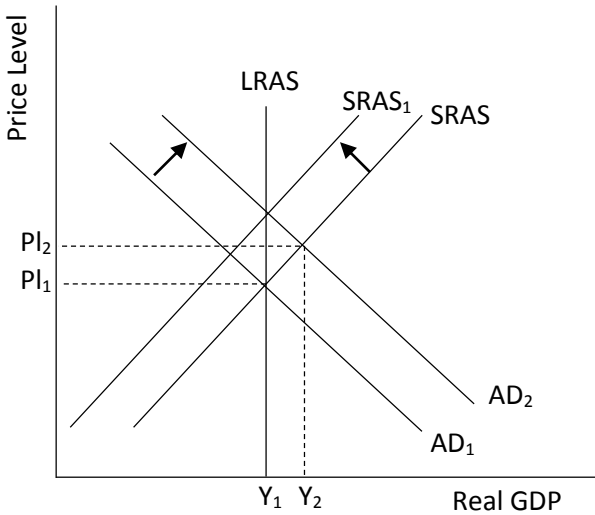
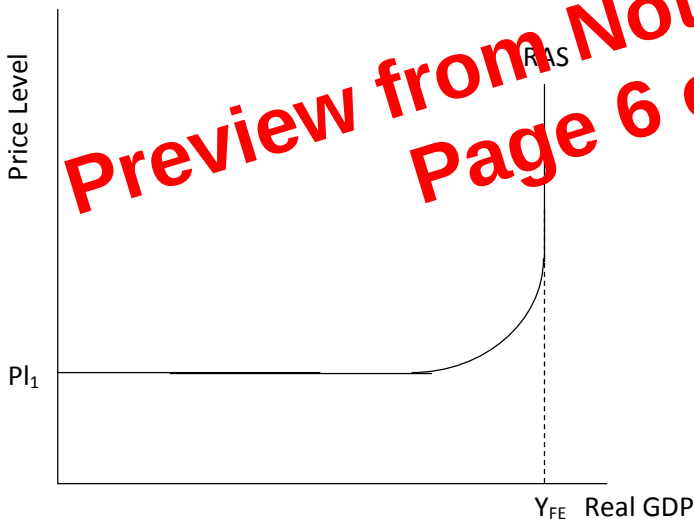




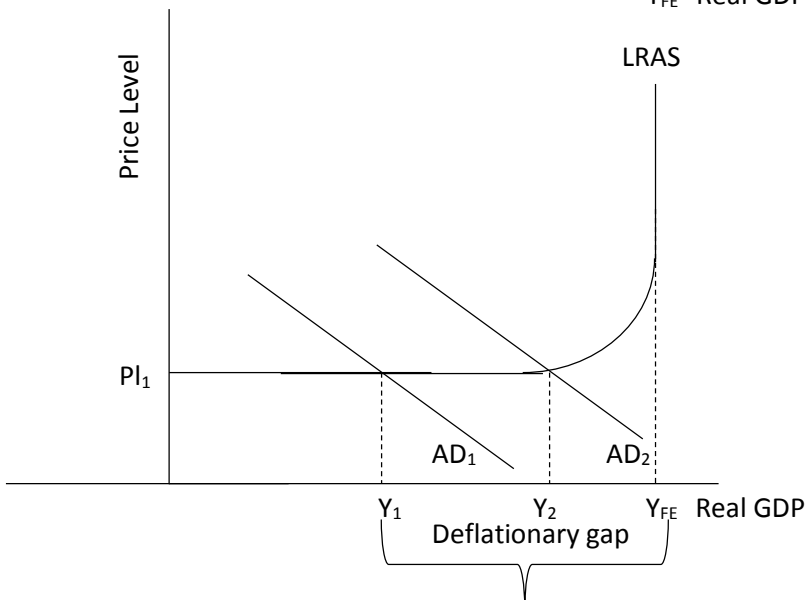
AD increases. It may seem that the economy is producing beyond the level of full employment of resources. Remember that in the short run, there still is some unemployment – frictional, seasonal, cyclical etc... thus, it is possible in the short run, to employ people, and produce more than the full level of output. Or this can be due to currently employed workers working harder or overtime. Producers thus produce more but pay the same amount of wages as wages are fixed in the short run – workers are slow to realise that they are in scarce supply and are working more but paid the same. In the long run, workers realise that they have bargaining power due to inflation, and thus demand higher wages, increasing the cost of production, and shifting SRAS back to long run equilibrium. This is called an inflationary gap

- Increase in output (greater than full level of employment)
- Decrease in unemployment (lower than natural rate of unemployment)

Keynesian model



- Full level of output represented by LRAS
- LRAS determined by the level of spare capacity in the economy
- Horizontal part because during periods of great spare capacity, when output increases there isn't much pressure put on resources, on factors of production, therefore the price of those does not have to rise, in which case there may not be any inflation as output increases
- Wages are "sticky", workers are unwilling to have their wages decrease



- In order to get out of a recessionary gap, fiscal policies such as increased government spending and a reduction should be used to increase AD and thus reduce the level of spare capacity in the economy
- Takes away the limitation of classical model – of when the long run occurs