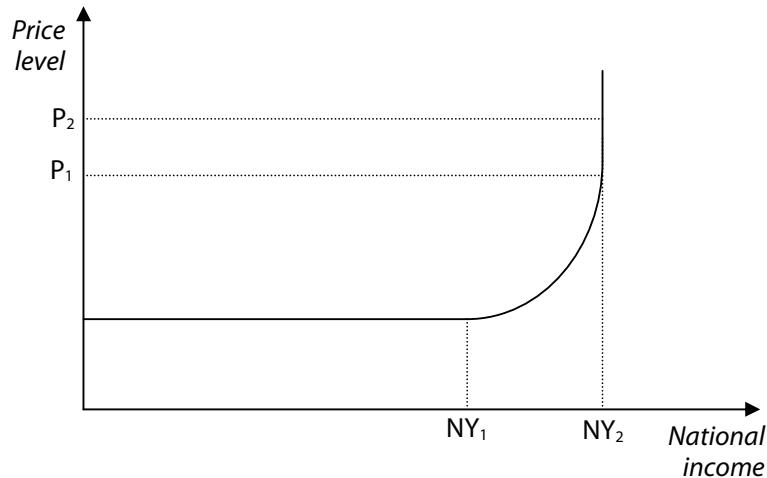


## Aggregate supply

Aggregate supply is the total supply of goods and services in the economy. It is measured in pounds and is the equivalent of real national income, or output.

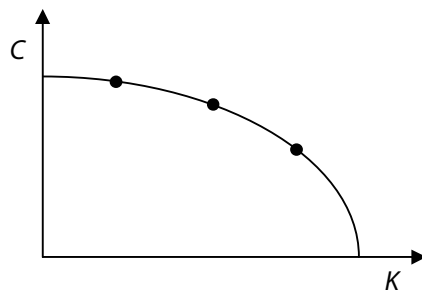
In the short run aggregate supply is upward sloping as firms feel they can increase output and so profit at a higher price. In reality this just causes inflation.



At a low output (up to  $NY_1$ ) the supply curve is perfectly elastic. This is because the economy is producing far inside its PPC. At this level there is an excess supply of labour (due to high unemployment of resources at an equilibrium up to  $NY_1$ ) so all firms can increase supply without raising the price as there is little extra cost involved in them doing so.

Between  $NY_1$  and  $NY_2$  businesses must pay increasingly more for resources as they become increasingly harder to obtain as the economy gets nearer to full capacity. Firms have to pay higher prices to obtain resources as they become more scarce and this increase in cost is passed on to the consumer, causing inflation both cost push and demand pull inflation. As the economy's output increases nearer to full capacity the negative output gap improves.

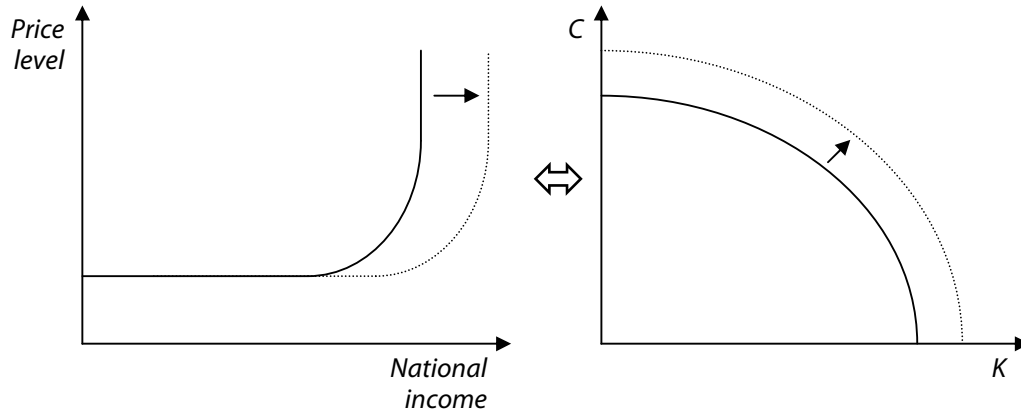
When the economy reaches  $NY_2$  there is only a natural rate of unemployment within the economy. The economy is working at its full capacity so any shift of the market equilibrium outward will cause only demand pull inflation. At price level  $P_1$  the economy is producing on its PPC, at price levels above  $P_1$ , such as  $P_2$ , the economy is overheating.



At  $NY_2$  the economy is operating at full capacity, on its PPC.

An increase of real output in an economy can be seen on a PPC as a shift outwards. This can also be shown as a shift outwards of the aggregate supply curve. Whereas a shift in aggregate demand is caused by a change in  $C$ ,  $I$ ,  $G$  or net exports a shift in supply is caused by a change in either the quality or quantity of resources available in an economy.

	<i>Quality</i>	<i>Quantity</i>
<b>Land</b>	Fertilisers or conservation.	Discovery of new natural resources or reclamation.
<b>Labour</b>	Training and education.	Immigrant labour, increasing the pension age, lowering the compulsory schooling age or part time and the unemployed working.
<b>Capital</b>	Research and development.	Investment.
<b>Enterprise</b>	Initiatives.	Training.



The macroeconomic objectives of the government are:

- Low and stable inflation.
- Low unemployment.
- Sustainable economic growth,
- Equilibrium in the balance of payments.

However, to achieve all of these objectives is impossible so the government must make tradeoffs between objectives. Targeting unemployment is likely to cause a rise in inflation as the aggregate supply curve shows; increasingly scarce resources cause firms costs to increase and so inflation.

Economic growth will bring about a rise in national income, and as most of the UK's luxury goods are imported this is likely to cause a worsening deficit on the balance of payments. There is also a trade off between the balance of payments equilibrium and inflation as a depreciating exchange rate makes exports most competitive in foreign markets so the balance of payments will work toward an equilibrium level. However a depreciating exchange rate will also cause imports to become more expensive and so inflation in the UK economy.

To manage these changes in supply the government has four key tools:

- Fiscal policy – the use of government expenditure and taxation to influence the level of economic activity.
- Monetary policy.
- Supply-side policy.
- Exchange rate policy.

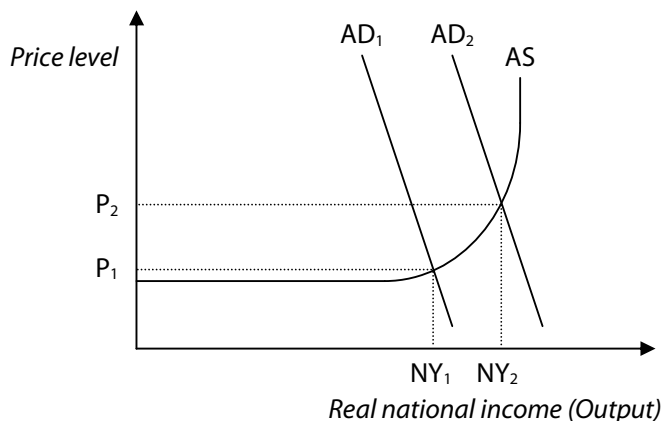
## Fiscal policy

Fiscal policy is the use of government expenditure and taxation to influence the level of economic activity.

Suppose the UK has a 15% rate of unemployment. The UK government decides to implement an expansionary fiscal policy. This may involve:

- Decrease in the rate of direct taxes such as income tax (causing an increase in C).
- Increase personal allowances (causing an increase in C).
- Decrease corporation tax (causing an increase in I).
- Lower indirect tax rates (such as VAT), although this is not as effective as lowering direct tax rates (causing an increase in C).
- Increase government discretionary spending (an increase in G).

This lowers disincentives to work, so is likely to reduce unemployment in the economy. This will shift the demand curve outward from  $AD_1$  to  $AD_2$  and an increase in the price level in the economy from  $P_1$  to  $P_2$ .



There is an increase in real national income which causes an increase in output so there is a decrease in unemployment. However the price level increases as resources are becoming scarcer.

Implementing an expansionary fiscal policy is not a good idea when:

- Near or at full employment as there will be proportionally large inflation compared to the change in national income as AD is inelastic.
- How increased discretionary spending is increased.
- What the government spends the money on.
  - Government spending on transfer payments causes a disincentive to work. AS will be affected and will not shift outwards at the normal rate. High levels of voluntary unemployment could cause AS to shift to the left in the LR.

Government discretionary spending has two parts, capital spending on assets that will be used again and again and current spending on consumables. In the short run both will increase the G component of AD, yet in the long run only capital spending will increase AS.

*Homework:* Complete grid about applying fiscal policies in the long and short run to the four economic problems and any problems associated with applying those policies.