

# Aggregate Demand (AD)

Aggregate Demand (AD) is the total demand for all goods and services in an economy at a given average price level. It is measured using the expenditure approach.

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

Where:

C (Consumption): Household spending on goods and services

I (Investment): Firm spending on capital goods such as machinery and factories

G (Government spending): Public sector spending on goods and services, excluding transfer payments

(X - M): Net exports, which is exports minus imports

## Relative Importance of AD Components (UK)

### Consumption (C)

Consumption is the largest component of AD, accounting for around 60% of GDP. Because it is so large, even small percentage changes can have big effects on the economy. It is the main driver of overall economic activity.

For example, in the USA Consumption makes up around 70% of the AD formula .

### Government Spending (G)

Government spending makes up around 20% of AD. It is the component most directly controlled by the government through fiscal policy. It is often used to stabilise the economy.

During a recession, the government may increase infrastructure spending to boost AD. Welfare spending also acts as an automatic stabiliser by supporting incomes when unemployment rises.

### Investment (I)

Investment accounts for around 15% of AD. It is the most volatile component and is highly sensitive to interest rates and business confidence, often called “**animal spirits**”.

A small change in demand expectations can cause a large change in investment due to the accelerator effect. In the long run, investment is crucial because it increases LRAS and potential output.

### Net Trade (X - M)

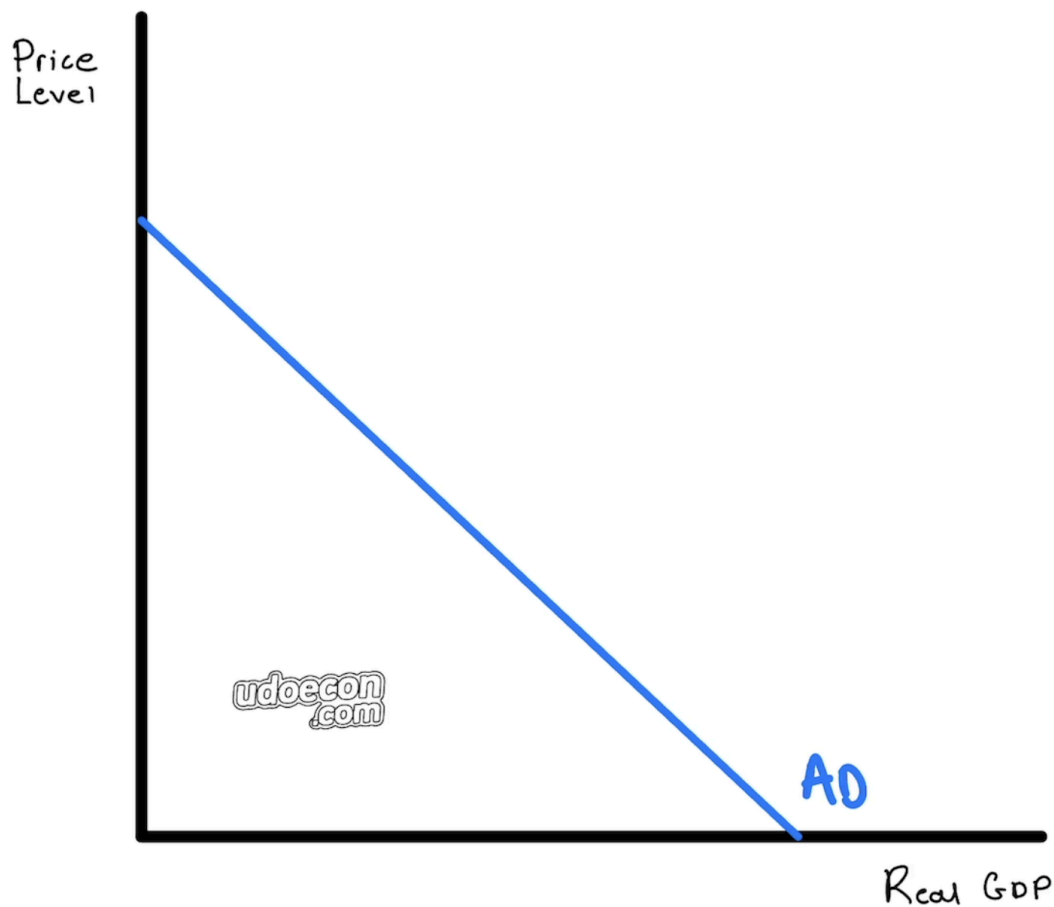
Written by [udoecon.com](https://udoecon.com)

Net trade is often negative in the UK due to a persistent current account deficit. It is usually the smallest component of AD.

It is the main link between the UK economy and the rest of the world. Changes in exchange rates or global recessions can strongly affect exports.

## The AD Curve

The AD curve shows the inverse relationship between the price level and real GDP. The price level is on the Y-axis and real GDP is on the X-axis.

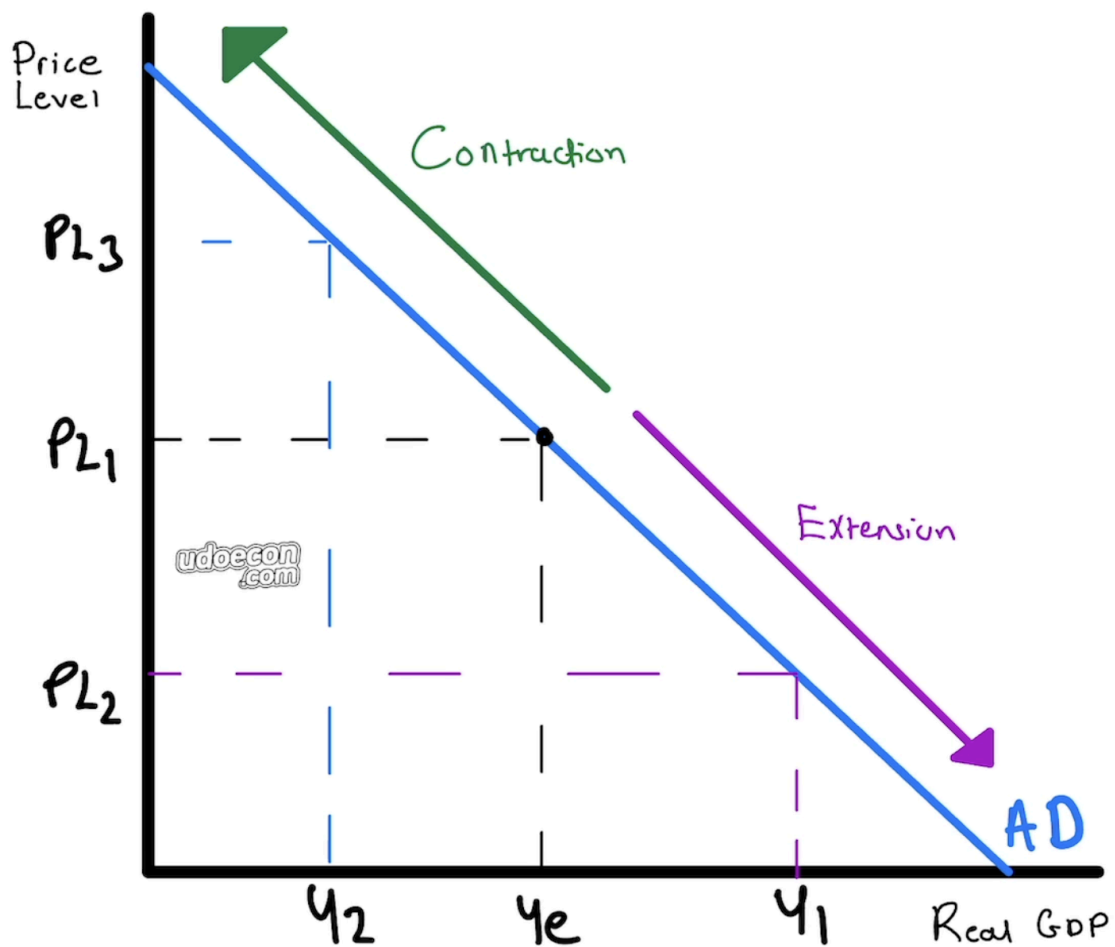


## Movement Along the AD Curve

A movement along the AD curve happens when the price level changes.

- A rise in price level causes a contraction of AD
- A fall in price level causes an expansion of AD

This is shown as movement along the same curve rather than a shift.



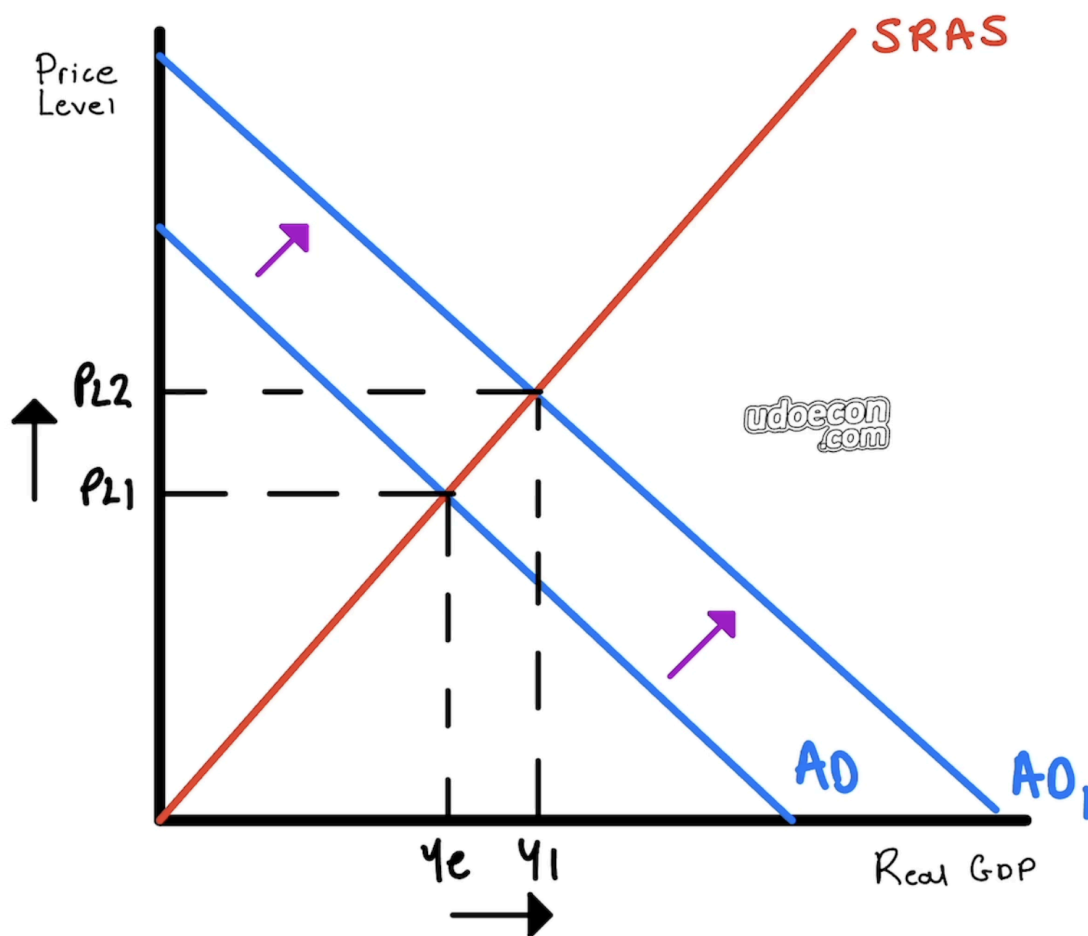
## Shifts of the AD Curve

A shift of the AD curve occurs when non-price factors change, such as  $C$ ,  $I$ ,  $G$  or  $(X - M)$ .

### Rightward Shift (AD increases)

This can be caused by:

- Higher consumer confidence
- Increased government spending
- Higher investment
- Rising exports



This is shown by AD shifting out to  $AD_1$ , this pulls up the price level from  $PL_1$  to  $PL_2$  (demand pull inflation) and increases real GDP from  $Y_e$  to  $Y_1$ .

### Leftward Shift (AD decreases)

This can be caused by:

- Higher taxes
- A recession
- Higher interest rates
- Falling exports

This leads to lower output at every price level.

