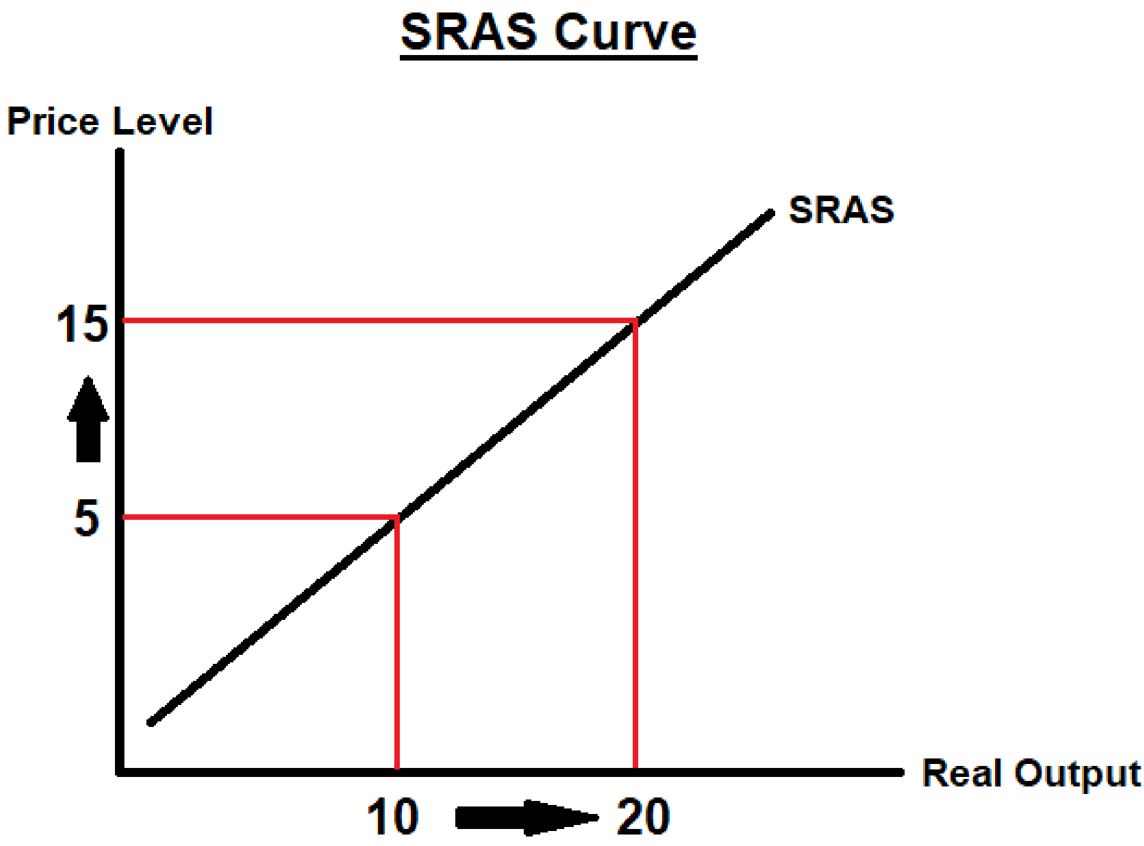
2.3 Aggregate Supply

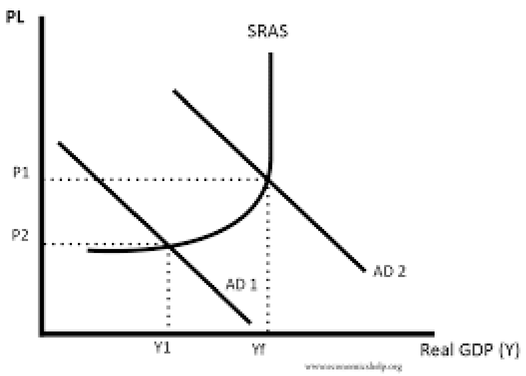
Aggregate Supply (AS) Overview

- Aggregate supply is the total amount of goods/services that all firms in an economy are willing and able to supply at a given price level in a year

SRAS Curve

- This curve is determined by costs of production (supply costs) and covers rent, wages, interest and profits
- It is upwards sloping since firms will increase output when the price level increases due to increased profits





- SRAS curve can also be drawn as a Keynsian curve which has the horizontal representing spare capacity, the upward slope representing bottlenecks and the vertical curve representing full employment (firms cannot supply more even after a price rise due to full employment)

- I do not reccomend the keynsian SRAS curve

Movements Along the AS Curve

- A change in the price level not related to AS cause a movement along the AS curve
- A change in consumption results in a shift in AD leading to an expansion in AS (movement along the curve)

Shifts of the AS Curve

- Changes in costs of production cause a shift in AS
- An increase in the costs of production causes a left shift of AS (such as an increases in tax or oil prices)
- A decrease in the costs of production causes the opposit (such as an increase in worker productivity)

The Relationship Between SRAS and LRAS

- SRAS curve is upwards sloping
- There is an assumption in SRAS that factors are fixed (as it is the short run) however current factors can be used more intensively (such as longer working hours or longer hours of capital operation)
- This is how output can change in the short run
- LRAS curve can be drawn as a vertical straight line (classical) or as a sloped curve ending in a vertical line (keynesian)
- LRAS assumes all factors are variable and classically in the long run, shifts in AD do not lead to increases in output as the economy is operating at full employment and is inelastic and in equilibrium

Classical Assumption

- Economy is free from regulation and is self adjusting
- Economy is in full employment in the long run hence the inelastic AS curve

Keynesian Assumption

- Economy can be in long run equilibrium but still contain spare capacity (horizontal section)
- This means that unemployment and recession will not regulate itself without government intervention
- Government may need to stimulate AD for long term growth and employment

Factors influencing SRAS

- Changes in costs of raw materials and energy
  - Costs of production rise
  - Left shift AS (Company can now supply less at same price level)

- Changes in exchange rates
    - If pound becomes stronger, imported materials become cheaper
    - Reduction in costs of production
    - Right shift AS
- Changes in tax rates
    - If taxes fall (e.g. corp tax or national insurance contributions) costs for the firm fall
    - Right shift AS
- Changes in level of tariffs
    - Tariffs on imports lead to more expensive imported materials
    - Increase in costs of production
    - Left shift AS

Factors influencing LRAS

- All factors influencing LRAS can be defined as improvements in the quantity of factors, quality of factors or state of technology

- Advancements in stage of technology
    - Reduces costs, LRAS increase
- Productivity changes
    - Reduces costs, LRAS increaase
- Education and skill changes
    - Increases productivity
    - LRAS increase
- Government regulation changes
    - Regulations can limit productive potential causing LRAS decrease
- Demographic changes
    - Skilled migration out of a country can lead to a decrease in LRAS
- Competition policy
    - If government uses laws to improve competition LRAS increases
- Changes in minimum wage
    - An increase in minimum wage is an increase in costs leading to a decrease in LRAS

- On the other hand an increase in minimum wage can lead to increased worker productivity which leads to an LRAS increase