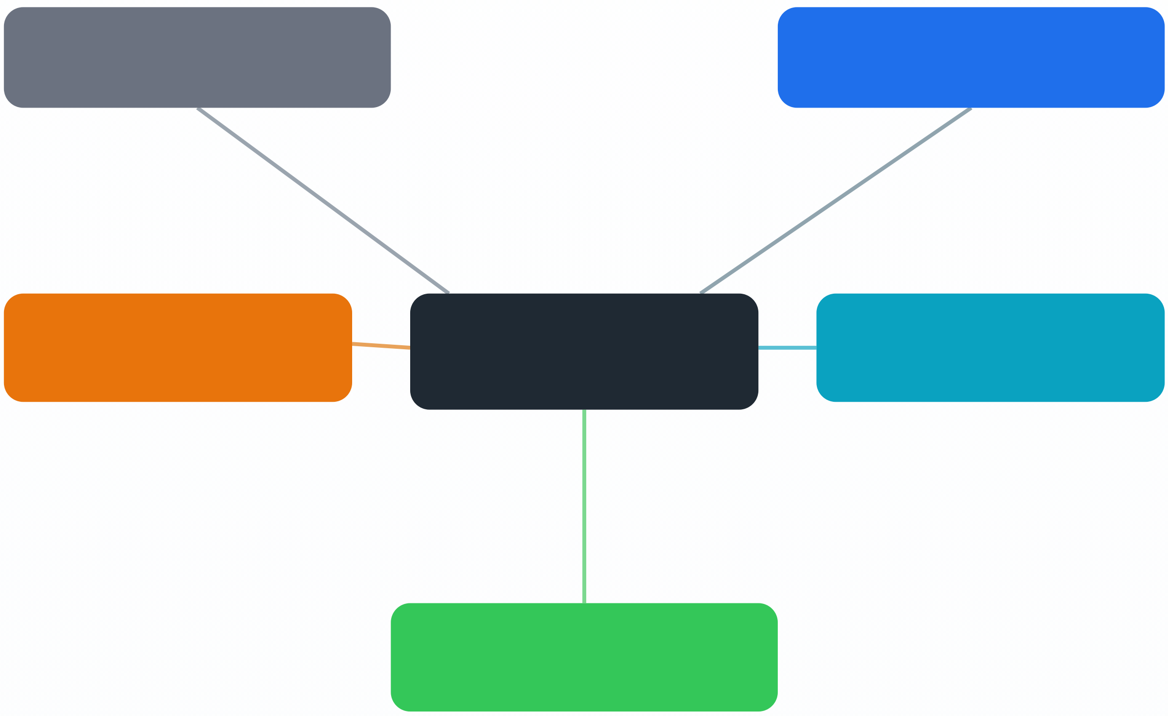
Unit 4 Study Guide — Macroeconomic Theory and Economic Policy

A consolidated, student-facing revision guide for Unit 4. Synthesises the six topics (the business cycle; the aggregate expenditure model and multiplier; the AD/AS model; fiscal policy; monetary policy; labour productivity and long-run growth) into one resource centred on the AD/AS model, with a synthesis diagram, key terms, must-know diagrams, and common exam traps. Designed for end-of-course revision before the Semester 2 examination (Task 8, which covers Units 3 and 4).

Unit 4 is built around a single diagram — the **AD/AS model** — and everything else either feeds into it or is explained by it. Master that one diagram and the relationships around it, and the whole unit falls into place. Use this guide to connect the six topics before the final examination.

Unit 4: macroeconomic theory & policy



The AD/AS model sits at the centre. The business cycle is what it explains; the AE model and multiplier drive aggregate demand; fiscal and monetary policy shift AD deliberately; and long-run growth shifts the LRAS curve to expand capacity.

1. The business cycle

The **business cycle** is the fluctuation of real GDP around its long-term trend, moving through expansion, peak, contraction and trough. You should be able to **explain** its causes and turning points and read the macroeconomic indicators (growth, unemployment, inflation) that signal which phase the economy is in. This is the *problem* that the rest of the unit manages.

2. The aggregate expenditure model & the multiplier

Aggregate expenditure is total planned spending: AE = C + I + G + (X − M). You should be able to **analyse** the consumption function, the **marginal propensity to consume** and to save, equilibrium (including the role of inventories), and the **multiplier** — where an initial injection produces a larger final change in output, with k = 1 ÷ (1 − MPC). This is what determines how far aggregate demand moves.

3. The AD/AS model

The **AD/AS model** plots the price level against real GDP. You should be able to draw and shift the downward-sloping **aggregate demand** curve, the upward-sloping short-run aggregate supply curve, and the vertical **long-run aggregate supply** curve, find equilibrium, and use the model to explain the business cycle. Every policy in this unit is shown as a shift on this diagram.

4. Fiscal policy

Fiscal policy uses the government's budget (G and T) to shift aggregate demand. You should be able to **evaluate** balanced/surplus/deficit outcomes, automatic stabilisers vs discretionary policy, expansionary and contractionary stances on the AD/AS model, and the strengths and weaknesses (lags, debt, crowding out).

5. Monetary policy

Monetary policy uses the RBA's **cash rate** to shift aggregate demand through the **transmission mechanism** (lending rates, the exchange rate, asset prices/wealth, household cash flow). You should be able to **evaluate** conventional and unconventional policy, the conditions for changing stance, and the strengths and weaknesses against fiscal policy.

6. Labour productivity & long-run growth

Long-run growth comes from the supply side. **Labour productivity** — output per unit of labour input — rises with human capital, capital deepening and technological progress, shifting the LRAS curve right and raising potential output. You should be able to **analyse** productivity's drivers, the government policies that support them, and the effect on the AD/AS model and the Aggregate Production Function.

> **The through-line.** The business cycle is the problem → the AE model and multiplier set how far AD moves → fiscal and monetary policy shift AD to smooth the short-run cycle → and productivity growth shifts LRAS to lift the long-run trend. Demand-side policy manages the cycle *around* the trend; supply-side growth raises the trend *itself*.

Must-know diagrams

- The multiplier process (shrinking rounds summing to k × the injection).

- The AD/AS model with a demand shift.
- Expansionary/contractionary fiscal policy on AD/AS (with LRAS and an output gap).
- The monetary transmission mechanism flow.
- A rightward LRAS shift from productivity growth.

Common exam traps. (1) Reading only one variable at the new AD/AS equilibrium — always give *both* the price level and real output. (2) Confusing an SRAS shift (input costs) with an LRAS shift (capacity). (3) Confusing fiscal (government, budget) with monetary (RBA, cash rate) policy. (4) Treating "working more" as a productivity gain — productivity is output *per unit of input*. (5) Forgetting the long, variable lag in monetary policy.