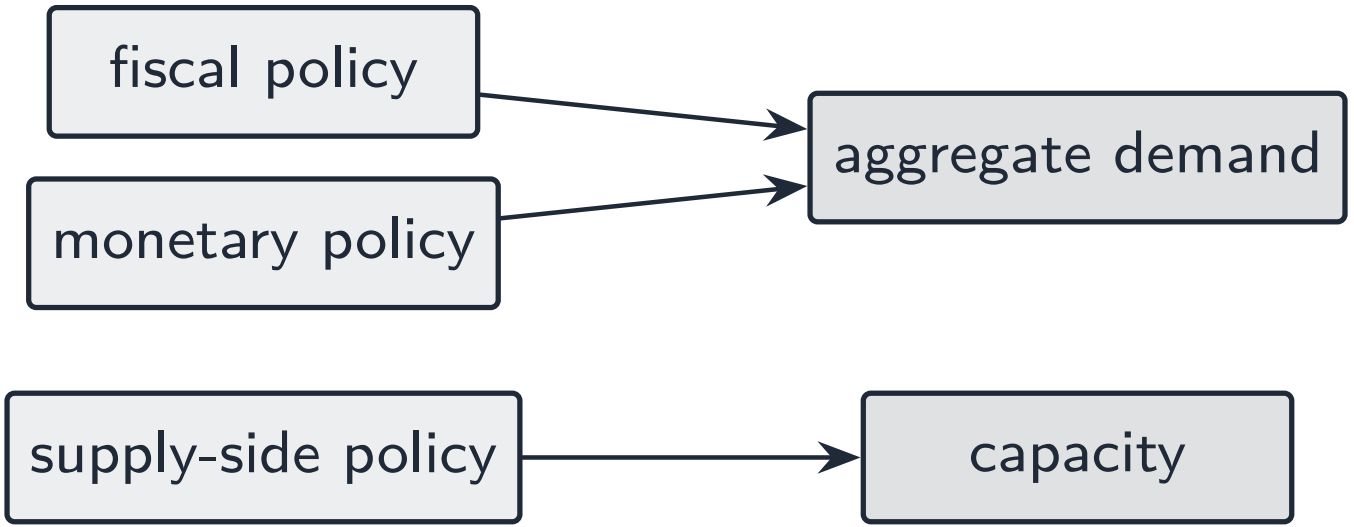
Exercise walk-through

4.1 Macroeconomic measures and policy: supported rehearsal

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Figure: Macroeconomic activity, objectives and policy

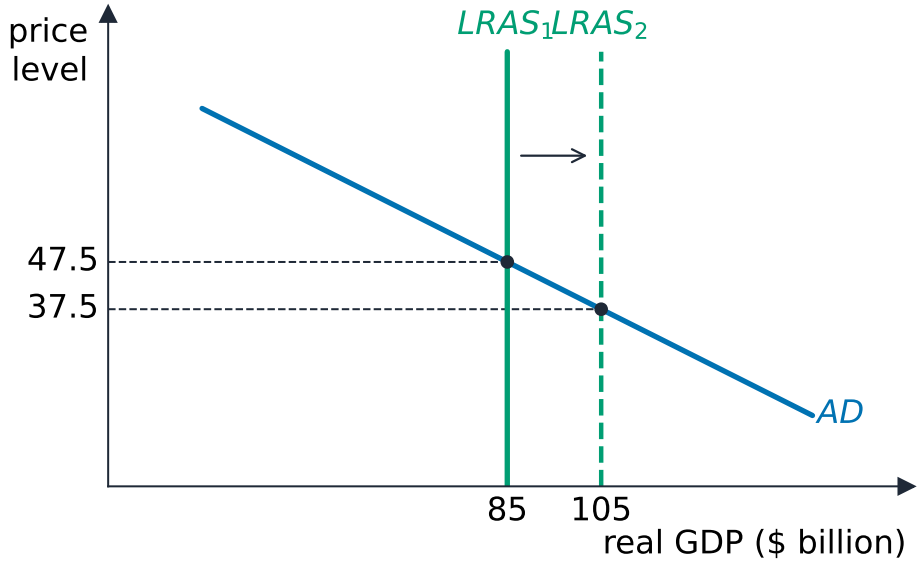


- Fiscal and **monetary policy** act on demand; supply-side on capacity
- Match each part of the diagram to the text.

Monetary policy

- the **policy interest rate** (the rate at which the **central bank** lends to commercial banks);
- **open market operations** : buying or selling government bonds to change the **money supply**;
- **minimum reserve requirements** : the share of deposits banks must keep and cannot lend. Lowering it lets banks lend more;
- **quantitative easing** (QE): large-scale bond buying with newly created money, used when interest rates are already near zero.

Figure: Supply-side policies



- Supply-side policy raises output and lowers the price level
- Match each part of the diagram to the text.

Exercises 2.1·2.2

2.1 Define gross domestic product, distinguish nominal from real GDP, and explain why real GDP per head is the better comparison of living standards. [3]

nominal GDP real GDP

2.2 State the four components of aggregate demand and explain one factor that would shift AD to the right. [2]

C I G X − M

Exercises 2.1·2.2

2.1 Define gross domestic product, distinguish nominal from real GDP, and explain why real GDP per head is the better comparison of living standards. [3]

nominal GDP | real GDP

2.1 GDP is the value of all final goods and services produced within a country in a period (1). Nominal GDP is measured at current prices; real GDP removes price changes so that it measures output (1). Dividing by population shows what the average person has, so growth from a larger population alone does not read as higher living standards (1).

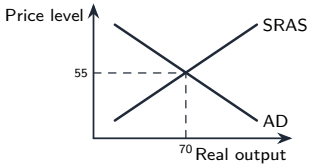
2.2 State the four components of aggregate demand and explain one factor that would shift AD to the right. [2]

C | I | G | X − M

2.2 $C + I + G + (X - M)$ (1). Any one: higher consumer confidence or disposable income raising C; lower interest rates raising I; a budget expansion raising G; a weaker currency or stronger world demand raising net exports (1).

Exercises 2.3·2.4

2.3 On the diagram AD meets SRAS at a price level of 55 and real output of 70; a stimulus shifts AD right so the new equilibrium is $(85, 62.5)$. State what happens to output and the price level, and explain how the outcome differs if long-run AS is vertical. [4]

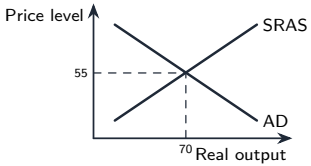


2.4 A CPI basket has weights 50, 30 and 20 with price relatives 110, 100 and 120. Calculate the CPI and the inflation rate. [3]

food: weight 50, relative 110
housing: weight 30, relative 100
transport: weight 20, relative 120

Exercises 2.3·2.4

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2.3 Output rises from 70 to 85 and the price level rises from 55 to 62.5 (1): demand management buys output with inflation (1). With a VERTICAL long-run AS the price level alone rises (1) – output is pinned at the full-employment level, the monetarist case for supply-side rather than demand-side policy (1).

2.4 A CPI basket has weights 50, 30 and 20 with price relatives 110, 100 and 120. Calculate the CPI and the inflation rate. [3]

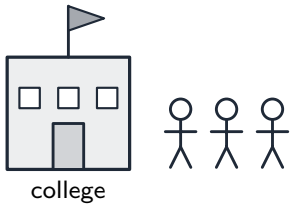
food: weight 50, relative 110
housing: weight 30, relative 100
transport: weight 20, relative 120

2.4 CPI $= 0.5 \times 110 + 0.3 \times 100 + 0.2 \times 120 = 55 + 30 + 24 = 109$ (2); inflation $= 9\%$ (1).

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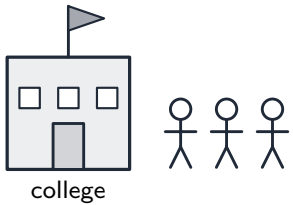
Exercise 2.5

2.5 Name any four instruments of supply-side policy. [2]



Exercise 2.5

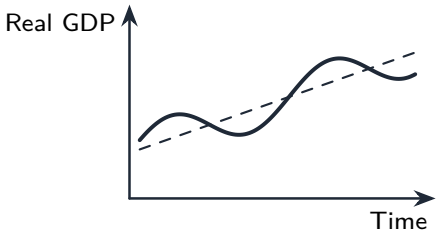
2.5 Name any four instruments of supply-side policy. [2]



2.5 Any four of: education and training; infrastructure investment; deregulation; privatisation; lower taxes on work/investment; labour-market reform.

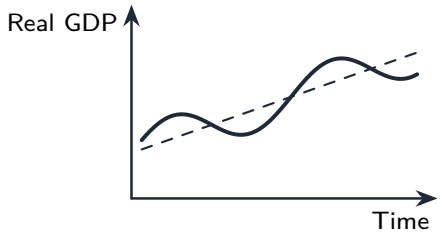
Exercise 3.1

3.1 *(Original, Paper 1 style.)* Describe the four stages of the business cycle and explain how unemployment and inflation move across them, naming two types of unemployment. [4]



Exercise 3.1

3.1 *(Original, Paper 1 style.)* Describe the four stages of the business cycle and explain how unemployment and inflation move across them, naming two types of unemployment. [4]



3.1 Recovery → boom → recession → trough (1). In the recovery and boom output grows and unemployment falls while inflation builds as spare capacity disappears (1); in the recession and trough output falls, cyclical unemployment rises and inflation eases or turns to deflation (1). Two types: cyclical (demand-deficient) and structural (skills or location mismatch) – or seasonal, frictional (1).

Exercise 3.2

3.2 *(Original, Paper 2 style.)* A central bank cuts interest rates from 6.5% to 6.25%. Explain the transmission mechanism to AD and name one trade-off the policy accepts. [3]

base rate: 6.5% → 6.25%

Exercise 3.2

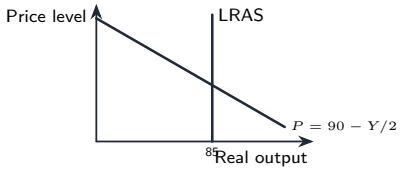
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base rate: 6.5% → 6.25%

3.2 Lower rates cut borrowing costs and the reward to saving: consumption and investment rise, so AD shifts right, raising output and (the closer to capacity) the price level; cheaper domestic assets may also depreciate the currency, lifting net exports (2). Trade-off accepted: higher inflation now, possible asset-price bubbles, and savers lose income (a distributional cost) (1).

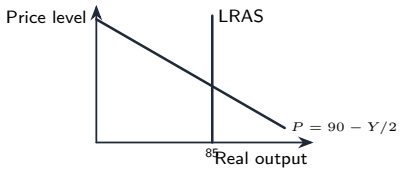
Exercise 3.3

3.3 *(Original, policy evaluation.)* On the diagram a supply-side programme shifts LRAS from 85 to 105, so along AD the price level falls from 47.5 to 37.5 while output rises. Using the diagram, evaluate supply-side policy against expansionary fiscal policy as a route to growth. [4]



Exercise 3.3

3.3 *(Original, policy evaluation.)* On the diagram a supply-side programme shifts LRAS from 85 to 105, so along AD the price level falls from 47.5 to 37.5 while output rises. Using the diagram, evaluate supply-side policy against expansionary fiscal policy as a route to growth. [4]



3.3 Diagram: LRAS right from 85 to 105 along a downward AD moves the equilibrium down the AD curve – output up, price level down from 47.5 to 37.5 (1): growth WITH disinflation. Expansionary fiscal policy shifts AD right instead – output up but the price level up with it, and the budget deficit grows (1). Supply-side gains are larger and non-inflationary but slow (education, infrastructure take years), can be costly, and some instruments (deregulation, lower taxes) worsen equity (1). Judgement: fiscal expansion for a demand-deficient recession; supply-side for long-run growth – the two are complements, not substitutes (1).

Local review guidance: both equilibria read from the diagram before the vertical-AS contrast; the weighted sum written out before the index; (R1 3.3) an evaluation reaches a judgement that names the circumstances. This is authored classroom guidance.

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