4.2 Aggregate demand, aggregate supply and the business cycle

Name: _____ Class: _____ Date: _____ **Total: 16 marks**

KEY WORDS business cycle • aggregate demand • aggregate supply • potential output • recessionary gap • multiplier

Objective

Build the skills to answer exam questions on the **business cycle** , **aggregate demand** (AD), **aggregate supply** (AS) and macroeconomic equilibrium, using the monetarist and Keynesian models.

You must be able to:

- describe the business cycle and output gaps
- explain the components and determinants of AD
- explain short-run and long-run AS in the monetarist/new classical and Keynesian models
- explain recessionary and inflationary gaps using AD/AS diagrams

1 Key knowledge and worked examples

■ AD, AS and the business cycle

Business cycle: real GDP fluctuates around its long-term trend (**potential output**): expansion → peak → contraction (recession: two quarters of falling real GDP) → trough. **Recessionary (deflationary) gap:** real GDP below potential; **inflationary gap:** above potential.

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Aggregate demand AD $= C + I + G + (X - M)$, the total spending on a country's goods and services at each price level. AD slopes down (wealth, interest-rate and international trade effects).

component	main determinants
consumption C	income, wealth, consumer confidence, interest rates, household debt, taxes
investment I	interest rates, business confidence, technology, corporate taxes, expected demand
government spending G	political and economic priorities
net exports $X - M$	foreign incomes, exchange rates, trade policies

Short-run aggregate supply (SRAS) slopes up; it shifts with changes in costs (wages, raw material and oil prices), business taxes and subsidies, and supply shocks.

Long-run aggregate supply:

model	shape	meaning
monetarist / new classical	vertical LRAS at potential output Y_p	in the long run, wages and prices adjust, so the economy returns to full employment by itself
Keynesian	flat, then rising, then vertical	in a deep recession output can rise without inflation; prices may not fall, so a recessionary gap can last

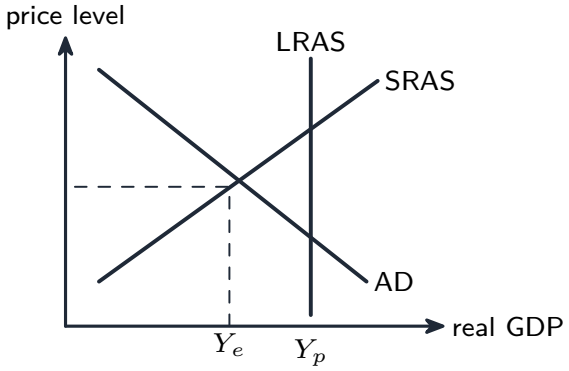
LRAS shifts right with more or better factors of production, technology, and institutional change.

Equilibrium: short run where AD = SRAS; long run (monetarist) where AD = SRAS = LRAS.

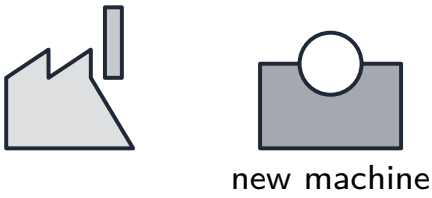
Answer shapes: an AD/AS diagram with axes (price level, real GDP), curves labelled, Y_p marked, the gap shown, and the shift explained step by step.

2 Practice

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



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



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

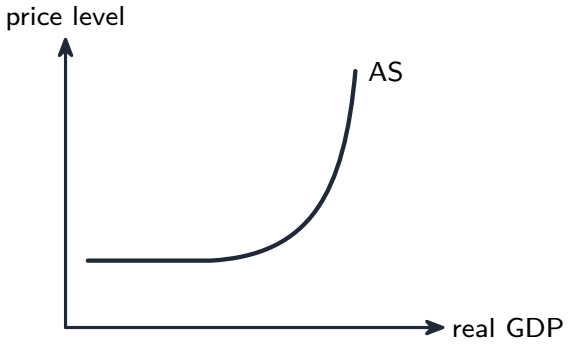


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3 Exam-style questions

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]]

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

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Solutions

Marking: **M1** a correct method, **A1** the correct answer, **B1** an independent mark.

Each answer shows the steps, then the **result**.

2.1

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

2.2

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

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

3.1

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

(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: $\text{AD}_1 \rightarrow \text{AD}_2$ in the flat section, higher Y, same P

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