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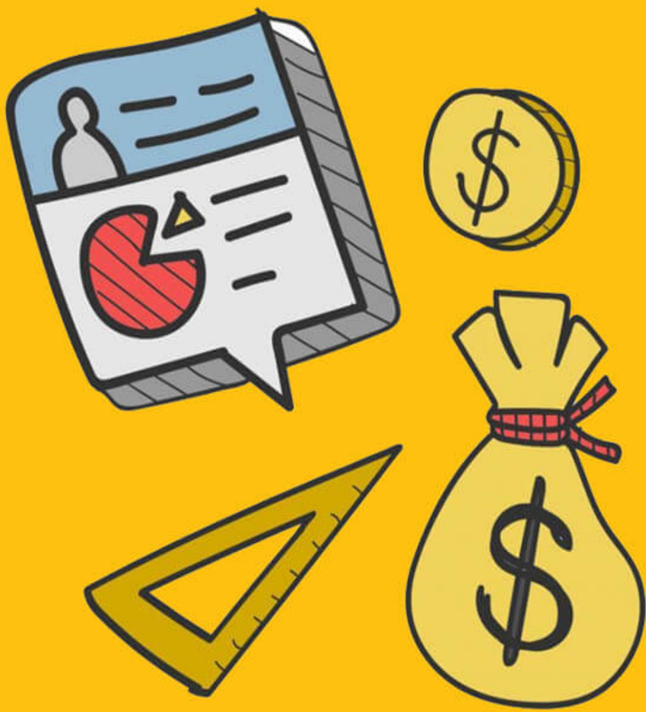
Aggregate Demand and the Level of Economic Activity



AQA A Level Economics Revision Notes

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The role of AD in influencing the level of economic activity:

The factors which influence the level of economic activity are:
- **Employment:** influences production and consumption
- **Confidence:** influences the level of spending and investment
- **Events:** natural disasters or Christmas influence the level of consumer spending
- **Other factors:** such as taxes and interest rates influence how much firms and consumers borrow, save or spend.

The multiplier process

The multiplier effect occurs when there is new demand in an economy. This leads to an injection of more income into the circular flow of income, which leads to economic growth. This leads to more jobs being created, higher average incomes, more spending, and eventually, more income is created.

The multiplier effect refers to how an initial increase in AD leads to an even bigger increase in national income.

It occurs since 'one person's spending is another person's income'.

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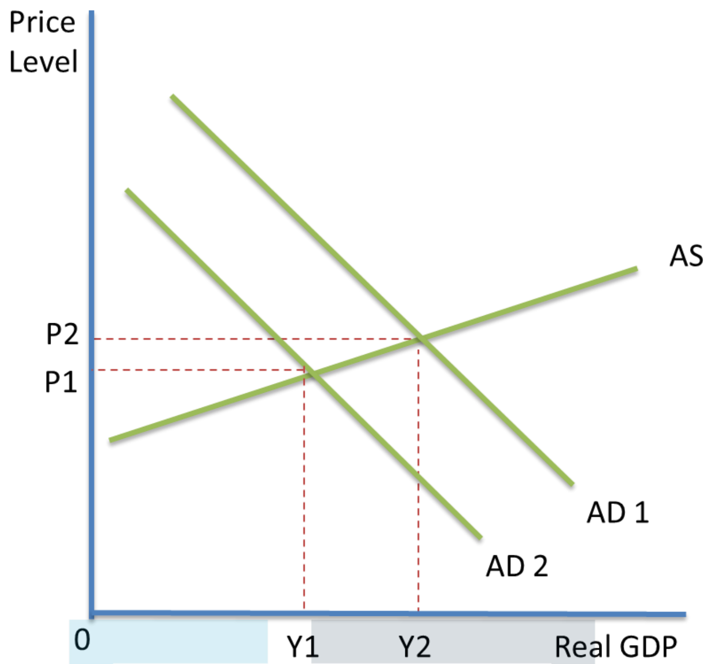
The multiplier ratio is the ratio of the rise national income to the initial rise in AD. In other words, it is the number of times a rise in national income is larger than the rise in the initial injection of AD, which led to the rise in national income.

The significance of the multiplier to shifts in AD

If an economy has a lot of spare capacity, extra output can be produced quickly and at little extra cost. This makes SRAS elastic and it means the size of the multiplier will be larger. A small increase in AD will lead to a large increase in national income.



If SRAS is inelastic, the multiplier effect is likely to be smaller than its potential. This is because if AD increases, prices will increase rather than a full increase in national income. This higher rate of inflation will lead to higher interest rates. This will discourage spending and borrowing, and it will encourage saving, since the reward for saving is higher.

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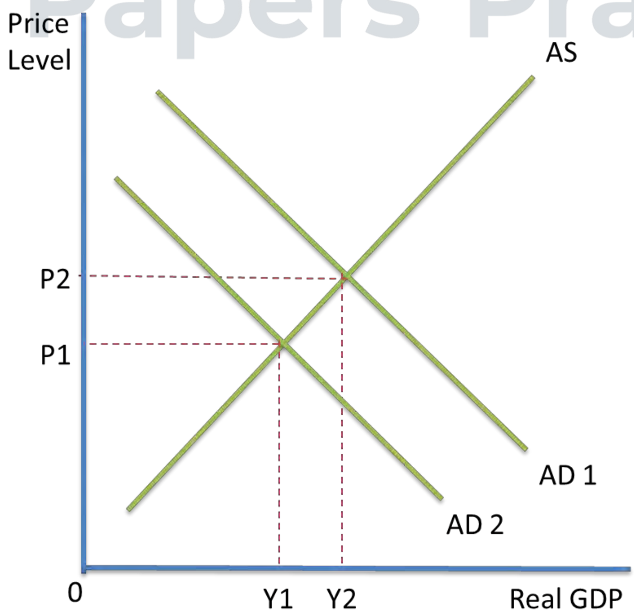

It is also possible to have a 'reverse' multiplier. This means that a withdrawal of income form the circular flow of income could lead to an even larger decrease in income for the economy. This could decrease economic growth and potentially lead to a decline in the economy.

The concept of the marginal propensity to consume (MPC) and use the MPC to calculate the size of the multiplier

- **Marginal propensity to consume (MPC)**
  A consumer's marginal propensity to consume is how much a consumer changes their spending following a change in income.
  The higher the MPC, the bigger the size of the multiplier.
  The government could influence the MPC by changing the rate of direct tax. If consumers have more disposable income due to lower income tax rates, their propensity to consume might increase.

- **Marginal propensity to save (MPS)**
  A consumer's marginal propensity to save plus the marginal propensity to consume is equal to 1.
  If consumers save more than they spend, the size of the multiplier will be small.

Calculating the multiplier

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- One formula that can be used to calculate the multiplier is **1/(1-MPC).**

- **Example:**
  If consumers spend 0.6 of every £1 they earn, they save 0/4. Therefore, the multiplier will be:
  1/(1-0.6) = 1/0.4 = 2.5.

  This means that every £1 of income generates £2.50 of new income.