

Edexcel Economics (A) A-level

Theme 2: The UK Economy - Performance and Policies

2.3 Aggregate Supply

Summary Notes

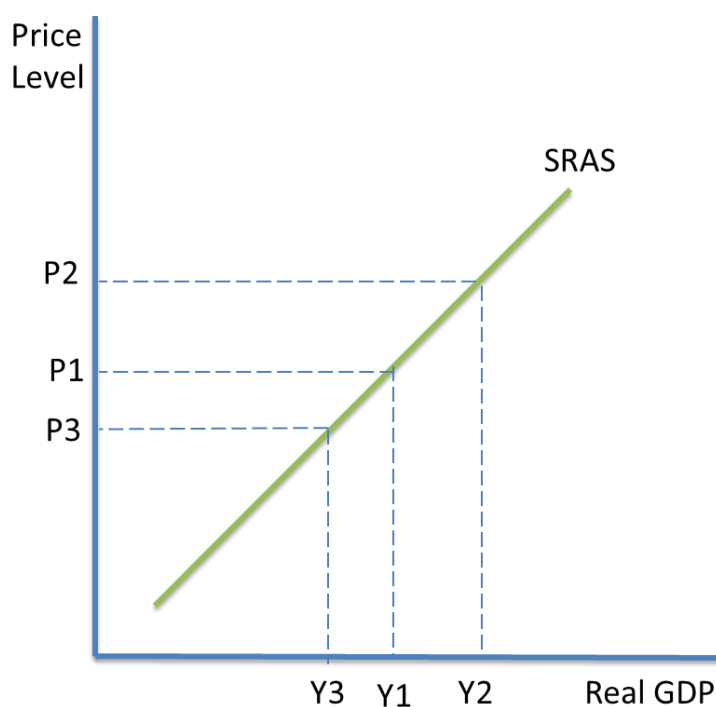


2.3.1 The characteristics of Aggregate Supply (AS)

The AS curve:

- Aggregate supply shows the quantity of real GDP which is supplied at different price levels in the economy.
- The SRAS curve is upward sloping because at a higher price level, producers are willing to supply more because they can earn more profits.

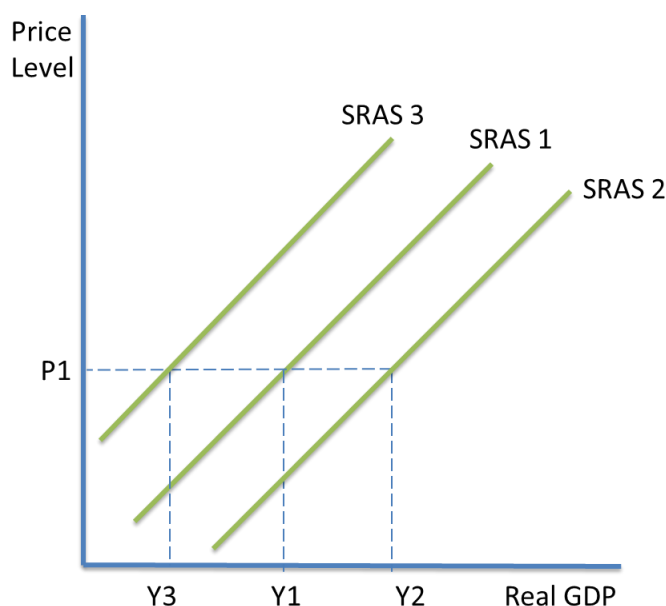
Moving along the AS curve:



- Only changes in the price level, which occur due to changes in AD, lead to movements along the AS curve.
- If AD increases, there is an **expansion** in the SRAS, from Y1 to Y2. If AD falls, there is a **contraction** in SRAS, from Y1 to Y3.



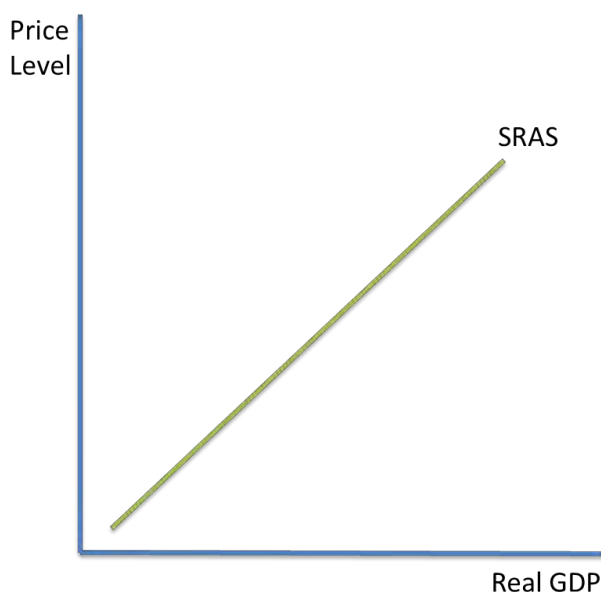
Shifting the AS curve:



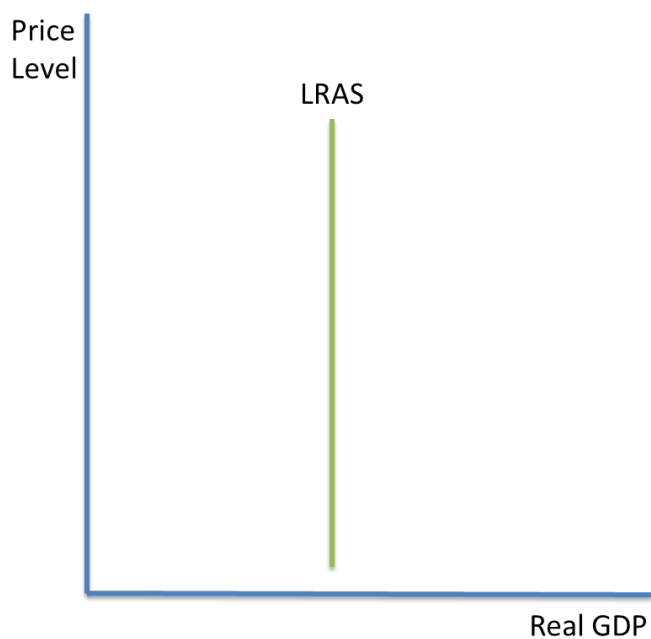
- The SRAS curve shifts when there are changes in the conditions of supply, any of the factors which affect SRAS.

The relationship between short run AS and long run AS:

- The short run is the period of time when at least one factor of production is fixed, whilst in the long run all factors of production are variable.
- The short run aggregate supply curve (SRAS) only covers the period immediately after a change in the price level. It shows the planned output of an economy when prices change, whilst the cost of production and productivity of the factor inputs are kept constant. A change in one of these will result in the shift of the curve.
- The curve is upward sloping because supply is assumed to be responsive to a change in AD, which is reflected in the price level.

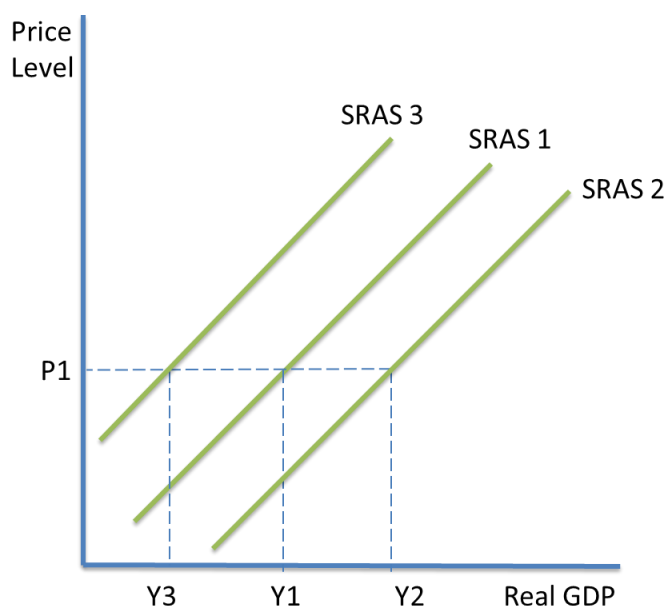


- The long run aggregate supply curve (LRAS) shows the potential supply of an economy in the long run. This is when prices, and the costs and productivity of factor inputs, can change. Similarly to the PPF, it can show the economy's productive potential.
- The curve is vertical in the classical model, because supply is assumed not to change as the price level changes.



2.3.2 Short-run AS

Factors influencing short-run AS:



- The SRAS curve shifts when there are changes in the conditions of supply. This is usually in the form of costs to businesses
 - The cost of raw materials and energy may change. A rise in their costs would increase costs for businesses and thus decrease SRAS from SRAS1 to SRAS3.
 - A stronger currency reduces the price of imports, so imported products will be cheaper. This would reduce business costs. The AS curve would shift outwards, from SRAS1 to SRAS2.
 - Increased tax rates would increase business costs and therefore decrease SRAS from SRAS1 to SRAS3.

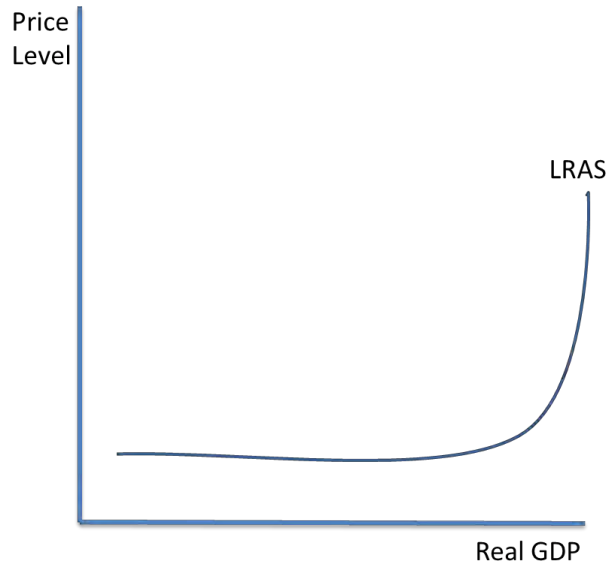
Synoptic point:

SRAS is determined by the cost of production. If microeconomic changes, such as the price of raw materials or indirect taxes, affect enough businesses, they will have macroeconomic impacts through a change in SRAS.

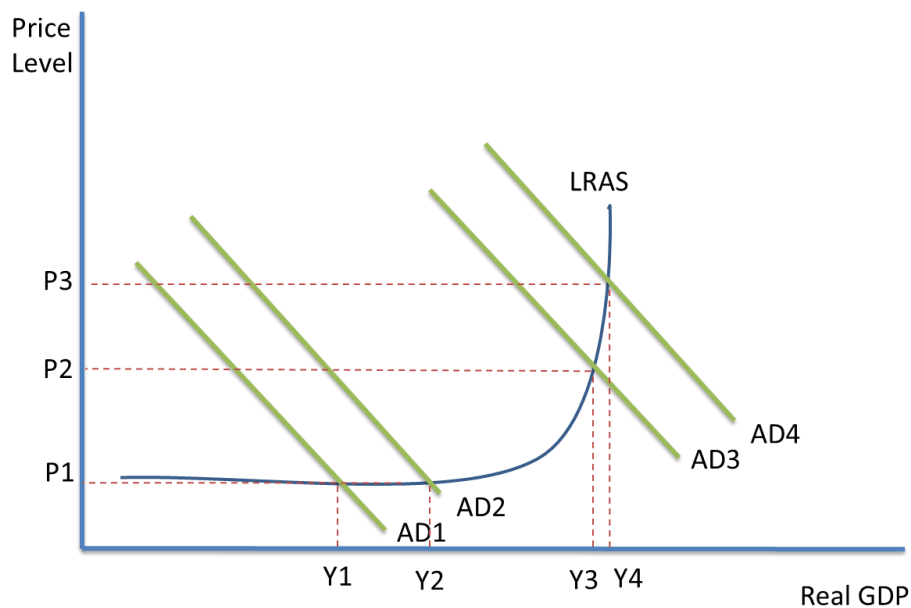


Different shapes of the long-run AS:

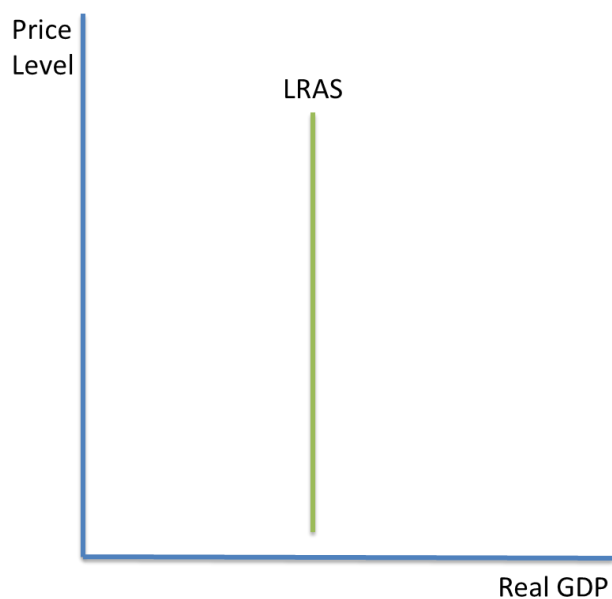
Keynesian





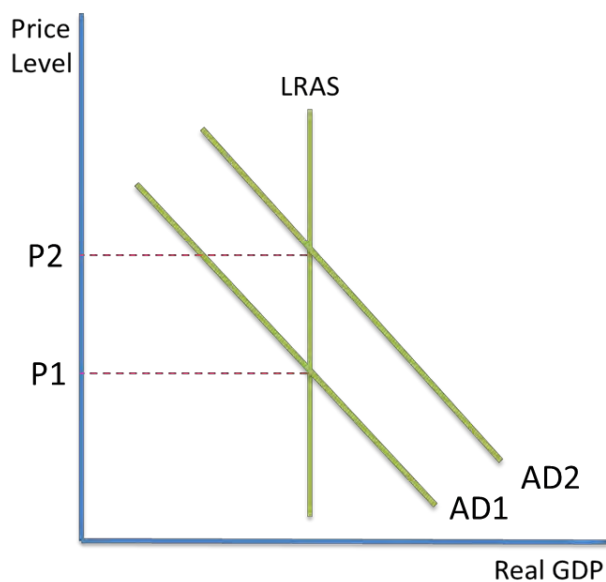
- The Keynesian view suggests that the price level in the economy is fixed until resources are fully employed. The horizontal section shows the output and price level when resources are not fully employed; there is spare capacity in the economy. The vertical section is when resources are fully employed.
- Over the spare capacity section, output can be increased (AD1 to AD2) without affecting the price level (stays at P1). In other words, output changes are not inflationary.
- Once resources are fully employed, an increase in output (AD3 to AD4) will be inflationary (price level increases from P2 to P3).



 **Classical**



-  This view suggests that output is fixed at each level. All factors of production in the economy are fully employed in the long run.
-  This means that changing AD, such as from AD1 to AD2, only makes a change in the price level (P1 to P2), and it will not change national output (real GDP).



Factors influencing the long-run AS:

The LRAS curve is influenced by changes which affect the quantity or quality of the factors of production. This is equivalent to shifting the PPF curve i.e. when the economy is operating at full capacity. An increase in the number of goods/services produced would mean that LRAS would shift outwards.

Technological advances:

If more money is spent on improving technology, the economy can produce goods in larger volumes or improve the quality of goods and services produced.

Changes in relative productivity:

A more productive labour and capital input will produce a larger quantity of output with the same quantity of input.

Changes in education and skills:

This improves the quality of human capital, so it is more productive and more able to produce a wider variety of goods and services. They may become more innovative and able to contribute to technological advances.

Changes in government regulations:

Government regulation could limit how productive and efficient a firm can be if it is excessive. This is sometimes referred to as 'red-tape'.

Demographic changes and migration:

If there is net inward migration and the majority of the population is of working age, the size of the labour force will increase, which means the economy can increase its output.

Competition policy:

A more competitive market encourages firms to be more efficient and more productive, so they are not competed out of business. Governments can use effective competition policy to stimulate efficiency in the economy.

Synoptic point:

Many of the factors which affect LRAS are microeconomic factors, for example competition policy. It is clear that microeconomic changes can have macroeconomic impacts if they are widespread enough.

