Unit 2:Aggregate Economics

Aggregate Demand: The Economy's Appetite for Goods and Services

The sources define **Aggregate Demand (AD)** as the total quantity of goods and services demanded in an economy at different price levels. This represents the combined spending plans of households, businesses, the government, and foreign buyers. The **Aggregate Demand Curve** slopes downward, illustrating the inverse relationship between the price level and the quantity of output demanded.

Factors Shifting Aggregate Demand:

The sources emphasize that shifts in the AD curve can occur due to changes in various factors, including:

- **Changes in Consumer Spending:** Increases in consumer confidence, wealth, or disposable income can boost aggregate demand, shifting the AD curve to the right. Conversely, declines in these factors would shift the AD curve to the left.
- **Changes in Investment Spending:** When businesses become more optimistic about the future or interest rates fall, they tend to increase their investment spending. This shifts AD to the right. Pessimism or higher interest rates would have the opposite effect.
- **Changes in Government Spending:** Increases in government spending, such as on infrastructure projects or social programs, directly boost aggregate demand (shifting AD to the right). Reductions in government spending would have a contractionary effect (shifting AD to the left).
- **Changes in Net Exports:** When a country's exports rise relative to its imports (perhaps due to a weaker domestic currency), net exports increase, adding to aggregate demand. A rise in imports relative to exports would reduce aggregate demand.

Aggregate Supply: The Economy's Capacity to Produce

Aggregate Supply (AS) represents the total quantity of goods and services that firms are willing and able to produce at different price levels. The sources distinguish between two different time horizons for aggregate supply:

- **Short-Run Aggregate Supply (SRAS):** The SRAS curve is typically upward-sloping, suggesting that firms are willing to produce more output at higher price levels in the short run. This is often attributed to factors like sticky wages and prices (meaning that they don't adjust immediately to changing economic conditions).
- **Long-Run Aggregate Supply (LRAS):** The LRAS curve is generally depicted as vertical. This reflects the idea that in the long run, an economy's potential output is determined by factors like the size of its labour force, its capital stock, and its level of technology—not by the price level.

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Factors Shifting Aggregate Supply:

The sources highlight that shifts in the SRAS curve can occur due to changes in:

- **Input Prices:** Increases in the prices of key inputs, such as oil or labour, can reduce profitability and cause firms to cut back on production, shifting the SRAS curve to the left.
- **Productivity:** Improvements in technology or worker efficiency can boost productivity, allowing firms to produce more output with the same amount of inputs. This would shift the SRAS curve to the right.
- **Government Regulations:** Changes in taxes, subsidies, or regulations can also affect production costs and shift the SRAS curve.

Shifts in the LRAS curve occur when there are changes in:

- **Quantity and Quality of Resources:** Discoveries of new natural resources, increases in the size of the labor force, or improvements in education and skills (human capital) can expand an economy's long-run potential output, shifting the LRAS curve to the right.
- **Technological Progress:** Technological advancements allow firms to produce more output with the same amount of resources, leading to long-term economic growth (shifting LRAS to the right).

Equilibrium: Where Demand Meets Supply

The intersection of the aggregate demand curve and the short-run aggregate supply curve determines the economy's **short-run equilibrium** price level and output level. However, the sources emphasize that this short-run equilibrium may not coincide with the economy's long-run potential output. In the **long run**, the economy will tend to gravitate towards a level of output consistent with its productive capacity, as represented by the LRAS curve.

Economic Fluctuations: Riding the Waves

The AD-AS model provides a framework for understanding **economic fluctuations**, such as recessions and booms. The sources explain how shifts in aggregate demand or aggregate supply can lead to periods of above-trend or below-trend growth. For example, a sudden decrease in aggregate demand would shift the AD curve to the left, causing output to fall and unemployment to rise in the short run.

By analyzing the factors driving shifts in AD and AS, economists and policymakers can gain insights into the causes of economic fluctuations and develop strategies to promote greater stability.

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