

Aggregate demand and aggregate supply revision exercise

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1. What are the components of aggregate demand?

Consumer consumption, investment by businesses, government discretionary expenditure and net exports (that is exports minus imports) sum to give the value of aggregate demand in the economy.

2. Identify three reasons why aggregate demand might fall.

A decrease in any of the components of aggregate demand will cause aggregate demand to fall. For example a high interest rate makes the opportunity cost of businesses investing higher, so this might cause a decrease in business investment. A strong pound causes UK produced exports to be less competitive overseas, so causing a decrease in exports. A decrease in taxes by the government may cause a decrease in government spending and so a fall in aggregate demand.

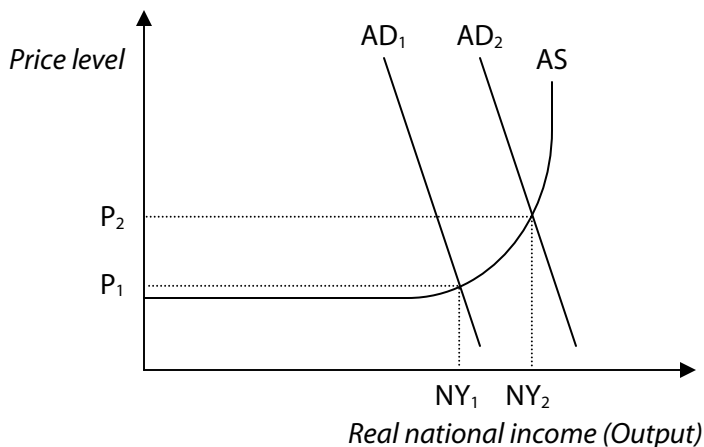
3. Identify three reasons why aggregate supply might increase.

An increase in the quality of resources, quality of resources or technological understanding in an economy will cause an increase in aggregate supply.

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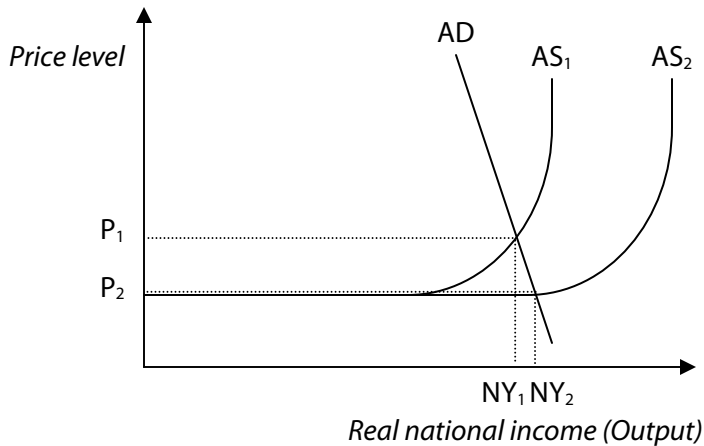
The effects on price level and real national income of...

1. A housing market boom.



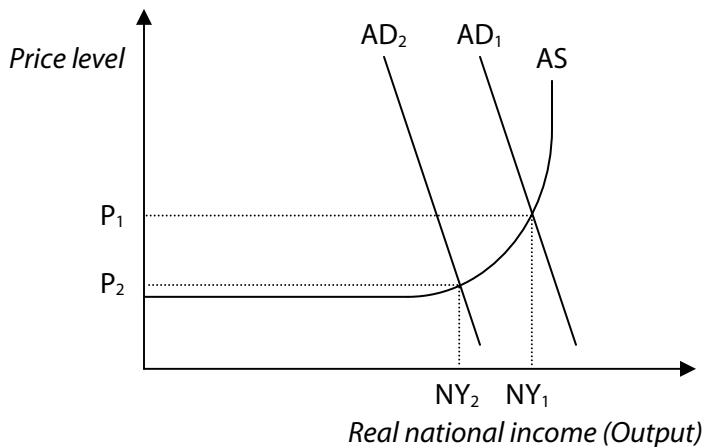
An increase in the price of houses causes an increase in consumer expenditure and business expenditure, so there is an increase from AD₁ to AD₂. This causes an increase in national income from NY₁ to NY₂ and an increase in the price level (inflation) from P₁ to P₂.

2. A new government training scheme for the youth and long term unemployed.



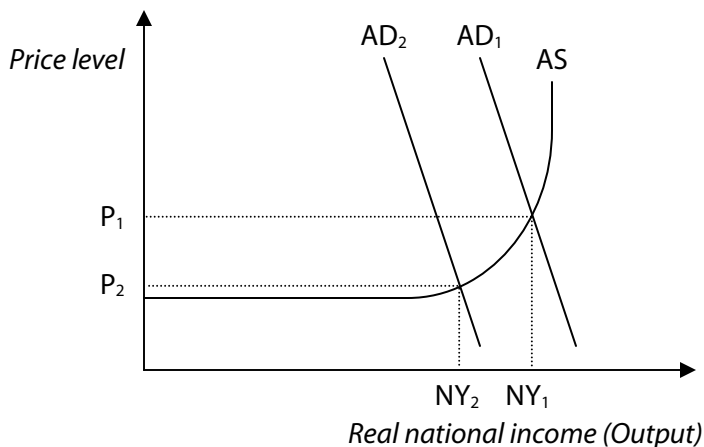
Training improves the quality of the resources in the economy – skilled labour is more productive. Over the long term this causes an increase in AS from AS₁ to AS₂.

3. A series of successive interest rate rises.



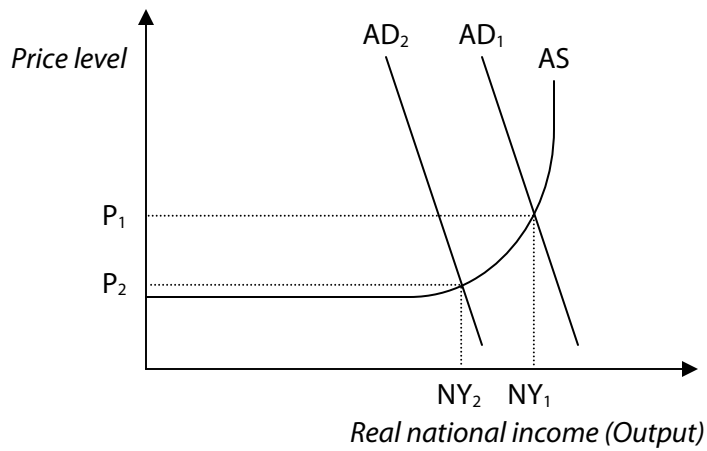
Rising interest rates make the opportunity cost of investment for businesses and consumption for consumers higher; this causes a decrease in aggregate demand. 'Hot money' may flow into the UK so lessen the effect, but it is likely there will still be a decrease from AD₁ to AD₂ causing a decrease in the national income from NY₁ to NY₂ and a decrease in price level from P₁ to P₂.

4. A substantial rise in world oil prices.



Oil has very price inelastic demand in the UK economy so an increase in the price of oil will lead only to a small fall in quantity demanded per unit of time so the value of imports will increase, causing a decrease in AD from AD₁ to AD₂. This causes a decrease in national income from NY₁ to NY₂ and a decrease in price level from P₁ to P₂.

5. A significant appreciation of the exchange rate.



An appreciation in the exchange rate makes UK exports less competitive overseas so exports will decrease. As imports are relatively price inelastic the higher price of imports will not cause a decrease in the quantity demanded per unit of time so the value of imports will increase as well. This will cause a decrease in AD from AD_1 to AD_2 . This causes a decrease in national income from NY_1 to NY_2 and a decrease in price level from P_1 to P_2 .