AGGREGATE SUPPLY

AGGREGATE SUPPLY (AS)

- Short – run aggregate supply (SRAS)
- Long – run aggregate supply (LRAS)

SHORT – RUN AGGREGATE SUPPLY (SRAS)

Output that will be supplied in a period of time when the prices of factors of production (inputs, resources) have not had time to adjust to changes in aggregate demand and the price level

A graphical model that shows the positive relationship between the aggregate price level and amount of aggregate output supplied in an economy.

LONG – RUN AGGREGATE SUPPLY (LRAS)

Output that will be supplied in the time period when the prices of factors of production have fully adjusted to changes in aggregate demand and the price level

Measures long – term national output, the normal amount of real GDP a nation can produce at full employment

Perfectly vertical, curve can be shifted when the factors of production change in quantity

THE SHORT – RUN AGGREGATE SUPPLY CURVE

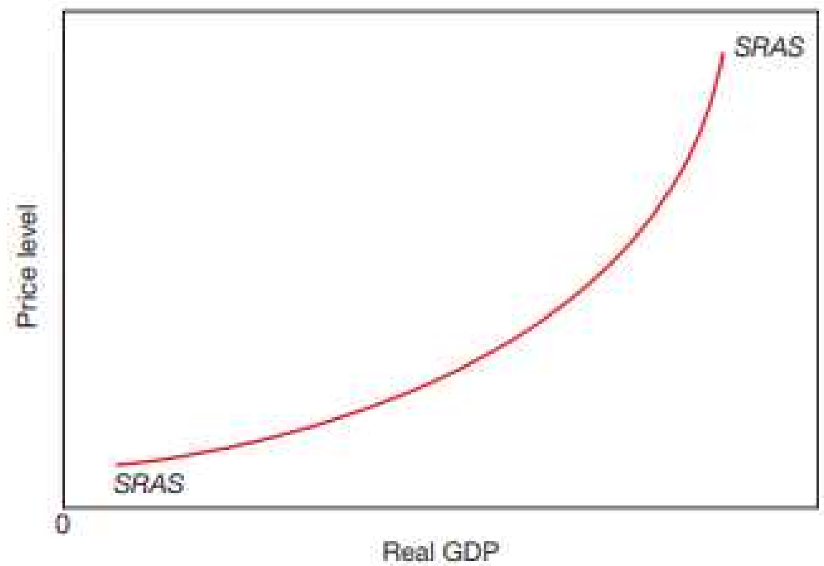


Figure 4.3 The short-run aggregate supply curve

As the price level rises, producers are willing and able to supply more goods and services.

POSITIVE RELATIONSHIPS

1. The profit effect – as the price level increases, the price of factors of production such as wages do not change. The gap between output and input prices widens and the amount of profit increases.

2. The cost effect – although the wage rates an raw material costs remain unchanged in the short run, average costs may rise as output increases. F/E: overtime payments, recruiting more members, cover any extra costs, etc.

3. The misinterpretation effect – producers may confuse changes in the price level with changes in relative prices. They may think that a rise in the price they receive for their products indicates that their own product is becoming more popular. As a result they may be encouraged to produce more.

SHIFTS IN THE SHORT – RUN AGGREGATE SUPPLY CURVE

While a change in the price level will cause a movement along the short-run aggregate supply curve.

1. A change in the price of factors of production – a rise in wage rates, not matched by an increase in labor productivity, and raw material costs will cause a decrease in SRAS, shifting the curve to the left

2. A change in taxes on firms – a reduction in corporation tax or indirect taxes will cause an increase in SRAS

3. A change in factor productivity/quality of resources – a rise in labor productivity and/or capital productivity will cause an increase in aggregate supply both in the short and long run.

4. A change in the quantity of resources – input of SRAS may be influenced by supply side shocks including natural disasters. These shocks may not have a significant impact on productive potential in the long run. The factors that will cause an increase in the quantity of resources in the long run will also increase SRAS.

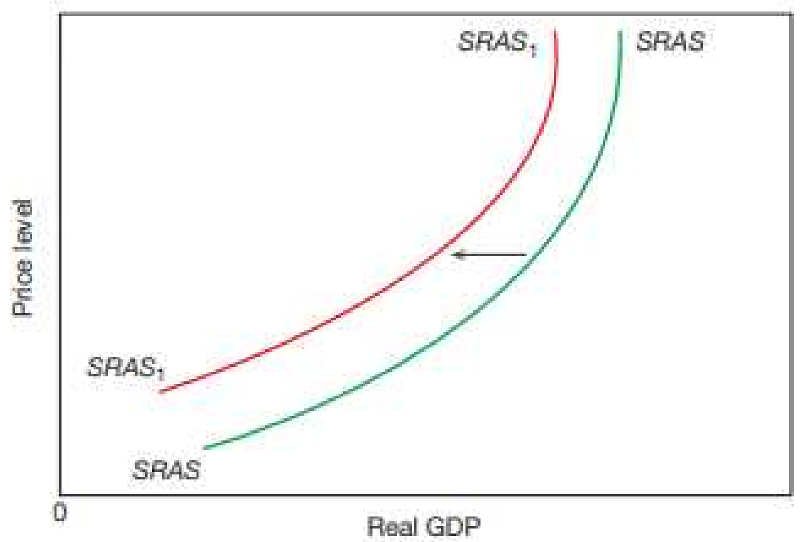
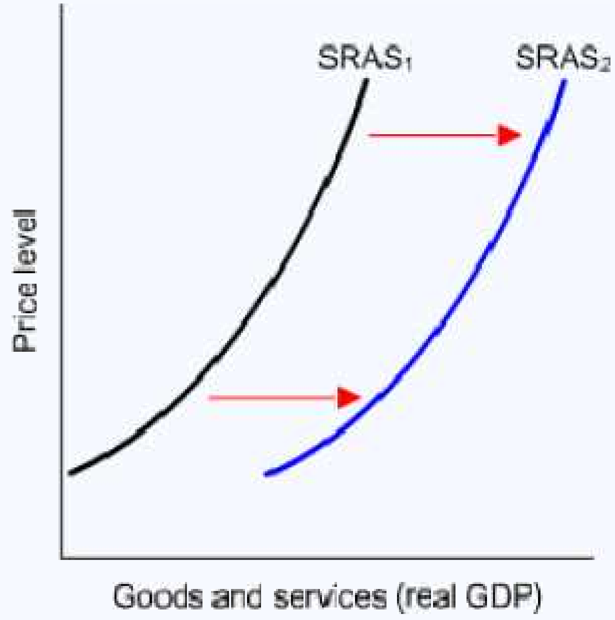


Figure 4.4 A decrease in short-run aggregate supply



THE SHAPE OF THE LONG-RUN AGGREGATE SUPPLY CURVE

the relationship between real GDP and changes in the price level when there has been time for input prices to adjust to changes in aggregate demand.

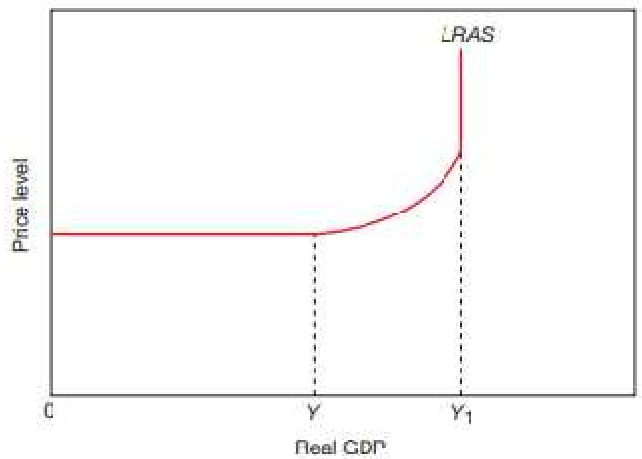


Figure 4.5 The Keynesian long-run aggregate supply curve

Keynesians = LRAS curve as perfectly elastic at low rates of output, then upward sloping over a range of output and final perfectly inelastic.

This is to emphasize their view that, in the long run, an economy can operate at any level of output and not necessarily at full capacity.

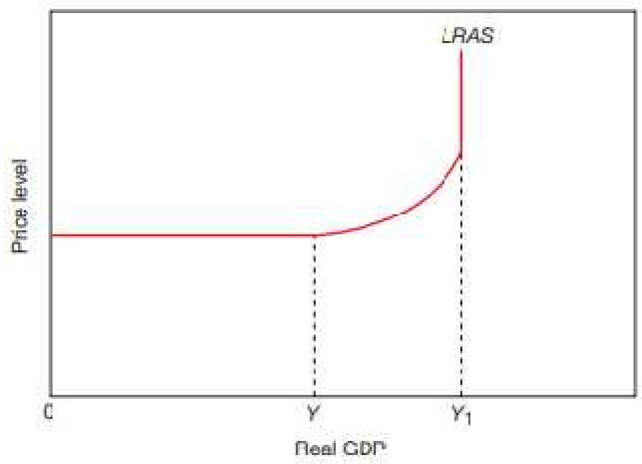


Figure 4.5 The Keynesian long-run aggregate supply curve

When output and hence employment are low, firms can attract more resources without raising their prices. There is time for input prices to change but, due to the low level of aggregate demand, they do not. For example, when unemployment is high, the off er of a job may be sufficient to attract new workers.

As output rises from Y to Y1 , fi rms begin to experience shortages of inputs and bid up wages, raw material prices and the price of capital equipment. When output reaches Y1 , the economy is producing the maximum output it can make with existing resources.

NEW CLASSICAL ECONOMISTS

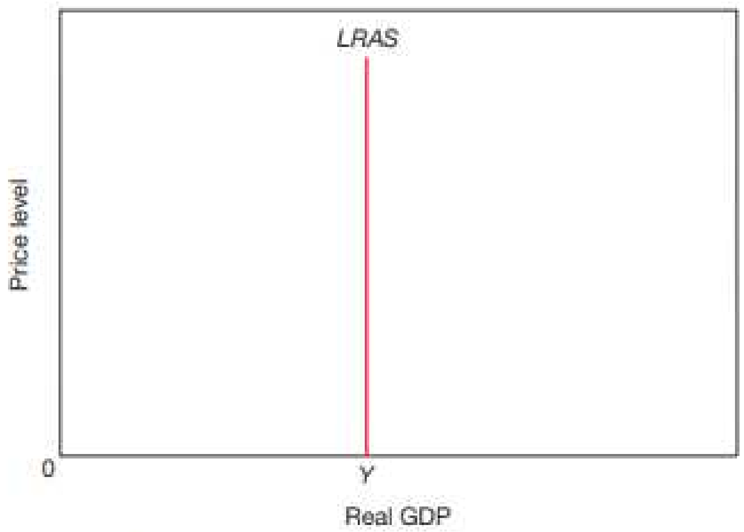


Figure 4.6 The new classical long-run aggregate supply curve

Another group of economists, called new classical economists, illustrate the LRAS curve as a vertical line. This is because they think that in the long run the economy will operate at full capacity.

SHIFTS IN THE LONG – RUN AGGREGATE SUPPLY CURVE

change in the quantity and/or quality of resources (factor productivity). Both of these will increase the productive potential of an economy.

The two main causes of an increase in the quality of resources are:

1. improved education and training – this will increase the skills of workers and so raise labor productivity.
2. advances in technology – these both reduce costs of production and increase productive capacity.

The causes of an increase in the quantity of resources in the long run are:

1. Net immigration – if the immigrants are of working age, increase the size of the labor

2. An increase in the retirement age – increase the size of the labor force. A number of countries have raised the age at which people can receive a state pension.

3. More women entering the labor force – proportion of women who work varies from country to country. F/E, in 2013 only 15% of women of working age were in the labor force in Saudi Arabia, while 75% of women in Norway were in the labor force.

4. Net investment – if gross investment (total investment) exceeds depreciation (capital goods that have to be replaced because they have become worn out or become out of date) there will be additions to the capital stock.

5. Discovery of new resources – the discovery of, for instance, new oil fields or gold mines can increase a country's productive potential.

6. Land reclamation – for instance, in recent years, Dubai has added considerably to its land area by reclaiming land on which it has built houses, hotels, marinas, theme parks and beaches.