

Example of aggregate demand and aggregate supply essay

[Economics](#), [Macroeconomics](#)



The Keynesian economics school has invented the aggregate demand (AD) and aggregate supply (AS) model to explain the macroeconomic equilibrium in the economies. The model is based on two main macroeconomic variables those are the explanatory variables of AS and AD: 1) price level in the economy and 2) real output in the same economy. In this essay, I will explain what AS and AD includes, and how the economy works at the macroeconomic level.

Graph 1: AS and AD model in Graph

Aggregate supply (AS) includes the information of the total production level in an economy depending on the price level. In the short run, AS is parallel to the real output axis. That means the production level of the economy is very sensitive to the price level in the economy. In the short run, the total production cannot use all the resources efficiently; therefore it is possible for the economy to produce more. When the economy starts using relatively more and more resources, and then the AS curve becomes relatively steeper and becomes less sensitive to the price level in the economy. That happens in the long run. In the long run, the economy management can find relatively better ways of using all the resources in the economy, and the production level of the economy reaches a top. After a certain point (Y^*), the AS becomes relatively steeper, and the AS curve becomes less sensitive to the prices.

Aggregate demand (AD) is the sum of consumption expenditures (C), government spending (G), investment expenditures (I), and net exports [exports - imports (X-M)]. AD is the total expenditures in the economy. A negatively sloped curve represents AD because when the price level is

increasing the agents in the economy spend relatively less based on the law of demand. The AD curve's slope is determined by the sensitivity of the agents who make the expenditures in the economy to the prices and the real output level. If the agents care relatively more about the prices, and then the AD curve becomes relatively flatter, vice versa. The agents living in the economies those face very high level of inflation; the AD curve is relatively flatter because people become very sensitive to the inflation level. In the relatively more developed economies, the agents become more alert to the changes in the real output level; thus, the AD curve becomes relatively steeper. In a simple explanation, the agents in the developed economies care more about the level of the real output and they become aware that the price level is only a signal of how the economy is developing.

Consequently, AD and AS are two main determiners of the inflation and the real output level in an economy. When AD equals to AS, and then the AD curve crosses the AS curve. This point is considered as the macroeconomic equilibrium point. As can be seen in the Graph 1, the equilibrium point in the short run and in the long run carries different characteristics. In the short run, the AS curve is relatively flatter, and the demand increase do not create a high level of inflation because it is possible to increase the amount of products in the economy thanks to the not-used production potential in the economy. In the long run, the AS is relatively steeper, and the increase in the demand causes a large inflation in the economy because it is not possible to increase relatively more in the long run as explained in the previous paragraphs.

Consequently, the economy managements, in the short run, try to produce

as much as possible while, in the long run, the economy managements implement anti-inflationary economic policies. The developed economies are relatively more close to the equilibrium in the long run while the less developed or the developing economies are relatively more close to the equilibrium in the short run. The technological advancements in the production might change the short run and the long run terms and the AS-AD equilibrium. The short run is the time period where the technology does not change and the long run is the time period when the technology might be developed and changed. Therefore, any technological advancement might change all the picture in the AS-AD model.

Works Cited

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