Section 8: Aggregate Demand and Aggregate Supply

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Module 28
The Aggregate Supply Curve

- The aggregate supply curve shows the relationship between the aggregate price level (P) and the quantity of aggregate output (Y) in the economy.
The Short-Run Aggregate Supply Curve

• The **short-run aggregate supply curve** is upward-sloping because nominal wages are sticky in the short run:
  - a higher aggregate price level leads to higher profits and increased aggregate output in the short run.

• The **nominal wage** is the dollar amount of the wage paid.

• **Sticky wages** are nominal wages that are slow to fall even in the face of high unemployment and labor shortages.
The Short-Run Aggregate Supply Curve

A movement down the SRAS curve leads to deflation and lower aggregate output.
Shifts of the Short-Run AS Curve

- Changes in commodity prices, nominal wages, or productivity lead to changes in producers’ profits and shift the short-run aggregate supply curve.
Shifts of the Short-Run AS Curve

(a) Leftward Shift
- Decrease in short-run aggregate supply

(b) Rightward Shift
- Increase in short-run aggregate supply
Long-Run Aggregate Supply Curve

- The long-run aggregate supply curve shows the relationship between the aggregate price level (P) and the quantity of aggregate output (Y) supplied that would exist if all prices, including nominal wages, were fully flexible.
A fall in the aggregate price level...
...
...leaves the quantity of aggregate output supplied unchanged in the long run.

Long-run aggregate supply curve, LRAS

Aggregate price level (GDP deflator, 2005 = 100)

Potential output, YP

Real GDP (billions of 2005 dollars)
Actual and Potential Output

- There is a **recessionary gap** when aggregate output is below potential output.
- There is an **inflationary gap** when aggregate output is above potential output.
- The **output gap** is the percentage difference between actual aggregate output and potential output.

\[
\text{Output gap} = \frac{\text{Actual aggregate output} - \text{Potential output}}{\text{Potential output}} \times 100
\]

- Potential output exceeds actual aggregate output.
- Actual aggregate output exceeds potential output.
- Actual aggregate output roughly equals potential output.
From the Short Run to the Long Run

(a) Leftward Shift of the Short-Run Aggregate Supply Curve

A rise in nominal wages shifts SRAS leftward.

(b) Rightward Shift of the Short-Run Aggregate Supply Curve

A fall in nominal wages shifts SRAS rightward.
Economics in Action

Prices and Output During the Great Depression

Aggregate price level (GDP deflator, 2005 = 100)

Real GDP (billions of 2005 dollars)