3.2 Aggregate demand and aggregate supply

Name: _____ Class: _____ Date: _____ **Total: 24 marks**

KEY WORDS aggregate demand • aggregate supply

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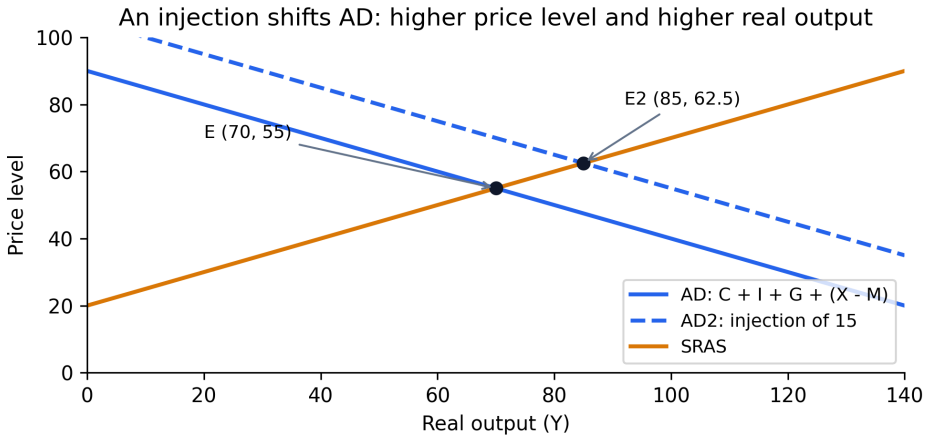
Objective

Use the AD equation and its components' influences, movements versus shifts, SRAS shift factors and the Keynesian and classical LRAS shapes with the equilibrium model (spec 2.3.2–2.3.3).

1 Key knowledge and worked examples

AD and AS. AD = C + I + G + (X − M); a price-level change moves along AD, a component change shifts it. SRAS shifts with input costs, exchange rates and taxes. LRAS is Keynesian (flat with spare capacity, vertical at capacity) or classical (vertical at full employment). The worked model: AD is $P = 90 - Y/2$, SRAS is $P = 20 + Y/2$, equilibrium (70, 55); an injection of 15 shifts AD to equilibrium (85, 62.5).



Original model; both equilibria are computed in the worked examples.

2 Practice

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

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]

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

2.4 Distinguish gross investment from net investment. [2]

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

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

3 Exam-style questions

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]

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

3.3 *(Original.)* Analyse how a currency depreciation affects the net trade balance component of AD. [4]

Solutions

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

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.

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

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

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.

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.

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).

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.