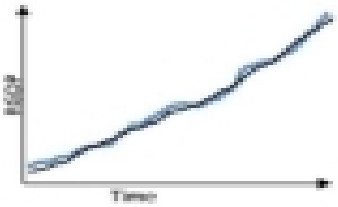
Macroeconomics: Aggregate Demand & Aggregate Supply

Macroeconomics: the three basic goals for a healthy economy are high output of goods and services, low unemployment, and low rate of inflation. An economy functioning at full capacity means that all of the economy's resources are fully employed at their normal utilization rates (no overtime, unemployment level = NAIRU level).

The level of real GDP attained when an economy is at full capacity is called the **full capacity** or **full potential output (GDP)**, and has the symbol, Y^*. In general, the long-term GDP for an economy (called potential GDP) will increase over time. However in the short term, the real GDP, Y^R, fluctuates around the potential GDP.

In the graph to the right, potential GDP is the thick black line, and real GDP is the thin blue line. These fluctuations in RGDP are called expansions and contractions in the business cycle. The high points of the fluctuations are called peaks and the low points are called troughs. Where the real GDP is relative to the potential GDP defines whether an economy is in a **recessionary** ($Y^R < Y^*$) or **inflationary gap** ($Y^R > Y^*$).



We can look at these periods of recession or inflation (disequilibrium in the market) more closely by introducing the concepts of aggregate demand, short-run aggregate supply, and long-run aggregate supply.

Aggregate demand (AD) is the total demand for goods and services from the four major sectors of the economy (think of the demand curve from micro, but now on a larger scale); it is the planned expenditures for the entire economy. The equation is the same as for the GDP expenditure approach. The AD curve shows the quantities of all goods and services demanded (RGDP) at varying price levels. It is downward sloping.

$$AD = C + I + G + (X - M)$$

Aggregate supply shows the relationship between the total output of goods and services and the cost per unit of producing that output. Aggregate supply consists of both **short-run aggregate supply (SAS)**, where only one factor of production (labour) can be varied, and **long-run aggregate supply (LAS)**, where all factors of production can be varied.

Short-run aggregate supply shows the upward sloping relationship between price level and the total quantity of goods and services that firms will produce (RGDP) assuming constant factor prices and fixed capital/equipment. The positive slope reflects the increasing average cost with each additional unit of good produced.

Authored by Emily Tompson