# Chapter 26 – Aggregate Supply and Demand

**Aggregate Supply**

*Quantity Supplied and Supply*

The quantity of real GDP supplied is the total quantity that firms plan to produce during a given period

Depends on:

Labour

Physical and Human Capital

State of technology

At a given time, only quantity of labor can way

Potential GDP: the quantity of real GDP supplied at full employment

Aggregate supply is the relationship between the quantity of real GDP supplied and the price level.

*Long Run Aggregate Supply (LRAS)*

It is the relationship between the quantity of real GDP supplied and the price level when the real GDP equals potential GDP.

It is vertical at potential GDP. Increase in the price level leads to equivalent percentage increase in resource prices, which means profits and real wages remain constant.

*Short Run Aggregate Supply (SRAS)*

It is the relationship between real GDP supplied and price level when the money wage rate, the prices of other resources, and potential GDP remain constant.

It is upward sloping.

*Changes in the aggregate supply*

Aggregate supply changes if an influence on production plans other than the price level.

These influences include

1. changes in potential GDP: When potential GDP increases there is a shift in both LRAS and SRAS and they both shift rightwards.
   1. Potential GDP increases if:
      1. The full employment quantity of labour increases
      2. The quantity of capital (physical or human) increases
      3. An advance in technology occurs
2. Changes in money wage rate (and other factor prices)

**Aggregate Demand**

The quantity of real GDP demanded, Y, is the total amount of final goods and services produced in Canada that people, businesses, governments, and foreigners plan to buy.

The quantity is the sum of the consumption expenditures, C, investment, I, government expenditure, G, and net exports, X – M,

That is, by the Circular flow of consumption and expenditure we get,

Buying plans depend on many factors and some of the main ones are

1. The price level
2. Expectations
3. Fiscal Policy and monetary policy
4. The world economy

*The aggregate demand curve*

Aggregate demand is the relationship between the quantity of real GDP demanded and the price level.

It is downward slope for two reasons:

1. Wealth Effects: A rise in the price level, other things remaining constant decreases the quantity of real wealth (money, stocks, etc.)
2. Substitution Effect:
   1. Intertemporal substitution effect: A rise in the price level, with other things constant, decreases the real value of money and raises the interest rate.
   2. International Substitution effect: A rise in the price level, with other things constant, n=increases the price of domestic goods relative to the foreign goods.

*Changes in aggregate demand*

A change in any influence on buying plans other than the price level changes aggregate demand.

The main influences on aggregate demand are

1. Expectations: Expectations about future income, future inflation, and future profits change aggregate demand.
2. Fiscal Policy and Monetary Policy:
   1. Fiscal Policy: It is the governments’ attempt to influence the economy by setting and changing taxes, making transfer payments, and purchasing goods and services.
   2. Monetary Policy: It is the changes in the interest rates and the quantity of money in the economy.
3. The world economy: Affects the aggregate demand in two ways:
   1. A fall in forex lowers the price of domestic goods and services relative to foreign goods and services, which increases exports, decreases imports, and increases aggregate demand
   2. An increase in foreign income increases the demand for increase in Canadian exports and increases aggregate demand.

**Explaining Macroeconomic Trends and Fluctuations**

*Short Run Macroeconomic Equilibrium*

This occurs when the quantity of real GDP demanded equals the quantity of real GDP demanded equals the quantity of real GDP supplied at the point of intersection of the AD curve and the SAS curve.

**Macroeconomic School of Thoughts**

Macroeconomics can be divided into three broad schools of thought:

1. Classical

A classical macro-economist believes that the economy is self-regulating and always at full employment

A new classical view is that business cycle fluctuations are efficient responses of a well-functioning market economy that is bombarded by shocks that arise from the uneven pace of technological change.

1. Keynesian

A Keynesian macro-economist believes that left alone, the economy wold rarely operate at full employment and that to achieve and maintain full employment, active help from fiscal policy and monetary policy is required.

A new Keynesian view holds that not only is the money wage rate sticky but also are the prices of goods sticky.

1. Monetarist

A monetarist is a macro-economist who believes that the economy is self regulting and that it will normally operate at full employment, provided that monetary policy is not erratic and that pace of money growth is kept steady.