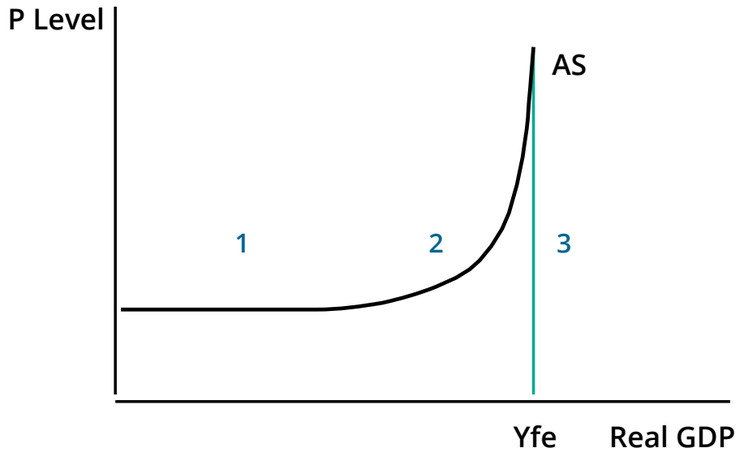
Aggregate Supply

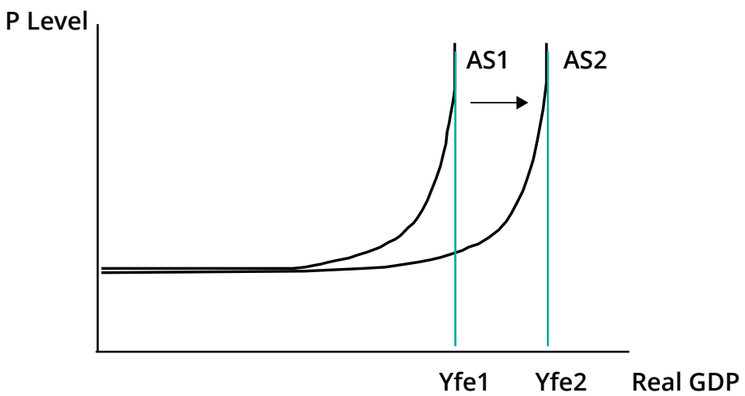
The Keynesian Aggregate Supply function shows the relationship between the Price Level in the economy and the Real Output that can be supplied.



Zone 1: The AS curve is drawn relatively 'flat'. This represents the economy operating well below its full capacity (Yfe). There are lots of spare factors of production. As demand increases, the economy can satisfy the demand easily without much inflationary pressure on the price level. Real GDP increases without much rise in the price level.

Zone 2: The AS curve begins to 'curl upwards'. The gradient increases at an increasing rate. This represents the economy nearing full capacity. As demand increases, the economy can still satisfy the extra demand but factors of production are becoming scarcer and this scarcity puts upwards pressure on the price level. Real GDP increases but with large increases to the price level.

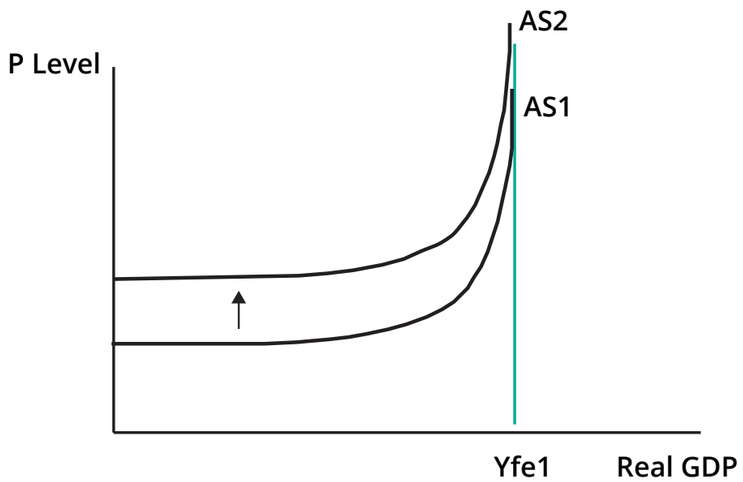
Zone 3: The AS curve is drawn as a vertical straight line at Yfe. This represents the economy now operating at full capacity (or, on the PPF boundary). There are no more factors of production available to be used. As demand increases, Real GDP can no longer increase but price level rises quickly.



AS shifts right when:

Increase in the **quantity of resources** such as increased immigration, work incentives, increased purchases of capital goods, new resources discovered.

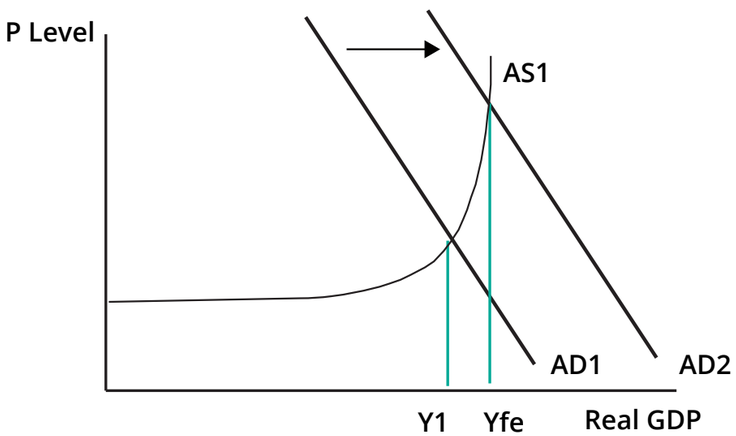
Increase in the **productivity of resources** such as increased spending on R&D, education and training, technological advances.



AS shifts upwards when there is an increase in **costs of production.**

For example:

- Increased in minimum wages
- Rise in oil prices
- Rise in commodity prices
- ER depreciation
- Increase in sales tax
- Increase in import tariffs



AD/AS equilibrium. The economy is said to be in equilibrium where AD and AS intersect.

In the diagram (left) the original equilibrium shows that the economy had a small **negative output gap** (the difference between Y1 and Yfe). This implies that there is some cyclical unemployment and the economy is producing below its full capacity. However, it is close to Yfe. When AD shifts to the right, the economy can still just about satisfy the extra demand. Real GDP increases but the new equilibrium is now at Yfe; the economy is at full capacity. This means that resources are extremely scarce and, therefore, there is upwards pressure on the price level. The economy is now at full employment but there is demand-pull inflation.

Both Government and Central Bank use policies to influence AD and AS to achieve the macro-objectives.