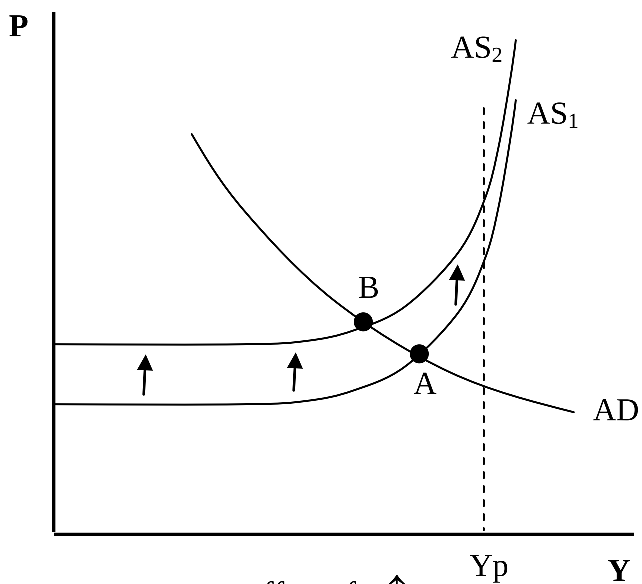
Shifts in Aggregate Supply
Econ 202/Haworth

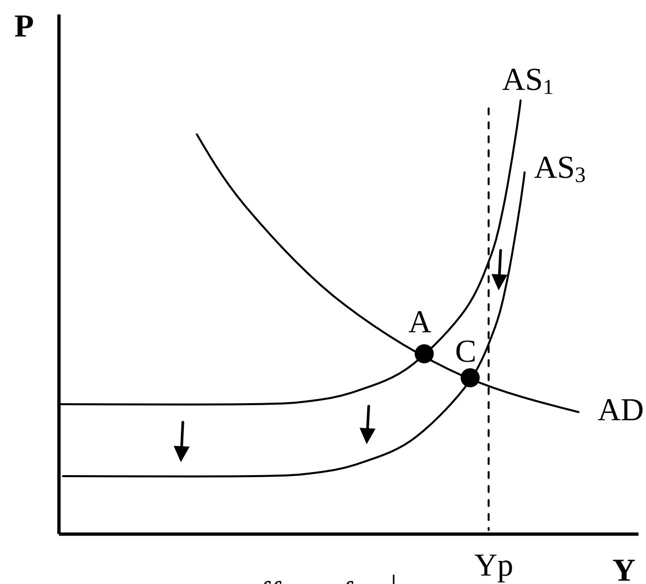
Prior to this section, we've considered an increase in AS to be a shift right, and a decrease is a shift left. In this section, we introduce the idea that AS can shift up or down, as well as left or right. The difference relates to the reason for the shift.

Changes in wages (factor price of labor):
If wages increase, then costs increase. Higher costs imply a decrease in AS. Does mean a shift left or a shift upward? Since higher wages do not change your ability to produce, as in this change only affects the price of the product you are producing, higher wages do not cause a shift left. Higher wages cause a shift upward.

Therefore, changes in wages (a nominal variable) have the following effect on AS:



effect of w↑



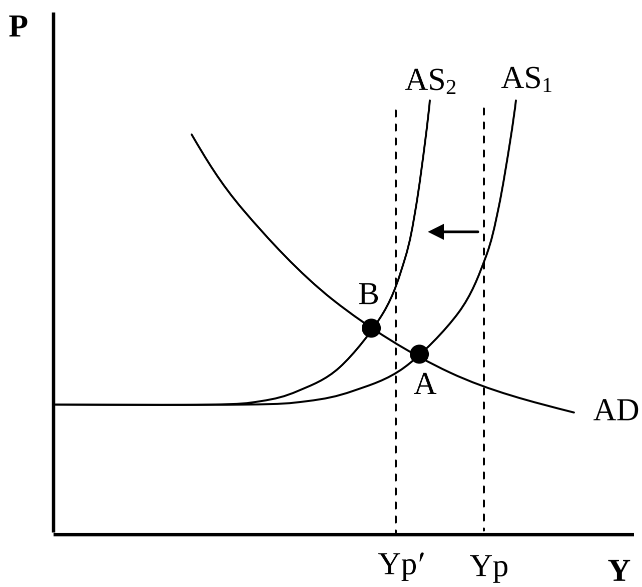
effect of w↓

Note that a change in wages does not affect Potential, and so Yp (Potential GDP) does not change when there is a change in wages. This is because wages are a nominal variable, which means that this is a variable which affects prices, but not your ability to produce.

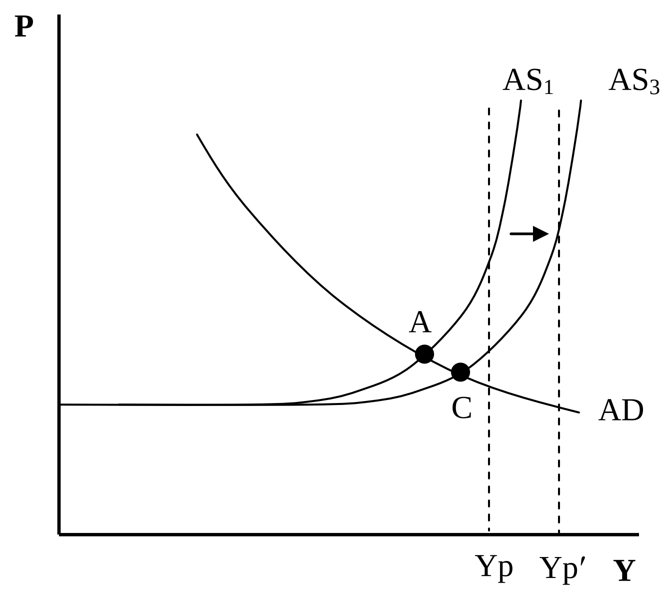
What if there is a change in something that we know can affect Potential?

A change in productivity can affect Potential (we know this from the PPC model). Suppose there's a change in productivity within the economy (e.g. all firms within the economy experience an increase in productivity). If productivity improves, then firms are able to produce more units of output with the same number of factors. This implies a shift to the right in the PPC and not a downward shift.

Therefore, changes in productivity (a real variable) have the following effect on AS:



effect of productivity↓



effect of productivity↑

Note that a change in productivity DOES affect Potential, and so Yp (Potential GDP) also changes whenever there is a change in productivity. This is because productivity relates to real variables, which means that this is something which affects your ability to produce.