Edexcel Economics (A) A-level

Theme 2: The UK Economy - Performance and Policies

2.2 Aggregate Demand

Summary Notes

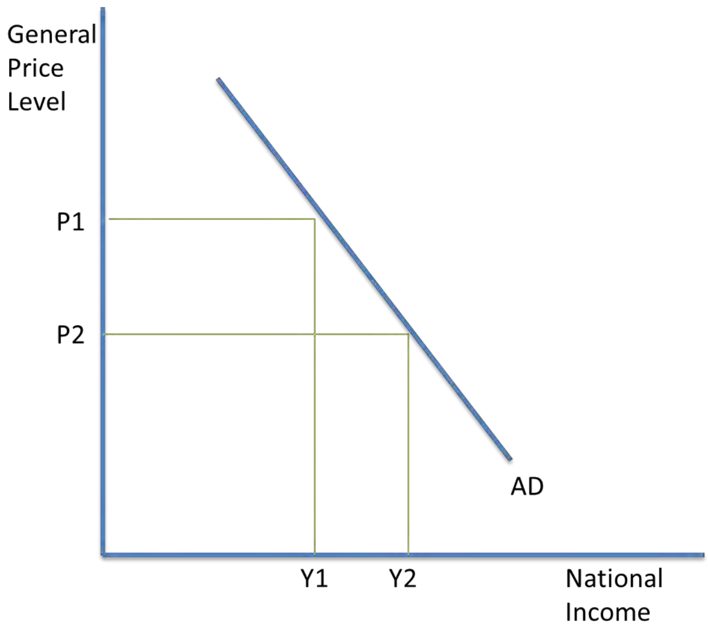
2.2.1 The characteristics of AD

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.
- **Investment:** This is business spending on capital goods. It 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.
- **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.
- **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 most insignificant part of AD.

Moving along the AD curve:

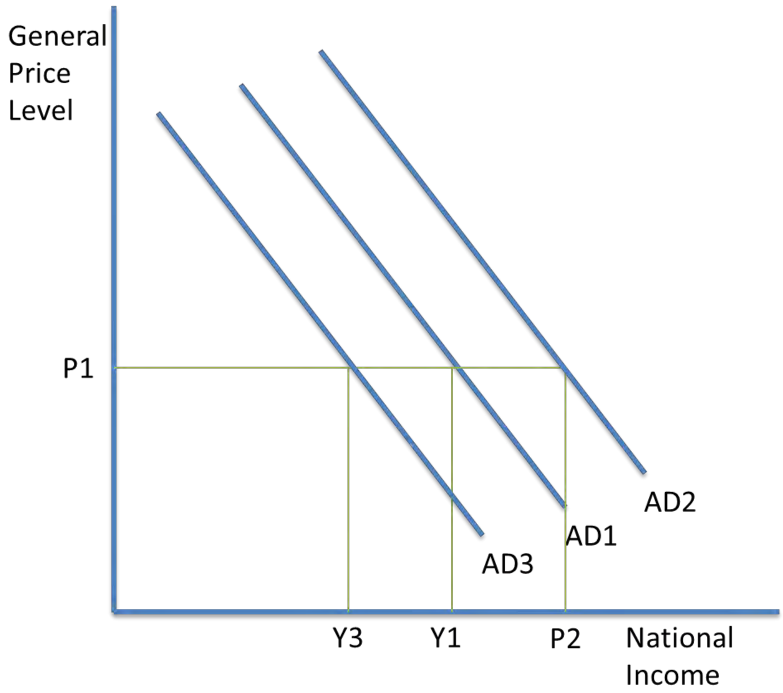


- A fall in the price level from P1 to P2 causes an expansion in demand from Y1 to Y2.
- A rise in the price level from P2 to P1 causes a contraction in demand from Y2 to Y1.
- Changes in the price level cause movements along the demand curve.

- 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 right in the demand curve (AD1 → AD2). This rise in economic growth occurs when any of the components of AD increase.

2.2.2 Consumption

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. 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 increases. There are time lags between the change in interest rates and the rise in consumption. Lower interest rates also lower the cost of debt, such as mortgages. This increases the effective disposable income of households.

Consumer confidence

- If consumers have higher confidence levels, they spend more because they are less concerned about needing to save for future difficulties. 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.
    - This can also occur with other assets, such as shares.

2.2.3 Investment

Distinction between gross and net investment:

Gross investment: This is the amount that a firm invests in business assets that does not account for depreciations. A depreciation is when something starts to lose value, such as how a car loses value the older it gets. If the depreciation in the value of the capital is greater than the growth in gross investment, there is a decrease in the value of capital in the economy and there is no economic growth.

Net investment: This is the actual addition to the capital stock of an economy, after depreciations have been considered. Net investment= gross investment – depreciation.

Influences on investment:

The rate of economic growth

- If growth is high, firms will be making more revenue due to higher rates of consumer spending. This means they have more profits available to invest.

Business expectations and confidence

- If firms expect a high rate of return, they will invest more. Firms need to be certain about the future, otherwise they will postpone their investments.
- Also, expectations about society and politics could affect investment. For example, if a change in government might happen, or if commodity prices are due to rise, businesses may postpone their investment decisions.
- Keynes coined the term **animal spirits** when describing instincts and emotions of human behaviour, which drives the level of confidence in an economy.

Demand for exports

- This is related to the rate of market demand. The higher demand is, the more likely it is that firms will invest. This is because they expect higher sales, so they might direct capital goods into the markets where consumer demand is increasing.

Interest rates

- Investment increases as interest rates falls. This means that the cost of borrowing is less and the return to lending is higher.
- The higher interest rates are, the greater the opportunity cost of not saving the money.

- Moreover, high interest rates might make firms expect a fall in consumer spending, which is likely to discourage investment.

Access to credit

- If banks and lenders are unwilling to lend, such as shortly after the financial crisis when banks became more risk averse, firms will find it harder to gain access to credit, so it is either more expensive or not possible to gain the funds for investment.
- Firms could use retained profits, however.
- The availability of funds is dependent on the level of saving in the economy. The more consumers are saving, the more available fund are for lending, and therefore for investing.

The influence of government and regulations

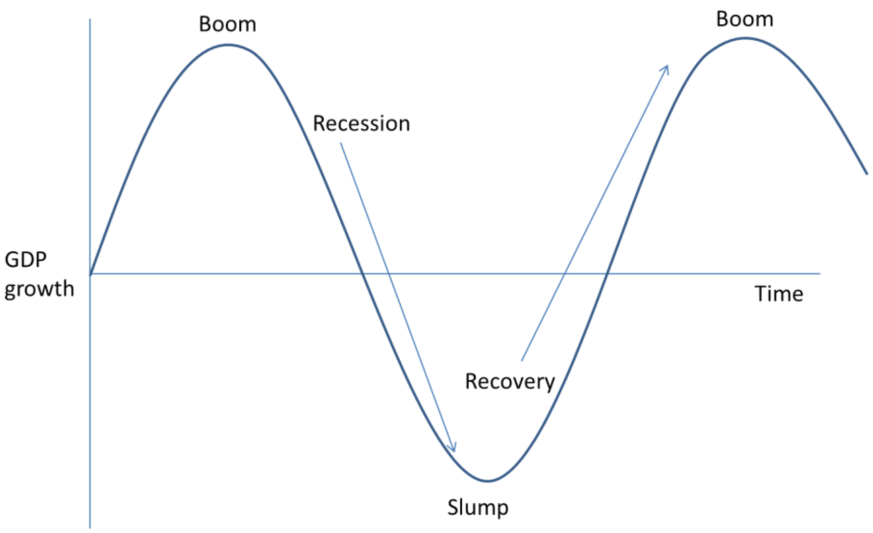
- The rate of corporation tax could affect investment. Lower taxes means firms keep more profits, which could encourage investment.
- Government subsidies or tax breaks could encourage investment
- High levels of regulation would discourage investment

2.2.4 Government expenditure

Influences on government expenditure:

The trade cycle

- This is another term for the **business cycle,** which refers to the stage of economic growth that the economy is in.
- The economy goes through periods of booms and busts.



- Real output increases when there are periods of economic growth. This is the recovery stage.
- The boom is when economic growth is fast, and it could be inflationary or unsustainable.
- During recessions, there real output in the economy falls, and there is negative economic growth.
- During recessions, governments might increase spending to try and stimulate the economy. This could involve spending on welfare payments to help people who have lost their jobs, or cutting taxes.
- This will increase the government deficit, and they may have to finance this.
- During periods of economic growth, governments may receive more tax revenue since consumers will be spending more and earning more. They may decide to spend less, since the economy does not need stimulating, and fewer people will be claiming benefits.

Fiscal policy

- Governments use fiscal policy to influence the economy. It involves changing government spending and taxation.

- Governments might spend on public goods and merit goods, as well as welfare payments.
- Fiscal policy is a **demand-side policy**, so it works by influencing the level or composition of AD.
- **Discretionary** fiscal policy is a policy which is implemented through one-off policy changes.
- **Automatic stabilisers** are policies which offset fluctuations in the economy. These include transfer payments and taxes. They are triggered without government intervention.
- The government might use **expansionary fiscal policy** during periods of economic decline. This involves increasing spending on transfer payments or on boosting AD, or by reducing taxes.
- During periods of economic growth, governments might use **contractionary fiscal policy** by decreasing expenditure on purchases and transfer payments. Additionally, tax rates might increase. This reduces the size of the government budget deficit.

2.2.5 Net trade (X-M)

Net trade- 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.

The main influences on the (net) trade balances:

Real income

- During periods of economic growth, consumers have higher incomes and they can afford to consume more. This means they are likely to import more so there is a larger deficit on the current account.
- During periods of economic decline, real incomes fall and historically, this has led to improvements in the UK's current account due to fewer imports.
- Incomes have little impact on exports.

Exchange rates

- A depreciation of the pound means imports are more expensive and exports are cheaper, so the current account trade deficit narrows as people are less likely to buy imports and more likely to buy exports.
  (SPICED- strong pound, imports cheap, exports dear)
- Depreciations make the currency relatively more competitive against other currencies.
- However, it depends on which currency the pound depreciates against. If it is the dollar or euro, it is likely to have a more significant effect, than a currency which is not from one of the UK's major trading partners.
- Moreover, the demand for UK exports has to be price elastic to lead to an increase in exports. If demand is price inelastic, exports will not increase significantly, and the value of exports will decrease.

State of the world economy

- A decline in economic growth in one of the UK's export markets means there will be a fall in exports. This is because consumer spending in those economies will fall, due to falling real incomes.
- For example, the UK's largest export market is the EU. If they face an economic downturn then demand for UK goods and services will fall, since consumers in the EU are less able to afford imports.

Degree of protectionism

- Protectionism is the act of guarding a country’s industries from foreign competition. It can take the form of tariffs, quotas, regulation or embargoes.
- If the UK employed several protectionist measures, then the trade deficit will reduce. This is because the UK will be importing less due to tariffs and quotas on imports to the UK.
- However, since protectionism leads to retaliation, exports might decrease too, which undoes the effect of reduced imports.

Non-price factors

- The **competitiveness** of a country’s goods and services, which is influenced by supply-side policies, impacts how many exports the country has.
- A country can become more competitive by being innovative, having higher quality goods and services, good advertising and marketing, strong customer service and operating in a niche market, having lower labour costs, being more productive or by having better infrastructure. These increase exports.
- Moreover, trade deals and being part of trading blocs can influence how much a country exports. This either opens up a country to, or closes a country from, significant export opportunities.