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

Total Marks

AQA 7136 · Calculator allowed · about 20 minutes

Name: _____ Date: ____ / ____ / _____

Answer ALL questions. Show all your working.

1 The circular flow of income.

(a) Using the circular flow of income model, distinguish between an injection and a withdrawal, giving one example of each. **(4)**

(b) State the condition, in terms of injections and withdrawals, required for the circular flow of income (national income) to be in equilibrium. **(2)**

(Total for Question 1 is 6 marks)

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2 Country Z's currency depreciates (falls in value) against other major currencies.

(a) Explain the likely effect of this depreciation on Country Z's exports (X) and imports (M), assuming the Marshall-Lerner condition holds. **(4)**

(b) State one factor, other than the exchange rate, that could cause a change in a country's net exports (X-M). **(2)**

(c) Explain why an improvement in net exports (X-M) causes an increase in aggregate demand (AD). **(2)**

(Total for Question 2 is 8 marks)

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

Question 1

(a) an injection is an addition to the circular flow of income that does NOT arise from household spending on domestically produced goods and services, e.g. investment (I), government spending (G) or exports (X) **B1**

(a) a withdrawal (leakage) is income that is removed from the circular flow rather than being spent on domestic output, e.g. saving (S), taxation (T) or imports (M) **B1**

(a) correct, valid example given for an injection (I, G or X) **B1**

(a) correct, valid example given for a withdrawal (S, T or M) **B1**

(a) Answer: Injection e.g. government spending; withdrawal e.g. saving.

(b) injections must equal withdrawals (J = W) **B1**

(b) i.e. I + G + X = S + T + M **B1**

(b) Answer: J = W, i.e. I+G+X = S+T+M.

Question 2

(a) a depreciation makes Country Z's exports cheaper for foreign buyers (in foreign currency terms), so the volume of exports sold is likely to rise **M1**

(a) a depreciation makes imports more expensive for Country Z's residents (in domestic currency terms), so the volume of imports bought is likely to fall **A1**

(a) the Marshall-Lerner condition states that a depreciation will improve the trade balance (net exports, X-M) only if the sum of the price elasticities of demand for exports and imports is greater than 1 **M1**

(a) if this condition holds, the rise in export volumes and fall in import volumes are large enough (in percentage terms) to outweigh the fact that each unit of exports now earns less foreign currency, so net exports (X-M) improve, increasing AD **A1**

(a) Answer: Export volumes rise, import volumes fall; if the Marshall-Lerner condition holds, net exports (and AD) improve overall.

(b) identifies a valid factor, e.g. a change in relative inflation rates between the country and its trading partners (allow instead: relative growth rates of the domestic economy vs trading partners, changes in trade policy/tariffs, or non-price competitiveness/quality changes) **B1**

(b) explains the mechanism, e.g. if Country Z's inflation is lower than its trading partners', its goods become relatively more price competitive, raising exports and reducing imports **B1**

(b) Answer: E.g. relative inflation rates between trading partners.

(c) net exports (X-M) is one of the four components of aggregate demand (AD = C+I+G+(X-M)) **M1**

(c) so, holding C, I and G constant, a rise in (X-M) directly increases the total value of AD, shifting the AD curve to the right **A1**

(c) Answer: Net exports is a direct component of AD, so a rise in (X-M) raises AD.

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