4.1 Macroeconomic activity, objectives and policy

Name: _____ Class: _____ Date: _____ **Total: 25 marks**

KEY WORDS aggregate demand • inflation

Macroeconomic activity, objectives and policy

Objective

Define and compare GDP measures, read the AD/AS diagram, apply the CPI basket, and evaluate the three policy families against the objectives and their conflicts (syllabus 3.1–3.7, SL).

1 Key knowledge and worked examples

Macro toolkit. GDP by output, income or expenditure; real GDP strips out price changes; per head divides by population. AD $= C + I + G + (X - M)$; on the shared diagram AD meets SRAS at $(70, 55)$ and a rightward AD shift moves it to $(85, 62.5)$. CPI: weights 50/30/20 over relatives $110/100/120 \to 109 \to 9\%$ inflation. A supply-side shift of LRAS from 85 to 105 cuts the price level from 47.5 to 37.5 while output rises. The objectives – growth, low unemployment, low stable inflation, equity – conflict in pairs.

2 Practice

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]

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

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]

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

3 Exam-style questions

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]

3.2 *(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]

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]

Solutions

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 $C + I + G + (X - M)$ (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).

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

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

3.1 Recovery $\rightarrow$ boom $\rightarrow$ recession $\rightarrow$ 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).

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).

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.