

LONG-RUN AGGREGATE SUPPLY

There are two major views relating to the shape of the LRAS. The different beliefs about the shape of the LRAS curve lie at the basis of controversies about appropriate policies to be followed by (1)_____.

The new-classical view ((2)_____ or free market view)

These economists argue that the LRAS curve does not respond to changes in (3)_____ in the long run and is determined completely independently of demand. Its position depends upon the quantity and productivity (quality) of factors of (4)_____. An expansion of AD will always lead to (5)_____ inflation and will not, in the long run, lead to growth in output and thus employment. So new-classical economists argue that national output may only be increased by adopting (6)_____ policies to shift the LRAS to the right.

The Keynesian view (interventionist view)

The shape of the curve that is known as the Keynesian LRAS shows (7)_____ possible phases. In region 1, the LRAS is perfectly (8)_____. Producers in the economy can raise their level of output without higher average costs, because of 'spare (9)_____ ' in the economy.

In region 2, as the economy approaches its (10)_____ output (Y_f), and the spare capacity is used up, the available factors in the economy become more (11)_____. As producers increase output, they bid for the increasingly scarce factors and prices begin to rise.

In region 3, when the economy is at full capacity, all factors are being used and so output cannot increase. Thus, LRAS is perfectly (12)_____.

AGGREGATE DEMAND CAPACITY DEMAND-PULL ELASTIC GOVERNMENTS
INELASTIC MONETARIST POTENTIAL PRODUCTION SCARCE SUPPLY-SIDE THREE

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KEY

LONG-RUN AGGREGATE SUPPLY

There are two major views relating to the shape of the LRAS. The different beliefs about the shape of the LRAS curve lie at the basis of controversies about appropriate policies to be followed by governments.

The new-classical view (monetarist or free market view)

These economists argue that the LRAS curve does not respond to changes in Aggregate Demand in the long run and is determined completely independently of demand. Its position depends upon the quantity and productivity (quality) of factors of production. An expansion of AD will always lead to demand-pull inflation and will not, in the long run, lead to growth in output and thus employment. So new-classical economists argue that national output may only be increased by adopting supply-side policies to shift the LRAS to the right.

The Keynesian view (interventionist view)

The shape of the curve that is known as the Keynesian LRAS shows three possible phases. In region 1, the LRAS is perfectly elastic. Producers in the economy can raise their level of output without higher average costs, because of 'spare capacity' in the economy.

In region 2, as the economy approaches its potential output (Y_f), and the spare capacity is used up, the available factors in the economy become more scarce. As producers increase output, they bid for the increasingly scarce factors and prices begin to rise.

In region 3, when the economy is at full capacity, all factors are being used and so output cannot increase. Thus, LRAS is perfectly inelastic.