Edexcel (A) Economics A-level

Theme 2: The UK Economy, Performance and Policies

2.2 Aggregate Demand

2.2.1 The characteristics of AD

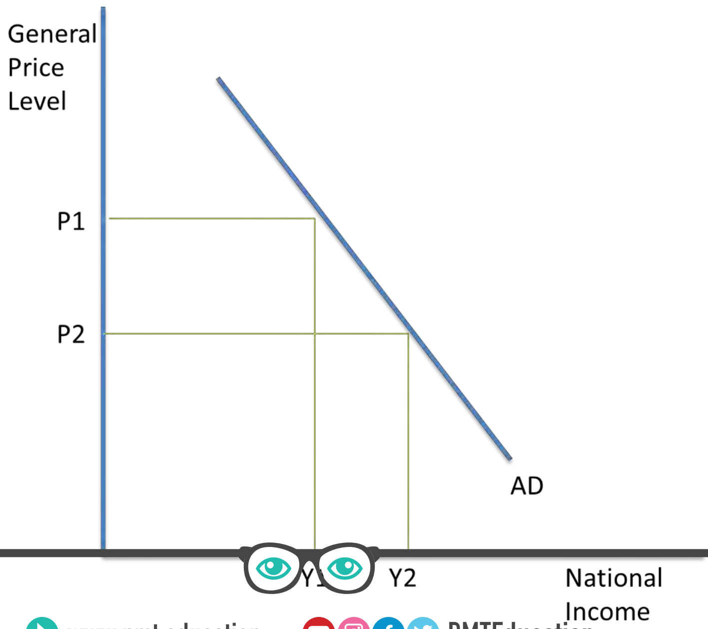
Notes

Components of AD and their relative importance:

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.
It is made up of the following components, which make up the equation:
C + I + G +(X-M)

- **Consumer spending:** This is how much consumers spend on goods and services. This is the largest component of AD and is therefore most significant to economic growth.
- **Capital investment:** This accounts for around 15-20% of GDP in the UK per annum, and about ¾ of this comes from private sector firms. The other ¼ is spent by the government on, for example, new schools. This is the smallest component of AD.
- **Government spending:** This is how much the government spends on state goods and services, such as schools and the NHS. It accounts for 18-20% of GDP. Transfer payments are not included in this figure, because no output is derived from them, and it is simply a transfer of money from one group of people to another. Government spending is the third largest component of AD.
- **Exports minus imports:** This is the value of the current account on the balance of payments. A positive value indicates a surplus, whilst a negative value indicates a deficit. The UK has a relatively large trade deficit, which reduces the value of AD. This is the second largest component of AD.

Moving along the AD curve:



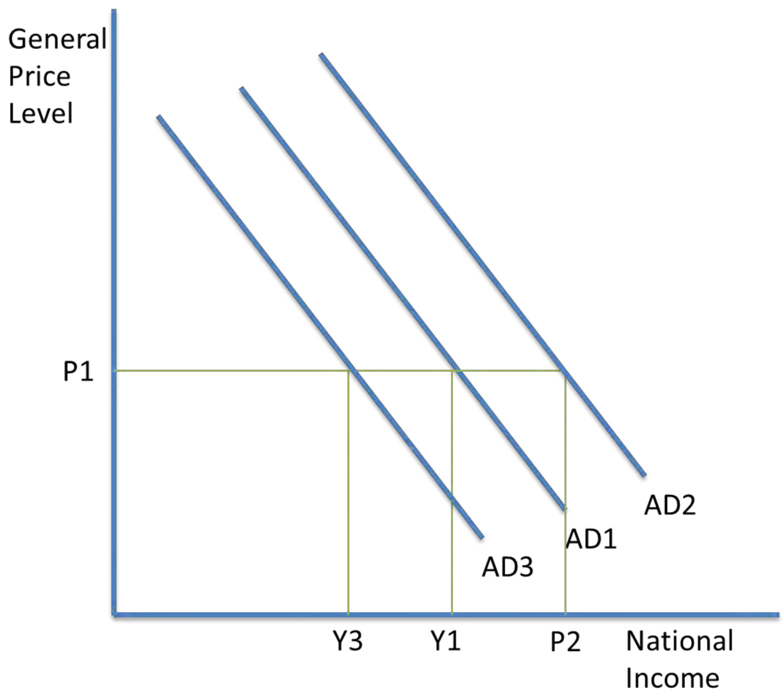
- A fall in the price level from P1 to P2 causes an expansion in demand from Y1 to Y2.
- A rise in the price level from P2 to P1 causes a contraction in demand from Y2 to Y1.
- Changes in the price level cause movements along the demand curve.

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

    - 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.

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 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.