Derivation:

Instructions:

This exercise is designed to get students to think about why AD curves might shift and then, using this idea, derive the Keynesian AS function. The opening is a recap on why AD functions slope down and then there are two separate exercises. The first is really just a recap on some of the factors that affect C and I (plus G and X-M if they're thinking). The second is an attempt to get them to understand why AS functions look as they do by applying real world logic.

If they are struggling, a good analogy to use is to simplify the whole economy down to a restaurant with 10 tables – at Y1 there are only 2 tables occupied and the waiting staff are fearful of their jobs. As the economy approaches full employment, more and more tables are in use, new restaurants are opening up who need new staff and so on. At full employment, the restaurant has a queue 200 yards down the road and the waiting staff are being bombarded with job offers from other restaurants!

Task 1:

Aggregate Demand

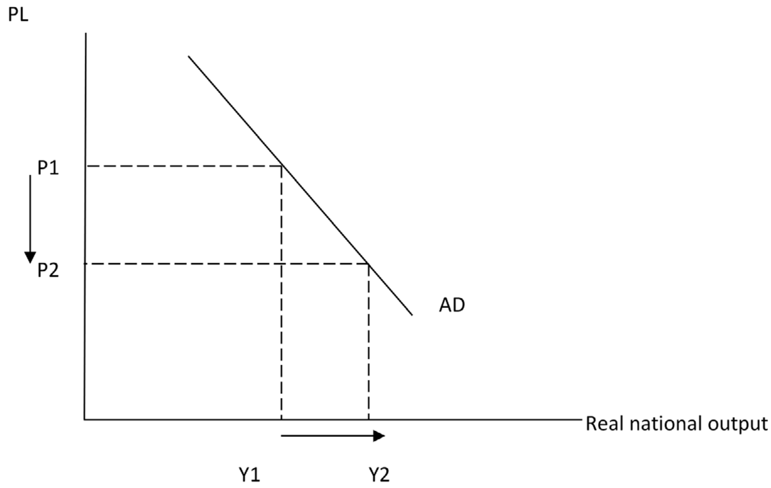
We know that a fall in the price level would increase AD for three main reasons:

(i) A fall in the price level would increase the value of savings and cash holdings (the 'real balance effect')

(ii) A fall in the price level would increase the competitiveness of UK exports, again increasing AD (C+I+G+X-M)

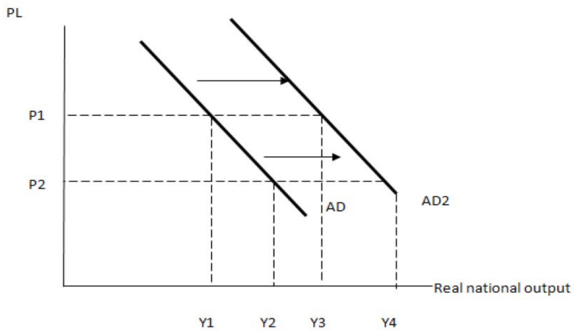
(iii) A fall in the price level will increase the real value of deposits in banks, putting downward pressure on interest rates,

Thus, we had:

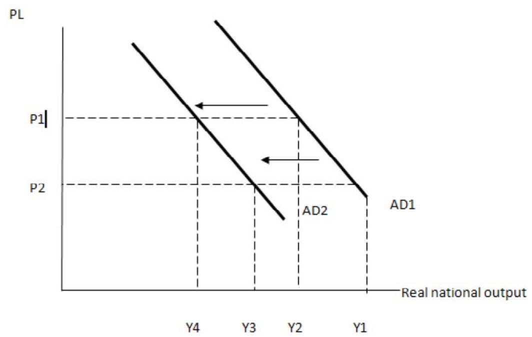


We then said that if any factor other than price shifted, AD would shift either:

Right (an increase)



or Left (a decrease)

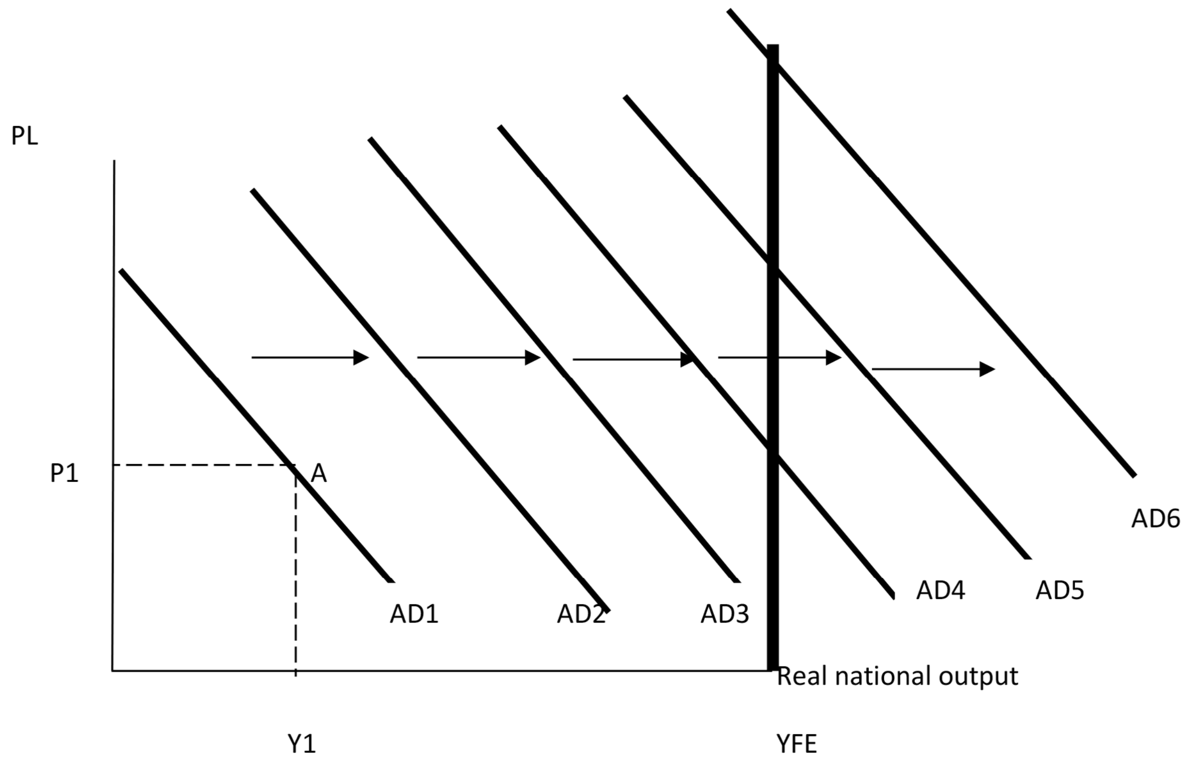


Task – come up with two factors that might cause AD to shift left and right (two for each – and not just opposites!)

Task 2:

Suppose that an economy is in equilibrium at point ‘A’ (P1, Y1). There are lots of spare resources – unemployment is high, there are lots of empty retail units, firms are operating well below capacity.

Suppose that AD rises steadily from AD1 to AD5



Question:

Draw on the likely relationship between price and output (mark on points ‘B’, ‘C’, ‘D’, ‘E’ and ‘F’) and explain (i.e. write a paragraph) about what happens:

(i) Just after Y1

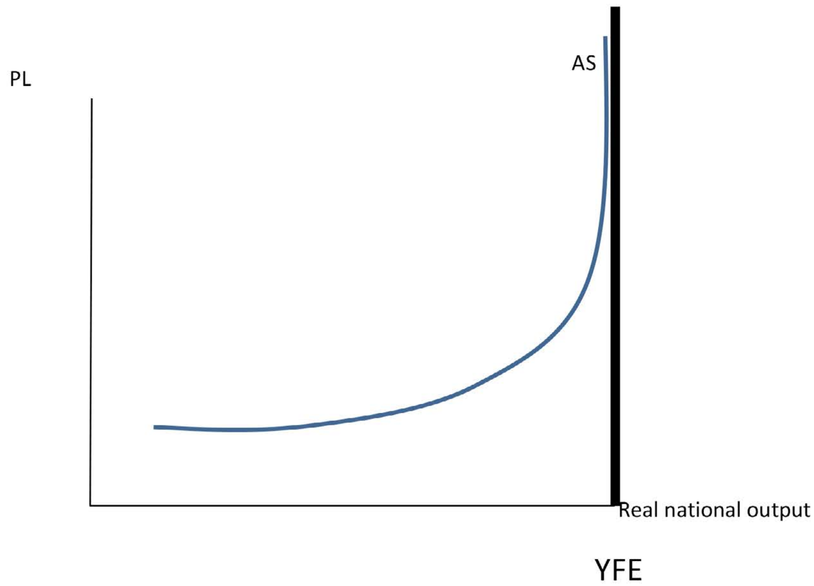
(ii) As the economy gets near to YFE

(iii) When the economy reaches YFE.

Answers:

AD: All the factors that might affect its components apart from the price level – interest rates, confidence, income and corporation tax, house prices, availability of credit etc.

AS: Hopefully they will intuitively come up with something like this:



Just after Y1, there are lots of spare resources and firms do not have many customers. Hence product and labour markets are both very competitive. If AD rises, workers will not be in a position to demand pay rises in general (because unemployment is still very high) and firms will not want to increase prices (because they are still well short of capacity and face lots of competition from other firms).

As the economy continues to grow, unemployment of labour (and other factors such as land – office space etc.) will fall. At the same time, firms will have more customers. It is likely that skills shortages will begin to emerge in some sectors (technology?) and areas (Southeast?). Wages and other factor prices are likely to be pushed up (as firms compete for skilled workers), and since firms now face less competition because of rising demand, prices will probably follow.

At full employment, an increase in demand simply can't be met – any further increase in AD will be purely inflationary.