OCR Economics A-level

Macroeconomics

Topic 1: Aggregate Demand and Aggregate Supply

1.4 The Interaction of Aggregate Demand and Supply

Notes

The assumptions underlying the AD/AS model

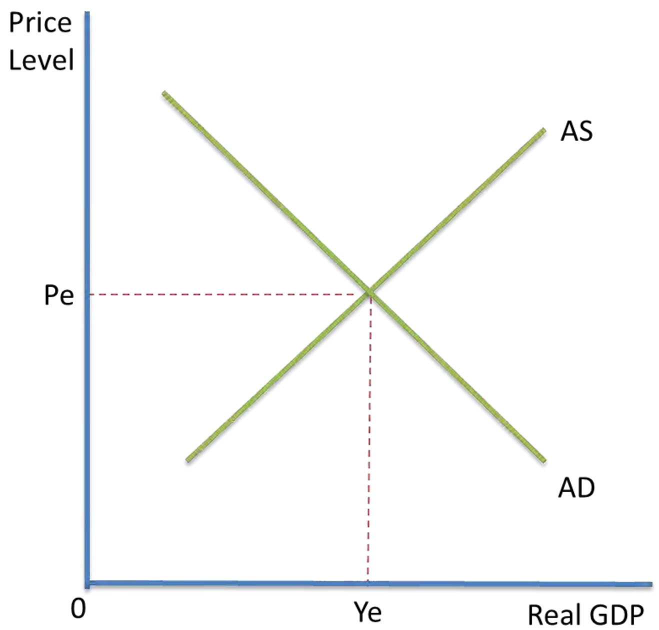
For the AD curve, it is assumed that the supply of money available for borrowing is fixed.

Both curves assume ***ceteris paribus,*** the assumption that all other factors remain constant.

The vertical shape of the LRAS curve assumes that the economy is operating at full employment, and that the price level and production costs change proportionally, so the economy maintains the level of full employment.

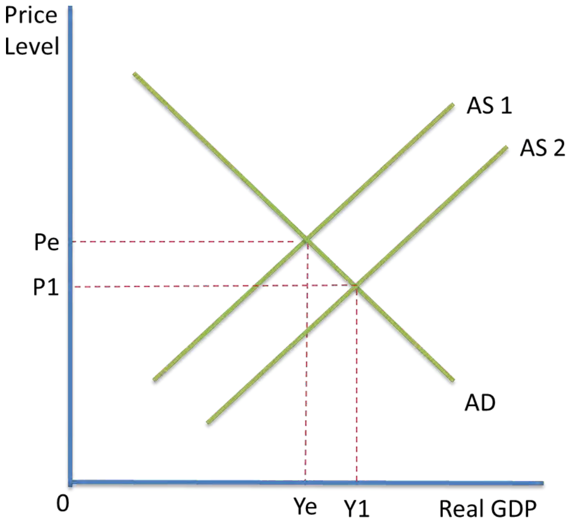
The economy reaches a state of equilibrium where AD = AS.

How both demand-side and supply-side shocks affect the macro economy



- At a price above equilibrium, there will be excess supply. At a price below equilibrium, there will be excess aggregate demand, in the short run.

- **Shift in AS:**



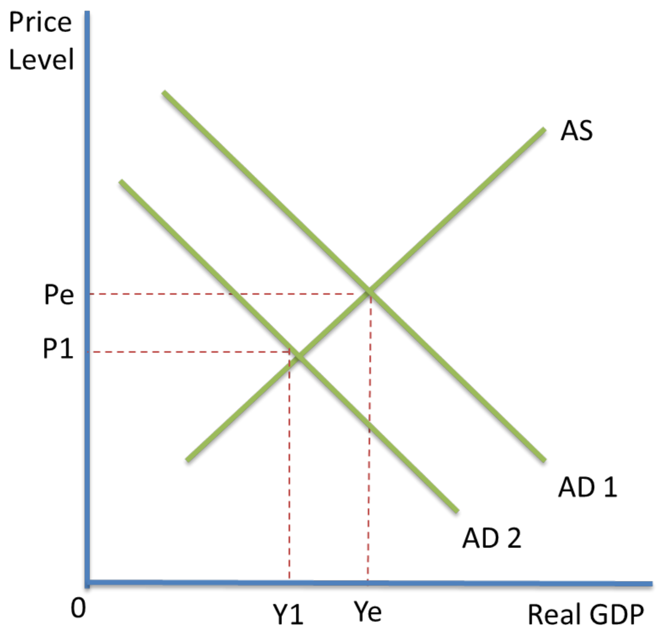
- If the economy becomes more productive, or if there is an increase in efficiency, supply will shift to the right. This lowers the average price level (Pe to P1) and increases national output (Ye to Y1).

- If AS shifts inwards, price increases and national output decreases.

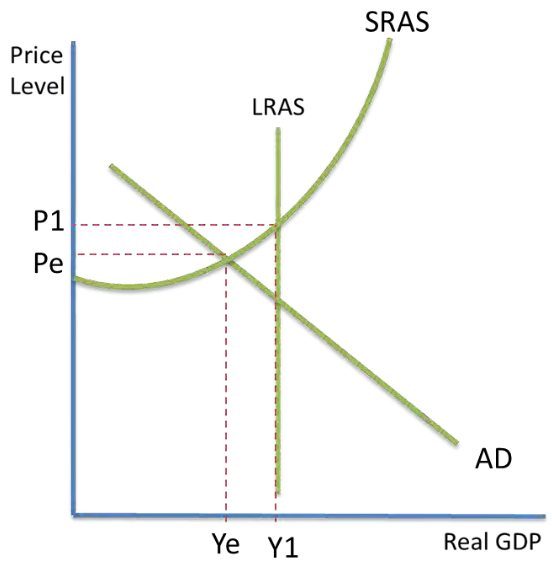
- **Shift in AD:**

- If firms have less confidence or there is a recession, AD might shift inwards. This causes the price level to fall from Pe to P1, and national output to fall from Ye to Y1.

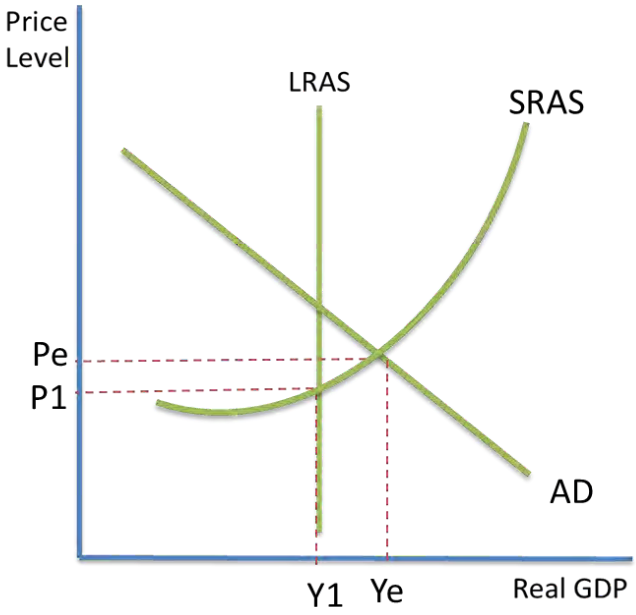
- If AD increases, the price level and level of national output both increase.



- In the short run, equilibrium might be less than the level needed to reach the level of GDP at full employment. This occurs when there is **inefficient AD** in the economy, and a negative output gap is created (Ye to Y1 below). This means there is unemployment in the economy.



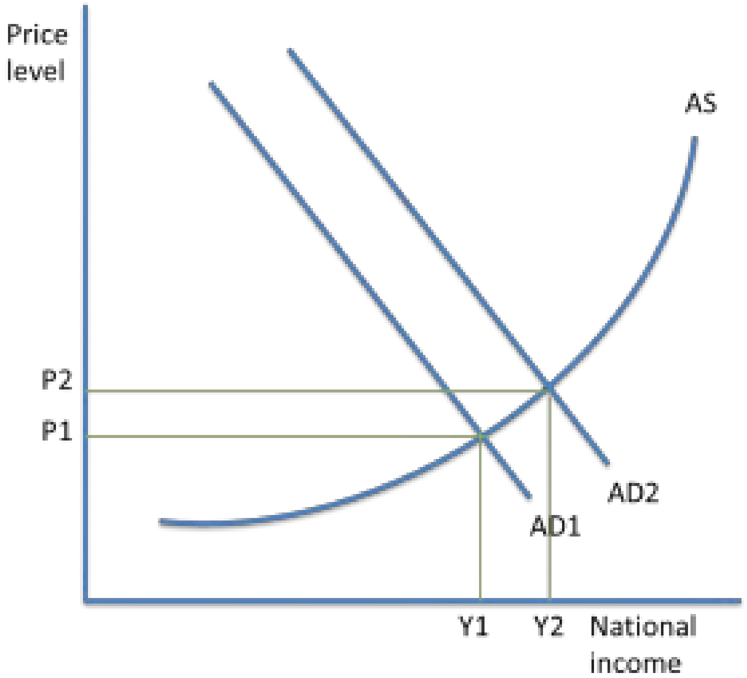
In the short run, the equilibrium position might be above the level needed to reach the level of GDP at full employment. This occurs when there is **excess AD** in the economy, and a positive output gap is created (Ye to Y1).



Demand and supply-side policies may be seen as appropriate ways of managing the economy

Demand-side policies are policies designed to increase consumer demand, so that total production in the economy increases.

This could be done during periods of economic decline. Negative output gaps can be reduced with the use of demand-side policies. Demand-side policies can increase AD from AD1 to AD2.



Supply-side policies can be used to increase the productive potential of the economy. This is depicted by a rightward shift in the LRAS curve.