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Aggregate Supply and Aggregate Demand Model - I

Subject:	Business Economics
Course:	B. A. (Hons.), 3rd Semester, Undergraduate
Paper No. & Title:	Paper – 301 Macroeconomics - I
Unit No. & Title:	Unit – 3 Aggregate Supply and Aggregate Demand Model
Lecture No. & Title:	Lecture – 1 Aggregate Supply and Aggregate Demand Model - I

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1. Introduction

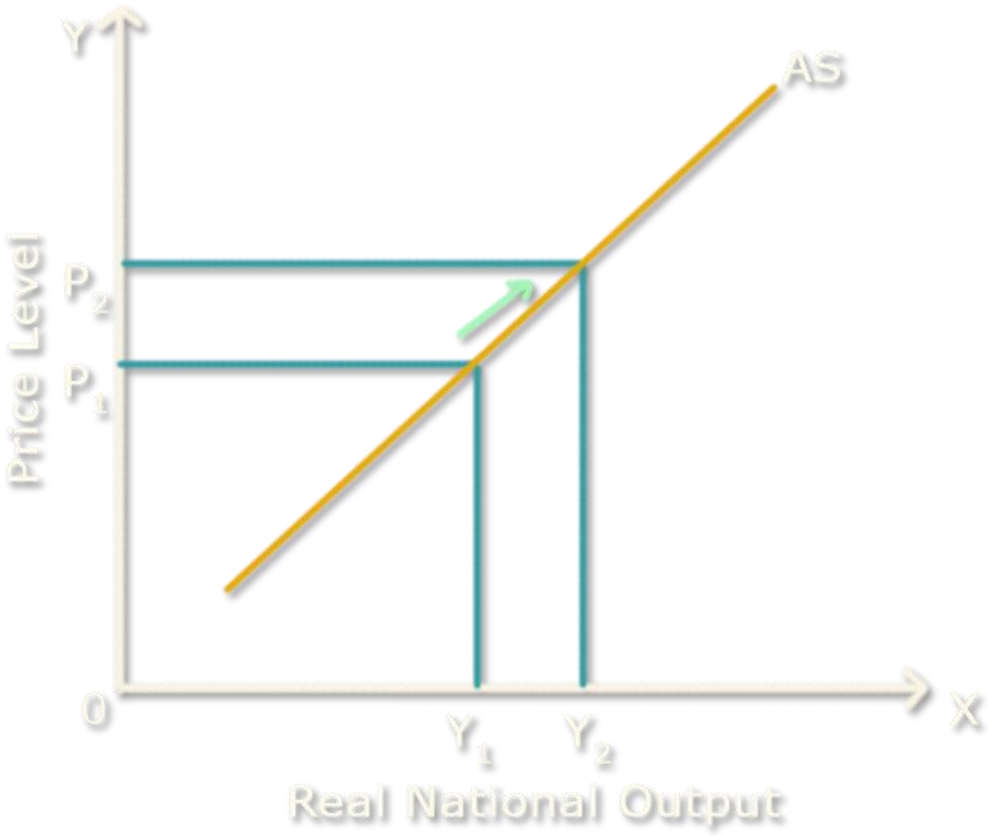
Aggregate supply and aggregate demand determines total supply or total demand for the economy, and how total demand and total supply interact at the macroeconomic level.

The aggregate demand curve explains us the quantity of all goods and services demanded in the economy at any given price level while on the other hand aggregate supply curve explains us the total quantity of goods and services that firms produce and sell at any given price level.

2. Aggregate supply

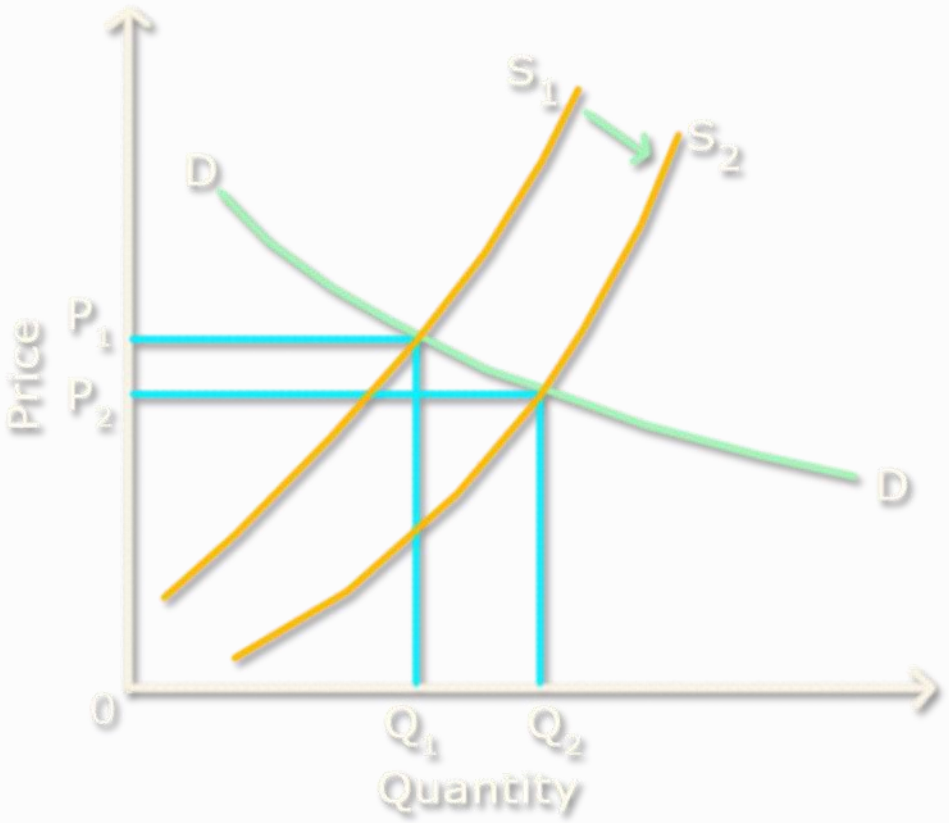
Aggregate supply is the total supply of goods and services produced within an economy at a given overall price level in a given time period.

It is represented by the aggregate-supply curve, which describes the relationship between price levels and the quantity of output that firms are willing to provide.



Shift in aggregate supply

The aggregate supply curve may shift labor market disequilibrium or labor market equilibrium. If labor or another input suddenly becomes cheaper, there would be a supply such that supply curve may shift outward, causing the equilibrium price in to drop and the equilibrium quantity to increase.

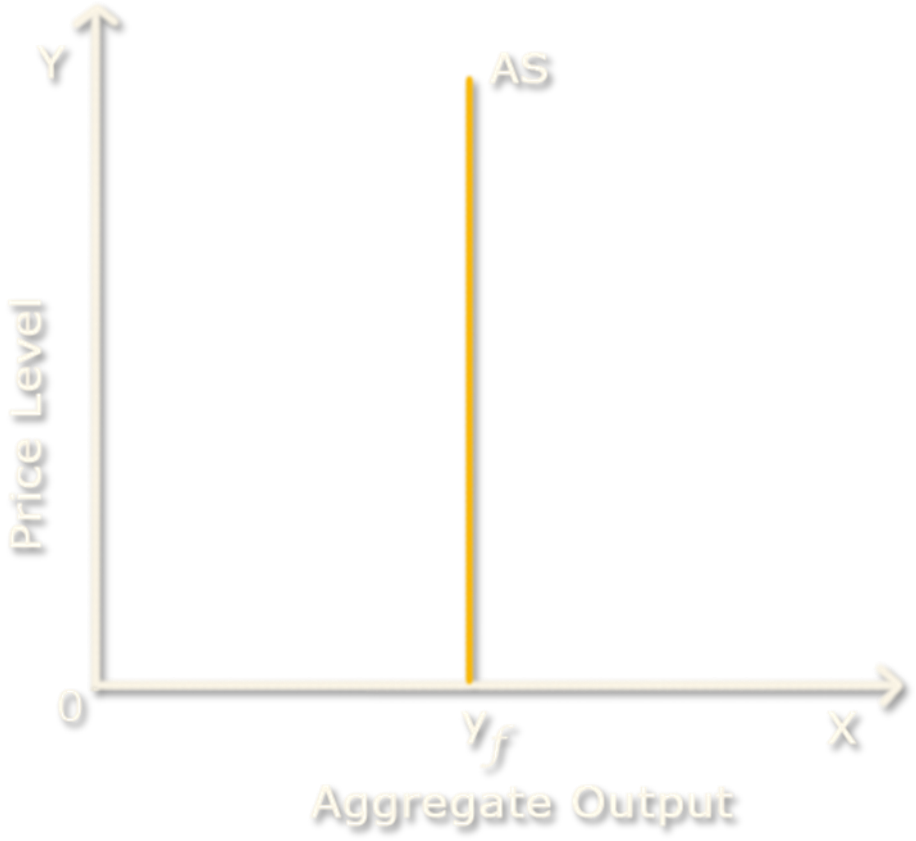


During the short-run, there is one fixed factor of production, usually capital. However, the fixed factor does not stop the curve's ability to shift outward. When the curve shifts to the right, it causes an increase in the output and a decrease in the GDP at a given price. Examples of events that cause the curve to shift to the right in the short-run include a decrease in the wage rate, an increase in physical capital stock, and technological progress.

In the long-run only capital, labor, and technology affect the aggregate supply curve because at this point everything in the economy is assumed to be used optimally. The long run curve is often constant because it shifts very slowly. Examples of events that shift the long-run curve to the right include an increase in population, an increase in physical capital stock, and technological progress.

Aggregate supply in the long run

The long-run aggregate supply curve explains the economy's supply schedule in the long-run. The long-run is defined as the period when input prices have completely adjusted to changes in the price level of final goods. In the long-run, the increase in prices that sellers receive for their final goods is completely offset by the proportional increase in the prices that sellers pay for inputs. The result is that the quantity of real GDP supplied by all sellers in the economy is independent of changes in the price level. The long run supply curve is a vertical line, reflecting the fact that long-run aggregate supply is not affected by changes in the price level. The long run supply curve is vertical at the point defined as the level of real GDP that arises when the economy is fully employing all of its available resources (full employment).



Aggregate supply curve in the short run

In the short-run, the aggregate supply curve is upward sloping. There are two main reasons why the quantity supplied increases as the price rises:

1. The AS curve is drawn using a nominal variable, such as the nominal wage rate. In the short-run, the nominal wage rate is fixed. As a result, an increasing price indicates higher profits that justify the expansion of output.
2. It is explained that the AS curve increases because some input prices are fixed in the short-run and as output rises, more production processes encounter bottlenecks. At low levels of demand, large numbers of production processes do not make full use of their fixed capital equipment. As a result, production can be increased without much diminishing returns. The average price level does not have to rise much in order to justify increased production. In this case, the AS curve is flat. Similarly, when demand is high, there are few production processes that have unemployed fixed outputs. Any increase in demand production causes the prices to increase which results in a steep or vertical AS curve.

3. Aggregate Demand

The theory of aggregate demand was Keynes' central contribution. The aggregate demand is the amount of money which entrepreneurs expect to get by selling the output produced by the number of labourers employed.

When a certain number of labour is employed by all the entrepreneurs, taken together, and a certain quantity of output

is produced by them and is sold, it fetches a certain amount of money. How much it will fetch will depend on the state of demand in the economy. The expected receipts of entrepreneurs by the sale of total output when a given volume of employment is offered to workers are called the Aggregate Demand Price.

In other words, the "aggregate demand price at any level of employment is the amount of money which all the entrepreneurs in the economy taken, together really do expect that they will receive if they sell the output produced by this given number of labour."

In AS the entrepreneurs must recover their cost, otherwise they will not employ that number of men. In AD, however, the idea is that the demand is such that the entrepreneurs do expect to receive that amount of money by the sale of goods produced by that number of men.

Like the aggregate supply price, there will be a different aggregate demand price for different levels of employment in the economy.

Aggregate Demand Schedule

Employment	Expected Revenue
10	90
20	140
30	200
40	240
50	270
60	300

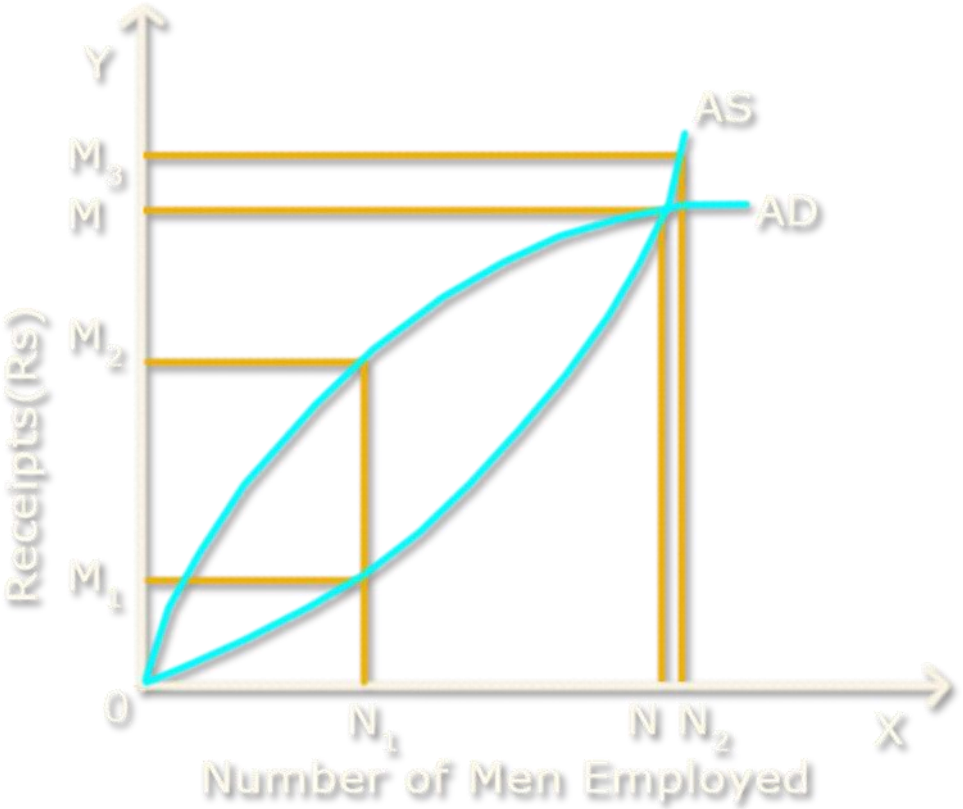
Keynes' concept of aggregate demand was the expected proceeds by selling the output produced at each level of employment. Therefore, aggregate demand would be equal to the amount people would spend on that output. In short aggregate demand would be the sum total of expenditures of different segments of an economic system.

4. Effective Demand

Effective demand is the crucial concept of Keynes' theory of employment. It is quite different from the term 'aggregate demand' as used by Keynes. We have seen that the aggregate demand of an economy is different at different levels of employment or, in other words, we can construct an aggregate demand schedule for the economy. But at which aggregate demand will the economy be in equilibrium?

The answer to the question is - the economy is in equilibrium at that level of employment at which the aggregate demand curve intersects the aggregate supply curve or at which aggregate demand in the economy is equal to aggregate supply. That aggregate demand at which the economy is in equilibrium is called Effective Demand.

Thus, "Effective Demand is that aggregate demand price which becomes effective, because it is equal to aggregate supply price and thus represents a position of 'short-run' equilibrium." It is distinguished in this way from all other points on the aggregate demand schedule. It represents an equilibrium position which actually is realized, while at all other point's aggregate demand is either greater or less than aggregate supply.



5. Summary

At the end Let us summarize by quickly revising, what we have learnt today. In today's session we have understood what is:

Aggregate Demand: It is the total demand for goods and services in an economy. It is the sum total of expected demand of all goods & services produced during a given period of time.

Aggregate Supply: It is the total supply of goods and services in an economy for a given period of time keeping in mind that the AS curve is always constant.

Effective Demand: The point on AS curve where the AD is equal to AS is known as effective demand.