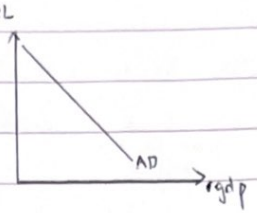
Aggregate Demand and characteristics



"aggregate demand": The total amount of g/s within an economy.

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

Reasons for downward sloping: ① Real "balance/income" effect: when price level are higher, real wages will become relatively lower, individuals can afford less goods/services with the same amount of money, as there g/s form a higher proportion of income, ∴ less incentive to buy it. so demand (AD) will fall when PL↑.

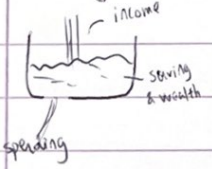
② Trade effect: when price level are lower, exports are more attractive (domestic export) to both domestic and foreign consumers, domestic consumer are less likely to import and foreign consumer are more likely to buy our export, ∴ X↑ M↓ so (X-M)↑, ∴ AD↑, so when PL↓, rgdp is going to be high as (AD↑);

③ Interest rate effect: when interest rate is higher, individuals are incentivized to save, ∴ lead to less consumption (∴ C↓, AD↓), however, as I.R↑, foreign savers would want to save in the UK for a higher return, to do so, they have to exchange their currency into British pounds; ∴ A demand shift for pound (£), this causes pound to appreciates, which makes British good more expensive for foreign consumer (note: for domestic consumer, this doesn't effect as much) and import cheaper relatively ∴ (X-M)↓ and (AD)↓. [note: Marshall-lerner condition]

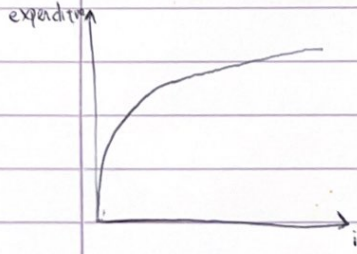
① component ①: "Consumption": household consumption on g/s.

!!: forms about 60% of AD.

Durable good: good that can provide long-term benefit (eg: cars)



- savings are the part of income that's not spend but saved for future consumption
- disposable income: amount of money left over for household after expenditures on "necessities".

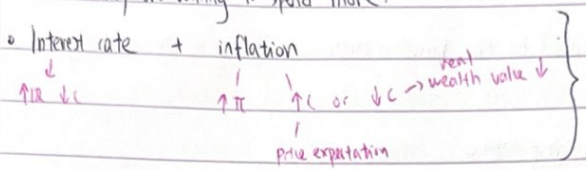


* increase in consumption when income is higher, but MPC↓

↳ MPC = $\frac{\Delta C}{\Delta I}$ (ie gradient of graph). At higher income, individual's spending on necessities worth less of a proportion to all they have, ∴ they save more. [overall, C still increase, but at a slower rate]

key effect of "consumption".

- wealth effect, wealth = total value of asets that household owns
  ↳ when household has more wealth, they feel richer ∴ spend more! [the biggest asset is usually house, hence why house price are so important] "link to MPC changes, previous page".
- consumer confidence, eg: better job security. consumer believe that they are in a comfortable position hence they are willing to spend more.
- Interest rate + inflation



explore later in detail.

② component: "Investments" : The addition of "capital stock" of an economy.
↳ The stock of material /goods used for other production/ services.

Gross vs Net : Gross = before depreciation [before tax: eg]

70% of investment is retained profit !!

- Interest rate → affect investment from borrowing [explore in detail in IR]
- Marginal efficiency of Capital
- Business expectations : - political stability
  - "Animal spirits" : keyne used this term → self-fulfiling prophecy, if an ceo, think the economy will do badly, they invest less which lowes AD ∴ the economy will actually do badly, the CEOs then validate their original thoughts and keep on invest less ∴ rgdp↓. Expectation is vital.
- The world economy : espically for firms who rely on export, so they would invest when global demand ↑.
- Access to credit : how easy is it to get an loan for inverting
  ↳ after 2008, banks became risk-averse ∴ firms find it more difficult to borrow.
- Government regulation : - without this, may be problem of corruption etc, disincentivise I.
  - Gov can guarantee loans ∴ make access to credit better.

↳ risk of "moral hazard" in which damages the government.

- Too strict regulation may incentivise some firm to invest and build factories overseas, ↪ production is abroad, GDP that could be in domestic land ↓.

!! Economic growth + "Accelerator theory" : [An increase in economic growth (↑GDP) = more Investment.]
↳ when demand surges, firm expect this demand and economic growth to further enhance, they will soon ramp up to full capacity, and to meet future demand, they invest. [this works vv, even when GDP is ↑, I might ↓ because the economy are growing at slower rate]

work with multiplier effect
↳ I↑AD, ∴ if AD↑ → even more I.

Equations for accelerator model: $I_E = \alpha(Y_t - Y_{t-1})$ or $I = \alpha \cdot \Delta Y$

I = Investment

α = accelerator coefficient = $\frac{\text{Investment}}{\Delta \text{ in national income (GDP)}}$ — α: The amount of capacital investment needed in an economy to increase gdp by £1.

Y = output) or income. (exp)

③ "Government spending"

Government spending is influenced by the "business cycle" to stablize the economy.
↳ "Fiscal policy"

- Education, health, debt interest etc

↳ if we don't pay back: - Sanctions: eg lex trade internationally
- No borrowing from other countries
- vulnerability eg: China take resource from Africa, of which value is greater than debt.

- "Automatic stabilisers": government spending ↑ when economy in recession, as crime-rate ↑, more ppl qualify for welfare benefit etc ∴ need to spend more.
- Active fiscal policy to stimulate the economy thrugh ↑AD.

④ "Net trade (X-M)": ·@Cheaper FoP: Eg: cheaper labour in certain economy with fewer regulation @also level of productivity effect cost. ② Abundance of natural resource ④ Fiscal policy across different countries.

- level of "protectionism": protecting domestic supplier ↳ eg: Korean with Samsung
  ↳ usually by Tariffs
- "Exchange rate" → China artificially maintain a low currency to make its export more appealing.
  ↳ IR.