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Key Macroeconomic Topics With Chain-of-Analysis

1. Aggregate Demand (AD)

Notes:

- AD = C + I + G + (X − M)

- Shifts caused by changes in confidence, interest rates, taxation, investment, or net exports

- Strong AD → higher GDP, employment, inflation

Essay Question:

Evaluate the impact of a fall in consumer confidence on real GDP and unemployment.

Chain of Analysis:

A fall in consumer confidence reduces consumption, causing AD to shift left. Lower AD reduces real GDP in the short run, leading firms to cut production. This results in higher unemployment as labour demand falls. Reduced income further weakens consumption, deepening the slowdown.

2. Aggregate Supply (AS)

Notes:

- SRAS changes with production costs (wages, oil prices, taxes)

- LRAS changes with productivity, technology, education, and infrastructure

- SRAS left → cost-push inflation + lower output

Essay Question:

Explain how rising wages could affect price level, output, and employment.

Chain of Analysis:

Rising wages increase firms' costs, shifting SRAS left. Higher costs cause cost-push inflation, while real GDP falls due to reduced output. Firms may reduce hiring, increasing unemployment.

3. Inflation

Notes:

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- Demand-pull inflation occurs when demand rises too quickly

- Cost-push inflation occurs when firm costs increase

- Inflation reduces purchasing power and creates uncertainty

Essay Question:

Discuss how an increase in global oil prices may create macroeconomic challenges for the UK economy.

Chain of Analysis:

Higher oil prices raise transport and production costs, shifting SRAS left. Cost-push inflation emerges while real GDP falls. Rising prices reduce real incomes, lowering consumption. Unemployment may rise as firms cut production.

4. Fiscal Policy

Notes:

- Government uses taxation and spending to influence AD

- Lower income tax increases disposable income and consumption

- Higher spending increases AD directly

Essay Question:

Evaluate whether reducing income tax is an effective way to stimulate economic growth.

Chain of Analysis:

Reducing income tax raises disposable income, boosting consumption and shifting AD right. Rising AD increases GDP, leading to more hiring. However, effectiveness depends on confidence and whether households save the tax cut.

5. Monetary Policy

Notes:

- Bank of England controls interest rates to influence AD

- Higher interest rates reduce borrowing, consumption, and investment

- Lower interest rates stimulate spending

Essay Question:

Analyse how an increase in interest rates could affect investment, inflation, and unemployment.

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Chain of Analysis:

Higher interest rates increase borrowing costs, reducing investment and consumption. AD shifts left, leading to lower inflation. Lower demand reduces production and increasing unemployment.

6. Exchange Rates & Balance of Payments

Notes:

- Depreciation makes exports cheaper and imports more expensive

- Net exports affect AD directly

- Effectiveness depends on price elasticity of exports and imports

Essay Question:

Explain how a depreciation of the pound may affect the UK's current account and growth.

Chain of Analysis:

A weaker pound makes UK exports cheaper, increasing foreign demand. Imports become more expensive, reducing import spending. This improves (X − M) and shifts AD right, boosting GDP. However, higher import prices may create cost-push inflation.

7. Multiplier Effect

Notes:

- Initial injection leads to a larger final increase in GDP

- Depends on marginal propensities to save, tax, and import

- Higher MPC → stronger multiplier

Essay Question:

Discuss how increased government spending can create a multiplier effect.

Chain of Analysis:

Government spending injects demand, raising AD. Firms expand output and hire more workers. Rising incomes boost consumption, causing a secondary rise in AD. This cycle continues, creating a multiplier effect where final GDP increases more than the initial spending.

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