

Revision – Aggregate demand and aggregate supply

Aggregate demand (AD): The total spending on goods and services in a period of time at a given price level. It is made up of consumption, investment, government spending and net export expenditure.

Consumption: The total spending by consumers on domestic goods and services.

Investment: The addition of capital stock to the economy.

Net exports: The value of export revenues minus import expenditure over a period of time.

Aggregate supply (AS): The total amount of goods and services that all industries in the economy will produce at every given price level.

Aggregate demand (AD)

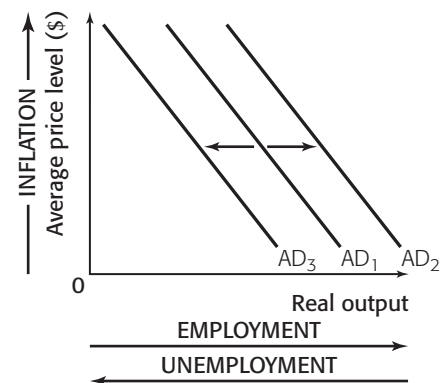
AD measures the demand for all goods and services at different price levels and so it shows the relationship between the **average price level** and **real output**.

The **components of AD** are consumer spending (C), investment expenditure by firms (I), government spending (G), and the expenditure by foreign residents on the country's exports (X) minus domestic expenditure on imports (M). AD is usually shown by the equation: $AD = C + I + G + (X - M)$. **The components set the position of the AD curve.**

The AD curve shows total demand in the economy at different average price levels. Since the vertical axis measures average prices, it can be said to be measuring inflation. The horizontal axis measures national output, which means that any increase is likely to require more labour and so it may be said to be 'measuring' employment.

We must remember that there is a **trade-off** between inflation and unemployment on the AD curve.

The **determinants of AD** change the components of AD and so shift the AD curve to the right or left.



Component	Causes of changes in components			
Consumption	Changes in interest rates	Changes in income	Changes in wealth	Changes in consumer confidence
Investment	Changes in interest rates	Changes in the level of national income	Technological change	Changes in business confidence
Government spending*	Changes in interest rates	Changes in the goals of the government		
Net exports	Changes in interest rates and so exchange rates	Changes in domestic and foreign incomes	Changes in demand for imports	Changes in demand for exports

* Governments use demand-side policies to shift the AD curve to the left or right. These policies may be fiscal policies or monetary policies. (See the revision sheet on demand-side and supply-side policies.)

Short-run aggregate supply (SRAS)

The SRAS curve is upward sloping, i.e. the higher the level of prices, the more producers will be prepared to produce. This is because higher output will involve higher marginal costs. If firms face rising marginal costs, they will need to receive higher prices to encourage them to produce more.

Factors that cause the SRAS curve to shift are known as **supply shocks**. **The SRAS curve can only be shifted by factors that change the costs of production.** The most common examples would be changes in:

- wage rates
- the cost of raw materials
- the price of imports
- government policy.

Long-run aggregate supply (LRAS)

There are two major views relating to the shape of the LRAS. The different beliefs about the shape of the LRAS curve lie at the basis of controversies about appropriate policies to be followed by governments.

1 The new-classical view (monetarist or free market view)

These economists argue that the LRAS curve does not respond to changes in AD in the long run and is determined completely independently of demand. **Its position depends upon the quantity and productivity (quality) of factors of production.** An expansion of AD will always lead to demand-pull inflation and will not, in the long run, lead to growth in output and thus employment. So new-classical economists argue that national output may only be increased by adopting **supply-side policies** to shift the LRAS to the right. (See the diagram on the left below.)

2 The Keynesian view (interventionist view)

There are a number of views held in this 'camp', but we will focus on one, the moderate view. The shape of the curve that is known as the Keynesian LRAS shows three possible phases. These are shown in the diagram on the right above as regions (1), (2), and (3).

In region 1, the LRAS is perfectly elastic. Producers in the economy can raise their level of output without higher average costs, because of 'spare capacity' in the economy.

In region 2, as the economy approaches its potential output (Y_f), and the spare capacity is used up, the available factors in the economy become more scarce. As producers increase output, they bid for the increasingly scarce factors and prices begin to rise.

In region 3, when the economy is at full capacity, all factors are being used and so output cannot increase. Thus, LRAS is perfectly inelastic.

