# Chapter 12
# Aggregate Demand in the Goods and Money Markets

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**BIZ 203**

**Macroeconomics**

# MONEY, THE INTEREST RATE, AND OUTPUT: ANALYSIS AND POLICY

**Goods market** =

**Money market** =

# THE LINKS BETWEEN THE GOODS MARKET AND THE MONEY MARKET

- Link 1: Aggregate output (income) and the Demand for Money

- Link 2: Planned Investment Spending and the Interest Rate

# INVESTMENT, THE INTEREST RATE, AND THE GOODS MARKET

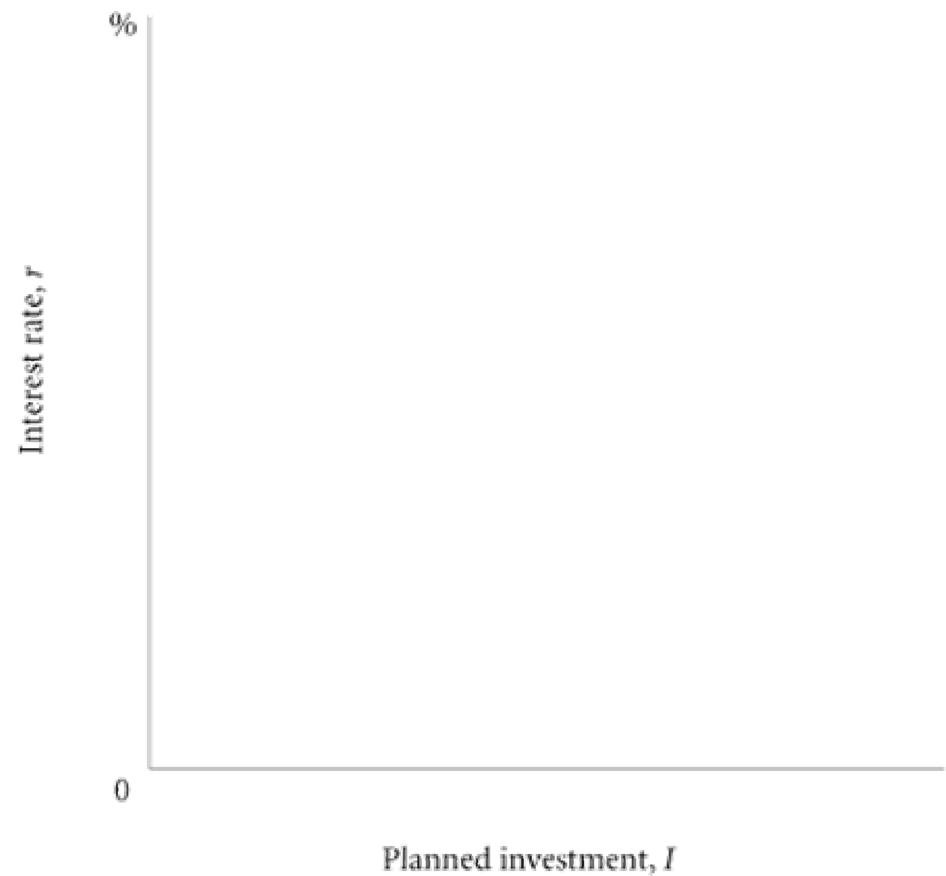


**FIGURE 12.2** Planned Investment Schedule

# INVESTMENT, THE INTEREST RATE, AND THE GOODS MARKET

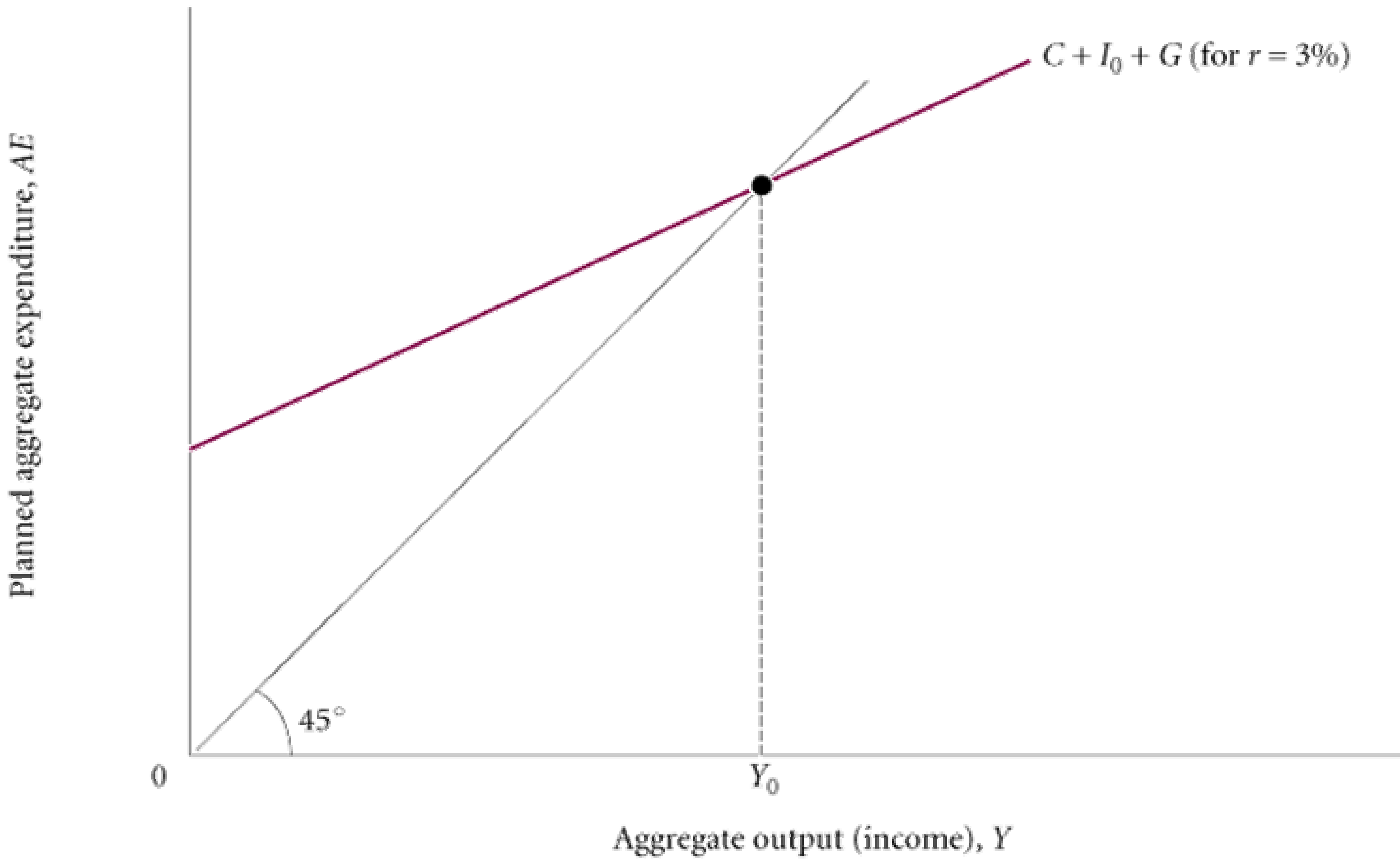


**FIGURE 12.3** **The Effect of an Interest Rate Increase on Planned Aggregate Expenditure**

# INVESTMENT, THE INTEREST RATE, AND THE GOODS MARKET

The effects of a change in the interest rate include:

- High interest rate (*r*) discourages planned investment (*I*).
- Planned investment is a part of planned aggregate expenditure (*AE*).
- Thus, when the interest rate rises, planned aggregate expenditure (*AE*) at every level of income falls.
- Finally, a decrease in planned aggregate expenditure lowers equilibrium output (income) (*Y*) by a multiple of the initial decrease in planned investment.

# MONEY DEMAND, AGGREGATE OUTPUT (INCOME), AND THE MONEY MARKET

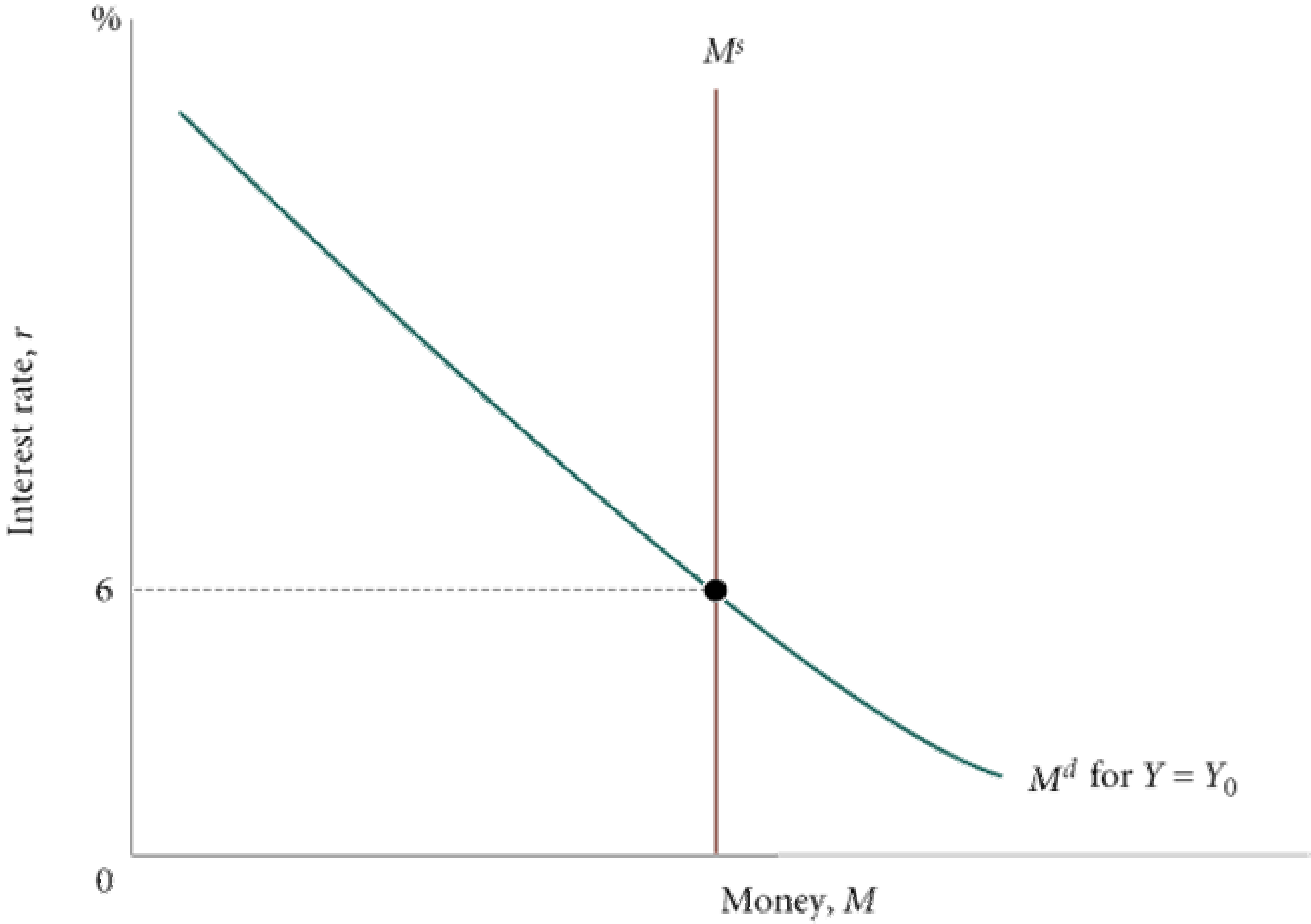


**FIGURE 12.5** **The Effect of an Increase in Income (*Y*) on the Interest Rate (*r*)**

# COMBINING THE GOODS MARKET AND THE MONEY MARKET

## EXPANSIONARY POLICY EFFECTS

**Expansionary fiscal policy**

**Expansionary monetary policy**

# Expansionary Fiscal Policy: An Increase in Government Purchases (*G*) or a Decrease in Net Taxes (*T*)

# An Increase in Government Purchases (*G*)

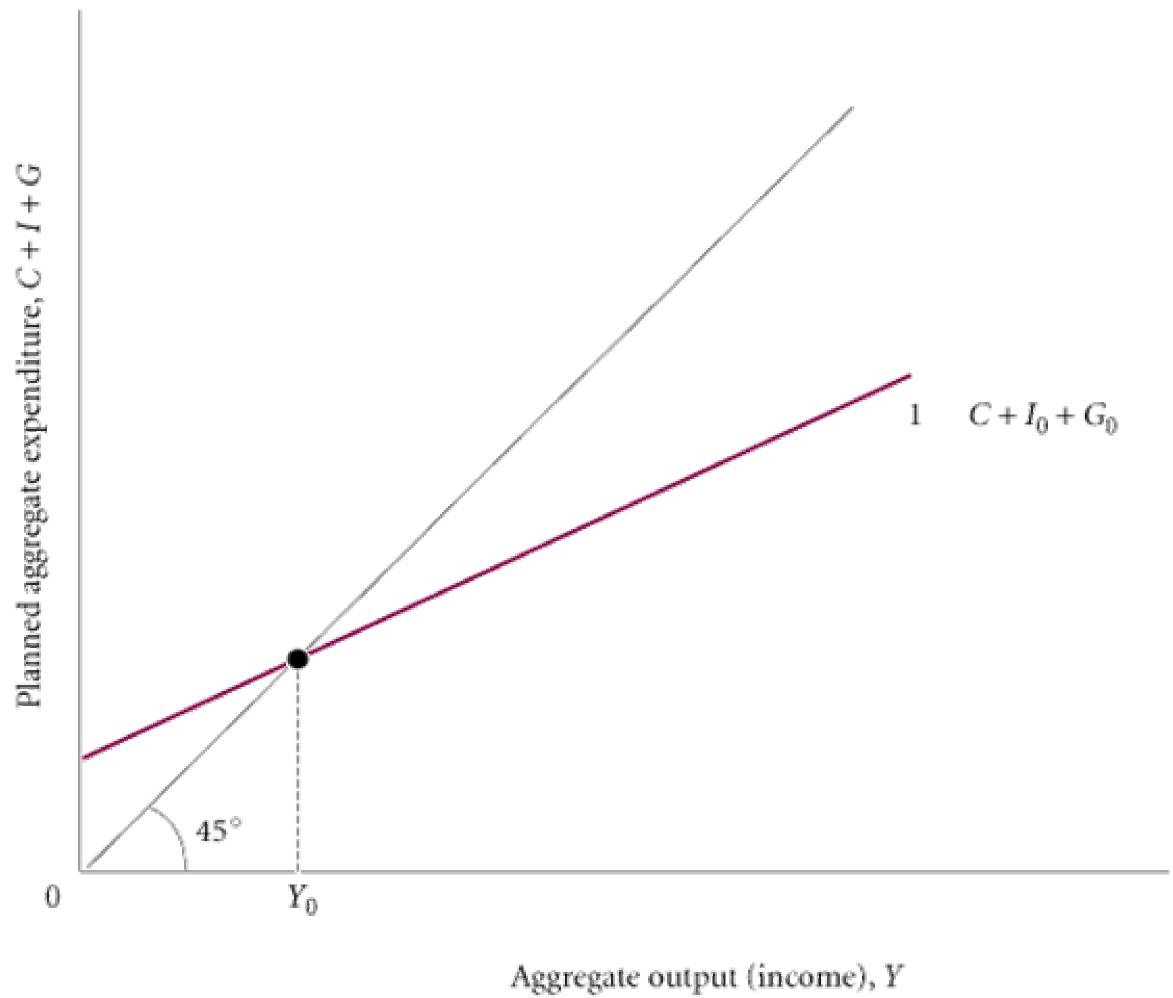


**FIGURE 12.6** The Crowding-Out Effect

# An Increase in Government Purchases (G)

- The size of the crowding-out effect and the ultimate size of the government spending multiplier depend on several things.

[1]

[2] **Interest sensitivity or insensitivity of planned investment** = The responsiveness of planned investment spending to changes in the interest rate. Interest sensitivity means that planned investment spending changes a great deal in response to changes in the interest rate; interest insensitivity means little or no change in planned investment as a result of changes in the interest rate.

# Expansionary Monetary Policy: An Increase in the Money Supply

- Consider what will happen when the Fed decides to increase the supply of money through open market operations.

## Expansionary Monetary Policy: An Increase in the Money Supply

- Monetary policy can be effective only if $I$ reacts to changes in $r$.

# CONTRACTIONARY POLICY EFFECTS

## Contractionary fiscal policy

# Contractionary monetary policy

# THE MACROECONOMIC POLICY MIX

**Policy mix =** The combination of monetary and fiscal policies in use at a given time.

**TABLE 12.1 The Effects of the Macroeconomic Policy Mix**

| | | FISCAL POLICY | |
|---|---|---|---|
| | | Expansionary ($\uparrow G$ or $\downarrow T$) | Contractionary ($\downarrow G$ or $\uparrow T$) |
| Monetary Policy | Expansionary ($\uparrow M^S$) | $Y\uparrow, r?, I?, C\uparrow$ | $Y?, r\downarrow, I\uparrow, C?$ |
| | Contractionary ($\downarrow M^S$) | $Y?, r\uparrow, I\downarrow, C?$ | $Y\downarrow, r?, I?, C\downarrow$ |

Key:

$\uparrow$: Variable increases.

$\downarrow$: Variable decreases.

?: Forces push the variable in different directions. Without additional information, we cannot specify which way the variable moves.

# OTHER DETERMINANTS OF PLANNED INVESTMENT

The determinants of planned investment are

- The interest rate
- Expectations of future sales
- Capital utilization rates
- Relative capital and labor costs