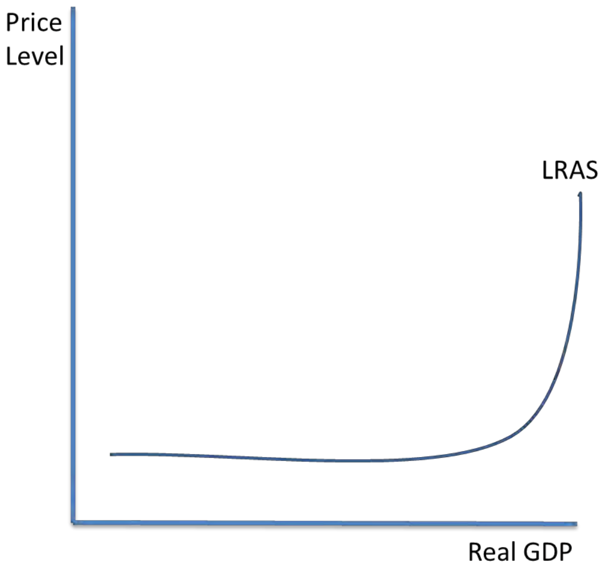
WJEC (Eduqas)
Economics A-level
Macroeconomics

Topic 1: Macroeconomic Theory

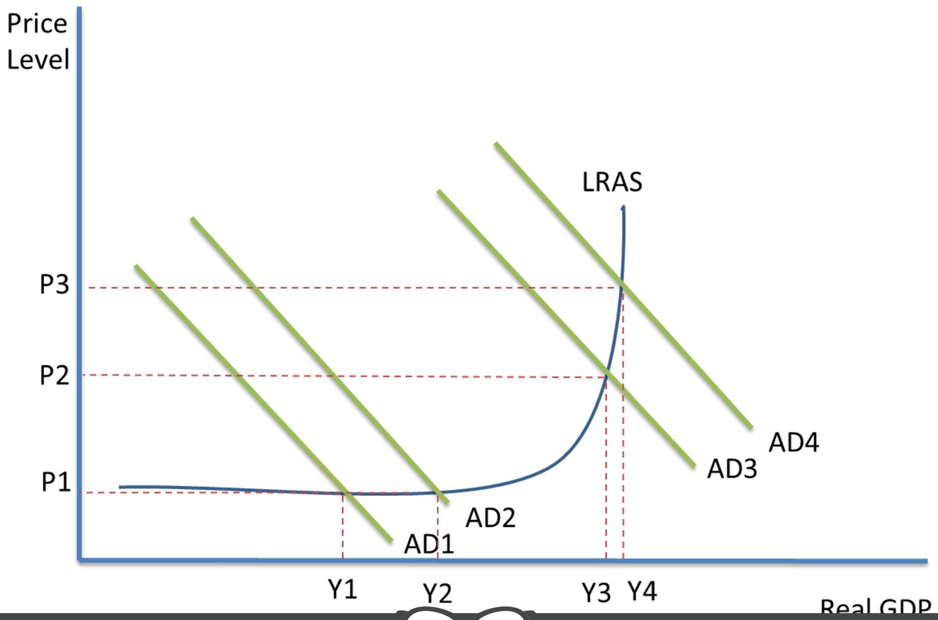
1.6 Long run aggregate supply (LRAS)

Notes

Keynesian long-run AS:

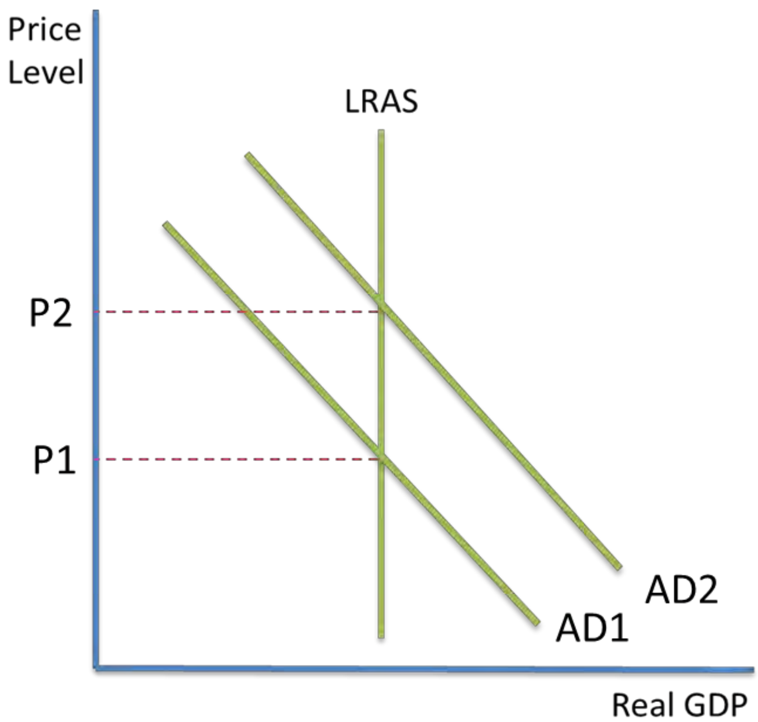


- The Keynesian view suggests that the price level in the economy is fixed until resources are fully employed. The horizontal section shows the output and price level when resources are not fully employed; there is spare capacity in the economy. The vertical section is when resources are fully employed.
- 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).



Neo-classical long run aggregate supply

- In the long run, output is fixed at each level and all factors of production in the economy are fully employed.
- 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).
- The position of the vertical LRAS curve represents the normal capacity level of output of the economy. The Neo-Classical view suggests that the economy can readjust to this long run equilibrium.



- Keynesians disagree with this readjustment because of inflexible labour markets. Keynes coined the phrase 'sticky wages'. Wages in an economy do not adjust to changes in demand. The minimum wage makes wages sticky and means that during a recession, rather than lowering wages of several workers, a few workers might be sacked instead. This means that the LRAS function might not be vertical at the equilibrium level of output.

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.

- **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.

- **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 is going to be significant, 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 this in the economy.