Big Question: How does the AS AD model show the way in which the macroeconomy functions?

SYLLABUS REFERENCE 2.2:
Macro model No 2: Introduction to the AS / AD Model

The Aggregate Demand /Aggregate Supply Model

Macroeconomic Short Run: prices of final goods change but not factor prices. There is a time lag. Wages static.

Macroeconomic Long Run: prices of final goods include the changes to factor prices i.e. costs of factors of production increase

A

$$AD = C + I + G + X - M$$

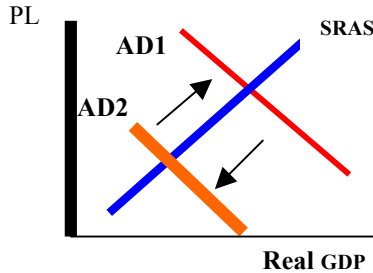**Aggregate Demand is the total demand for all goods and services in all final markets. It corresponds with the National Income of a nation**

i

1. AD downward sloping as the micro demand curve (refer to real balance, interest rate and net export effects)
2. AD inversely related to PL
3. AD represents spending of consumers (H), investors   (F or I) ,government(G), and foreigners (F or I).
4. Govt. policy should therefore attempt to control AD to ensure that equilibrium in the economy i.e. growth + stable prices prices

B

What causes AD to shift ?
1. *Fiscal policy*
• Government spending e.g. education
• Transfer payments
• Tax policy
2. Monetary policy
• Government controls money supply
• Interest rates controlled by government bank affect spending on durable goods, saving and investment
3. Foreign income changes
• Incomes rising in trading nations will see a rise in demand for the exports of the domestic nation
4. Expectations/ confidence: of Firm and Household.
5. External shocks: sudden changes in Demand. (Also known as a demand side shock)

C

AS = Sum total of all final goods and services which firms plan to produce
As with AD changes in AS take place along the curve and by shifting the curve

D

Features:
1. Shape of LRAS curve is disputed see Keynes vs Monetarists
2. The key issue amongst economists is the shape of the AS. To what extent does it take a vertical shape ? It is this vertical trend which leads to inflationary pressure

F

What causes **LRAS** to shift ?
1. Quantity + Quality of capital investment
2. Q+Q of labour
• Supply side policies play a key role- see **web 261**
• SRAS? Short run impacts on aggregate supply are noted in webnote 221
• See causes of short run shifts in AS in webnote 220 (slide 10) and in Blink pp 194-195. These outline the main causes of increased costs for firms in a macroeconomy.

E

Consumption (C) is a key factor:

What causes changes in consumption?
1. ▲ wealth e.g houses
2. ▲ in expectations and consumer confidence

G

H

Points to note: AS / AD model?
• **AS /AD allows analysis of the macroeconomy**
• **Shape of LRAS is disputed**
• **Behavioural factors represented in by statistical indices such as a business confidence index plays a vital role in any economy and model expectations can often be unfulfilled**

Note: short run shift in AS are outlined in webnote 220