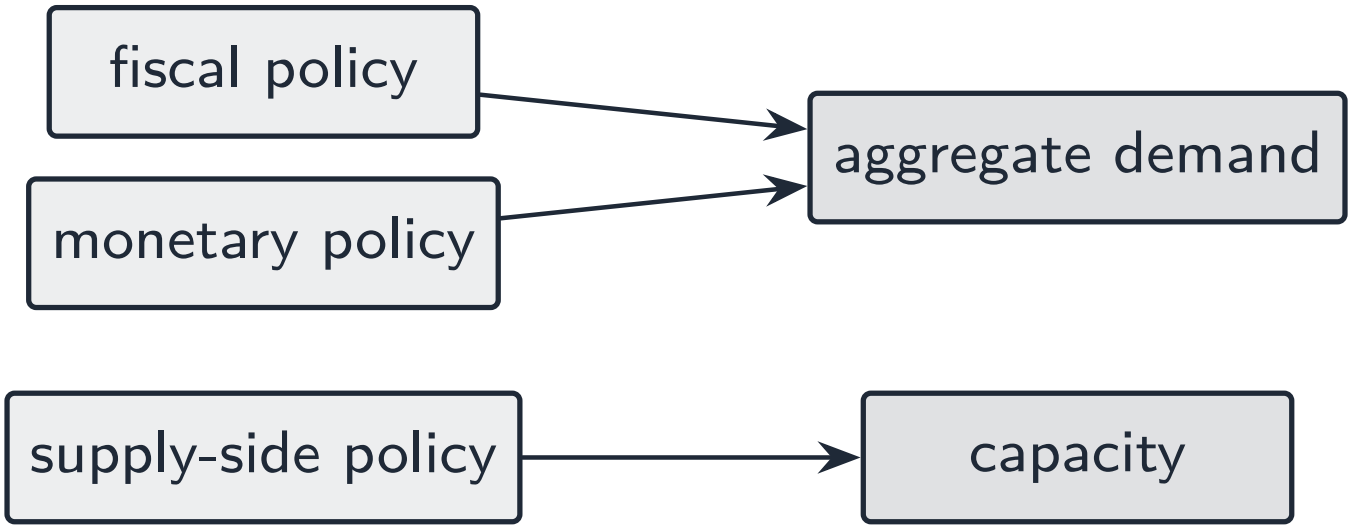
Exercise walk-through

# 4.2
# Aggregate demand, aggregate supply and the business cycle

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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.

# Aggregate demand and aggregate supply

- In the **monetarist** (new classical) view, the **long-run aggregate supply** (LRAS) curve is vertical at **potential output** . In the long run wages adjust, so the economy returns to full employment by itself. Demand changes only move the price level.
- In the **Keynesian** view, the economy can stay stuck below full employment. When there is a lot of spare capacity, AS is flat: more demand raises output without raising prices. Near full capacity, bottlenecks push prices up, and at full employment AS is vertical.
- Equilibrium: $90 - Y/2 = 20 + Y/2$, so $Y = 70$ and $P = 55$.

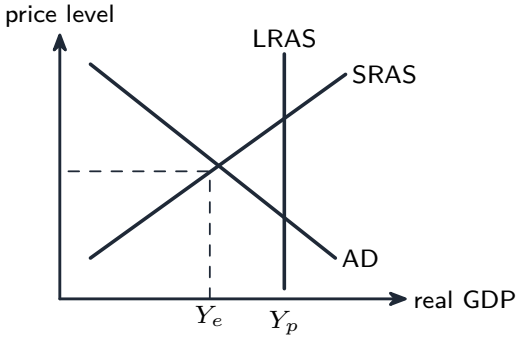
$$AD = C + I + G + (X - M)$$

# Key terms (2)

- **Natural rate of unemployment**: the rate of unemployment when the labour market is in equilibrium, made up of frictional, structural and seasonal unemployment.
- **Monetary policy**: the **central bank**'s use of interest rates and the **money supply** to influence **aggregate demand**.
- **Supply-side policy**: policy that aims to increase the economy's productive capacity (LRAS).

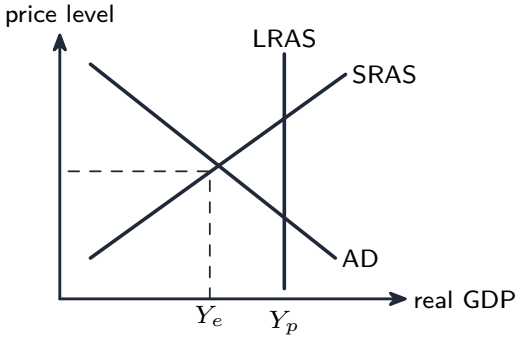
# Exercise 2.1

**2.1** Define a **recessionary gap**. [2]



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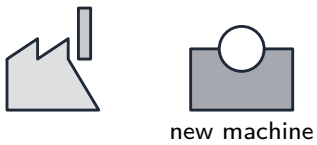



**2.1**

the difference when real GDP is below potential output; so there is unemployment of resources / cyclical unemployment

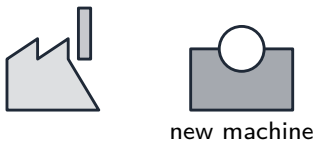
# Exercise 2.2

**2.2** State **two** determinants of investment. [2]



# Exercise 2.2

**2.2** State **two** determinants of investment. [2]




**2.2**

any two: interest rates; business confidence / expected demand; technology; business taxes

# Exercise 2.3

**2.3** Using an AD/AS diagram, explain the effect of a large rise in world oil prices on an oil-importing economy. [4]




[[drawlines:4]]

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**2.3** Using an AD/AS diagram, explain the effect of a large rise in world oil prices on an oil-importing economy. [4]




[[drawlines:4]]

**2.3**

oil is a key input, so firms' costs rise; SRAS shifts left; the price level rises and real GDP falls: stagflation / cost-push inflation and higher unemployment; correctly labelled diagram showing $\text{SRAS}_1 \rightarrow \text{SRAS}_2$, higher $P$, lower $Y$

# Exercise 3.1 (a)

**3.1** An economy is in a deep recession: unemployment is 12% and prices are stable.

(a) Draw a Keynesian AS curve and label its three sections. [2]

[[drawlines:3]]

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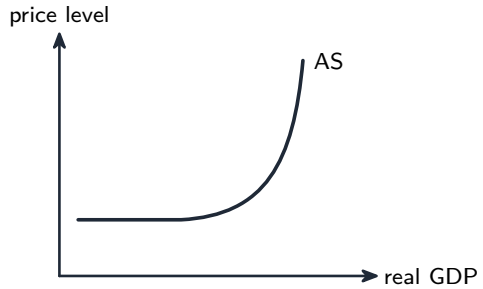
[[drawlines:3]]

(a) AS horizontal at low output, upward-sloping, then vertical at full employment output; all three sections and axes labelled

# Exercise 3.1 (b)

**3.1** An economy is in a deep recession: unemployment is 12% and prices are stable.

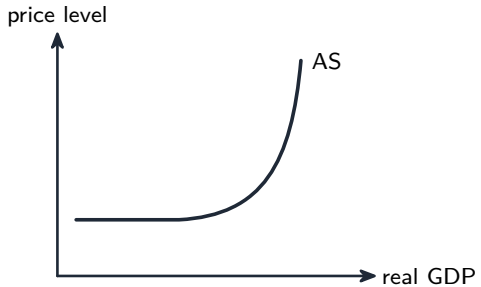
(b) Using your diagram, explain why a rise in AD may raise output without causing inflation. [6]



# Exercise 3.1 (b)

**3.1** An economy is in a deep recession: unemployment is 12% and prices are stable.

(b) Using your diagram, explain why a rise in AD may raise output without causing inflation. [6]




(b) in a deep recession there are many unemployed resources / spare capacity; firms can raise output without bidding up wages or costs; so AD shifts right along the flat section of AS; real GDP rises and the price level stays about the same; as the economy nears full employment, costs rise, and further AD increases cause more inflation; diagram: $AD_1 \rightarrow AD_2$ in the flat section, higher $Y$, same $P$