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Economics Revision Focus: 2004

# AS Economics

# Aggregate Demand (AD)

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# Revision Focus on Aggregate Demand (AD)

**AS Syllabus Requirements**

Candidates should be able to analyse the determinants of the components of aggregate demand (AD). They should also be able to explain and analyse the determinants of savings and the demand for imports. Candidates should recognise the role of AD in influencing the level of economic activity.

**Aggregate Demand**
The aggregate-demand curve shows the quantity of goods and services that households, firms, and the government want to buy at each price level.

**AD = C + I + G + (X-M)**

**C: Consumers' expenditure on goods and services**: This includes demand for consumer durables (e.g. washing machines, audio-visual equipment and motor vehicles & non-durable goods which are "consumed" and must be repurchased).

**I: Capital Investment –** This is investment spending by companies on capital goods. Investment also includes spending on working capital such as stocks of finished goods and work in progress. Capital investment spending in the UK typically accounts for between 16-20% of GDP in any given year depending on the strength of demand for new capital (itself linked strongly to the economic cycle). Of this investment, approximately 75% comes from private sector businesses and the remainder is spent by the public (or government) sector. A mobile phone company spending money on extending its network and the government allocating funds to build a new hospital are both counted as part of gross capital investment.

**G: General Government Spending –** This is government spending on goods and services including public and merit goods. Transfer payments in the form of social security benefits (pensions, job-seekers allowance) are not included in general government spending because they are not a payment to a factor of production for output produced.

**X: Exports of goods and services** - Exports sold overseas are an inflow of demand into the circular flow of income and add to the demand for UK produced output.

**M: Imports of goods and services.** Imports are a withdrawal (leakage) from the circular flow of income and spending. Goods and services come into the economy - but there is a flow of money out of the economic system.

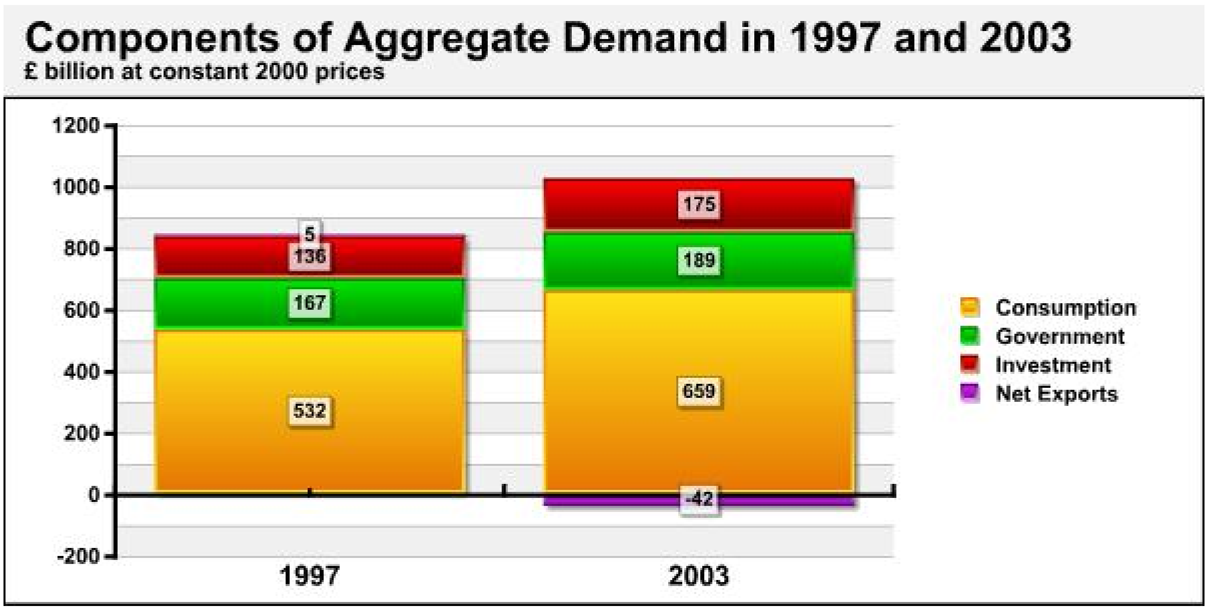
**Net exports (X-M)** represent the net effect of international trade on the level of aggregate demand. When net exports are positive, there is a trade surplus (adding to AD); when net exports are negative, there is a trade deficit (reducing AD). This is shown in the next chart which looks at the main components of AD for the UK in two separate years, 1997 and 2003.

**Aggregate demand shocks**

These are "shocks" that can cause the economy to move to a new short run equilibrium output

- A capital investment boom e.g. a construction boom or rapid growth of spending on ICT

- A pre-election government spending spree (fiscal policy expansion before an election)
- A sudden rise or fall in the real exchange rate – affecting net export demand
- A consumer boom abroad
- An unexpectedly large boom in the housing market or a slump in share prices
- An unexpected cut in interest rates (monetary policy shocks are possible!)




- Strong growth of consumer spending (real terms increase of 24% since 1997)
- General government spending has grown 13%
- Capital investment spending has expanded by 29%
- Exports of goods and services have grown by 19%
- Imports of goods and services have grown by 41%
- Net exports have been strongly negative in recent years as the trade deficit has widened

**Components of Aggregate Demand - £ billion, at constant 2000 prices**

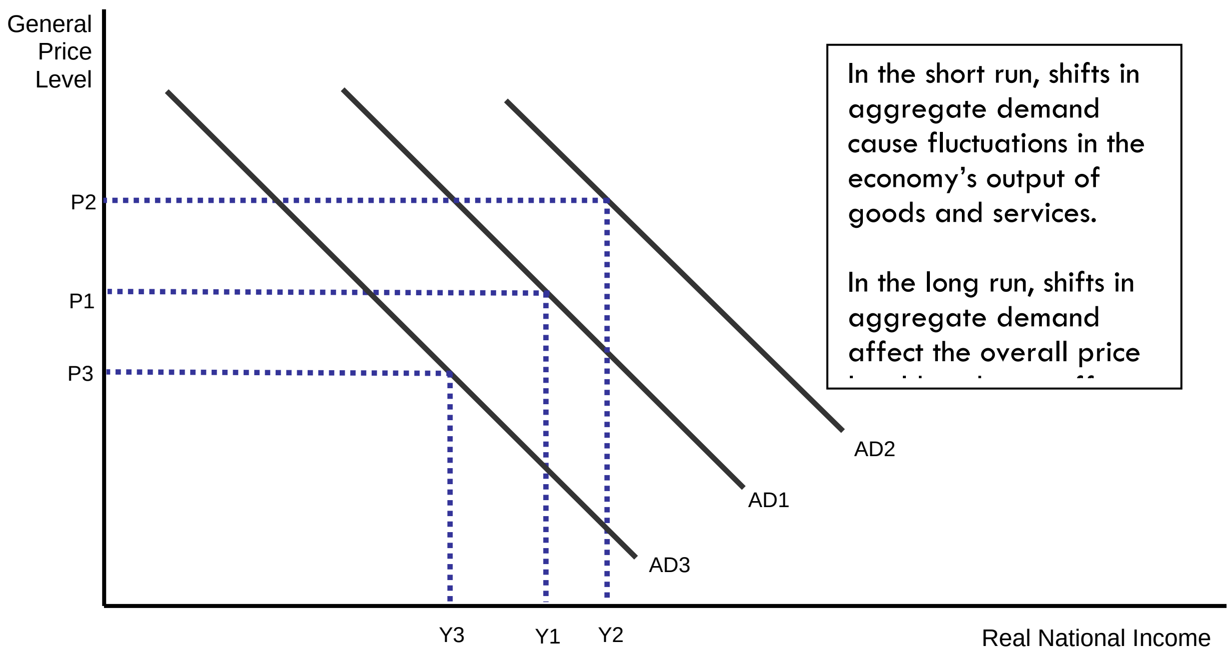
| | Household Spending | Government Spending | Gross Investment | Exports | Imports |
|---|---|---|---|---|---|
| 1995 | 494 | 166 | 120 | 193 | 185 |
| 1997 | 532 | 167 | 136 | 228 | 223 |
| 1999 | 578 | 174 | 149 | 244 | 263 |
| 2001 | 622 | 181 | 167 | 274 | 299 |
| 2003 | 659 | 189 | 175 | 272 | 314 |

**The aggregate demand curve**

The AD curve shows the relationship between prices and real GDP. The AD curve is assumed to slop downwards from left to right because, if there is a fall in the general level of prices, this will lead to lower interest rates which in turn will stimulate an increase in consumer demand and capital investment spending by businesses.

A change in factors affecting any one or more components of aggregate demand, households (C), firms (I), the government (G) or overseas consumers and business (X) changes planned aggregate demand and results shift in the AD curve.

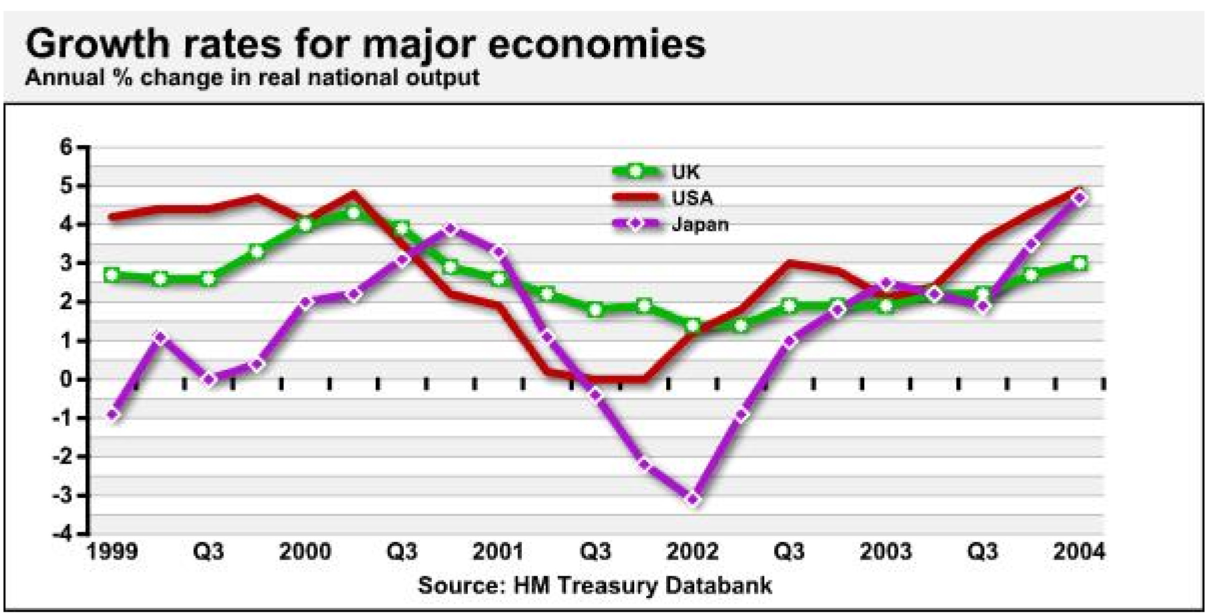
Consider the diagram below which shows an inward shift of AD from AD1 to AD3 and an outward shift of AD from AD1 to AD2. The increase in AD might have been caused for example by a fall in interest rates or an increase in consumers' wealth because of rising house prices.



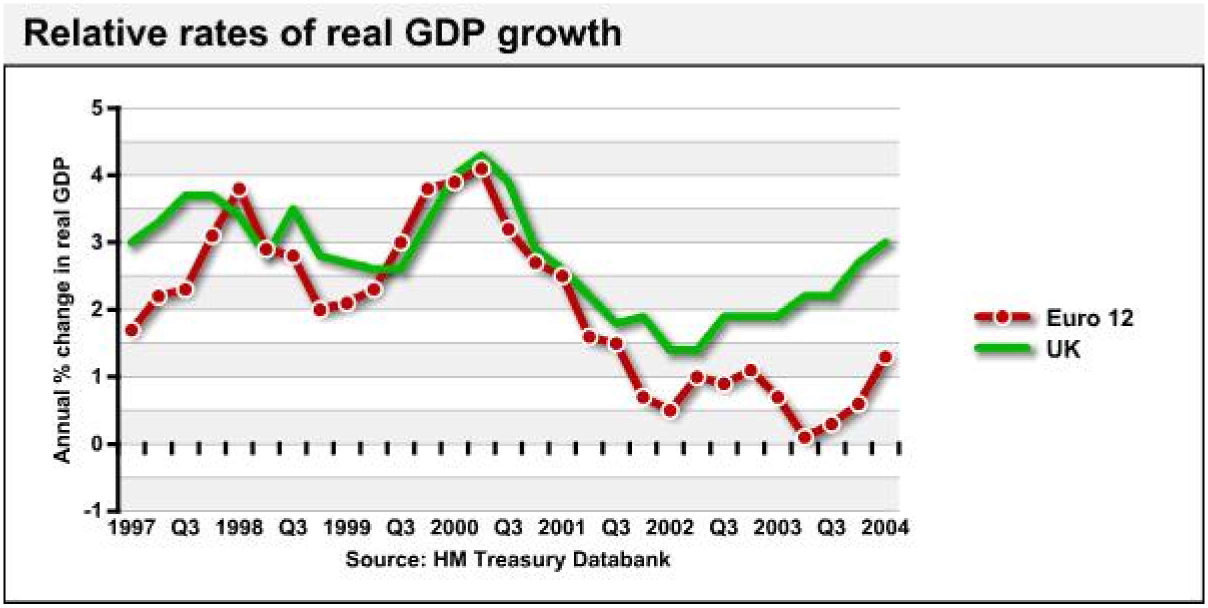

| Factor causing a shift in AD | Aggregate demand increases - *ceteris paribus* |
|---|---|
| **Changes in Business and Consumer Expectations**<br><br>Current spending is affected by *anticipated* future income, profit, and inflation | Expectations can have a powerful effect on planned expenditure<br><br>E.g. expected increases in consumer incomes, wealth or company profits encourage households and firms to spend more – boosting AD. Similarly, higher expected inflation encourages spending now before price increases come into effect - a short term boost to AD<br><br>When confidence turns lower, we expect to see an increase in household saving and some companies deciding to postpone capital investment projects because of worries over a lack of demand and a fall in the expected rate of profit on investments |
| **Changes in Monetary Policy – i.e. a change in interest rates**<br><br>(Note there is more than one interest rate in the economy, although borrowing and savings rates tend to move in the same direction) | Interest rates fall – this lowers both the cost of borrowing and the incentive to save, thereby encouraging consumption<br><br>Lower interest rates also encourages firms to borrow and invest<br><br>Lower interest rates encourages capital investment by firms<br><br>There are time lags between changes in interest rates and the main impact of these changes on the components of aggregate demand |

| | |
|---|---|
| **Changes in Fiscal Policy**<br><br>Fiscal Policy refers to changes in government spending, welfare benefits and taxation, and the amount that the government borrows | Government increases its expenditure e.g. financed by a higher budget deficit, - this directly increases AD<br><br>Income tax affects disposable income e.g. lower rates of income tax raise disposable income and should boost consumption.<br><br>An increase in transfer payments raises AD – particularly if welfare recipients spend a high % of the benefits they receive |
| **Economic events in the international economy**<br><br>International factors such as the exchange rate and foreign income (e.g. the economic cycle in other countries) | A fall in the value of the £ (a depreciation) makes imports dearer and exports cheaper thereby discouraging imports and encouraging exports – the net result should be that UK AD rises – impact depends on the price elasticity of demand for imports and exports and also the elasticity of supply of UK exporters in response to an exchange rate depreciation<br><br>An increase in overseas incomes raises demand for exports and UK AD rises. In contrast a recession in a major export market will lead to a fall in UK exports and an inward shift of aggregate demand |
| **Changes in household wealth**<br><br>Wealth refers to the value of assets owned by consumers e.g. houses and shares | An rise in house prices or the value of shares increases consumers' wealth and allow an increase in borrowing to finance consumption increasing AD<br><br>In contrast, a fall in the value of share prices will lead to a decline in household financial wealth and a fall in consumer demand |

**Economic cycles in other countries and AD in the UK**




The growth of real GDP in the UK has been more stable than either of the USA and Japan in recent years – our growth rate has remained fairly close to our estimated trend rate of 2.5% pa. But events in other countries inevitably affect prospects for our export industries and they also have an affect on movements in share prices, currencies, relative interest rates between the UK and elsewhere.




UK short term economic growth has outpaced the Euro Zone since 2001 – a reflection that the components of aggregate demand have been much stronger – in particular the very high levels of consumer spending.