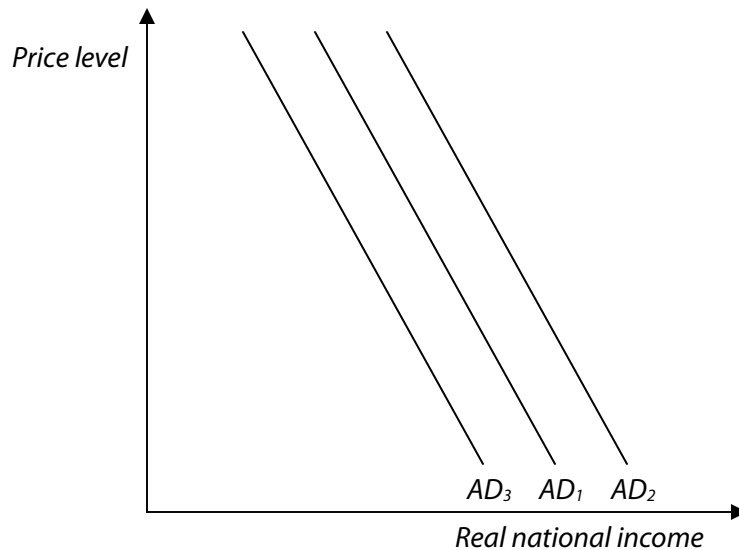


### Exercise on shifts in aggregate demand



(Source: Hills Road Sixth Form College Unit 3 study guide, DMB)

AD<sub>1</sub> represents the initial AD curve. Which shift represents the following changes?

1. A cut in income tax rates announced in the budget.

This causes an increase in disposable income so C will increase as we know the UK has a high MPC. To create goods and services for this extra consumption investment will increase too, causing a movement to AD<sub>2</sub>.

2. An increase in planned spending on the NHS and education.

This is an increase in G, government discretionary spending so will cause a shift outward to AD<sub>2</sub>.

3. A decision by the bank of England's monetary policy committee to cut interest rates by 0.5%.

This will make saving less attractive to consumers, the cost of borrowing money will decrease (greater availability of credit at a lower cost) and consumers discretionary income will increase as their mortgage payments will be lower. This increase in C will be followed by businesses investing more. If the rate of interest is now below those of other countries where hot money can be banked there will be an increased supply of UK pounds. This will cause a drop in the exchange rate price of a pound which may then cause exports to increase and imports to decrease. However, most likely the overall effect will be a shift outward to AD<sub>2</sub>.

4. An increase in the savings ratio.

This is an increase in the proportion of national income that is saved, so there must be a decrease in C, which will lead to a shift inward to AD<sub>3</sub>.

5. Business confidence is hit by political events abroad.

This causes a decrease in expectations so investment decreases causing a shift inward to  $AD_3$ .

6. A sharp fall in the sterling exchange rate against other major currencies.

This will make imports for UK businesses and consumers more expensive so imports will increase. Exports will be better value for overseas consumers and businesses so exports are likely to increase. However the drop in imports is likely only to be small as in the UK imports are price inelastic especially in the short run. This means that consumers may choose to still buy the same goods just accept having to pay a higher price for them. This is particularly true for areas of industry like manufactured goods although demand for some goods, like holidays for example, may fall. Most likely, especially in the short run this will result in a shift outwards to  $AD_2$ .

7. A significant fall in share prices on the London stock market.

Pensioners who may be relying on shares to sell for their retirement will feel their wealth decrease and individuals who have share portfolios will feel less well off, so C will decrease. Businesses are faced with lower expectations and so will decrease investment. This will cause a shift inwards to  $AD_3$ .

8. A period of high inflation.

A one-off inflationary increase may cause a movement along the demand curve. Persistent inflation will cause C to decrease as individuals aim to keep the real value of their savings constant. Investment will fall due to uncertainty about the future. If the rate of inflation is higher than in export market exports may fall as they are less competitive overseas. Whilst in the short run this may lead to a movement along the AD curve in the long run it will lead to a shift inward to  $AD_3$ .