Demand curve shift worksheet 4.11.3 answers

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Students learn in microeconomics that the demand curve for a good, which shows the relationship between the price of a good and the quantity of the good that consumers demand- i.e. are willing, ready, and able to purchase- has a negative slope. This negative slope reflects the observation that people demand more of almost all goods when they gets cheaper and vice versa. This is known as the law of demand. In contrast, the aggregate demand curve used in macroeconomics shows the relationship between the overall (i.e. average) price level in an economy, usually represented by the GDP Deflator, and the total amount of all goods demanded in an economy. Note that "goods" in this context technically refers to both goods and services. Specifically, the aggregate demand curve shows real GDP, which, in equilibrium, represents both total output and total income in an economy, on its horizontal axis. Technically, in the context of aggregate demand, the Y on the horizontal axis represents aggregate expenditure. As it turns out, the aggregate demand curve also slopes downwards, giving a similar negative relationship between price and quantity that exists with the demand curve for a single good. The reason that the aggregate demand curve has a negative slope, however, is quite different. In a lot of cases, people consume less of a particular good when its price increases because they have an incentive to substitute away to other goods that have become relatively less expensive as a result of the price increase. On an aggregate level, however, this is somewhat difficult to do- though not totally impossible, since consumers can substitute away to imported goods in some situations. Therefore, the aggregate demand curve must slope downwards for different reasons. In fact, there are three reasons why the aggregate demand curve exhibits this pattern: the wealth effect, the interest-rate effect, and the exchange-rate effect. When the overall price level in an economy decreases, consumers' purchasing power increases, since every dollar they have goes further than it used to. On a practical level, this increase in purchasing power is similar to an increase in wealth, so it shouldn't be surprising that an increase in purchasing power makes consumers want to consume more. Since consumption is a component of GDP (and therefore a component of aggregate demand), this increase in purchasing power caused by a reduction in the price level leads to an increase in aggregate demand. Conversely, an increase in the overall price level decreases the purchasing power of consumers, making them feel less wealthy, and therefore decreases the number of goods that consumers want to purchase, leading to a decrease in aggregate demand. While it is true that lower prices encourage consumers to increase their consumption, it is often the case that case that this increase in the number of goods purchased still leaves consumers with more money left over than they had before. This leftover money is then saved and lent out to companies and households for investment purposes. The market for "loanable funds" responds to the forces of supply and demand just like any other market, and the "price" of loanable funds is the real interest rate. Therefore, the increase in consumer saving results in an increase in the supply of loanable funds, which decreases the real interest rate and increases the level of investment in the economy. Since investment is a category of GDP (and therefore a component of aggregate demand), a decrease in the price level leads to an increase in aggregate demand. Conversely, an increase in the overall price level tends to decrease the amount that consumers save, which lowers the supply of savings, raises the real interest rate, and lowers the quantity of investment. This decrease in investment leads to a decrease in aggregate demand. Since net exports (i.e. the difference between exports and imports in an economy) is a component of GDP (and therefore aggregate demand), it's important to think about the effect that a change in the overall price level has on the levels of imports and exports. In order to examine the effect of price changes on imports and exports, however, we need to understand the impact of an absolute change in the price level on relative prices between different countries. When the overall price level in an economy decreases, the interest rate in that economy tends to decline, as explained above. This decline in the interest rate makes saving via domestic assets look less attractive compared to saving via assets in other countries, so demand for foreign assets increases. In order to purchase these foreign assets, people need to exchange their dollars (if the U.S. is the home country, of course) for foreign currency. Like most other assets, the price of currency (i.e. the exchange rate) is determined by the forces of supply and demand, and an increase in demand for foreign currency increases the price of foreign currency. This makes domestic currency relatively cheaper (i.e. the domestic currency depreciates), meaning that the decrease in the price level not only reduces prices in an absolute sense but also reduces prices relative to the exchange-rate adjusted price levels of other countries. This decrease in the relative price level makes domestic goods cheaper than they were before for foreign consumers. The currency depreciation also makes imports more expensive for domestic consumers than they were before. Not surprisingly, then, a decrease in the domestic price level increases the number of exports and decreases the number of imports, resulting in an increase in net exports. Because net exports is a category of GDP (and therefore a component of aggregate demand), a decrease in the price level leads to an increase in aggregate demand. Conversely, an increase in the overall price level will increase interest rates, causing foreign investors to demand more domestic assets and, by extension, increase the demand for dollars. This increase in demand for dollars makes dollars more expensive (and foreign currency less expensive), which discourages exports and encourages imports. This decreases net exports and, as a result, decreases aggregate demand. How to Calculate PED Analysis of Demand and Supply How to Calculate Elasticity of... Equations Used in Economics How Does a Change in Supply Affect... Why Are Supply & Demand Important... The Effects of Purchasing Power Tools of Economics What Is a Horizontal Demand Curve? How to Calculate the Amount of... In economics, demand is the consumer's need or desire to own goods or services. Many factors influence demand. In an ideal world, economists would have a way to graph demand versus all these factors at once. In reality, however, economists are limited to two-dimensional diagrams, so they have to choose one determinant of demand to graph against quantity demanded. Economists generally agree that price is the most fundamental determinant of demand. In other words, price is likely the most important thing that people consider when they are deciding whether they can buy something. Therefore, the demand curve shows the relationship between price and quantity demanded. In mathematics, the quantity on the y-axis (vertical axis) is referred to as the dependent variable and the quantity on the x-axis is referred to as the independent variable. However, the placement of price and quantity on the axes is somewhat arbitrary, and it shouldn't be inferred that either is a dependent variable in a strict sense. Conventionally, a lowercase q is used to denote individual demand and an uppercase Q is used to denote market demand. This convention isn't universal, so it's important to check whether you're looking at individual or market demand. It will be market demand in most cases. The law of demand states that, all else being equal, the quantity demanded of an item decreases as the price increases, and vice versa. The "all else being equal" part is important here. It means that individuals' incomes, the prices of related goods, tastes, and so on are all held constant with only the price changing. The vast majority of goods and services obey the law of demand, if for no other reason than fewer people are able to purchase an item when it becomes more expensive. Graphically, this means that the demand curve has a negative slope, meaning it slopes down and to the right. The demand curve doesn't have to be a straight line, but it's usually drawn that way for simplicity. Giffen goods are notable exceptions to the law of demand. They exhibit demand curves that slope upward rather than downward, but they don't occur very often. If you're still confused as to why the demand curve slopes downward, plotting the points of a demand curve may make things clearer. In this example, start by plotting the points in the demand schedule on the left. With price on the y-axis and quantity on the x-axis, plot out the points given the price and quantity. Then, connect the dots. You'll notice that the slope is going down and to the right. Essentially, demand curves are formed by plotting the applicable price/quantity pairs at every possible price point. Since slope is defined as the change in the variable on the y-axis divided by the change in the variable on the x-axis, the slope of the demand curve equals the change in price divided by the change in quantity. To calculate the slope of a demand curve, take two points on the curve. For example, use the two points labeled in this illustration. Between those points, the slope is (4-8)/(4-2), or -2. Note again that the slope is negative because the curve slopes down and to the right. Since this demand curve is a straight line, the slope of the curve is the same at all points. A movement from one point to another along the same demand curve, as illustrated here, is referred to as a "change in quantity demanded." Changes in quantity demanded are the result of changes in price. The demand curve can also be written algebraically. The convention is for the demand curve to be written as quantity demanded as a function of price. The inverse demand curve, on the other hand, is the price as a function of quantity demanded. These equations correspond to the demand curve shown earlier. When given an equation for a demand curve, the easiest way to plot it is to focus on the points that intersect the price and quantity axes. The point on the quantity axis is where price equals zero, or where the quantity demanded equals 6-0, or 6. The point on the price axis is where the quantity demanded equals zero, or where 0=6-(1/2)P. This occurs where P equals 12. Because this demand curve is a straight line, you can then just connect these two points. You will most often work with the regular demand curve, but in a few scenarios, the inverse demand curve is very helpful. It's fairly straightforward to switch between the demand curve and the inverse demand curve by solving algebraically for the desired variable.

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