Aggregate supply and aggregate demand essay samples

Business, Marketing

Aggregate supply refers to the total combined demand for individual goods and services in an economy at different price levels that prevail in the economy.

AD

As shown in the diagram above, the aggregate demand curve is downward sloping.

Reasons for downward sloping of the aggregate demand curve

There are three reasons that explain the downward sloping, and they include;

Wealth effect

The assumption is made that the government maintains the supply of money at a constant level, and this represents the level of wealth available in the economy. As the price level increases, the wealth in the economy as given by the supply of money declines due to a reduction in the purchasing power of money leading to a decrease in real GDP. On the other hand a due to a decrease in the price level, the purchasing power of money increases and they become wealthier as they can obtain relatively more goods and services and consequently increase the real GDP.

Interest rate effect

When the price level increases, the households and firms require more money in order to meet their current transactions. Since the money supply is fixed, the increased money demand increases the interest rate and therefore reducing the level of spending on goods and services sensitive to interest rates. This consequently will lead to a reduction in the real GDP, and the converse is true (Cohn, 2013).

Net exports effect

An increase in the prices for the domestically produced goods increases the demand for foreign made products as the consumers find them relatively cheaper. This increases the amount of imports while at the same time decreasing the level of exports as the other countries also find the goods expensive(Cohn, 2013).. Consequently, the net exports decrease and being a component of real GDP, the GDP also decreases and the converse is also true.

Shifts in the aggregate demand curve

AD2

The aggregate demand curve can either shift leftwards or rightwards as shown in the figure above i. e. shifts from the original AD0 to AD2 and AD1 respectively. The shifts care caused by the changes in any of the components of real GDP as opposed to price changes. Increased consumption of goods and services, investments and government expenditure as well as an increase in the net exports will shift the aggregate demand curve to the right and the converse is true for all the components of real GDP.

Aggregate supply

It refers to the combination of all the individual supply of goods and services that the producers are willing to release to the market at a given price level.

Aggregate supply curve

AS

As shown in the diagram, the aggregate supply curve is upward sloping. This is because an increase in the cost of inputs ultimately increases the cost of living as the cost will be carried to the consumers of the final goods. This increase in prices stimulates the suppliers to offer more to the market as the price is adjusted to reflect the effect of the increase in the price of inputs(Cohn, 2013). This represents the short run where the inputs are variable while in the long run after all the prices of inputs have adjusted, the curve now becomes a vertical line. The GDP, therefore, increases with the increase in the price level and decreases with a decrease in the price level.

Shifts in aggregate supply curve

AS2AS0

AS1

The aggregate supply curve can either shift to the right (AS1) or to the left (AS2) as in the diagram above. The reasons for the shift include;

Change in price of inputs

An increase in the price of inputs shifts the aggregate supply curve leftwards from AS0 to AS2 . The producers will find it uneconomical to produce more at the high costs of inputs and therefore reduce the amount of goods and services supplied to the market (Cohn, 2013). Conversely, a decrease in the price of inputs, will increase the aggregate supply, and this will be indicated by a shift from AS0 to AS1 .

Economic growth

Positive economic growth increases the level of real GDP thereby increasing the purchasing power of the consumers at a given price level. This makes the aggregate supply curve to shift to the right whereas when the economy experiences negative economic growth, the curve shifts to the left (Cohn, 2013).

Equilibrium in the AD-AS model

The equilibrium price level and level of GDP are obtained by the point where the aggregate demand and aggregate supply curve meet (intersect). At the point of equilibrium, the economy full employs its resources, and their utilization is also fully maximized. The equilibrium is shown in the diagram below.

ADAS

P*

Y*

The equilibrium price level is represented by P* while the equilibrium GDP level is represented by Y*.

References

Cohn, S. (2013). Reintroducing macroeconomics (2nd ed.). Armonk, N. Y.: M. E. Sharpe.