2.1 How the macroeconomy works: the circular flow of income and AD/AS analysis: 30-minute Pack

AQA 7136 · Calculator allowed · about 30 minutes

Total Marks

Name: _____ Date: ____ / ____ / _____

Answer ALL questions. Show all your working.

1 Components of aggregate demand.

(a) State the equation for aggregate demand (AD), naming each component. **(3)**

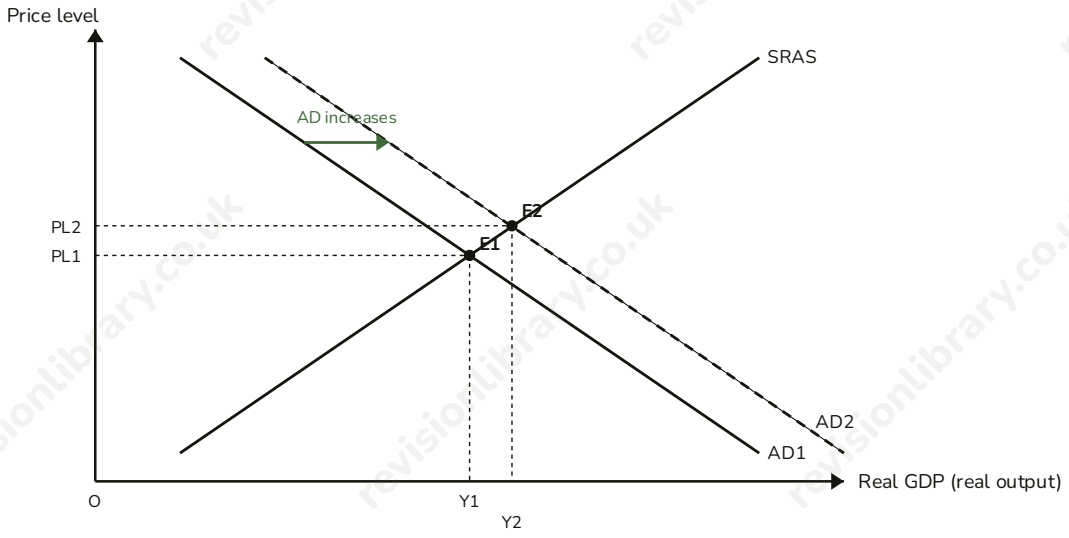
(b) State two factors, other than income, that could cause an increase in consumer spending (C). **(2)**

(c) Explain how a fall in interest rates could increase investment (I) spending by firms. **(2)**

(Total for Question 1 is 7 marks)

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2 The diagram shows the economy initially in equilibrium at E1. Aggregate demand then rises, shown by a rightward shift of the AD curve from AD1 to AD2, with short-run aggregate supply (SRAS) unchanged. A new equilibrium is reached at E2.



(a) State the change in the equilibrium price level and real output (real GDP) shown by the shift from AD1 to AD2. **(2)**

(b) Using the diagram, and an example, explain ONE factor that could cause the rightward shift in aggregate demand shown from AD1 to AD2. **(4)**

(c) Explain why the increase in aggregate demand shown causes the price level to rise (demand-pull inflation). **(4)**

(Total for Question 2 is 10 marks)

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3 Evaluate which of these two policies is more likely to achieve a SUSTAINED increase in real GDP without causing demand-pull inflation.

(Total for Question 3 is 7 marks)

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Mark scheme · 2.1 How the macroeconomy works: the circular flow of income and AD/AS analysis: 30-minute Pack

Question 1

(a) AD = C + I + G + (X - M) **B1**

(a) C = consumer spending/household consumption; I = investment (spending by firms on capital goods); G = government spending **B1**

(a) X = exports, M = imports, so (X - M) = net exports **B1**

(a) Answer: AD = C + I + G + (X - M).

(b) a fall in interest rates (reduces the cost of borrowing/return to saving, encouraging spending) **B1**

(b) (allow) a rise in consumer confidence, a rise in house/asset prices (a positive wealth effect), or lower income tax rates - any valid, distinct factor **B1**

(b) Answer: E.g. lower interest rates; higher consumer confidence (any two valid factors).

(c) a fall in interest rates reduces the cost of borrowing to finance investment projects (or reduces the opportunity cost of using retained profit rather than saving it) **M1**

(c) more investment projects become profitable, since their expected rate of return now exceeds the lower cost of borrowing, so firms are willing to invest more, increasing I and therefore AD **A1**

(c) Answer: Cheaper borrowing makes more investment projects profitable, raising I and AD.

Question 2

(a) the price level rises, from PL1 to PL2 **B1**

(a) real output (real GDP) rises, from Y1 to Y2 **B1**

(a) Answer: Price level rises (PL1 to PL2); real output rises (Y1 to Y2).

(b) identifies a valid component of AD that could rise, e.g. a rise in consumer confidence increasing C, a fall in interest rates increasing C and I, a rise in government spending (G), or a depreciation of the exchange rate increasing net exports (X-M) **M1**

(b) explains the mechanism: this increases total planned spending in the economy at every price level **M1**

(b) links this explicitly to a rightward shift of the WHOLE AD curve (not a movement along it) **A1**

(b) correctly identifies the resulting new equilibrium as a higher price level and higher real output (ft candidate's own example) **A1**

(b) Answer: Example: a rise in government spending (G) raises total planned spending at every price level, shifting AD1 to AD2.

(c) as aggregate demand rises from AD1 to AD2, firms respond to rising demand for their output by increasing production, moving along the upward-sloping SRAS curve **M1**

(c) as the economy produces more output and moves closer to full capacity, firms face rising costs, e.g. paying overtime, using less efficient machinery/resources, or bidding up scarce raw material prices **M1**

(c) firms pass on some of these higher costs as higher prices, so the general price level rises **A1**

(c) this continues until a new equilibrium is reached at PL2/Y2, where aggregate demand once again equals aggregate supply **A1**

(c) Answer: Rising output pushes up firms' costs as the economy nears capacity, and higher costs are passed on as higher prices, giving demand-pull inflation.

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Question 3

a cut in interest rates is a demand-side policy: it works mainly by increasing AD (via higher C and I), which raises real output only if the economy has spare capacity, but risks causing demand-pull inflation if the economy is close to full capacity/LRAS **M1**

increased spending on infrastructure and education is a supply-side policy: it aims to raise LRAS by improving the quantity/quality of capital and labour, increasing the economy's long-run productive potential **M1**

because a supply-side policy raises the economy's potential output (LRAS) rather than just spending at each price level (AD), it can support a sustained rise in real GDP without the same inflationary pressure as a demand-side policy **A1**

however, supply-side policies such as infrastructure and education spending typically take much longer to feed through into higher output (long time lags), whereas an interest rate cut can affect AD relatively quickly **A1**

additional point: infrastructure/education spending may need to be funded by higher taxes or increased government borrowing, which could partly offset the benefit, e.g. if higher borrowing raises interest rates for private borrowers, partially crowding out private investment **M1**

developed: this crowding-out effect is likely to be much smaller than the direct supply-side benefit if the spending is well targeted and productive **A1**

evaluative conclusion: the supply-side policy is more likely to achieve the sustained, non-inflationary growth described, but a demand-side stimulus may still be useful in the short run if the economy currently has significant spare capacity, so the case depends on the current state of the economy relative to its potential output **A1**

Answer: The supply-side policy (infrastructure/education spending) is more likely to deliver sustained, non-inflationary growth, though it acts more slowly and may involve some crowding-out risk; a demand-side cut works faster but risks inflation nearer full capacity.

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