The AD/AS Model

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Aggregate Demand

- Aggregate demand refers to the total spending in the economy
- It is similar to aggregate expenditure factors in changes in inflation
- The aggregate demand curve will slope downwards on the model

Reasons for the Downward sloping curve

- The income effect
    - As price increases the purchasing power of households fall
- The interest rate effect
    - As price increases the interest rate will decreases which reduces spending
- The open economy effect
    - As price increase households will buy imports over domestic products

Shifts in Aggregate Demand

- Changes in confidence
- Changes in interest rates
- Global economic events

Short run Aggregate Supply

- Refers to the short term supply within the economy
- Aggregate supply slopes upward due to the fact that as the level of economic activity increases price increases

Factors affecting Aggregate Supply

- Global energy prices
- Wages increasing faster than productivity
- Cost of production (Company tax)

Long run aggregate supply

- Refers to the production possibility in the economy
- The long run aggregate supply position refers to the full employment position of the economy
- A shift in long run aggregate supply can only be achieved through an increase in productivity
- Thus either a quantitative or qualitative improvement of capital

Disequilibrium

- When the economy is not operating at a full employment position it is at disequilibrium
- If the economy is operating below full capacity it is experiencing a contractionary gap
- If the economy is operating above full capacity it is experiencing an expansionary gap