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TOPIC :- FACTORS RESPONSIBLE FOR CHANGES IN AGGREGATE DEMAND

The Aggregate Demand Curve shows an inverse relationship between the quantity of goods and services demanded and the price level, other things remaining constant. However, there are several other factors, which might affect aggregate demand apart from the price level. These factors include the level of income, the rate of interest, the exchange rate, expected rate of inflation, government policy, business expectations and so on.

In the long-run the changes in aggregate demand cause changes in national income only by changing the price level. Because in the long-run the level of real income is fixed at the natural rate. Depending on whether the change in aggregate demand is expected or unexpected it may encourage business firms to increase aggregate supply in the short-run. But in developing economies like India, the rise in aggregate demand, in many cases, results in spiralling inflation on account of supply bottlenecks and inadequate facilities, sometimes demanding stringent monetary controls.

(1) A change in Income:-

This is one of the major factors affecting disposable income and thus, aggregate demand. If

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institutional change or technological innovation enhances the efficiency of factor inputs and shifts the natural rate of output to a higher level, this implies an increase in aggregate supply in the long-run. This, in turn, results in higher level of real incomes to the community, because the higher level of output will provide higher incomes. However, according to monetarists, a rise of nominal income caused by an increase in the money supply will also result in expansion of aggregate demand. If money supply increases economic agents will be holding increased money balances, and consequently they will increase consumption spending.

(II) Rate of Interest :-

One of the reasons for downward sloping of aggregate demand curve is that as the price level rises the rate of interest will also rise and this in turn will reduce expenditure. As the price level rises, the cost of capital also rises and this will damper with the decline in expenditure, both consumption and investment spending. The analysis is as follows. Interest rate changes depend on several factors, apart from the changes in price level. When the rate of interest changes and other things including the

Price level remain constant, this alters the real cost of living or borrowing. If the rate of interest falls and the price level is constant, firms will be more willing to borrow to finance investment spending and households will be encouraged to borrow to purchase consumer goods. Therefore, the implication is that a decline in rate of interest when price level is constant will lead to an increase in aggregate demand whereas a rise in interest rate when the price level is constant will lead to fall in aggregate demand.

(iii) Government Policy :—

The changes in the fiscal policy, to a very large extent, can powerfully influence the aggregate demand. It is an established fact that if all other things remain equal an increase in govt. spending on goods and services imply an outward shift of the aggregate demand schedule. However, an increase in transfer payments or a reduction in taxation of incomes increases disposable income, leading to an increase in consumption spending. All this implies an increase in aggregate demand. The aggregate demand can also be increased, by cutting other taxes such as excise duties which will result in increased spending power.

(IV) A change in the Exchange Rate:-

The changes in the prices of exports and imports are due to the changes in exchange rate. Particularly the price foreigners pay for exports will fall, if the exchange rate falls and the price for imports paid by the domestic residents will increase. The result is that, though there has been no change in domestic price level, exports will increase and imports will fall. This specifically implies that aggregate demand will increase at each and every price level when there is a fall in exchange rate. In other words, the situation may be different when the exchange rate rises. In this situation there is a fall in aggregate demand at each and every price level.

(V) Change in the Expected Rate of Inflation:-

Any change in expected rate of inflation will lead to affect aggregate spending provided that other things remain constant. If the expectation of the economic agents is that there will be a rise in the inflation rate in future, they also expect a fall in the value of their real money balances in future. Acting accordingly they will bring forward many of their spending plans which they are able to. Therefore an increase in the expected rate of inflation is followed by a rise in aggregate demand and a reduction in the expected rate of inflation causes a reduction in aggregate demand.

(VI) Change in Business Expectations :- The investment decisions are highly influenced by the operations of the future. Confident and optimistic decision takers push up their investment levels expecting a spirit in sales. Therefore the aggregate demand also rises. Conversely there will be a fall in aggregate demand, if the investments are discouraged due to business pessimism.