

LECTURE 29: SHIFTING AGGREGATE SUPPLY

- I. Shifting LRAS
 - a. When LRAS curve shifts, something fundamental just happened in the economy. We call these *real shocks* (because they have a real effect: an effect that's adjusted for inflation).
 - i. A positive shock increases real GDP. Examples include technology, increases in the capital stock, higher levels of education, and increases in the population.
 - ii. A negative shock decreases real GDP. Examples include disasters and wars (which reduce both the capital stock and the population), and a fall in education levels.
- II. Shifting SRAS
 - a. *Productivity*. If an economy can produce more output with the same number of inputs, that's effectively the same as reducing input prices. In both cases, by spending the same amount of money on inputs, the economy will be able to create more output. Increases in productivity shift AS right/down.
 - b. *Legal Environment*. Changes in regulations shift the AS curve in the same way changes in input prices shift AS. Complying with regulations are costly.
 - c. *Taxes/Subsidies*. Paying taxes are costly, too. Subsidies, on the other hand, reduce cost-per-unit of production.
 - d. *Input prices*. While input prices are sticky, they are not set in stone. If wages fall (say, because of an increase in immigration) or the dollar appreciates (thus importing inputs are cheaper), the SRAS shifts right/down.
 - i. Cheaper dollars thus have two effects; one for input prices and one for greater exports/fewer imports.
 - ii. Here we can relax my rule from Unit 1: it's now okay to shift more than one curve. In this case, AD would shift right/up *and* AS would shift left/up.
 - e. When LRAS shifts, SRAS shifts with it, as long as the real shock affects the short-run, too (which it usually does).
 - i. Note that the last two effects (taxes/subsidies and input prices) are all various kinds of prices. They don't have a real effect and

thus they don't reflect economic fundamentals so these changes don't shift LRAS.

III. Understanding Shifts

- a. Time becomes an important factor in this analysis. Whatever happens, we must make all three curves eventually intersect at one point. The economy trends towards equilibrium
 - i. The question you must consistently ask yourself is: in the long-run, what should happen? Should real GDP change or only the price level?
- b. If you shift just one curve, the economy shows an imbalance. Rather than three lines intersecting on the same point, three lines will intersect at two different points. Three different scenarios can't be happening at the same time: the price level can only be one result; real GDP can only be one value. The imbalance must correct itself.
- c. The correction occurs when another curve shifts so all lines meet at the same point.
- d. For example, consider demand-pull inflation:
 - i. AD shifts out after the money supply increases.
 - ii. This shift puts upward pressure on prices and wages. In the short-run, output increases. This creates an "inflationary gap."
 - iii. But operating beyond full employment can only happen for so long. Inputs are in high demand; input prices and wages will rise.
 - iv. This cutting into profits causes SRAS to shift up to LRAS. The gap closes.
 - v. In the long-run, output won't change but we'll get a lot of inflation.

