2.1 How the macroeconomy works: the circular flow of income and AD/AS analysis: 10-minute Pack

AQA 7136 · Calculator allowed · about 10 minutes

Total Marks

Name: _____ Date: ____ / ____ / _____

Answer ALL questions. Show all your working.

1 An economy is currently operating with significant spare capacity (its real output is well below its potential/LRAS output).

(a) Explain why an increase in AD in this situation is unlikely to cause significant demand-pull inflation. **(4)**

(b) Explain one reason a government might still prefer a supply-side policy over a demand-side stimulus, even when there is spare capacity. **(3)**

(Total for Question 1 is 7 marks)

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Mark scheme · 2.1 How the macroeconomy works: the circular flow of income and AD/AS analysis: 10-minute Pack

Question 1

(a) with significant spare capacity, firms can increase output to meet higher demand without needing to bid up scarce resources or pay overtime rates, since unused labour and capital are readily available **M1**

(a) so the SRAS curve tends to be relatively flat/elastic at low levels of output relative to potential, meaning a rightward shift of AD mostly increases real output rather than the price level **A1**

(a) as the economy gets closer to full capacity (potential output/LRAS), SRAS becomes steeper, so further increases in AD would then cause a larger rise in the price level relative to output **M1**

(a) since this economy currently has significant spare capacity, it is operating on the relatively flat part of SRAS, so the immediate risk of demand-pull inflation from a further rise in AD is low **A1**

(a) Answer: With spare capacity, SRAS is relatively flat, so AD increases raise output much more than the price level.

(b) a demand-side stimulus may only provide a temporary boost to output, which falls back once the stimulus ends, without permanently raising the economy's potential output **M1**

(b) a supply-side policy instead raises LRAS itself, providing a more permanent/sustainable increase in potential output, which continues to benefit the economy even after spare capacity has been used up **A1**

(b) (allow other valid reasoning, e.g. concerns about a demand stimulus increasing government borrowing/the budget deficit, or about the size of the output gap being hard to measure precisely) **A1**

(b) Answer: A supply-side policy permanently raises potential output (LRAS), unlike a temporary demand-side boost.

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