

AS

The Aggregate Supply (AS) shows the total quantity of goods and services that are provided by firms in an economy at an average price level.

The AS is examined relative to a potential e.g. consider a hotel of 100 rooms: this is its potential occupancy (at 100%); so long as the potential is not changed, there is a long-run supply (LRAS). However, its actual average annual occupancy might be at 60 rooms (or 60%); this is its short-run supply (SRAS) which can change over time i.e. increase or decrease.

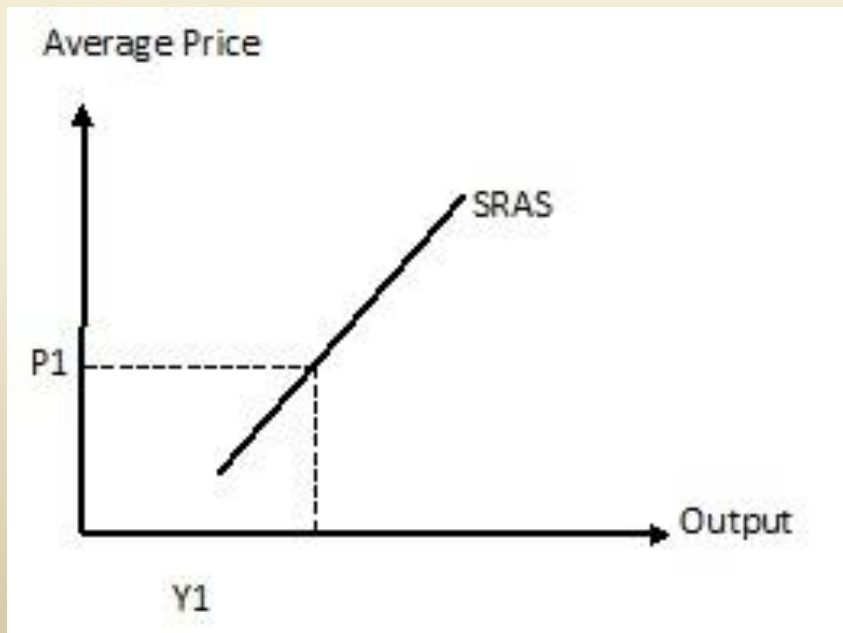
Thus for the aggregate supply of goods/services.

SRAS

The way the SRAS is understood and graphed depends on what view one adopts:

a/Classical and Monetarist views (Hayek, Friedman) consider that prices and wages are flexible relative to changes in demand and supply.

At the level of average prices P_1 the industries produce goods etc. i.e. output of $Y_1 = X$ GDP ; e.g. CH GDP 2009 = 314 bi. An increase in P will induce greater output Y .

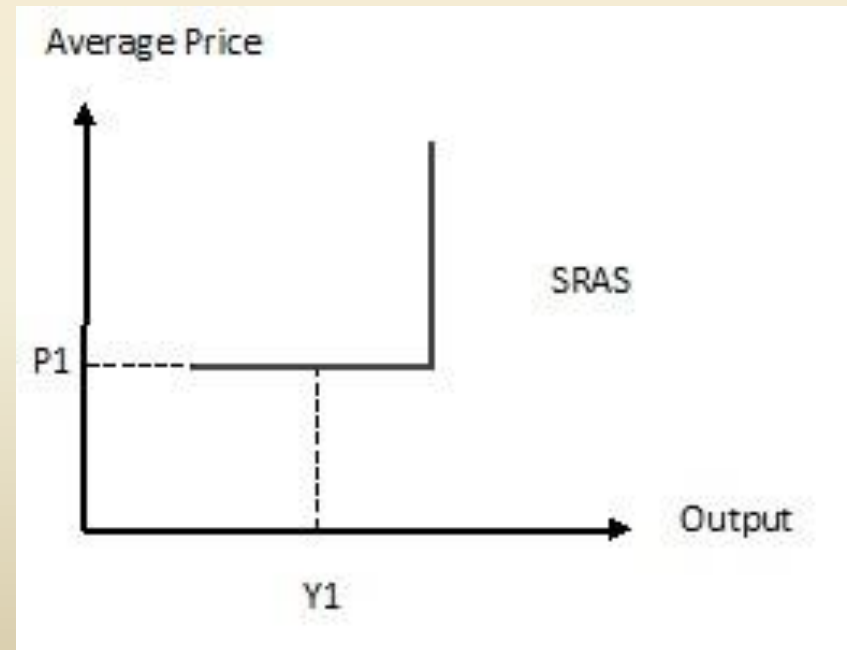


b/Modern (Keynes) considers that markets are slow to respond to changes because as businesses seek to influence the level of prices and the costs of production factors, and in particular, the wages, labor and unions seek to oppose this tendency.

At the level of prices P_1 the industries produce goods etc.

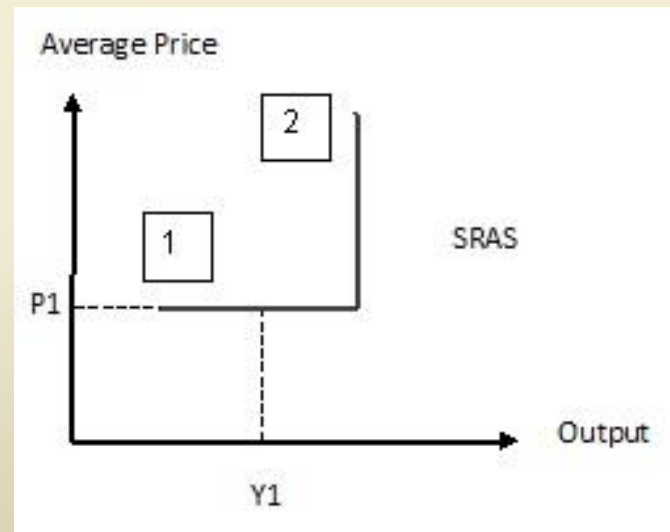
i.e. output of $Y_1 = X$ GDP ;

e.g. CH GDP 2009 = 314 bi.



The difference in assumptions about markets is translated as per the utilisation of resources:

- For Keynes an economy can be in region 1 (underutilization of resources), region 2 (overutilization of resources)



- For Friedman the under(over)utilisation of resources is temporary

c/Relational view (Zamaros) starts with the following observations

1. There are business markets, capital markets and labor markets
2. Business markets cannot be either perfect or imperfect as mainstream economics has it; they can either be
 - Passive – cannot use price as a competitive advantage (e.g. hotels, restaurants) but other means
 - Dynamic – use price as competitive advantage (e.g. IT, pharma) in addition to providing unique products/services
 - Non-competitive – they have no reason to compete (e.g. mega corporations, cement industry)

Would this apply to capital and labor markets?

3. Capital markets are not as perfect as it is often assumed. They are
- passive because the financial products are similar, widely available, and the prices are set by the market (bourses) or externally (prime interest of the banks set by the central bank); in this sense capital markets are price-takers.
 - dynamic in that investors seek opportunities and these tend to be more important in dynamic industries rather than passive or non-competitive.

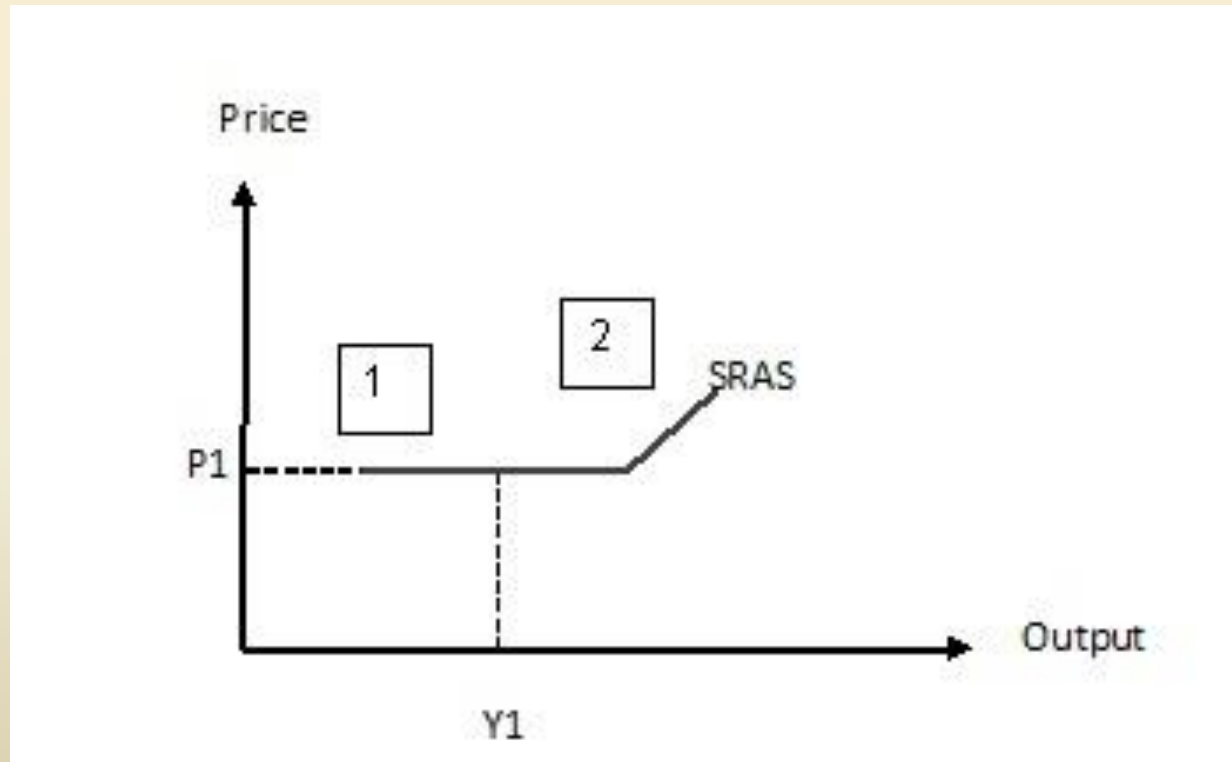
4. Labor markets can be classified according to the supply and degree of skills; they can be
- Passive (high supply, lowly skilled) e.g. hospitality industry
 - Dynamic (low supply, highly skilled) e.g. pharma
 - Non-competitive (regulated supply, variously skilled) e.g. public administration

Labor markets mirror the business markets but a 1/1 relation would be misleading

5. Thus economies are composed by a mix of these market types, yet some types will be predominant and geographically so; consequence:

- Capital and labor mobility is likely to vary as a function of geography and market type.
- The speed of adaption of these markets is likely to vary according to the dynamics of the market: the greater the dynamics the more likely its evolution and vice versa.

6. Graphically, at the level of prices P_1 the industries produce goods etc. i.e. output of $Y_1 = X \text{ GDP}$; e.g. CH GDP 2009 = 314 bi.



Under the relational view an economy can find itself in

- Either region 1 (underutilization of resources)
- Or region 2 (normal utilization of resources)

- Unlike Keynes, the scenario of stagflation is only temporary e.g. Switzerland was faced with stagflation in 2009 which lasted 6 months
- Unlike Friedman, the underutilisation of resources can be long-lasting e.g. 3.2% unemployment rate in Switzerland since the 1990s (variance has decreased from 4% to 1%) whereas before it was less than 1%

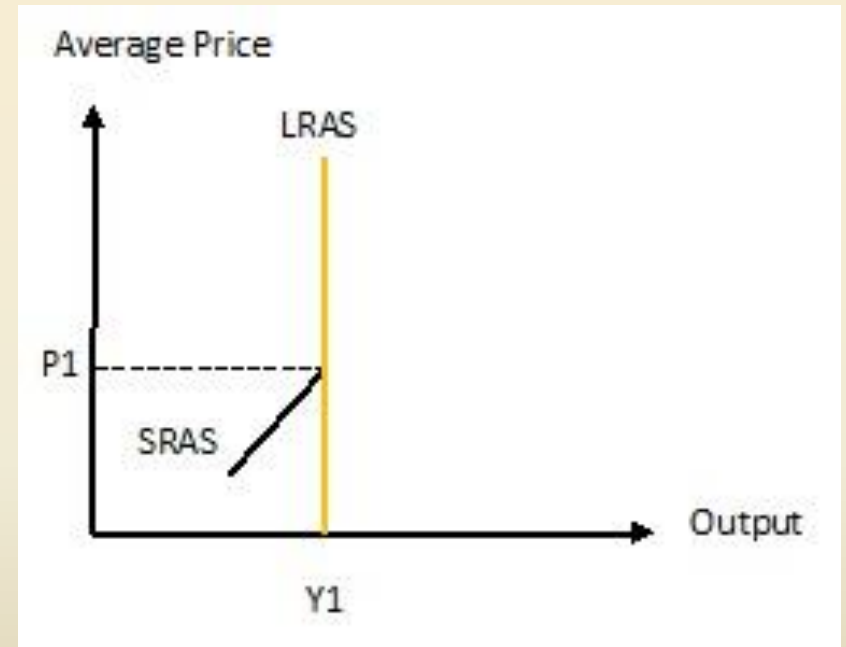
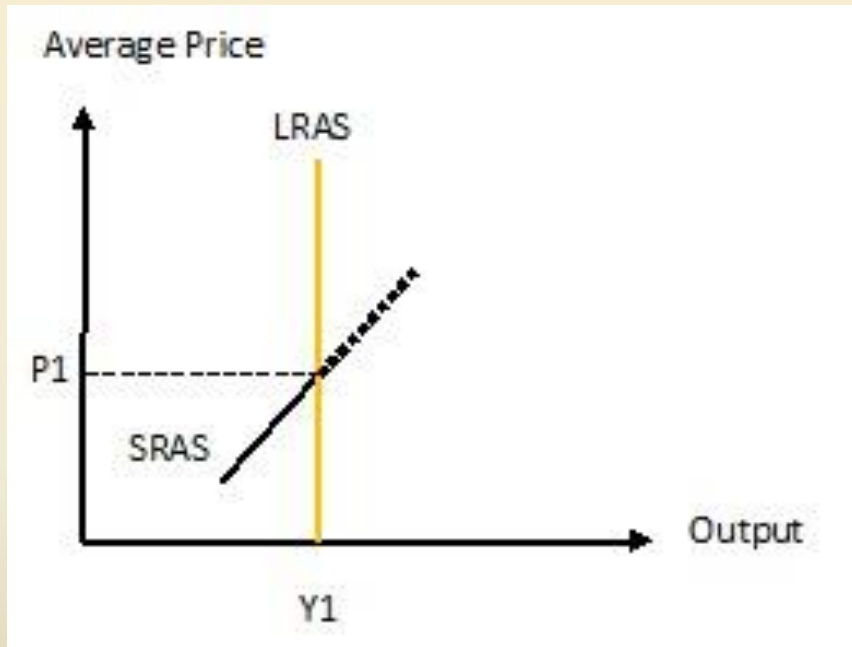
LRAS

If at the level of prices P_1 the industries produce goods etc. i.e. output of Y_1 (e.g. CH GDP 2009 = 314 bi), can the economy produce more at this point?

If the economy uses all its resources (K, L) the answer is: NO; it has reached its production possibility frontier (PPF) = long-run AS (LRAS)

The assumption made in mainstream economics is that at the LRAS the economy uses its resources optimally e.g. full employment, use of state-of-the-art technology by businesses; there follows that with SRAS the economy is at a less-than-efficient level. The LRAS is the ideal to pursue!

a/In the classical/monetarist view



b/In the Keynesian view

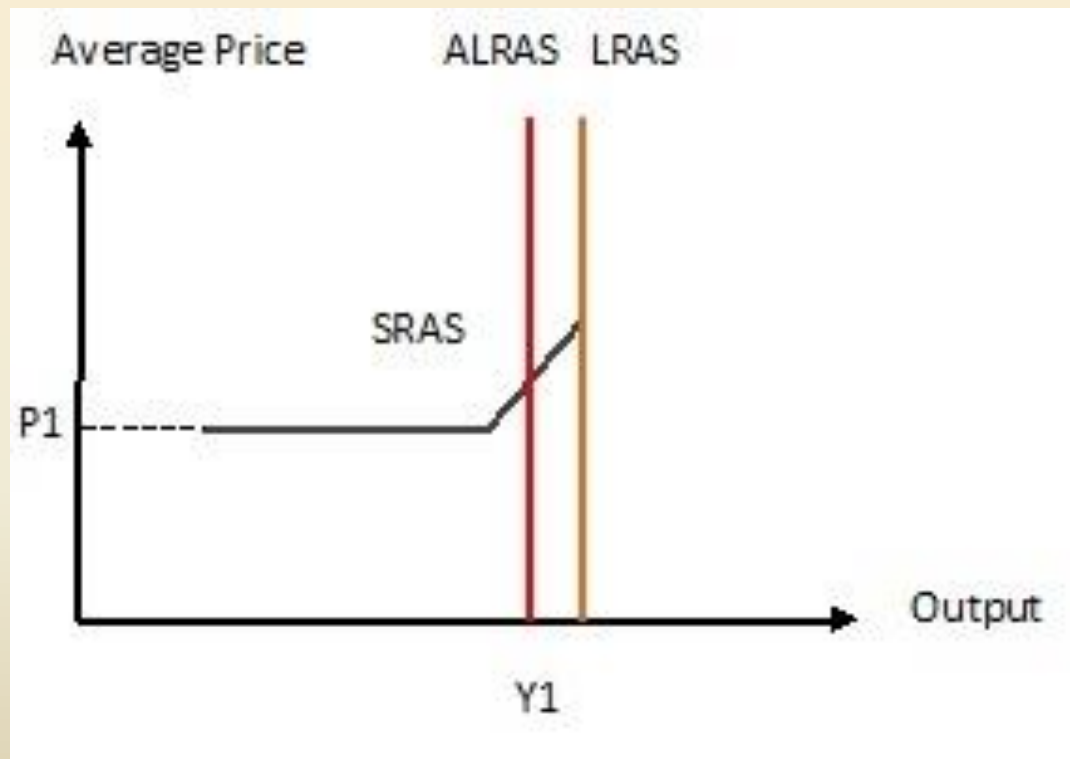


If there is agreement over the nature of LRAS in the Keynesian and Monetarist views they both mistake the PPF with what the economy is actually producing.

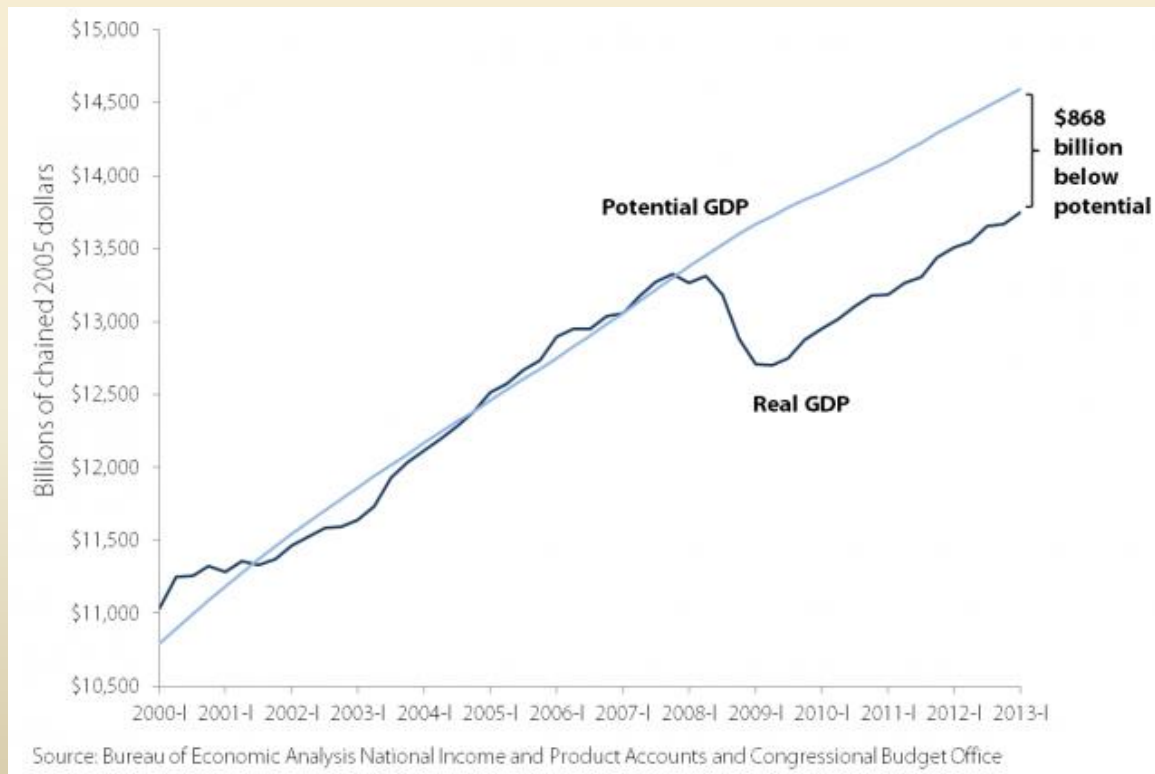
Observing that not all capital is used optimally (machines need to be serviced a time during which they are idle, businesses choose to reduce supply for strategic reasons) and given the mismatch between the labor and capital utilization (the so-called “law of diminishing marginal product”), the PPF is nothing more than a theoretical curiosity.

The actual LRAS (ALRAS) is thus lower than the theoretical LRAS (PPF). It corresponds to long-term inefficiencies e.g. natural unemployment.

c/In the relational view



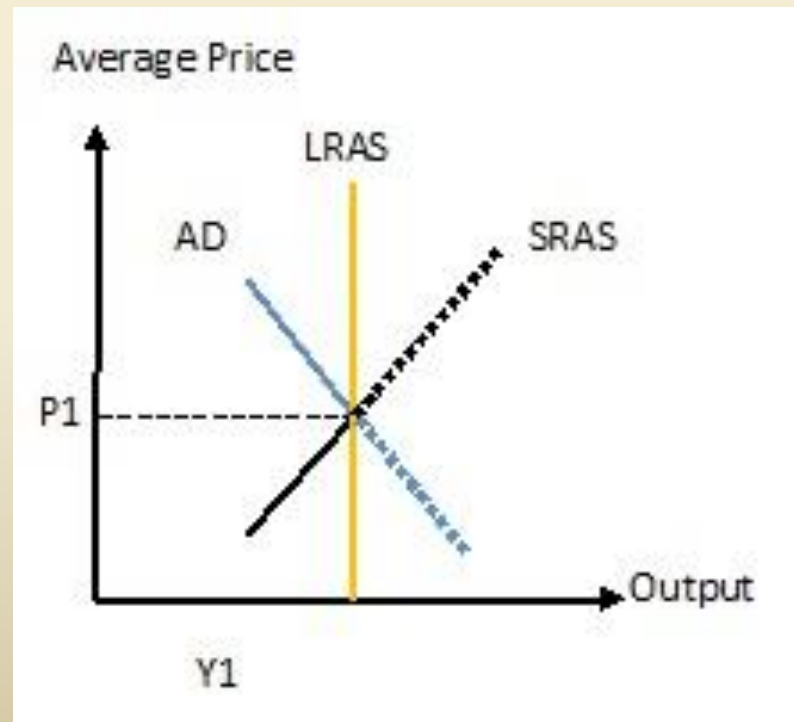
The difference between ALRAS and LRAS is what is referred to as GDP gap between what the economy produces (actual real GDP/GNI) and what it should be producing (potential GDP/GNI)



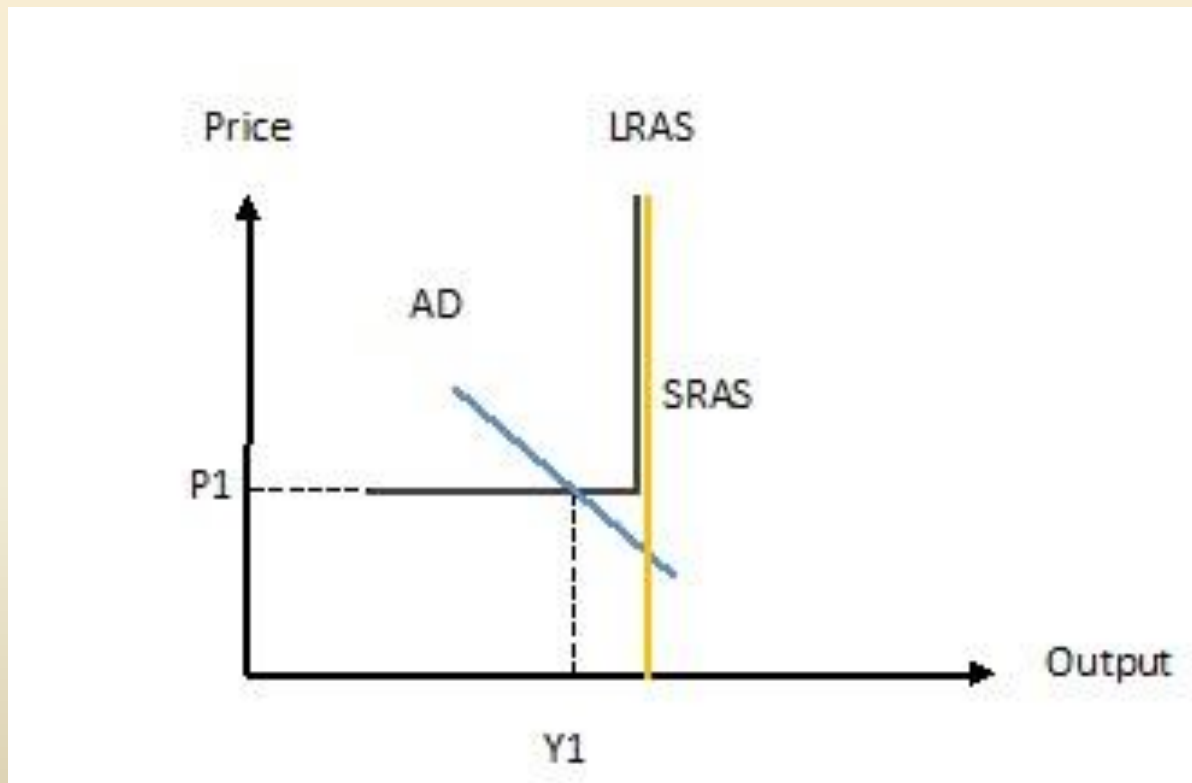
Equilibrium

Equilibrium between AD and AS in the sense what is demanded (spent) is produced (earned)

a/In the classical/monetarist view:



b/In the Keynesian view:



c/In the relational view:

