AQA Economics A-level
Macroeconomics

Topic 2: How the Macroeconomy Works, Circular Flow of Income, AD-AS Analysis and Related Concepts
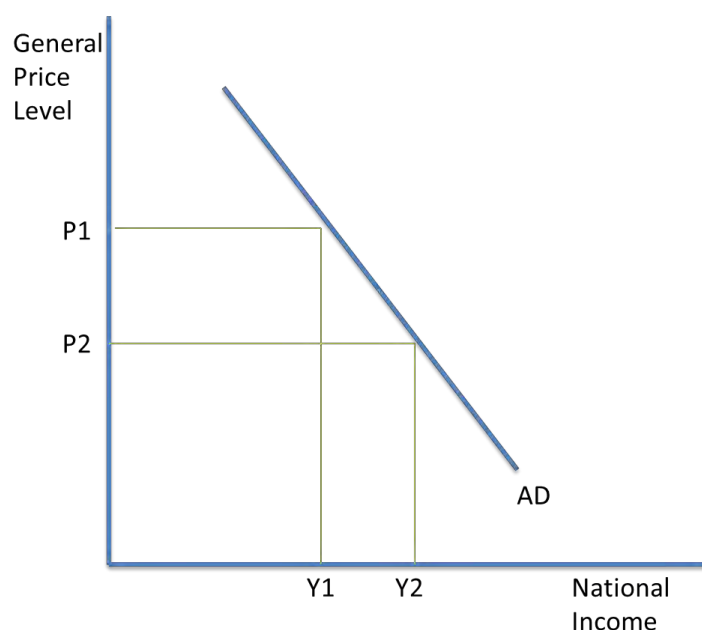
2.2 Aggregate demand and aggregate supply analysis

Notes

Aggregate demand is the total demand in the economy. It measures spending on goods and services by consumers, firms, the government and overseas consumers and firms.

▣ **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.

▣ The downward slope of the AD curve can be explained by:

o Higher prices lead to a fall in the value of real incomes, so goods and services become less affordable in real terms.

o 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.

o High inflation generally means the interest rates will be higher. This will discourage spending, since saving becomes more attractive and borrowing becomes expensive.

🔲 Shifting the AD curve:

🔲 The AD curve is shifted by changes in the components of AD (C, I, G or X-M):
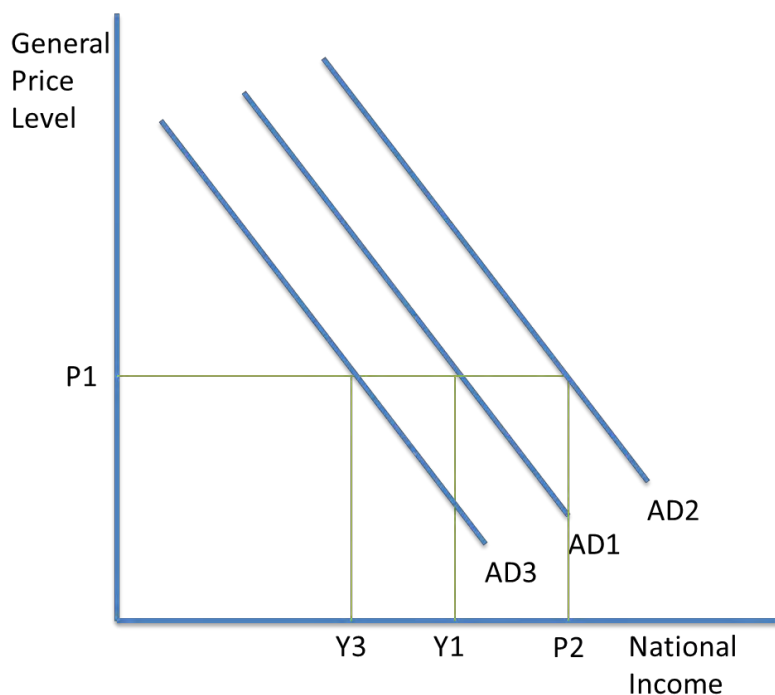
🔲 A rise in AD is shown by a shift to the right in the demand curve (AD1 → AD2).
This rise in economic growth occurs when:
- o Consumers and firms have higher confidence levels, so they invest and spend more, because they feel as though they will get a higher return on them. This is affected by anticipated income and inflation.
- o 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.
- o Lower taxes mean consumers have more disposable income, so AD rises.
- o An increase in government spending will boost AD.
- o 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.
- o 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.**

o 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.

The AS curve:

o Aggregate supply shows the quantity of real GDP which is supplied at different price levels in the economy.
o The AS curve is upward sloping because at a higher price level, producers are willing to supply more because they can earn more profits.
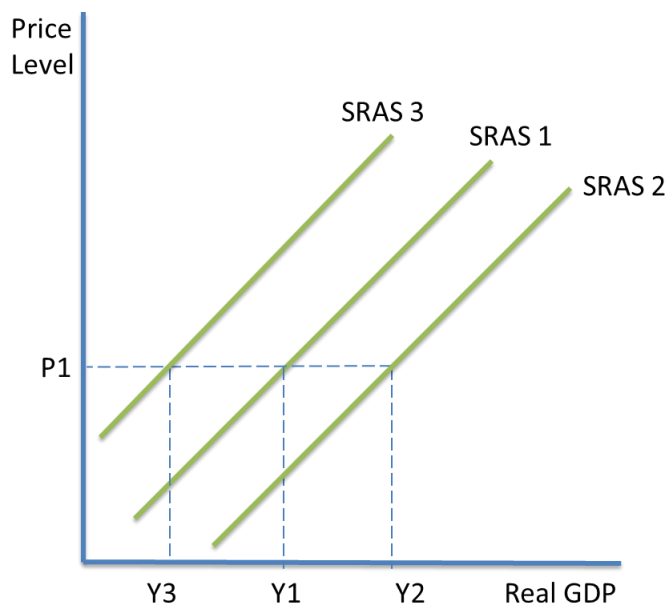
Moving along the AS curve:
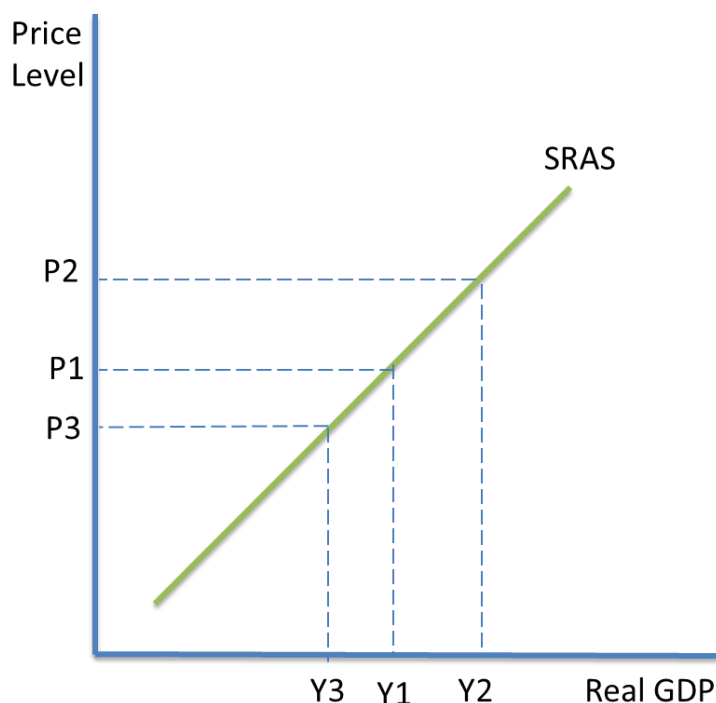
o Only changes in the price level, which occur due to changes in AD, lead to movements along the AS curve.
o If AD increases, there is an **expansion** in the SRAS, from Y1 to Y2. If AD falls, there is a **contraction** in SRAS, from Y1 to Y3.

🖼 Shifting the AS curve:

- The SRAS curve shifts when there are changes in the conditions of supply.
  - The cost of employment might change, e.g. wages, taxes, labour productivity
  - The cost of other inputs e.g. raw materials, commodity prices, the exchange rate if products are imported
  - Government regulation or intervention, such as environmental laws and taxes, and business regulation. Business regulation is sometimes called 'red tape'.

🖼 The factors which affect long-run AS distinguish them from those which affect short run AS:

- The short run aggregate supply curve (SRAS) only covers the period immediately after a change in the price level. It shows the planned output of an economy when prices change, whilst the cost of production and productivity of the factor inputs are kept constant. These could be wage rates or how technologically advanced capital is, for example.
- The curve is upward sloping because supply is assumed to be responsive to a change in AD, which is reflected in the price level.
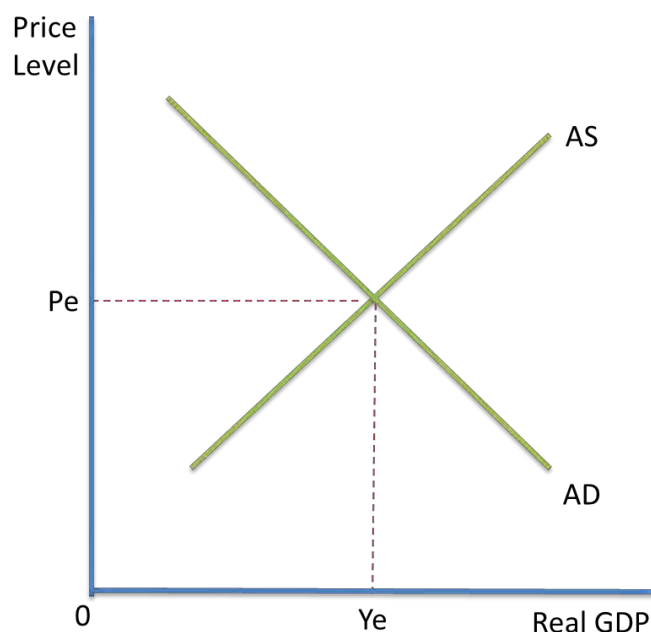
Price
Level

SRAS

Real GDP
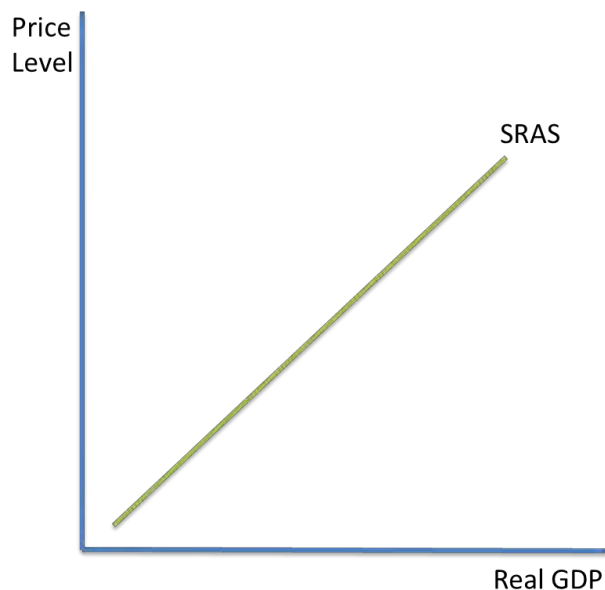
- o The long run aggregate supply curve (LRAS) shows the potential supply of an economy in the long run. This is when prices, and the costs and productivity of factor inputs, can change. Similarly to the PPF, it can show the economy's productive potential.
- o The curve is vertical, because supply is assumed not to change as the price level changes.
- o A right-ward shift in the LRAS curve shows economic growth.
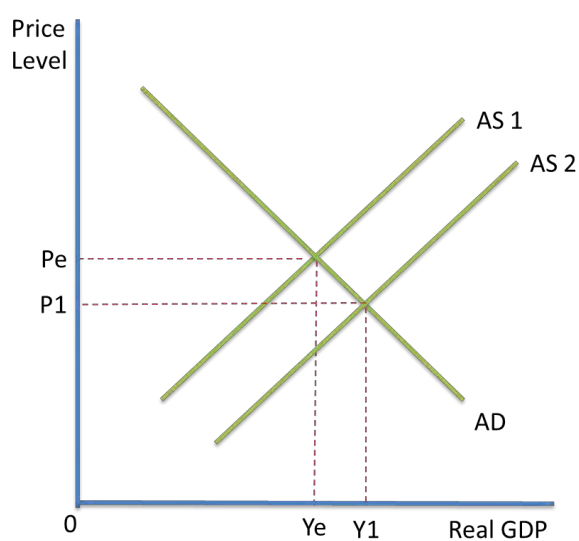
Price
Level

LRAS

Real GDP
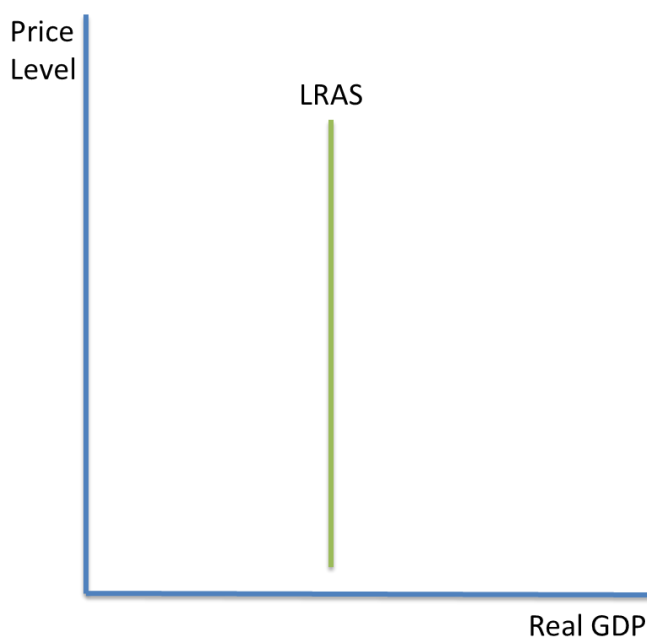
Macroeconomic equilibrium

The economy reaches a state of equilibrium when the rate of withdrawals = the rate of injections. This is equivalent to the point where AD = AS.

How both demand-side and supply-side shocks affect the macro economy

At a price above equilibrium, there will be excess supply. At a price below equilibrium, there will be excess aggregate demand, in the short run.

Shift in AS:

▣ If the economy becomes more productive, or if there is an increase in efficiency, supply will shift to the right. This lowers the average price level (Pe to P1) and increases national output (Ye to Y1).

▣ If AS shifts inwards, price increases and national output decreases.

▣ **Shift in AD:**

▣ If firms have less confidence or there is a recession, AD might shift inwards. This causes the price level to fall from Pe to P1, and national output to fall from Ye to Y1.

▣ If AD increases, the price level and level of national output both increase.