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Level 2 Economics, 2016

91222 Analyse inflation using economic concepts and models

2.00 p.m. Tuesday 15 November 2016
Credits: Four

Achievement	Achievement with Merit	Achievement with Excellence
Analyse inflation using economic concepts and models.	Analyse inflation in depth using economic concepts and models.	Analyse inflation comprehensively using economic concepts and models.

Check that the National Student Number (NSN) on your admission slip is the same as the number at the top of this page.

You should attempt ALL the questions in this booklet.

If you need more room for any answer, use the extra space provided at the back of this booklet.

Check that this booklet has pages 2–11 in the correct order and that none of these pages is blank.

YOU MUST HAND THIS BOOKLET TO THE SUPERVISOR AT THE END OF THE EXAMINATION.

Merit

TOTAL 15

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QUESTION ONE: CAUSES OF INFLATION

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"Weaker oil prices – depending on what's happening with the New Zealand dollar – tends to put downward pressure on inflation," said a Westpac senior economist.

Source: *The New Zealand Herald*, 8 January 2016, p. B14.

From 1 January 2016, the price of cigarettes will increase by 10 per cent, the fourth and final scheduled annual increase. The Government has yet to announce whether it will commit to further annual price increases but has said it wants to make the country smoke-free by 2025.

Source: http://www.radionz.co.nz/news/national/293137/anti-smoking-advocate-calls-for-further-price-hikes, 29 December 2015.

(a) Fully explain the different effects on the general price level measured by the Consumer Price Index (CPI) of weaker oil prices and an increase in the price of cigarettes.
In your answer, explain:

- how weaker oil prices can result in a change in inflation
- why an increase in the price of cigarettes may not cause a change in inflation.

- A weaker oil prices means a decrease price of oils. The cost of transfering raw material and goods will be cheaper, firms and household could spend less money on vehicles and ships. The cost of travel will also reduce as the oil price has decreased. The decrease in oil price, will lead to a decrease in general price level, and therefore will reduce inflation. //

- An increase of 10 percent in the price of cigarettes is just a price change in one single industry. It will affect few other industries' price level and will not have an effect on the general price level of the whole market. //

(b) (i) On Graph One below, show the impact of weaker global oil prices.

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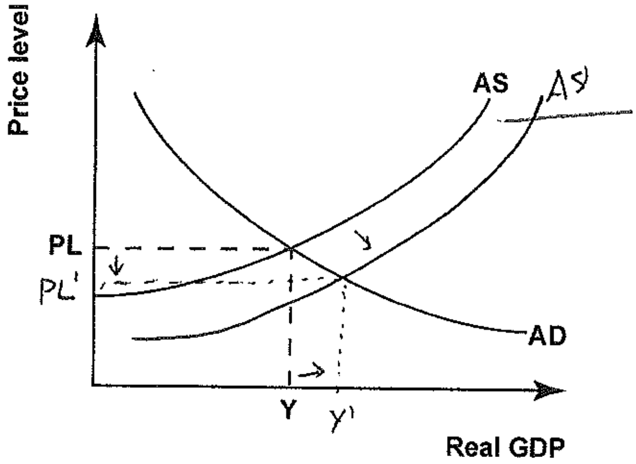
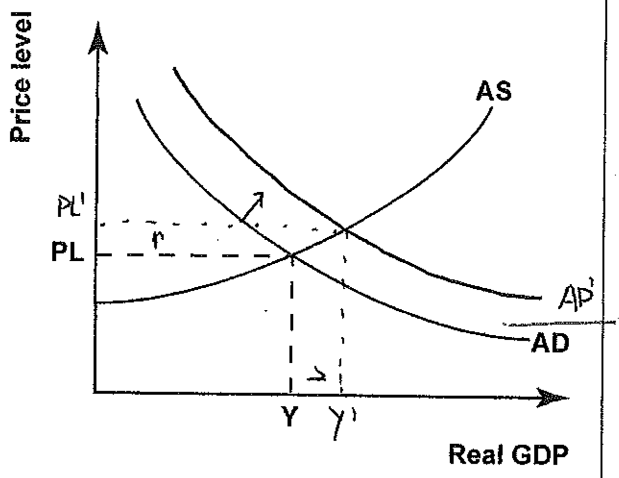
Graph One: AD/AS model of the New Zealand economy



Graph Two: AD/AS model of the New Zealand economy



The ANZ Bank expects the New Zealand dollar to decrease in value by year's end.

Source: *The New Zealand Herald*, 8 January 2016, p. B14.

(ii) On Graph Two above, show the impact of the decrease in the value of the New Zealand dollar.

(c) Use Graph One and Graph Two to compare and contrast the impact on inflation of a decrease in the value of the New Zealand dollar with the impact of weaker global oil prices. In your answer, fully explain:

- how the decrease in the value of the New Zealand dollar would affect inflation
- why the decrease in the value of the New Zealand dollar may have an impact on inflation that is different from the impact of weaker global oil prices.

- As the value of New Zealand dollar has decreased but the dollar value of other ~~contr~~ countries does not change, the import goods will become more expensive as we could only use the same amount of money buy less goods. Therefore the demand of import goods will fall as it is more expensive. Meanwhile the exports goods will become cheaper as it is cheaper than the domestic goods in other country. People are willing to buy cheaper exports goods from New Zealand, therefore the demand of export goods increases, and also the export receipts. As aggregate demand AD= C+I+G+X-M, when import payment (M) decreases and export receipts increases //

More space for this answer is available on the following page.

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It will lead to an increase in aggregate demand. Shown on the Graph ~~one~~ two, AD shifts to AD', indicate an increase. The real GDP shifts from Y to Y', and the general price level shifts from PL to PL'.

- The decrease value of New Zealand dollar has a ~~de~~ different impact from the weaker global oil prices as the decrease in NZ dollar value only ~~happen~~ happenes in New Zealand. It will lead to a different value of imports and exports guods and indicate inflation. But every ~~cou~~ country in the world are experience the weaker global oil prices. It will not make a different between import and export goods because the whole world is experience the same event. There might be minimal difference between country and country but it won't affect as much as the decrease value of New Zealand dollar. //

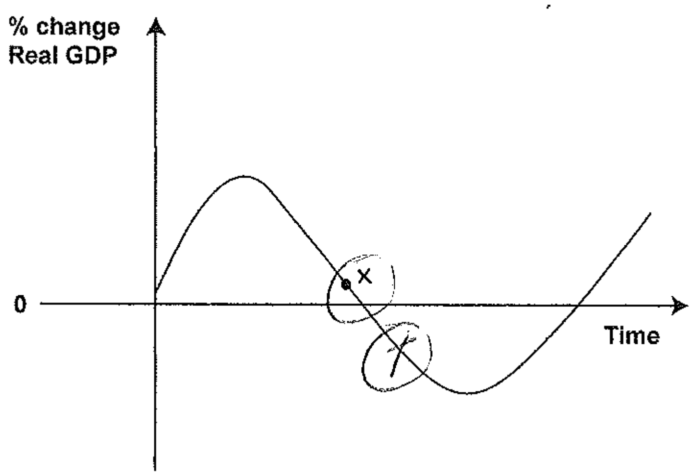
MS

QUESTION TWO: THE BUSINESS CYCLE AND DEFLATION

ASSESSOR'S USE ONLY

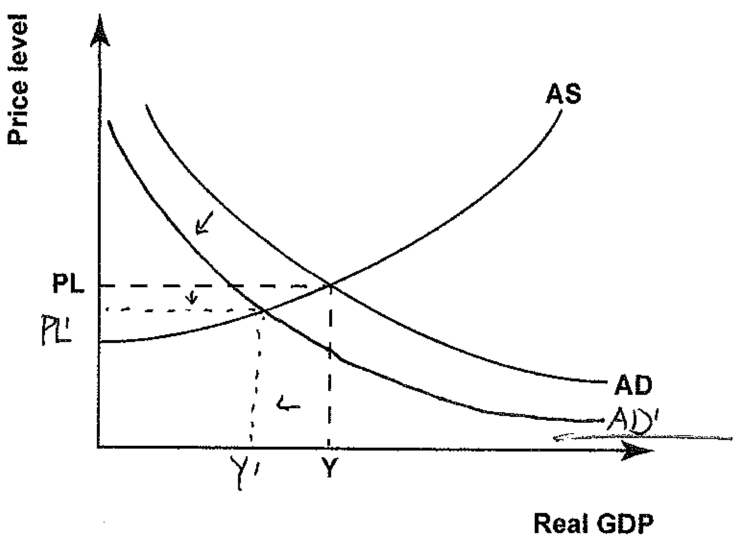
(a) On Graph Three below, clearly label an example of a recession. Label this point **X**.

Graph Three: The Business Cycle



(b) (i) On Graph Four below, show the effect of a recession on either the AD or the AS curve.

Graph Four: AD/AS model of the New Zealand economy



(ii) Use Graph Four to fully explain how a recession may lead to a period of deflation. In your answer, include a definition of deflation.

A deflation is ~~the~~ a decrease in general price level. You may use the same amount of money buy more goods. In a recession, the rate of unemployment is increasing, the economic activity is decreasing. People a likely less willing to spend their money to purchase goods and services. ~~The past firm will sold~~ The

More space for this answer is available on the following page.

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firms will be sell less goods and earn less profit. They might cut off the employees to pay less wage. The income of households will fall, some might even lose job. Firms may wish to bring down the price level to meet the aggregate demand so they could sell goods in a lower price. Therefore deflation has been occur.

A slowdown of growth in China

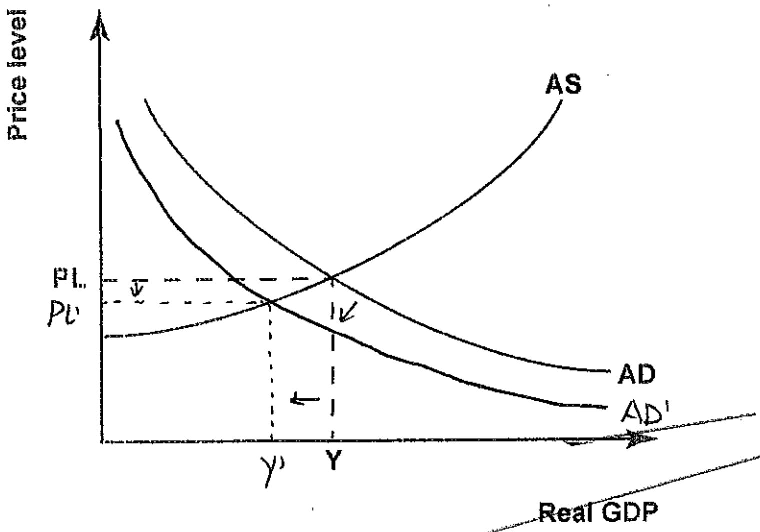
China is important to New Zealand as a trading partner. Australia and China are our main trading partners, and China is Australia's main trading partner. Therefore, any downturn in China will impact directly or indirectly on demand for our exports.

Source (adapted): http://www.rbnz.govt.nz/research_and_publications/speeches/2015/6012526.html

The downturn in China is likely to have a smaller impact on price levels than a recession in New Zealand.

(c) On Graph Five below, show the impact of a downturn in China on either the AD or the AS curve.

Graph Five: AD/AS model of the New Zealand economy



(d) Use Graphs Four and Five to fully explain why a downturn in China is likely to have a smaller impact on price levels than a recession in New Zealand.

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A downturn in China will lead to a decrease in export receipts. Due to the decreasing economic activity ~~the demand~~ China's demand of buying exports goods in NZ will fall, therefore a decrease in export receipts. ~~One~~ As AD=C+I+G+X-M, a decrease in export receipts will lead to a decrease in AD. Shown on Graph Five AD decrease from AD to AD'. Real GDP decrease from Y to Y' and price level decrease from PL to PL' //

A downturn in ~~Chia~~ China will likely have a smaller impact as the downturn in China will only affect the export ~~indstr~~ industries. Other industries produces domestic goods will not be affected as they don't sell goods to China. But a ~~res~~ recession in New Zealand could affect ~~an~~ all of the industries as the total economic activity of the country has decreased. Not only export industries, every firms are suffering from a lower economic activity situation. Therefore a recession in New Zealand is likely have a greater effect than a downturn in China //

M5

QUESTION THREE: THE IMPACTS OF DEFLATION

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The rate of inflation in New Zealand has, in recent years, been at historically low levels and has been falling. This is evidence of a period of disinflation. There is real concern about the possibility of deflation and its potential effects on the economy.

Compare and contrast the different effects of a period of deflation on:

- younger people saving to buy a first home AND older people in retirement who use their savings as a source of interest income
- New Zealand businesses producing for the New Zealand market AND New Zealand businesses producing for export.

- Younger people saving to buy a first home will be better off, as the general price level has been decreasing. Younger people's ~~[illegible]~~ saving have been increasing value and they could save for a ~~shorter~~ shorter period to buy the first home. Also they might wait until the price goes furthur down to purchase the first home. It might not be a good idea to wait for too long, because as soon as the deflation rate has decreased or there is an inflation, their saving will start to lose value again. //
- ~~The~~ Older people in retirement who use their savings as a source of interest income might be worse off. As in a deflation the rate of interest may fall, therefore they may not get ~~any in~~ as much interest income as before. Their income may fall and might bring down their quanlity of living as the may can't affort ~~of~~ as ~~no~~ much goods and services as before //
- New Zealand bussiness producing for the New Zealand market might be worse off. In a deflation the economic activity ~~is~~ might probably be low or decreasing. ~~As~~ Althrough the price of ~~goods an~~ raw material will also decrease, the ~~domesit~~ domestic industries will likely earn less ~~prof~~ revenue ane //

ASSESSOR'S USE ONLY

less profit.//

- New Zealand business producing for export might be better off because the deflation situation only happened in New Zealand not in the other country. As the price ~~lele~~ level is decreasing in New Zealand, the export goods will also be cheaper. People in other country will be willing to buy New Zealand export rather than domestic goods. Due to a greater demand, ~~It~~ the export business will likely earn more revenue and profit//

M5

Merit Exemplar for AS91222 (2016)		Total Score	15
Question	Grade	Comment	
1	M5	This is an M5 as the candidate has demonstrated a link between the depreciation of the New Zealand dollar and aggregate demand through the change in export receipts. An effective use of labels from the AD/AS model is evident, however on balance it is an M5 not an M6, as the candidate has not correctly discussed the price competitiveness of export receipts following a depreciation of the dollar (e.g. export goods will become cheaper).	
2	M5	In Question Two, the candidate has gained credit for his answer in (d), as (b) has not used the components of aggregate demand (consumption and investment) nor labels to explain his answer. In (d), the candidate has effectively used export receipts with a good use of labels (e.g. AD decreases from AD to AD' and price level decreases from PL to PL'). It is not an M6, as the candidate should also indicate that like (b) deflation has also occurred.	
3	M5	This is also an M5, as the candidate has adequately discussed the effect of deflation on one of the four scenarios. Thus, for older people using savings as a source of investment income, the candidate has stated an effect (e.g. they may not get as much interest income), given a reason (e.g. the rate of interest falls), and implied an outcome (e.g. their quality of life will fall, as they cannot afford as much as before). The other scenarios make at most only one point and, therefore, do not contribute to a higher grade.	