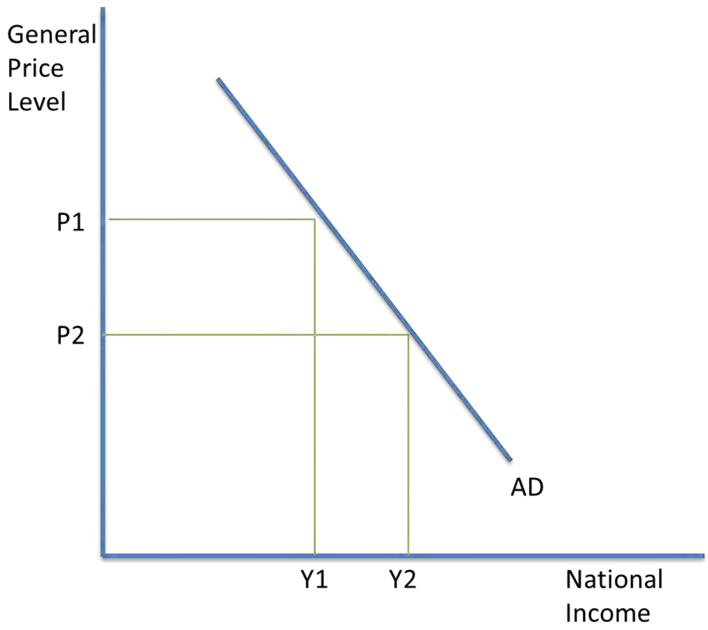
WJEC (Wales) Economics
AS-level
Macroeconomics

Topic 1: Macroeconomic Theory

1.3 The AD function

Notes

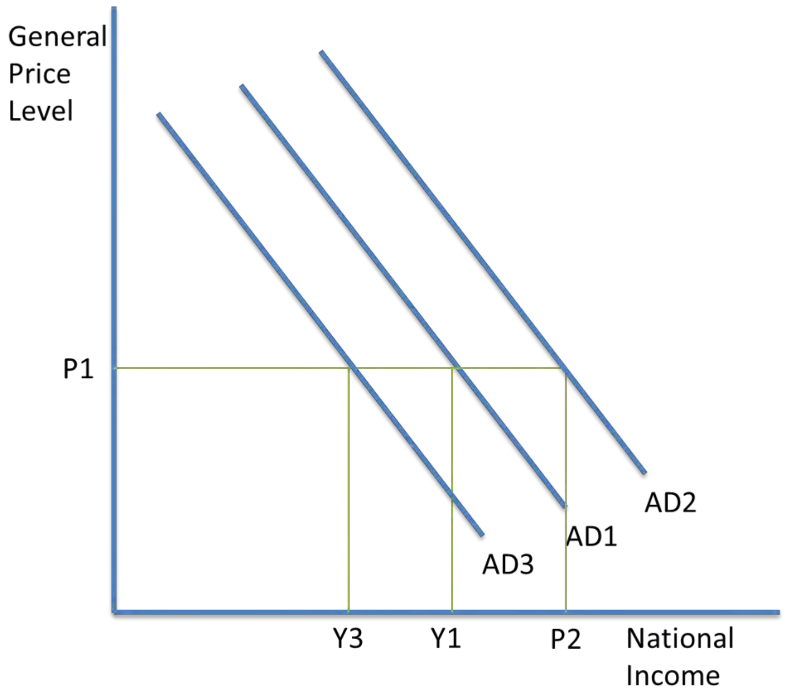
Moving along the AD curve:



- A fall in the price level from P1 to P2 causes an expansion in demand from Y1 to Y2.
- A rise in the price level from P2 to P1 causes a contraction in demand from Y2 to Y1.
- Changes in the price level cause movements along the demand curve.

Shifting the AD curve:

The AD curve is shifted by changes in the units of AD (C, I, G or X-M):



A rise in AD is shown by a shift to the left in the demand curve (AD1 → AD2). This rise in economic growth occurs when:

- Consumers and firms have higher confidence levels, so they invest and spend more, because they feel as though they will get a higher return on them. This is affected by anticipated income and inflation.
- If the Monetary Policy Committee lowers interest rates, it is cheaper to borrow and reduces the incentive to save, so spending and investment increase. However, there are time lags between the change in interest rates and the rise in AD, so this is not suitable if a rise in AD is needed immediately.
- Lower taxes mean consumers have more disposable income, so AD rises.
- An increase in government spending will boost AD.
- Depreciation in a currency means M is more expensive, and X is cheaper, so AD increases. A decline in economic growth in one of the UK's export markets means there will be a fall in X, so AD falls.
- In the UK, most people own their houses. This means that a rise in the price of houses makes people feel wealthier, so they are likely to spend more. This is the **wealth effect.**
- If credit is more available, then spending and investment might increase. Recently, since the financial crisis of 2008, banks have been less willing to lend due to the risks associated with lending.

Why an AD function will slope downward from left to right:

- Higher prices lead to a fall in the value of real incomes, so goods and services become less affordable in real terms.
- If there was high inflation in the UK so that the average price level was high, foreign goods would seem relatively cheaper. Therefore, there would be more imports, so the deficit on the current account might increase, and AD would fall.
- High inflation generally means the interest rates will be higher. This will discourage spending, since saving becomes more attractive and borrowing becomes expensive.

The real balance effect

This is also called the *Pigou effect.* It describes how an increase in consumption due to increases in real wealth (especially during deflation) encourages output to increase.

The trade effect

This refers to the price level and international trade. If there are high levels of inflation in the domestic market, exports become less competitive. This means consumers are likely to switch to imports. There is a lower level of AD when the price level rises.

The interest rate effect

When price levels are low, consumers demand less currency, since they need less to make a purchase. Therefore, consumers keep more money in their bank accounts. This increases the supply of money available for loans, which in turn, reduces the interest rate. Therefore, low price levels cause interest rates to fall. This increases the demand for investment and increases AD.

These three effects help explain the shape of the AD curve. At least one of these needs to be explained for the exam under the WJEC specification.