Exercise walk-through

3.2
Aggregate demand and aggregate supply (2.3.2-2.3.3)

Pearson Edexcel · International A-Level · Economics

Measures of economic performance (8)

- **seasonal** : ski instructors in summer;
- **structural** : workers' skills no longer match the jobs available. When China restructured its state-owned enterprises in the late 1990s, tens of millions of workers were laid off, many in the old industrial north-east;
- **demand-deficient** : too little total spending, as in a **recession**;
- **real-wage inflexibility**: wages stuck above the level that clears the labour market.

Aggregate demand

- **Consumption** (C) depends on disposable income, interest rates, confidence, **wealth** and credit. The **savings ratio** is saving as a share of disposable income; Chinese households save about a third.
- **Investment** (I) is spending on capital goods; **net investment** is gross investment minus depreciation. It depends on growth, interest rates, business confidence, credit and corporation tax.
- **Government spending** (G) depends on fiscal policy, the state of the economy and political priorities.
- **Net exports** (X − M) depend on income at home, the exchange rate, growth abroad, protectionism and quality.

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

Economic growth

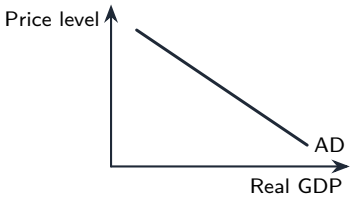
- **Actual growth** in the short run comes from any part of AD: **consumption**, **investment**, government spending or net exports. **Export-led growth** adds demand from abroad; China's exports grew from about 4% of world exports in 2001, when it joined the WTO, to about 13% by 2015.
- Potential growth comes from investment (domestic and **foreign direct investment**), innovation, a growing labour force and stronger competition. In the long run, **productivity** — output per worker — matters most. South Korea's GDP per head rose from about the same as Ghana's in 1960 to a high-income level by the 1990s, largely through investment in education and machinery.
- opportunity cost: investing more means consuming less today;

Exercises 2.1·2.2

2.1 Write the AD equation. With C = 60, I = 20, G = 20, X = 25 and M = 25, calculate AD. [2]

$C = 60,\ I = 20,\ G = 20$
$X = 25,\ M = 25$

2.2 For each event, state whether it moves the economy along AD or shifts AD (and in which direction): (a) the price level rises; (b) consumer confidence collapses. [2]



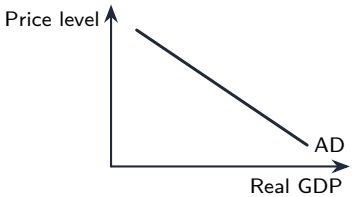
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$C = 60,\ I = 20,\ G = 20$
$X = 25,\ M = 25$

2.1 $AD = C + I + G + (X - M) = 60 + 20 + 20 + (25 - 25) = 100.$

2.2 For each event, state whether it moves the economy along AD or shifts AD (and in which direction): (a) the price level rises; (b) consumer confidence collapses. [2]



2.2 (a) A movement ALONG the AD curve (a higher price level lowers real spending). (b) A shift of AD LEFT – less consumption at every price level.

Exercises 2.3·2.5

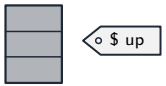
2.3 Name any four of the six influences on consumption. [2]



2.4 Distinguish gross investment from net investment. [2]

gross investment net investment

2.5 The world oil price rises. Which curve shifts, in which direction, and why? [2]



Exercises 2.3·2.5

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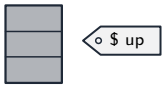
2.3 Any four of: disposable income, interest rates, consumer confidence, welfare payments, wealth effects, availability of credit.

2.4 Distinguish gross investment from net investment. [2]

gross investment net investment

2.4 Gross investment is total spending on capital; net investment is gross minus depreciation – only net investment ADDS to the capital stock.

2.5 The world oil price rises. Which curve shifts, in which direction, and why? [2]

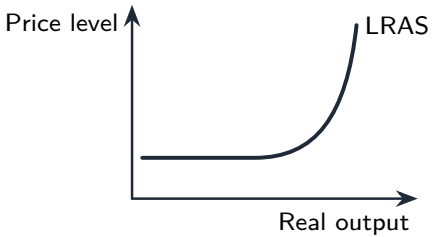


2.5 SRAS shifts LEFT: oil is an input cost, so production costs rise at every output level, raising the price level and cutting output.

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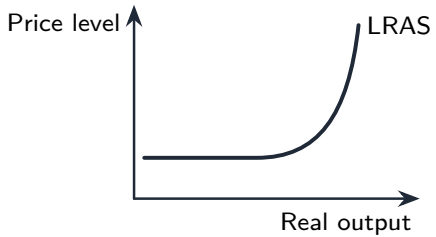
Exercise 2.6

2.6 With heavy spare capacity, what does the Keynesian LRAS imply about the price effect of a rise in AD? [2]



Exercise 2.6

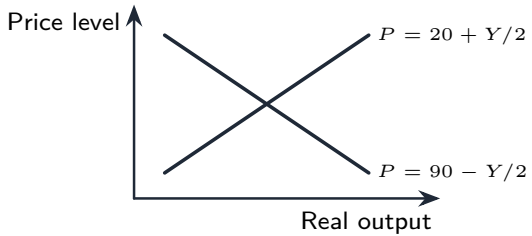
2.6 With heavy spare capacity, what does the Keynesian LRAS imply about the price effect of a rise in AD? [2]



2.6 With spare capacity, the Keynesian LRAS is flat at the given price level, so higher AD raises REAL OUTPUT with little or no inflation until capacity is approached.

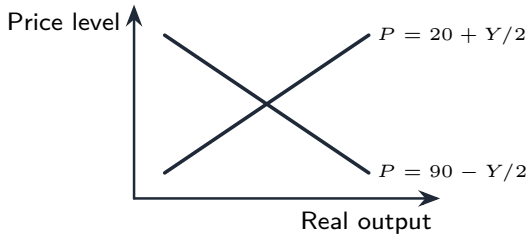
Exercise 3.1

3.1 *(Original.)* In the model AD: $P = 90 - Y/2$ and SRAS: $P = 20 + Y/2$, an investment injection shifts AD up by 15 at every output. Find both equilibria and describe the adjustment. [4]



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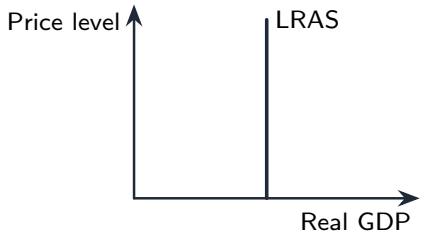
3.1 *(Original.)* In the model AD: $P = 90 - Y/2$ and SRAS: $P = 20 + Y/2$, an investment injection shifts AD up by 15 at every output. Find both equilibria and describe the adjustment. [4]



3.1 Before: $90 - Y/2 = 20 + Y/2$ gives $Y = 70$, $P = 55$. After the upward shift AD is $P = 105 - Y/2$: $105 - Y/2 = 20 + Y/2$ gives $Y = 85$, $P = 62.5$. Output rises from 70 to 85 and the price level from 55 to 62.5; at the old output the economy now demands more than firms supply, so prices and output rise together along SRAS to the new equilibrium.

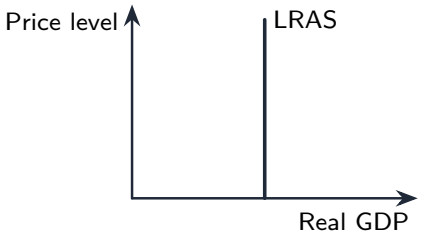
Exercise 3.2

3.2 *(Original.)* Explain two factors that shift LONG-run aggregate supply, with the mechanism for each. [4]



Exercise 3.2

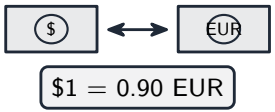
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3.2 Any two with mechanism: technology (more output per input shifts LRAS right); education and skills (a more productive workforce); demography or net migration (a larger labour force); competition policy or deregulation (more efficient allocation); lower income tax (incentives to work); investment (a bigger capital stock).

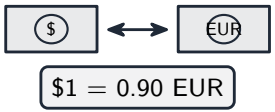
Exercise 3.3

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3.3 A depreciation makes exports cheaper abroad and imports dearer at home, so export volumes tend to rise and import volumes to fall – net trade (X − M) rises and AD shifts right. Limits: import prices rising can feed inflation (cost-push), and if export and import demand are price INELASTIC in the short run, the value of net trade can fall before it rises (the J-curve); non-price factors (quality, design) still matter.

Local review guidance: both equilibria solved from the equations before any description; LRAS factors from the specification list with the capacity mechanism; (R1 3.3) the Marshall-Lerner inelasticity caveat earns the analysis mark. This is authored classroom guidance.