



Edexcel A - AS Level Economics

Theme 2 – The UK economy – performance and policies

2.2 Aggregate demand (AD) Revision Notes

Contents

Hey there! 🙌

We're **Tutor Packs**, and our mission is simple: making learning easy, stress-free, and actually enjoyable. ✨📚

We've got FREE revision notes and worked examples for loads of subjects, perfect for smashing those exams. 💪🤪

Want to see what we're all about and show support please visit our social media pages: <https://www.tutorpacks.com/links>

- [2.2.1 The characteristics of AD](#)
- [2.2.2 Consumption \(C\)](#)
- [2.2.3 Investment \(I\)](#)
- [2.2.4 Government expenditure \(G\)](#)
- [2.2.5 Net trade \(X-M\)](#)

2.2.1 The characteristics of AD

Components of AD: $C+I+G+(X-M)$

Aggregate demand (AD) is the total demand for all goods and services in an economy at any given price level.

How is AD Calculated?

We calculate AD using the **expenditure approach**, which adds up everything spent in the economy:

AD = Consumption (C) + Investment (I) + Government Spending (G) + (Exports (X) – Imports (M))

or simply:

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

Breaking Down the Components of AD

1. **Consumption (C)** – This is **everything consumers spend on goods and services**. Whether it's groceries, clothes, or a new laptop, if a household buys it, it falls under consumption.
2. **Investment (I)** – This is **what businesses spend on capital goods** (things that help them produce more in the future, like machines, buildings, or technology).
3. **Government Spending (G)** – This is **what the government spends money on** to keep things running, such as public sector wages, education, and healthcare.
 - **Important:** It **doesn't** include **transfer payments** (like pensions or benefits), because these just move money around rather than creating new economic activity.
4. **Net Exports (X – M)** – This is the **difference between what a country sells to other countries (exports) and what it buys from them (imports)**.
 - If exports are greater than imports → **Trade surplus**
 - If imports are greater than exports → **Trade deficit**



2.2.1 The characteristics of AD

Components of AD: $C+I+G+(X-M)$

Why Does AD Matter?

If AD **increases**, the economy **grows** (more spending = more business activity). If AD **falls**, the economy **shrinks**, which could lead to job losses and lower incomes.

How Important is Each Component?

Different countries rely on different parts of AD. For example:

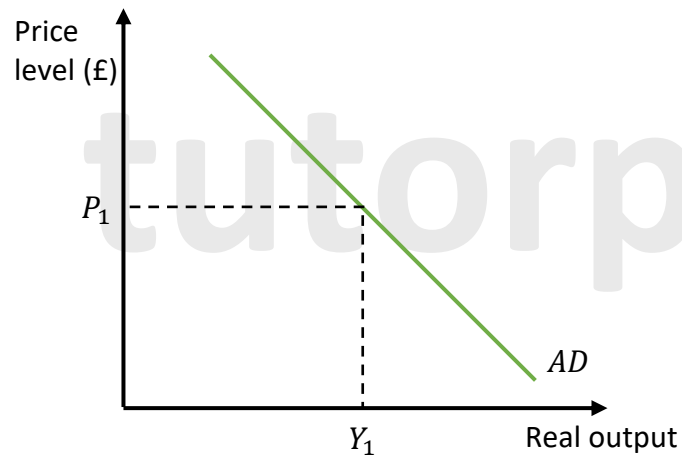
- In **South Korea**, **investment** plays a huge role in economic growth (big spending on technology and manufacturing).
- In **Brazil**, **government spending** is a major part of AD due to large public welfare programs.
- The breakdown looks like this for various countries:
 - **Consumption: Around 60%** (People love spending.)
 - **Investment: 14-20%**
 - **Government Spending: 18-25%**
 - **Net Exports – Around 1%**

2.2.1 The characteristics of AD

The AD curve

The **Aggregate Demand (AD) curve** shows the relationship between the **average price level** (how expensive things are) and the **total output** (real output/GDP) in an economy.

 **Think of it like this:** When things become cheaper, people buy more, businesses invest more, and exports rise. When prices go up, the opposite happens, spending and investment slow down.



2.2.1 The characteristics of AD

The AD curve

Why is the AD Curve Downward Sloping?

The AD curve slopes **downward** because when prices fall, demand **increases**. This happens for three main reasons:

1) Interest Rate Effect

- When the price level (P) **ris**es, **interest rates are likely to go up**.
- **Higher interest rates** make **borrowing more expensive**, so businesses invest less in new projects, and people **save more instead of spending**.
- **Example:** If borrowing costs increase, companies may **delay building a new factory**, and families may **skip buying a new car**.
- When prices **fall**, the opposite happens, borrowing gets cheaper, encouraging **spending and investment**.

2) Income Effect

- When the price level **ris**es, people's **purchasing power (the ability to buy things) falls**.
- **Example:** If prices increase but your salary stays the same, you can buy **less**. This means people **cut back on spending**, and AD falls.
- If prices **fall**, people **feel richer** and **spend more**, boosting AD.

3) Exchange Rate Effect

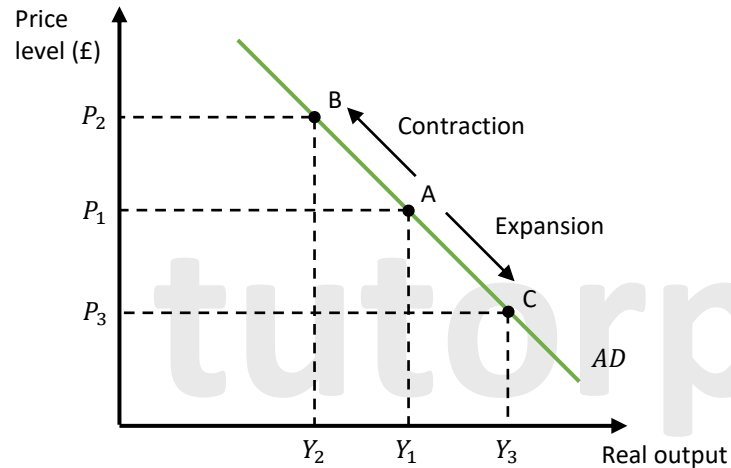
- When the price level **falls**, **interest rates usually drop too**, making the national currency **weaker** compared to other currencies.
- A **weaker currency** makes the country's exports **cheaper** for foreign buyers and imports **more expensive**.
- **Example:** If the UK's price level drops, the British pound weakens, and more foreign businesses **buy UK goods** (like British cars or software). Exports increase, which **raises AD**.

2.2.1 The characteristics of AD

The AD curve

Understanding Movement Along the AD Curve

📊 If **prices change**, but everything else stays the same (*ceteris paribus*), we don't shift the AD curve, we simply **move along it**.



2.2.1 The characteristics of AD

The AD curve

What Happens When Prices Change?

▲ If **Prices Go Up** → **Contraction of AD** (A → B) 📉

- When the **price level (P)** increases ($P_1 \rightarrow P_2$), the economy moves **up** the AD curve.
- Higher prices mean people and businesses can **afford less**, reducing overall demand.
- This leads to a **contraction in real output**, meaning the economy **shrinks** from $Y_1 \rightarrow Y_2$.
- **Example:** Imagine coffee prices suddenly surge. People buy **fewer cups**, and cafes cut back on purchases. This lowers total demand in the economy.

▼ If **Prices Fall** → **Expansion of AD** (A → C) 📈

- When the **price level (P)** decreases ($P_1 \rightarrow P_3$), the economy moves **down** the AD curve.
- Lower prices mean people and businesses can **buy more**, increasing demand.
- This leads to an **expansion in real output**, meaning the economy **grows** from $Y_1 \rightarrow Y_3$.
- **Example:** If smartphone prices drop, more people upgrade their phones, increasing demand for electronics, boosting production, and expanding GDP.



2.2.1 The characteristics of AD

The AD curve

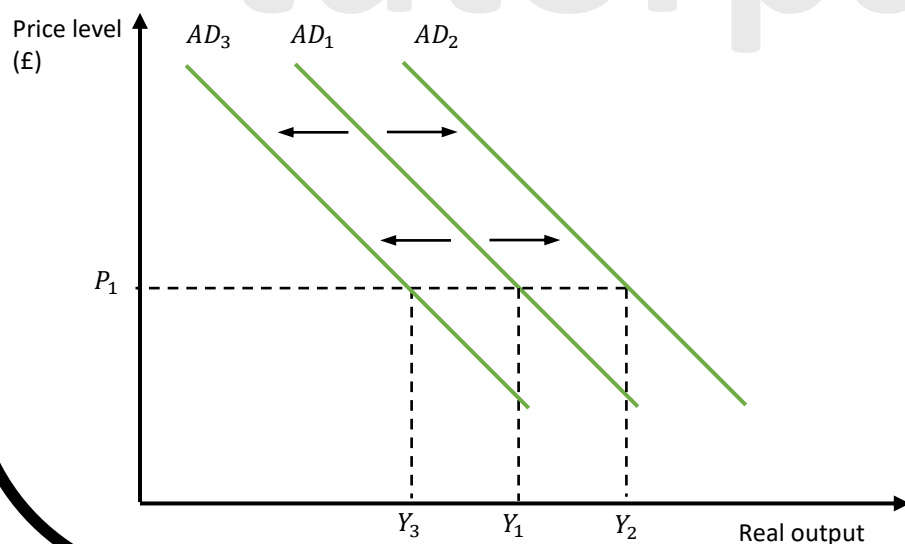
Understanding Shifts in the AD Curve 🚀

Sometimes, the entire curve **shifts** instead of just moving along it.

Why Does the AD Curve Shift?

The AD curve shifts when there is a change in **any factor** that affects demand, other than price. These factors are called the **determinants of aggregate demand**, and they include:

- **Consumer spending** (e.g., people feel wealthier and buy more)
- **Investment by businesses** (e.g., firms buy more equipment)
- **Government spending** (e.g., stimulus packages)
- **Net exports** (e.g., foreign demand for goods increases)



tutorpacks.com

2.2.1 The characteristics of AD

The AD curve

• What Happens When AD Shifts?

▢ If AD Increases ($AD_1 \rightarrow AD_2$) → Rightward Shift

- This happens when people **spend more**, and businesses **invest more**.
- The economy **grows** as real output **increases from $Y_1 \rightarrow Y_2$** .
- **Example:** If the government cuts taxes, people have more **money to spend**, boosting demand.

▢ If AD Decreases ($AD_1 \rightarrow AD_3$) → Leftward Shift

- This happens when people **spend less**, businesses **invest less**, or government **cuts spending**.
- The economy **shrinks** as real output **falls from $Y_1 \rightarrow Y_3$** .
- **Example:** If interest rates rise, people borrow and spend **less**, reducing demand.

tutorpacks.com

2.2.2 Consumption (C)

💰 How disposable income affects spending?

Disposable income is the money households **have left** after paying their **taxes** (like income tax) and receiving any **benefits** (such as unemployment support). It's the cash they can actually **spend or save**.

Here's how it works:

- If **income tax** goes up ➡ **Disposable income falls** (less money to spend)
- If **wages decrease** ➡ **Disposable income falls** (again, less to spend)
- If the government **gives more benefits** (like unemployment support) ➡ **Disposable income rises** (more money in your pocket!)

And guess what? **Spending follows income.**

- ➡ **More disposable income = More spending!** (People buy more things)
- ➡ **Less disposable income = Less spending!** (People cut back)

So, the more money people keep, the **more they fuel the economy** but if their income shrinks, so does their spending power. 🚀💰

2.2.2 Consumption (C)

💰 How disposable income affects spending?

📈 MPC (Marginal Propensity to Consume) – The Spending Effect

MPC measures **how much extra money people spend** when they get a pay rise.

- For most people, **MPC is positive but less than 1** → This means that when their income increases, they do spend more, but **not** every extra penny.
- Some people have an **MPC of more than 1** → They spend **even more** than they earn by borrowing or dipping into savings.

👉 **Note:** Lower income people tend to have a **higher MPC** because they need to **spend most of their income just to get by**, while **richer people** can afford to **save more**.

- Formula: $MPC = \text{change in consumption} / \text{change in income}$

📊 APC (Average Propensity to Consume) – The Big Picture

APC measures how much of a person's **total income** is spent rather than saved.

- Formula: $APC = \text{total consumption} / \text{total income}$
- In rich, industrialized countries, **APC is usually less than 1** because people don't spend **all** their income, some of it goes into **savings**.

2.2.2 Consumption (C)

The link between saving and spending

Think of your income as a **pie**, you can either **spend** it (consumption) or **save** it. The bigger the slice you spend, the smaller the slice you save, and vice versa.

- **Savings** = The money **not spent** from your income.
- If people **spend more**, they **save less**, and if they **save more**, they **spend less**, it's a simple **trade-off**.
- The same factors that **increase consumption** (like confidence in the economy) tend to **decrease savings**. For example, if people feel secure in their jobs, they're more likely to **splurge on holidays, gadgets, and eating out**, rather than **stash money away** for a rainy day.

Key Savings Metrics

1) MPS (Marginal Propensity to Save) = How much of an increase in income is saved instead of spent.

- Formula: **MPS = Change in savings / Change in income**
- If you get a **£100 pay rise** and save **£20**, your **MPS is 0.2 (20%)**.

2) APS (Average Propensity to Save) = The average proportion of total income that people save.

- Formula: **APS = Total savings / Total income**
- If someone earns **£2,000 a month** and saves **£400**, their **APS is 0.2 (20%)**.



2.2.2 Consumption (C)

The link between saving and consumption

The Big Picture

- When people **save more**, there's **less spending**, which can **slow down economic growth**.
- When people **save less**, they **spend more**, boosting the economy but leaving them with **less financial security**.

2.2.2 Consumption (C)

Other influences on consumer spending

Ever wondered why some people go on spending sprees while others save every penny? Several factors influence how much money people spend, from interest rates to personal attitudes. Let's break it down.

1. Interest Rates – The Cost of Borrowing

- Think of interest rates as the price tag on borrowing money. If interest rates are high, loans and mortgages become more expensive, meaning people have to pay back more than they borrowed. This makes them think twice before splurging on big-ticket items (i.e., a car), leading to **lower consumption**. High interest rates also mean bigger mortgage repayments, so homeowners have less to spend on other things. On top of that, higher interest rates can reduce the value of stocks, making people feel poorer; a double hit to spending.

2. Consumer Confidence – Spending with Optimism (or Fear)

- People don't just spend money based on what they have today, they also think about the future. If consumers **expect pay raises, stable jobs, or higher prices in the future**, they're more likely to spend now before things get expensive. On the other hand, if they **fear job losses or a recession**, they might **cut back on spending** and save instead. Even government tax changes influence spending habits, if people expect taxes to rise, they rush to buy before prices go up. But if they expect lower taxes, they might delay spending, hoping for better deals.

3. Wealth Effect – Feeling Richer, Spending More

- Wealth isn't just about the money in your bank account; it includes **assets like houses and stocks**. When **house prices rise**, homeowners feel wealthier and are more likely to **spend more** (even though their income hasn't changed). The same goes for the stock market, if people's shares increase in value, they might cash out some profits and go shopping. On the flip side, if stock or house prices **fall**, they feel poorer and **cut back on spending**.



2.2.2 Consumption (C)

Other influences on consumer spending

4. Income Distribution – Who Gets the Money Matters

- Not everyone spends money in the same way. **Wealthy individuals tend to save a bigger chunk of their income**, while those on lower incomes spend a higher proportion. If money is redistributed **from the rich to the poor** (through policies like higher taxes on the wealthy and increased benefits for lower earners), overall consumption is likely to **rise** because lower-income households tend to **spend rather than save**.

5. Tastes and Attitudes

- Let's face it, society is materialistic. Many people love having the latest gadgets, fashion trends, or cars, even if it means spending more than they earn. This **drives up consumption**, sometimes even beyond what's sustainable. But if people suddenly became less materialistic and focused on saving, overall spending would **decrease**.

2.2.3 Investment (I)

Gross and net investment

What is Investment?

- Investment is when businesses spend money on **capital goods**; things like machines, buildings, and equipment that help them **produce more goods and services**. The more businesses invest, the **more they can produce**, which helps the entire economy grow.

Depreciation – When Things Wear Out

Over time, machines, tools, and buildings **lose value** as they wear out, break down, or become outdated. This is called **depreciation**.

👉 If a company just replaces old equipment without upgrading, it **doesn't actually expand** production.

👉 But if they buy **new and improved** machines with better technology, they can **increase production capacity** and boost economic growth.

Gross Investment vs. Net Investment

Not all investment leads to growth – sometimes it just replaces what's already worn out. Here's the difference:

🔵 **Gross Investment** – This is the **total** money spent on capital goods. It includes:

- Buying **brand-new** machines and equipment 🏭
- Replacing **old, worn-out** capital goods 🔧

2.2.3 Investment (I)

Gross and net investment

🔵 **Net Investment** – This tells us how much actual new capital has been added to the economy. It's calculated as:

$$\text{Net Investment} = \text{Gross Investment} - \text{Depreciation}$$

- If net investment is **positive**, businesses are **growing** and expanding production. 📈
- If net investment is **zero or negative**, companies are just replacing what's worn out, not really growing. 🚫

Why Does It Matter?

- Net investment is super important because it shows whether businesses are **just maintaining** their operations or **actually growing and innovating**. The more firms invest in **new capital goods**, the **more jobs, higher productivity, and better economic growth** we get. 🚀💰

2.2.3 Investment (I)

Influences on investment

Businesses don't just throw money into investments for fun; they carefully consider **whether it's worth it**. Firms will only invest if they feel **confident** that they'll make a **good return** (a profit) on what they put in. The whole point? **Profit maximisation** – making as much money as possible while keeping costs low.

Here are **some key factors** that influence how and when businesses invest:

1) Economic Growth

Think of economic growth as a **green light for businesses** to expand! When the economy is growing fast:

- Businesses expect **higher demand** → means **more sales**
- **More sales = higher profits** 
- The quicker the economy grows, the **more urgent** it is for businesses to invest so they don't fall behind competitors.

2) Business Expectations & Confidence

Imagine running a business, you wouldn't throw money into big investments if you weren't **confident** about the future, right?

- ◆ When the economy is **growing steadily**, businesses feel **optimistic**, so they **invest more**.
- ◆ If there are signs of a **slowdown**, businesses start **worrying about future profits**, so they hold back on investment.

2.2.3 Investment (I)

Influences on investment

3) Keynes & Animal Spirits

Ever heard of **“herd mentality”**? That's exactly what economist **John Maynard Keynes** was talking about when he described **animal spirits**.

- ◆ In **good times**, businesses can be **too optimistic**, investing **too much** and taking **big risks**.
- ◆ In **bad times**, fear takes over, and businesses **panic** and stop investing, even if conditions aren't that bad.

Essentially, businesses often **follow the crowd** rather than making purely rational decisions. If everyone's investing, they **jump on the bandwagon**. If everyone's holding back, they **do the same**.

4) Demand for Exports

When businesses **sell products to other countries**, they **export**. If demand for exports is high, firms **invest more** to keep up with global demand.

 **Two major reasons exports increase:**

- 1 More people around the world **want** what a business sells 
- 2 **Exchange rate depreciation** – when a country's currency **loses value**, its goods **become cheaper** for foreign buyers, boosting sales abroad.

When businesses expect higher exports, they **invest more** in production to keep up with demand.

2.2.3 Investment (I)

Influences on investment

5) Interest Rates 🏦

Most businesses **borrow money** to invest, so interest rates matter **A LOT**.

◆ If **interest rates are high** 💰⬆️ → **borrowing becomes expensive** → investment **slows down** 🛑

◆ If **interest rates are low** 💰⬆️ → **cheaper loans** → businesses **invest more**. 🚀

Basically, investment and interest rates have an **inverse relationship**; when one goes up, the other usually goes down.

6) Access to Credit 🏦📄

Investment isn't cheap as businesses **borrow money** to finance big projects. But what happens if they **can't get loans**?

◆ If **banks are willing to lend** (meaning there's **easy access to credit**), businesses **invest more**.

◆ If **loans are hard to get** (like in a financial crisis), businesses **struggle to fund investments**, and growth slows down.

Developing countries often face **low access to credit**, making it much harder for businesses to expand and invest.

2.2.3 Investment (I)

Influences on investment

7) Government & Regulations 🏛️

The government **plays a BIG role** in business investment sometimes helping, sometimes making things harder:

✅ **Government support** (e.g. subsidies) → Encourages businesses to **invest more**.

-
❌ **Strict regulations** (e.g. environmental rules, worker protections) → Can **increase costs** and **reduce profits**, making businesses less likely to invest



2.2.4 Government expenditure (G)

Influences on government expenditure

The **government** plays a HUGE role in an economy by **spending money** on things like **defence, education, healthcare (NHS in the UK), infrastructure, and social benefits**.

But here's the catch: **where they spend and how much they spend affects the economy massively**.

Government spending is one of the key components of **Aggregate Demand (AD)** (which is the total demand for goods and services in an economy). If the government **spends more**, it can boost demand, but if they **increase taxes at the same time**, it might cancel out the impact.

1) The Trade Cycle

The economy goes through **ups and downs**, just like a rollercoaster. The government tries to **smooth out the ride** by adjusting its spending:

✓ **Recession (Bad Times)** 😞 → The government **spends more** to create jobs and support people, e.g., increasing unemployment benefits. This helps **boost demand** and get the economy back on track.

✓ **Boom (Good Times)** 😊 → The government **spends less** to **control inflation** (when prices rise too fast). This prevents the economy from overheating!



2.2.4 Government expenditure (G)

Influences on government expenditure

2) Fiscal Policy

Fiscal policy is just a fancy term for **how the government manages its budget – spending and taxes**.

✓ Some spending is **fixed** (they HAVE to pay for schools, pensions, etc.).
✓ But governments can **change spending levels** based on their **priorities**, for example, increasing investment in **healthcare, defence, or public transport**.

Governments must **balance their budget**, deciding **how much to tax** and **how much to spend**.

2.2.5 Net trade (X-M)

Influences on the net trade balance

Net trade is simply **exports minus imports**. If a country sells more goods and services abroad than it buys, it has a **trade surplus**. If it buys more than it sells, it has a **trade deficit**. But what actually affects how much a country trades? Let's break it down.

1. Real Income (How Rich People Feel)

When people in the UK earn more money (real income rises), they usually **spend more**, often on imported goods (think fancy foreign cars, exotic food, and cool gadgets). This means **imports go up**, reducing net trade.

However, if incomes are rising because **UK businesses are exporting more**, then **net trade could actually increase**. So, the impact of income changes depends on whether people are spending more on local or foreign goods.

2. Exchange Rates (How Expensive the £ Feels)

Exchange rates determine how much the UK pound is worth compared to other currencies.

- **If the pound is strong**, imports become **cheaper** (because UK consumers can buy more foreign currency), and exports become **more expensive** (making it harder for UK businesses to sell abroad). This **lowers net trade**.
- **If the pound is weak**, the opposite happens, UK exports **become cheaper** for foreign buyers, and imports **become more expensive**. This can **increase net trade**, depending on how much demand changes.

3. The State of the Global Economy (How Well Other Countries Are Doing)

- If the countries that **buy UK goods are booming**, they'll likely **import more from the UK**, increasing exports and improving net trade. But if those economies slow down or enter a recession, **they'll buy less**, meaning **UK exports fall** and net trade worsens.

[tutorpacks.com](https://www.tutorpacks.com)

2.2.5 Net trade (X-M)

Influences on the net trade balance

4. Protectionism (Government Barriers to Trade)

- Protectionism is when governments introduce measures to **protect local businesses from foreign competition**. This includes:
- **Tariffs** (taxes on imports to make them more expensive)
- **Quotas** (limits on the amount of imports allowed)
- **Regulations** (rules that make it harder for foreign businesses to sell)

If **other countries** put up trade barriers against **UK goods**, **exports fall**, and net trade worsens. On the flip side, if the UK **imposes tariffs on imports**, it might **reduce imports** and improve net trade.

However, **free trade** (when there are no barriers) can **increase or decrease net trade**, depending on how competitive UK goods are.

5. Non-Price Factors (It's Not Just About Money)

Sometimes, people don't just buy things based on price, they care about **quality, branding, and marketing** too! If UK products are known for their **high quality** and **strong branding**, **foreign buyers will prefer them**, increasing exports and improving net trade.

For example:

- **Luxury British brands (like Burberry or Jaguar) sell well even when they're expensive** because of their reputation.
- **If UK goods look cheap and unreliable**, people will buy from other countries instead.

Marketing and product design can **make exports more inelastic**, meaning people will buy them even if the price goes up.

[tutorpacks.com](https://www.tutorpacks.com)



Please see the '2.2 and 2.3 Aggregate Demand and Aggregate Supply Worked Examples' pack for exam style questions.

For more revision notes, tutorials, worked examples and more help visit www.tutorpacks.com

