How equilibrium occurs using the as ad framework economics essay

ASSIGN BUSTER

This essay will explain the concepts of aggregate demand, aggregate supply and explore how nominal, real and potential gross domestic product are calculated, It will then...

Jain and Sandhu (2008) define aggregate demand as the sum total spent on all goods and services produced in a national economy over the period of time. The components of Aggregate Demand are; the expenditure from the consumption of collective households (C), that of capital investment (I), government expenditure on public services (G) and finally and the expenditure created from interactions between other economies; where imported goods and services (M) are subtracted from those that are exported (X). Therefore;

AD = C + G + I + (X-M)

When this is transposed onto an Aggregate Demand the y-axis represents the price of goods at different levels and the x-axis is real GDP. The price levels in both aggregate demand and aggregate supply are The price levels used in both aggregate supply and aggregate demand are themselves aggregate price levels; representing that as while inflation may occur in some prices in the economy, deflation may be occurring in others therefore the price level used is an average of all prices in the economy (Sloman, 2006)

The curve is aggregate demand curve is downwards sloping, which means that there is an inverse relationship, as the price level of goods and services fall the nation is able to buy more represented in real GDP

Gross Domestic Product (GDP) is defined as ' the value of output produced within a country over a twelve month period' (Sloman, 2006, p373). It can be meassured by calculating national income, expenditure or production, all three values should be equal. (Sloman, 2007)

Nominal GDP is the result of this calculation using the current prices for goods within the year and is the same value as aggregate Demand. Real GDP (rGDP) allows for inflation by comparing the nominal GDP for that year with a base year. This is because inflation may make it appear that a country was producing more goods whereas it may be that production had fallen but the price of goods had increased. It is therefore rGDP which is on the x-axis of aggregate supply and demand curves. (Kroon, 2007)

The aggregate demand curve is downwards sloping for three reasons all of which assume that the money supply remains constant in the economy. The first is the wealth effect; when the cost of goods and services are higher, the economy experiences lower levels of consuming as individuals and businesses feel less wealthy and are therefore are more frugal with their resources. This means that purchasing power is decreased when prices are high and increased when the price levels are low. The second is the net exports effect means that as the price level of goods in the economy fall, the goods imported seem relatively more expensive, so therefore decreases while the number of goods exported increases causing an increase in rGDP. Finally, the interest rate effect; as the price level decreases people need to borrow less money so their consumption increases, reflected in increased aggregate demand and higher levels of rGDP (Tucker, 2009)

Turner (1993) defines aggregate supply as the sum total of national output. It is considered in both the short run and the long run because there are different factors of the labour market which show their effects over the two periods.

In the short run potential GDP, the wage rate and the price of the factors of production are all ceteris paribus. A change in any of these would mean that a new demand curve would need to be created. The only variables represented are the overall price level of goods are services and the amount that is produced and real GDP for that year.

In the short-run there is a positive correlation between price and the quantity produced. That is to say that as price levels increase, caused by an increase in aggregate demand, so too does the amount of goods and services produced in order to meet this increased demand. At lower price levels however, there is less aggregate demand and therefore less produced.

The LRAS curve is formed at the point on the short run aggregate supply curve where potential GDP is the same as real GDP and the labour market is in equilibrium. The points on the short-run aggregate supply curve to the left of the LRAS curve are when potential GDP is lower than real GDP and to the left show when potential GDP is higher than real GDP.

The long-run aggregate supply curve represents the relationship between price level and output at a level in the economy where full-employment output is occurring and the labour market is in equilibrium; the number of jobs is equal to the number of people seeking them. Although there will still be some frictional unemployment while individuals perhaps search for a

better job and structural unemployment where those seeking employment are not able to meet the criteria or location of available work. The natural rate of employment is the level of unemployment that exists when the labour market is in equilibrium. This level of full-employment output is also known as potential GDP (Parkin, Powell and Matthews, 2008)

However, a change in price level or wages is not enough to move national output away from this level of full employment in long-run aggregate supply hence the curve is a vertical line rather than a slope showing a positive correlation as it does in short-run aggregate supply. (Kroon, 2007)

Equilibrium in the short run aggregate curve supply occurs when the aggregate supply curve crosses the aggregate demand curve; this gives the equilibrium price level and the equilibrium level of real GDP.

The Business Cycle [FIG >>>] depicts potential GDP or trend growth as the dashed line continuously rising as technological advances occur, the productivity of labour stocks improve or grow and capital is further invested. In the short term real GDP fluctuates around potential GDP which is characterised as four periods in the business cycle;

causing periods of expansion when the economy grows, recession when economic output falls and stagnation where little or no growth or decline occurs, contraction when economic growth slows down. (Sloman, 2007)

The reasons for fluctuations in real GDP are because of either an increase or decrease in aggregate demand or aggregate supply.

http://welkerswikinomics.

com/blog/wp-content/uploads/2008/01/businesscycle_1. jpeg

In the business cycle Real GDP is recorded quarterly and when it falls for more than two consecutive quarters a recession is declared. This lack of economic growth is caused by real GDP being less than potential GDP spending in the economy and therefore a fall in aggregate demand. This shifts the aggregate demand

In September 2012, the UK Government introduced quantitative easing in an attempt. Although no money was physically printed bonds were theoretically bought electronically which meant that the money supply in the economy increased. This had the effect of (British Broadcasting Corporation, 2012)

When a recession is occurring and there is a decrease