

# [The aggregate demand and keynesian range](https://assignbuster.com/the-aggregate-demand-and-keynesian-range/)

Aggregate demand shows the amount of total goods and services those household, firms governments and foreign buyers desire to consume at each different price level. Aggregate demand is downward sloping because it has negative relationship between price level and total output. The higher the price level, the lower the output consume by household. In other word, the lower the price, the higher the outputs consume, vice versa.

Aggregate supply curve shows the relationship between the overall price level and the total aggregate quantity of output supplied by all firms in an economy. In macroeconomic, the aggregate supply curves comprise into 3 segments which are Keynesian range (horizontal), Intermediate range (up sloping) and Classical range (vertical).

In Keynesian range, the firms did not make full use of the resources. So, more workers and capital can be hire and invest more to economy. These will not increase the price. In intermediate range the AS curve is upward sloping and the economy still faces shortages, so some resources still can be inject to the business. By this, rising in output will raise the price too. In the classical range, since the economy has reached full employment, output will remain constant although price level increase.

Short run aggregate supply curve is upward sloping, intermediate range. Due to the curve is upward sloping, any expansion in output will lead to rising in price level.

A short run macroeconomic equilibrium occurs when domestic output equals the price level. In others words, it forms when AD curve intersect with upward sloping AS curve (P2, Y2). In this case, the AD and AS curves show the quantity of demand and supply in each price level. The economy is operating nearly full employment and the equilibrium is depends on price level and output. Any changes in price or output will make changes in equilibrium. Thus, the multiplier is close to zero.

When the firms keep on increase the labours, machinery and others vital resources, the economy will reach full employment because the firms have fully use of the resources to produce output. Hence, the upward sloping AS curve (short run) will become vertical (long run).

Long run aggregate supply curve is vertical, classical range. Due to the curve is vertical, any rising in price level will not make changes on domestic output.

A long run macroeconomic equilibrium occurs when domestic output equals the price level. In others words, it forms when AD curve intersect with vertical AS curve (P3, Y3). In this case, the AS curves show the same quantity of output on different price level. Since the economy is operating full employment, so the equilibrium is depends on price level only. Any changes in price will lead to changes in equilibrium. Thus, the multiplier is close to zero.

Question 2

Aggregate demand (AD) shows how much do the consumers, firms, foreigners, government are willing to purchase at possible price level.

Aggregate output(Y) and the price level are having an inversely relationship.

When AD increases, the firms will increase their supply and raise the prices of outp1ut. In this situation, prices of the goods and services but the output remain constant, it is because the aggregate output is already reached the maximum and full employment is reached.

There is not to be possible to increase the output, as economy is reached full capacity. Increasing in output will push up the cost of output.

Aggregate Supply, AS

Price level, P

Aggregate output, Y

e1

e0

As the graph above shows that, although the AD is increase from increase to as well as shift to the right, but the aggregate output still remain at its full employment output. The price of output increase from to to reach the equilibrium.

The equilibrium is increase from e0 to e1.

Any changes in AD doesn’t affect the output, thus, the multiplier is totally zero.

On the other hand, if long run aggregate supply(AS) curve shift to the right, the price and output will be affected.

Aggregate output, Y

Price level, P

Aggregate Supply, AS

e1

e0

As the graph shows above, when the AS curve shift to the right while the AD is shifting to the same direction from to.

Obviously the output is rising from to Y1 whereas the Price level is slight increase from P0 to P1

Other than that, the equilibrium is slightly increased from the e0 to e1.

Question 3

Credit creation is the ability of the bank sector expands their money supply to make more loans. There are four assumptions for us to understand credit creation. Firstly, the bank can only have one kind of liability – demand deposit and invest one kind of asset – loans. Secondly, the reserve ration must be fix. Thirdly, bank only hold requiring reserve and finally is there are no cash withdraw from the financial system. Although these four assumptions are impossible in real world, but these assumptions can let us more understand about the credit creation.

Required reserve ratio is the minimum percentage of cash reserve of commercial banks to deposit in central bank. At first, we assume the individual deposit RM 1000 into CD Bank and the required reserve is 0. 25 (25%). After individual deposit money into his account, the credit side of the bank’s account shows CD bank’s liabilities have increase by RM 1000. On the debit side, the CD bank will record RM250 (1000\*0. 25= 250) as the required reserve ratio and the remaining balance- RM750 (1000-250= 750) which are excess reserve. So RM750 excess reserve can be loan out. The people who receive the loan (RM 750) will deposit the money into others bank, which known as second generation banks.

Again the 2nd generation bank will record RM 750 in credit side (liabilities increase). Due to require reserved ratio 25%, 2nd generation bank will record require reserve RM187. 5 (RM750\*0. 25= 187. 5) and balance can be loan out RM562. 5 (750-187. 5= 562. 5) in debit site. Repeatedly, 2nd generation bank will loan out the remaining balance and the people who receive the loan will deposit the money into third generation banks. 3rd generation banks will also follow the 25% of reserve ratio and the remaining balance will be loan out. This process will continuously until the deposit become zero. Finally, the total new deposits are RM 4000 with initially RM1000. The total credit created is RM 3000. Refer the diagram below to know how it being created.

Another faster way to calculate total new deposit is using money multiplier formula, which is 1/ require reserve ratio. The money multiplier formula is the reciprocal of the required reserve ratio. In the example above, the required reserve ratio is 0. 25, so the money multiplier is 1/0. 25 = 4, it means every RM 1 increase in reserve would cause increase RM 4 in deposit when there are no withdrawal. An additional RM 1000 in reserve will cause deposits increase to RM 4000 and credit creation is RM 3000 (4000-1000= 3000). In case if the required reserve ratio is 0. 4, than the money multiplier is 1/0. 4 = 2. 5. An increase RM 1000 in reserve will cause RM 2500 increase in deposit and credit creation will be RM 1500. From here, we can conclude the higher the ratio caused the lower of the credit creation. The lower the ratio caused the higher of the credit creation, vice versa.

Question 4

Presence of borrower

In money supply, borrowers play the independent roles; it is because the money supply is generated by the loans from bank. Thus, money supply cannot create without the borrowers.

Fixed reserve ratio

Commercial banks are obliged by the law to follow the reserve ratio which is insisted by the central bank. Money supply cannot leave out this consumption; it is because this consumption is to prevent the prospective interruption in the financial system.

Securities power

Banks would grant the loans with the security that the depositor recognize. So, the higher securities power will lead to a higher money supply.

Condition of economy

Borrower will loan more money when the condition of economy is well being, on the other hand, borrower would not take the loans from the bank when economy is having the dire situation.

No cash drain from the financial system

Money must remain within the country to prevent the cash drain from the financial system. For example, depositor should deposit the money in local bank and the loan should be in the local bank also. The loans should not loan out to another country.