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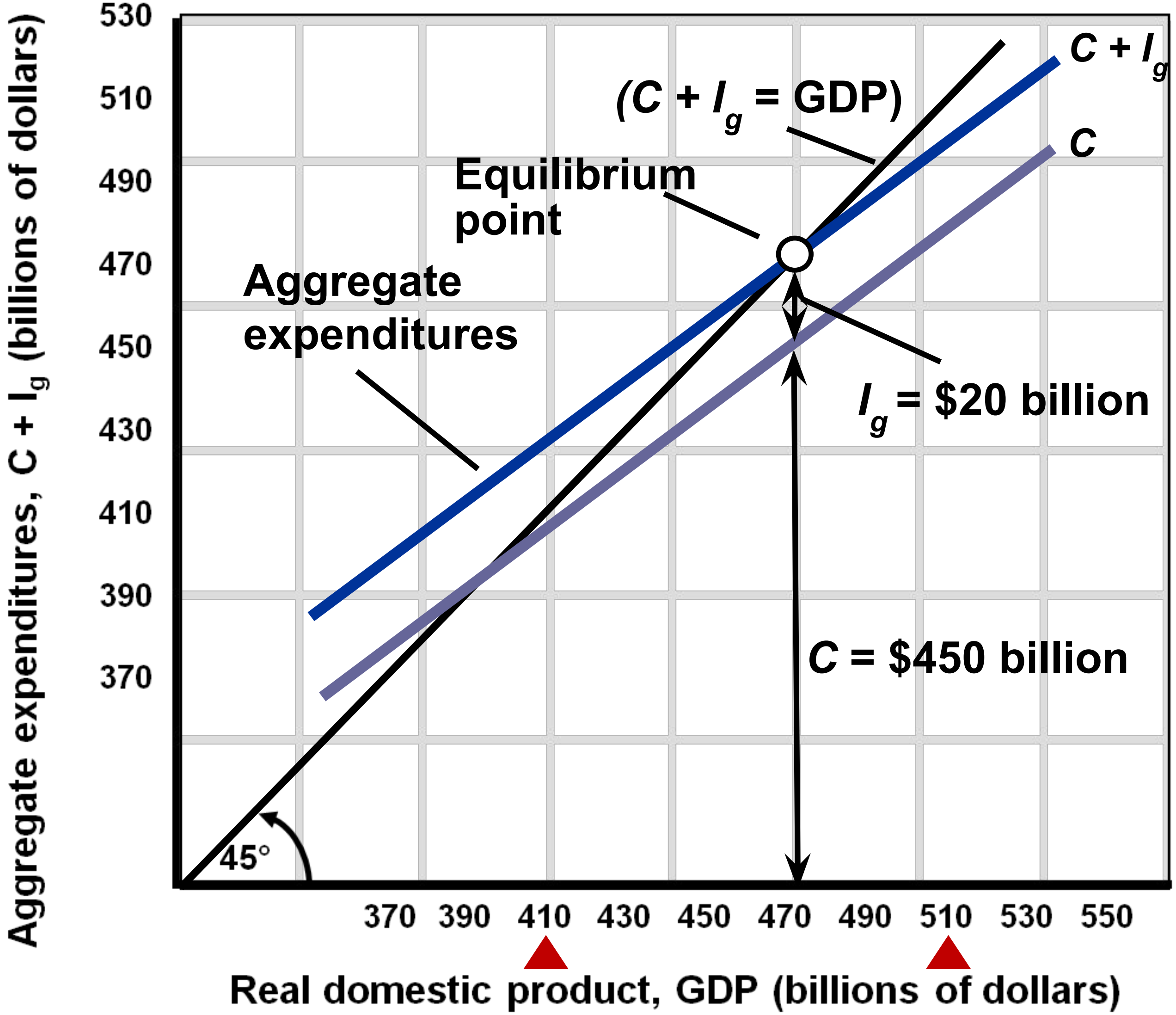
The Aggregate Expenditures Model

McGraw-Hill/Irwin

Assumptions and Simplifications

- Use the Keynesian aggregate expenditures model
- Prices are fixed
- GDP = DI
- Begin with private, closed economy
  - Consumption spending
  - Investment spending

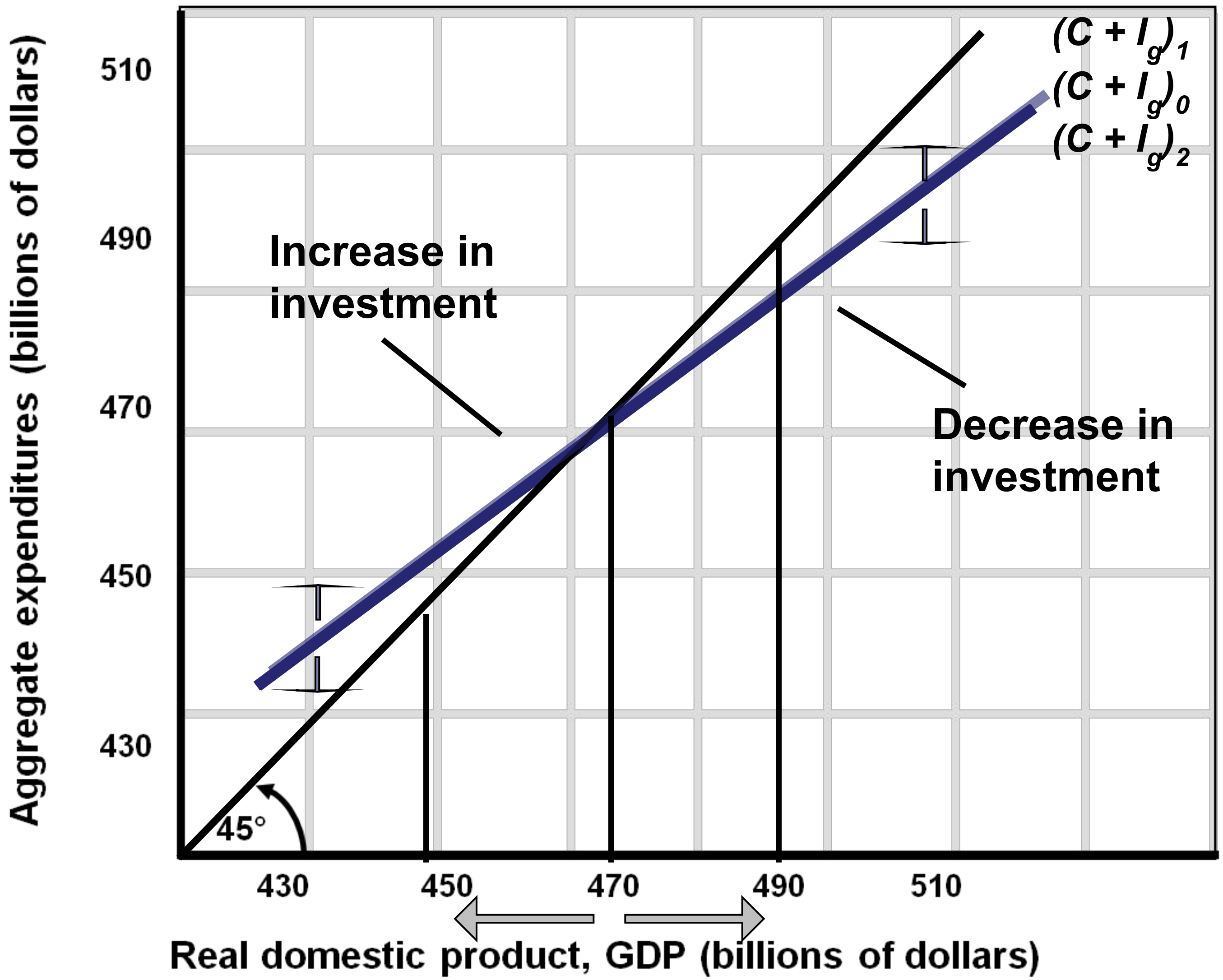
Equilibrium GDP



Other Features of Equilibrium GDP

- Saving equals planned investment
  - Saving is a leakage of spending
  - Investment is an injection of spending
- No unplanned changes in inventories
  - Firms do not change production

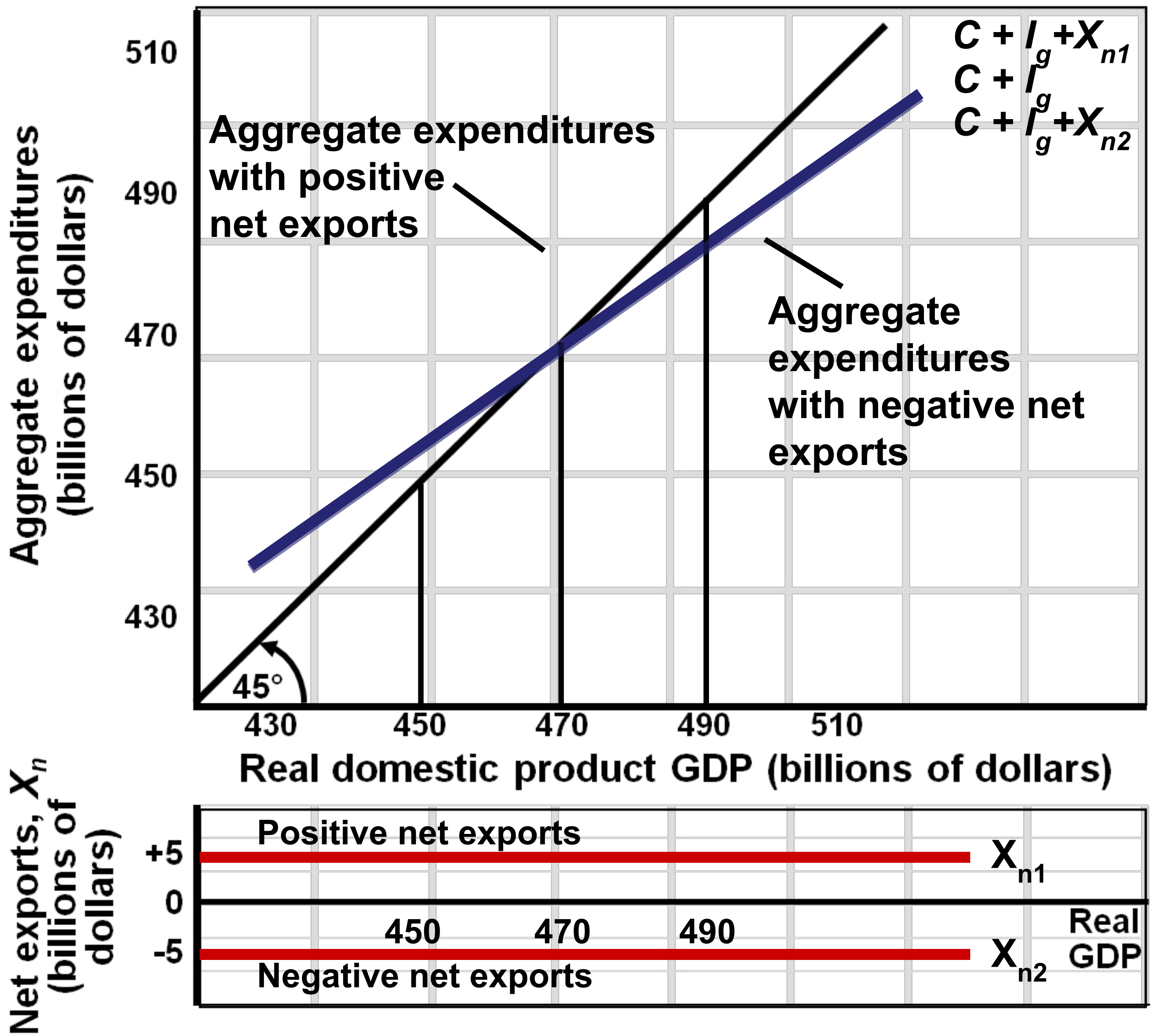
Changes in Equilibrium GDP



Adding International Trade

- Include net exports spending in aggregate expenditures
  - Private, open economy
- Exports create production, employment, and income
- Subtract spending on imports
- X_n can be positive or negative

Net Exports and Equilibrium GDP



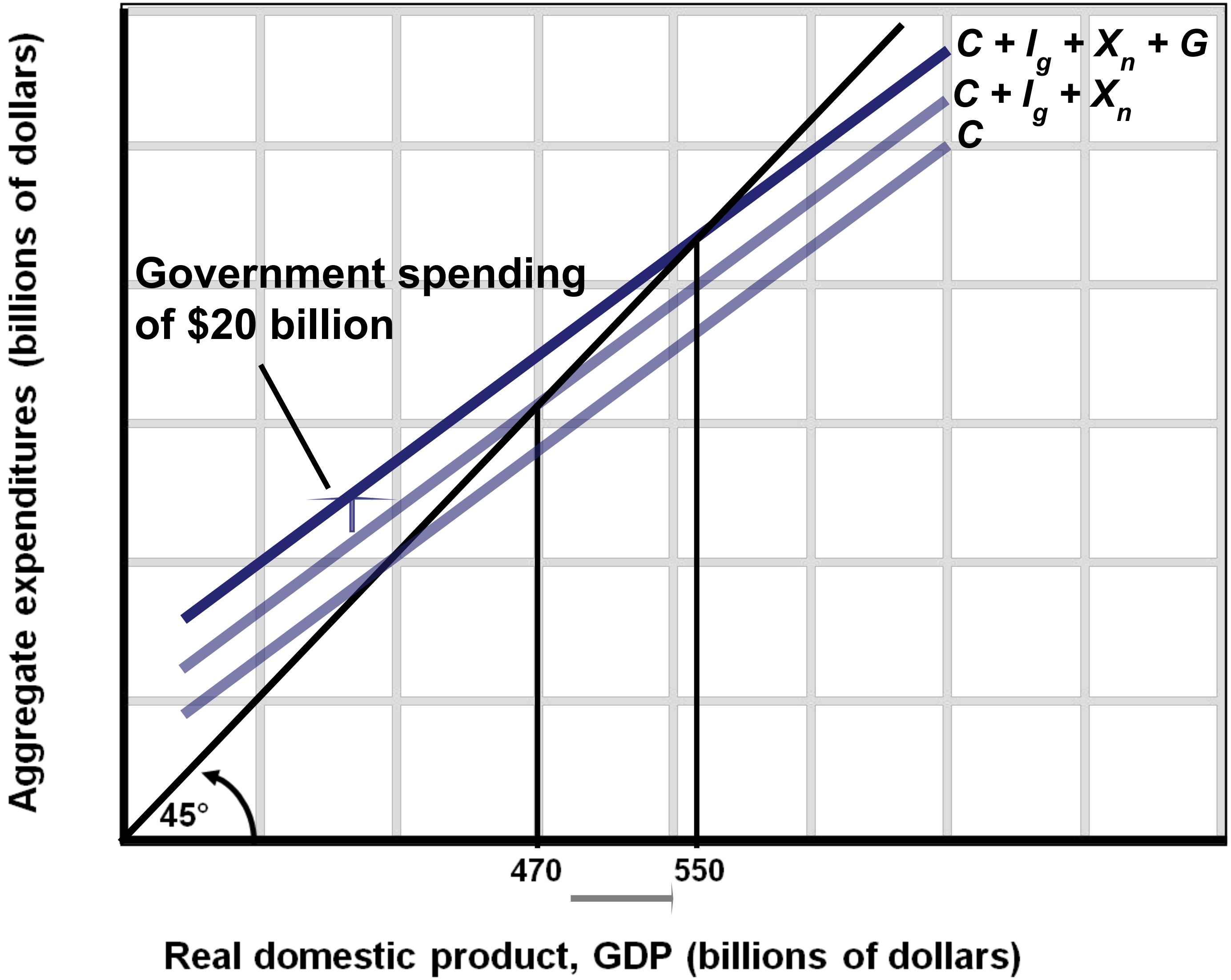
International Economic Linkages

- Prosperity abroad
  - Can increase U.S. exports
- Exchange rates
  - Depreciate the dollar to increase exports
- A caution on tariffs and devaluations
  - Other countries may retaliate
  - Lower GDP for all

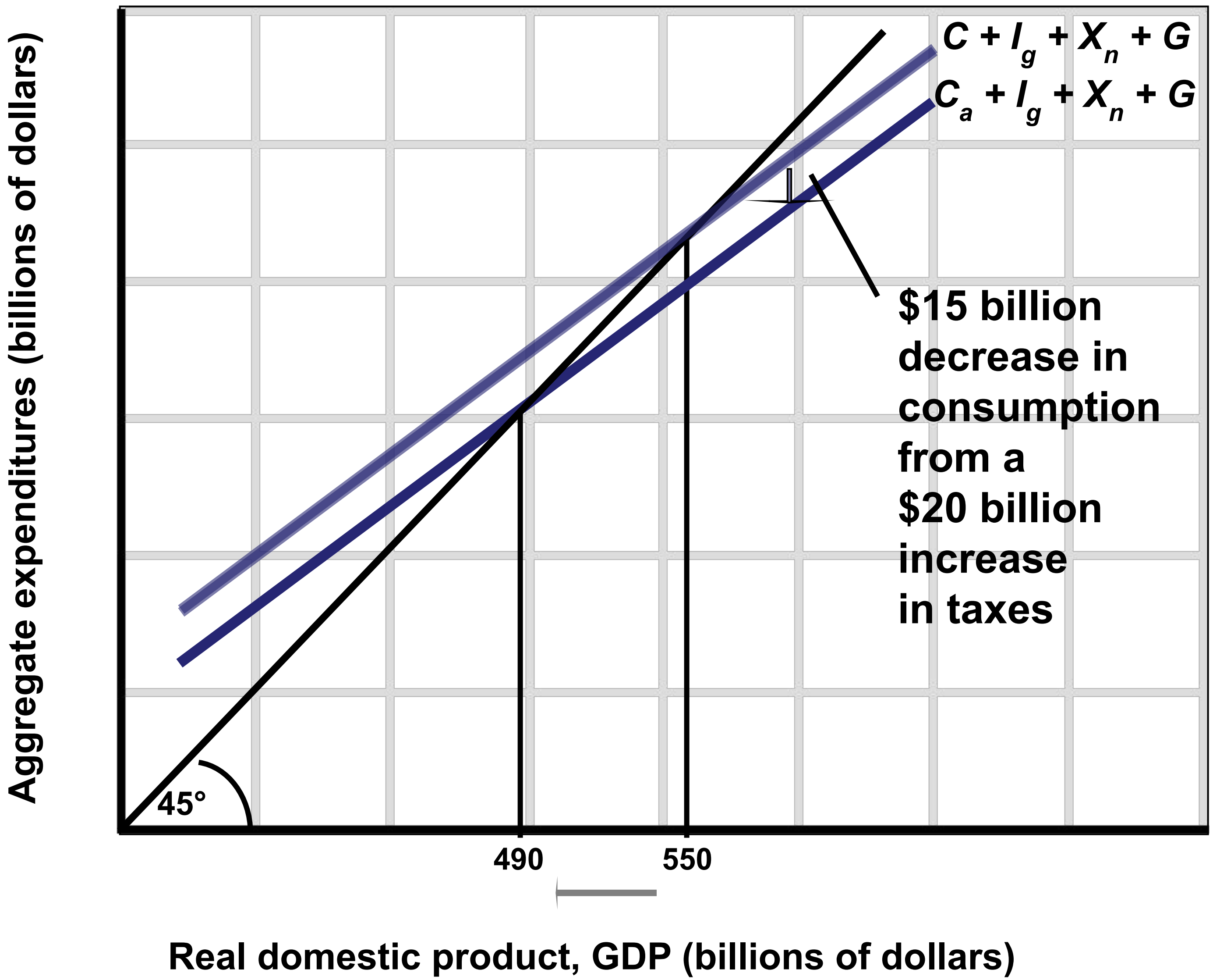
Adding the Public Sector

- Government purchases and equilibrium GDP
  - Government spending is subject to the multiplier
- Taxation and equilibrium GDP
  - Lump sum tax
  - Taxes are subject to the multiplier
  - DI = GDP

Government Purchases and Eq. GDP



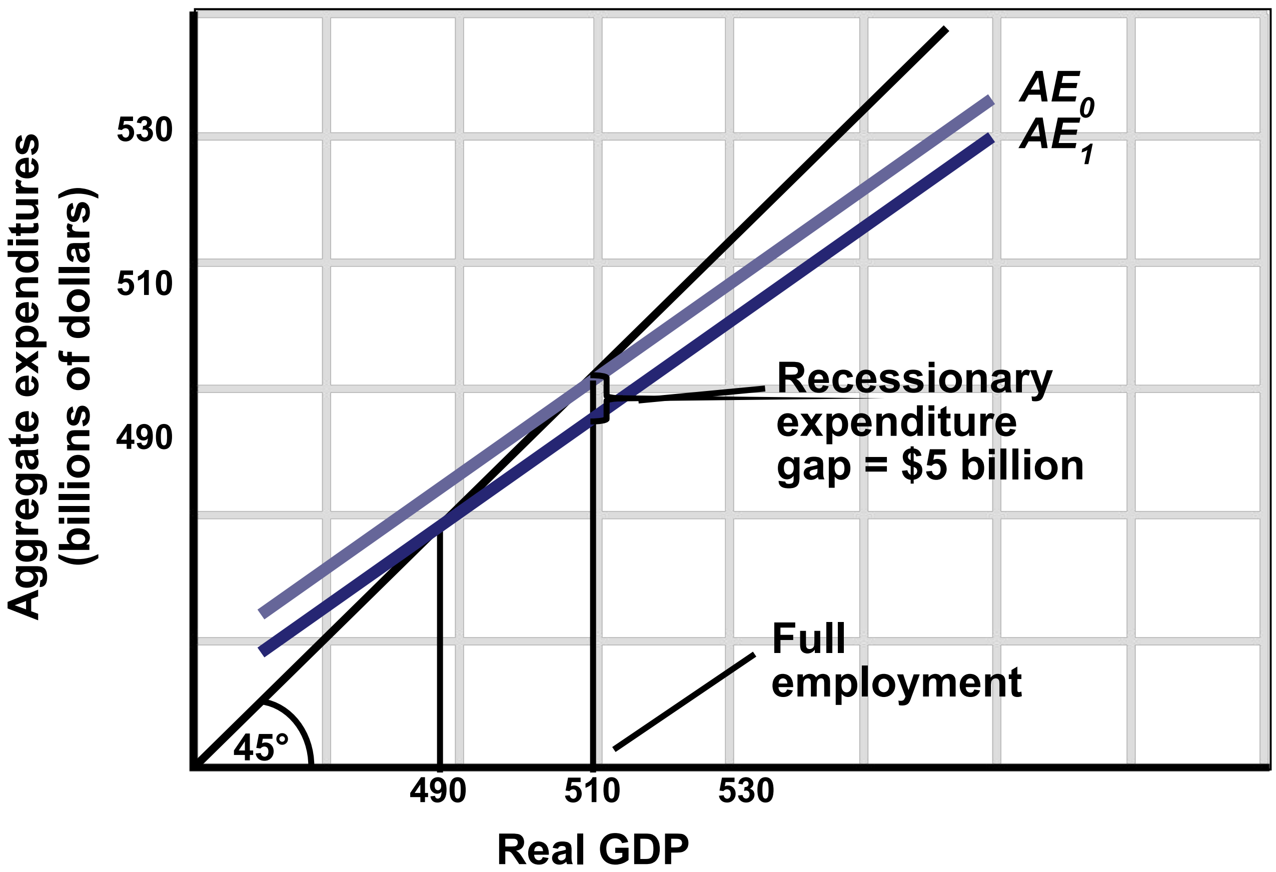
Taxation and Equilibrium GDP



Equilibrium versus Full-Employment

- Recessionary expenditure gap
  - Insufficient aggregate spending
  - Spending below full-employment GDP
  - Increase G and/or decrease T
- Inflationary expenditure gap
  - Too much aggregate spending
  - Spending exceeds full-employment GDP

Equilibrium versus Full-Employment



(a)
Recessionary expenditure gap

Equilibrium versus Full-Employment