2.2.2 Components of AD

1. Consumption (C) : measures all spending by domestic households on goods and services during a particular period of time
    a. Function of household income
    b. Function of marginal propensity to consume
2. Investiment (I) : measures the total spending by firms on capital equipment
    a. Function of national output
    b. Function of interest rate
    c. Short for gross domestic private investment
3. Government spending (G) : measures a country's government's expenditures on goods and services
    a. Short for gross government investment
4. Net exports (X–M) : measures the total income earned from the sale of exports X) minus the total amount spent by a nation's households, firms, and government on goods and services imported (M) from other countries
    a. Can be negative or positive
        i. Negative when nations spends more on imports
        ii. Positive when a nation earns more from sale of its exports

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

THE AD CURVE

- ➢ Y axis: average price levels
- ➢ X axis: nation's output / real GDP
- ➢ Downward sloping due to:
    - ○ The wealth effect
        - ■ The public feels poorer at higher price levels → lower quantity demanded of nation's output
        - ■ The public feels wealthier at lower price levels → more demand of nation's goods and services
        - ■ Similar to the income effect (microeconomics demand)
    - ○ The interest rate effect
        - ■ High price levels → banks increase interest rate on loans to households → quantity demanded of products and capital for which households must borrow decreases
        - ■ Fall in price levels → decline in interest rates → borrowing more attractive → increase in quantity of output demanded
    - ○ The net export effect
        - ■ Increases in price levels → domestic output less attractive to foreigners + foreign products more attractive to domestic consumers → net expenditure on exports falls
        - ■ Decrease in price levels → domestic output more attractive to foreigners + foreign products less attractive to domestic consumers → net expenditure on exports rises

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Page 4 of 20

2.2.3 Determinants and shifts of AD

1. Consumption
    a. Level of national income
    b. Wealth
    c. Interest rates
    d. Household debt and expectation of future income
    e. Consumer confidence
2. Investment
    a. Interest rates
    b. Level of national income
    c. Business confidence

2.2.7 Long-run equilibrium: Neoclassical model

- ➔ Assumes that regardless of the total demand in a nation, the level of output would typically return to a level corresponding with the nation's production possibilities i.e. full employment level
- ➔ Assumes that wages and prices are perfectly flexible and will adjust to the level of demand to ensure that output always remains at its full employment level
- ➢ No involuntary unemployment → workers who might lose their jobs will simply accept lower wages
- ➢ Allows firms to maintain their output and employment while lowering their prices in response to declining demand

2.2.8 Shifts in AS

Increase in KAS

- ➔ In the short run, a fall in AD causes a fall in output and a small decrease in the price level
- ➔ In the long run, when wages have adjusted to the lower AD the KAS curve shifts to the right and output is restored at the full employment level and at a lower price level
    - ◆ Shifts only after the wage rate in an economy falls because of low demand for output and labor
- ➔ Other factors that can lead to an increase in KAS include:
    - ◆ Lower resource costs (e.g. oil, minerals, and other raw material)
    - ◆ Improvement in the productivity of land or capital
    - ◆ Reduction in the minimum wage
    - ◆ Government subsidies to producers
    - ◆ Investment tax credits (encouraging firms to invest in capital)
    - ◆ Reduction in trade union power
    - ◆ Better infrastructure
    - ◆ Better educated or more skilled workforce (increases productivity of labor)
    - ◆ Stronger currency (makes imported resources cheaper)

Decrease in KAS

- ➔ Decrease in AD when an economy is already producing at Y_{FE} will result in inflation as the nation's output increases in the short run
- ➔ In the long run, wages adjust upwards, SRAS shifts left, restoring output at Y_{FE} with more inflation
- ➔ Other factors that reduce KAS in a nation include:
    - ◆ Increase in resources (oil shocks, energy shortages, higher food prices)
    - ◆ Increase in trade union power
    - ◆ Increase in the minimum wage
    - ◆ Higher business taxes
    - ◆ Weaker currency (makes imported raw materials more expensive)
- ➔ If an economy is producing at Y_{FE}, and any of the above change, it will result in both a recession and inflation

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Page 7 of 20

UNEMPLOYMENT

2.3.1 Introduction of four macro objectives

Macroeconomic policies are aimed at the following four objectives:

1. Full employment
    a. People who are willing and able to work finding (suitable) jobs
    b. High unemployment creates social and economic challenges for a nation
2. Low inflation
    a. Average price level of goods should increase slowly over time
    b. Unanticipated fluctuations in the price level in a nation are undesirable
3. Economic growth
    a. A nation's output should increase year after year
    b. Ensure constant improvement in the standard of living of its people
    c. Recession should be avoided
4. Income distribution

- The closer to 0 the more equal the income distribution
- Essentially the Gini coefficient expressed as a percentage: [A ÷ (A+B)] x 100

2.6.3 Indicators of poverty

Relative poverty: the condition experienced by people in a country whose incomes are considerably lower than the higher income groups in the same country

- Exists everywhere
- Relative poverty often persists
- Could lead to macroeconomic instability
- Solve it using policies aimed at redistributing the nation's income

Absolute poverty: the condition experienced by individuals who cannot afford to acquire basic necessities for a healthy and safe existence

- Limited to the world's poorest countries (with lowest incomes)
- May be reduced through international economic development strategies
- If average income of a nation rises: income distribution and level of relative poverty remain the same, but level of absolute poverty decreases

Causes

- Low income
- Unemployment
- Lack of human capital

2.6.4 Role of taxation

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Page 14 of 20

Direct taxes: taxes paid directly to the government by those on whom they are imposed

Indirect taxes: paid by households through an intermediary (such as a retail store) which then pays the government

Burdens of taxes

- Marginal tax rate (MTR): the percentage taken by the government on the last dollar earned, or the extra tax paid as a result of extra income earner
- Average tax rate (ATR): the ratio of the tax collected over the income earner / the ratio of the tax collected over the tax based (whatever is taxed)
- Proportional tax system
  - All individuals pay the same proportion of their income independently of the level of their income
  - ATR remains constant as income rises
  - MTR = ATR
- Regressive tax system
  - Poorer individuals pay a greater proportion of their income
  - ATR decreases as income rises
  - MTR < ATR
- Progressive tax system
  - Individuals with higher incomes pay proportionally more
  - ATR rises as income rises
  - MTR > ATR