Edexcel (A) Economics A-level

Theme 2: The UK Economy, Performance and Policies

2.2 Aggregate Demand

2.2.2 Consumption

Notes

Disposable income and its influence on consumer spending:

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. It makes up just over 60% of GDP.

Disposable income is the amount of income consumers have left over after taxes and social security charges have been removed. It is what consumers can choose to spend.

Consumer income might come from wages, savings, pensions, benefits and investments, such as dividend payments.

A consumer's **marginal propensity to consume** is how much a consumer changes their spending following a change in income.

Keynes developed a theory of consumption and its link to disposable income.

Consumers on low incomes are more likely to spend.

The relationship between savings and consumption:

A consumer's **marginal propensity to save** is the proportion of each additional pound of household income that is used for saving.

A consumer's marginal propensity to consume added to the marginal propensity to save is equal to 1.

Consumer income which is not spent is saved.

Influences on consumer spending:

Interest rates

- 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 interest rates also lower the cost of debt, such as mortgages. This increases the effective disposable income of households.

Consumer confidence

- 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 consumers fear unemployment or higher taxes, consumers may feel less confident about the economy, so they are likely to spend less and save more. This delays large purchases, such as houses or cars.

Wealth effects

- 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.**
- A consumer's **housing equity** is the difference between the market value of a property and how much loan is remaining to be paid. If house prices increase, consumers experience a rise in equity, so they might be paying less on their mortgage than the house is worth on the market. This makes consumers feel wealthier, so they are more willing to spend.