing view of business cycles held that recessions last about as long as it takes for the price system to reallocate goods and services, a process thought to be reasonably quick. This view focused on the economy's long-run potential as the primary determinant of the level of economic activity. Keynes, in contrast, argued that prices can be quite sticky, forcing output to contract for sustained periods in response to negative shocks to aggregated demand.

By the 1960s, the theory of aggregate demand shortfalls became widely accepted as not just a description of business

cycles but as a workable prescription for how policymakers should respond to them. This backfired when attempts to continually boost aggregate demand worked a little too well, resulting in inflation. The lesson was that the economy can't be pushed beyond its sustainable level of supply for long.

But many economists continue to argue that economists should counteract demand shortfalls in recessions. This is what the 2009 fiscal stimulus law tried to do. And in the aftermath of the Great Recession, Christina Romer, then head of the President's Council of Economic Advisers, noted the presence of factors that Keynes might have agreed would be harmful to aggregate demand: a fall in wealth following the 2007-2008 financial crisis, disruptions of credit, shrinking government spending, and cautious spending from nervous consumers.

The remedy, she said, would be “new actions aimed at stimulating aggregate demand” such as federal assistance to state governments, tax incentives for hiring, funding for small businesses, and even consumer incentives to make homes energy efficient.

Critics argue that appeals to aggregate demand shortfalls often are simply an excuse for constituent-pleasing spending that risks distorting the allocation of resources. Moreover, there are circumstances when aggregate demand *should* fall or grow less quickly, namely, when the economy's productive potential has done the same. It can be hard to identify such effects in real time, which explains the heated debates during and after the Great Recession about whether unemployment was the result of structural or cyclical forces.

In the critics' view, it is somewhat pointless to try and disentangle whether a recession stems from aggregate demand or from aggregate supply. Instead, policy should focus on the factors that gum up the economy's adjustment to shocks.

For example, recessions tend to make consumers nervous about future job prospects, thus causing them to postpone major purchases or vacations and increase savings, called a spike in precautionary savings. The reaction may make perfect sense for each individual household while worsening the recession in the aggregate. The fundamental problem — the fact that it is hard for households to insure themselves against the risk of unemployment — could be addressed with enhanced unemployment benefits.

Such policies can appeal to both camps; Romer also suggested an expansion of unemployment benefits to help boost spending by those households — and thus aggregate demand. **EF**

