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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.

Excellence

TOTAL 22

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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.

Weaker oil prices can result in a change in inflation. This is because oil is used in the production of most goods & services. Cheaper oil prices will lower cost of production ~~[illegible]~~ for various goods & services. This will have a wide effect on the price level as oil is used widely in production. Weaker oil prices will thus lead to a decrease in inflation.
An increase in the price of cigarettes may not cause a change in inflation. This is because cigarettes are only a small product of a small sector in the economy. Inflation is the rise in the general price level, which won't be affected by the increase in cigarette prices. Furthermore, cigarettes aren't widely used in NZ since they are unaffordable for the majority of households. It is therefore, weighted less in the CPI compared to the popularly used oil. Thus, increasing prices of cigarettes won't lead to inflation. //

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

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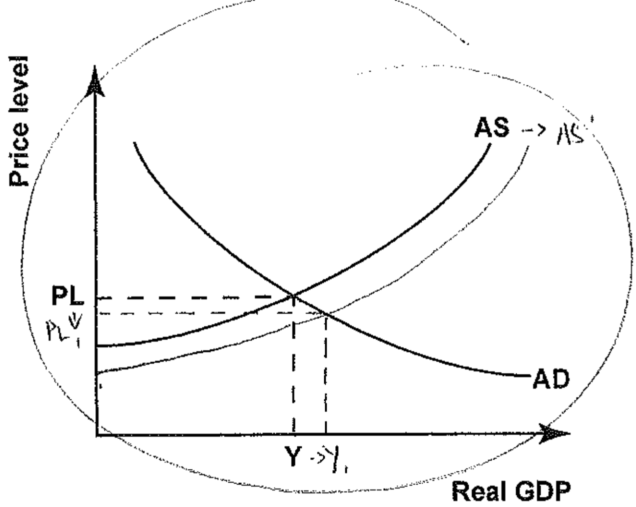
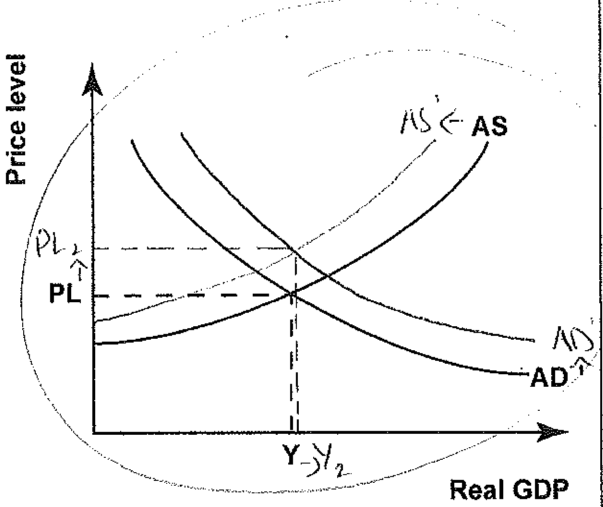
Graph One: AD/AS model of the New Zealand economy



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.

The decrease in value of the NZ$ will mean that buying imported raw materials from overseas will be more expensive. This leads to an increase in cost of production, decreasing aggregate supply from AS to AS'. Because it is more expensive to produce the same amount of goods as before, firms will increase the price of their products to maintain profit. ~~[illegible]~~ Imported products will be less desirable and firms will import less as they are more expensive and have low sales. This decreases import payments, M. Exports from NZ will increase as the depreciation of the NZ$ will make exports overseas from NZ

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

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more affordable, giving it better competetivity in the overseas markets. Export receipts, X, will increase as a result. Net exports, (X-M) is a component of aggregate demand. When there is an increase in X & decrease in M, net exports will increase, causing an increase in AD from AD to AD'. As demand goes up for exports overseas, and for domestic products as a substitute for imports, people will bid up the price of the products so that they'll get them, causing demand pull inflation. Along with cost push inflation caused by the increase in cost of production, the price level will rise from PL to PL_2 //

The weaker oil prices will lead to a shift to the ~~left~~ right of the AS ~~to~~ curve to AS'_1. The price level, PL will fall to PL_1 as a result of the decrease in cost of production. This decreases inflation. The decrease in the NZ$ will cause demand pull & cost push inflation. This is due to the increase in cost of production that shifts AS to AS' & due to the increase in export receipts along with the decrease in import payments that shifts AD to AD'. The price level, therefore, increases from ~~PL_{1K}~~ to PL_2. Furthermore, weaker oil prices only affect one curve while the decrease of the NZ$ affects 2 curves as shown on the graphs. Moreover, weaker oil prices affect cost of production while the decrease of the NZ$ affects cost of production & 2 components of AD, leading to a bigger impact on inflation. Overall, weaker oil prices will have an impact on inflation that is different from the decrease of the NZ$. //

E7

QUESTION TWO: THE BUSINESS CYCLE AND DEFLATION

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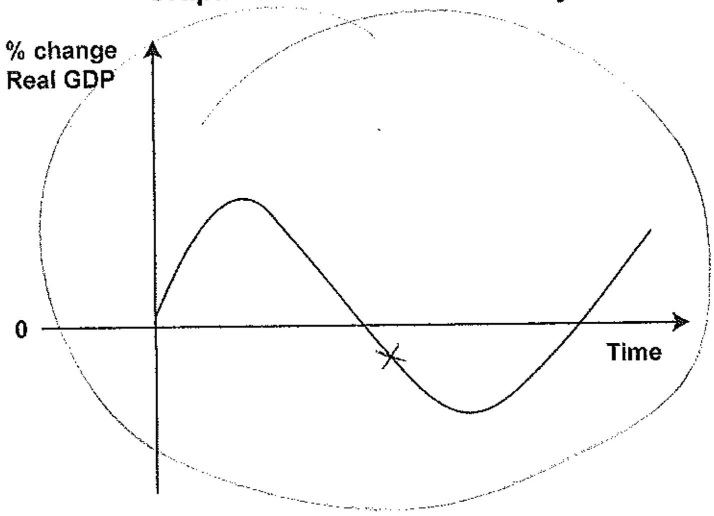
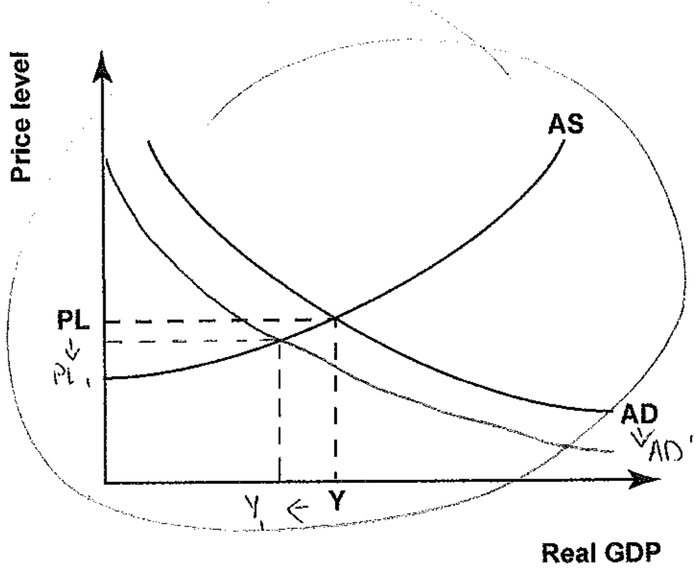
(a) On Graph Three below, clearly label an example of a recession. Label this point **X**.

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.

During a recession, business activity decrease along with employment. Businesses will start to lose confidence and invest less ~~in the~~, decreasing investments, I. As they invest less and produce less, they'll have to lay off workers. This leads to a decrease in household disposable

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

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income. Less disposable income leads to less consumption spending, C. As investments & consumption spending are both components of aggregate demand, AD will decrease to AD' as a result of the recession. As businesses try to encourage consumption spending, they will lower the price of goods & services. This leads to a decrease in the price level from PL to PL_2. Thus, a recession will cause a decrease in inflation.//

A slowdown of growth in China

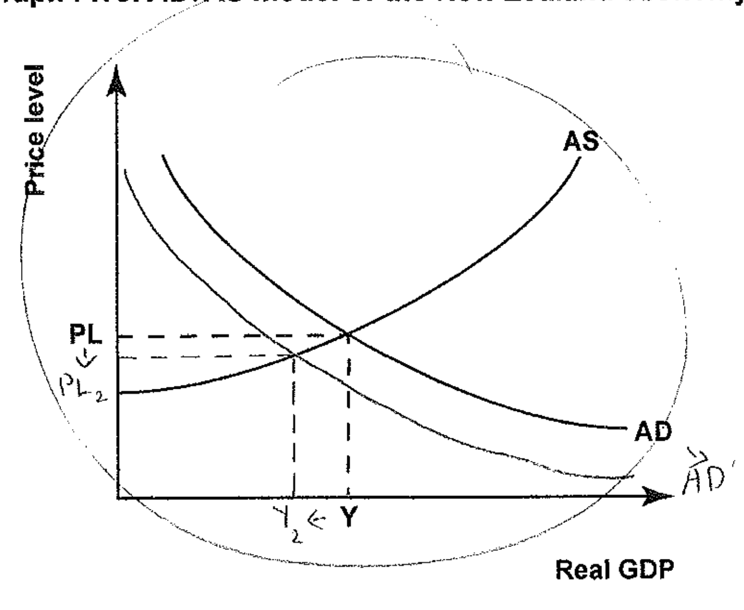
China is important to New Zealand as a trading partner. Australia and China are our main trading partners, and China is Australia's main trading partner. Therefore, any downturn in China will impact directly or indirectly on demand for our exports.

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 means that there is less consumption in its economy. This means that NZ exports will be less desired or unaffordable by Chinese buyers. Export sales ~~to~~ will decrease, leading to a decrease in export receipts, X. Net exports, (X-M), will decrease as X decreases. Net exports is also a component of aggregate demand, a decrease in net exports will lead to a decrease in aggregate demand. Thus, AD shifts to the left to AD'. Exporters will reduce the price so that their exports is more desirable or affordable to maintain profit margins. The price level will decrease from PL to PL_2 //

A downturn in China is likely to have a smaller impact on the price levels than a recession in NZ. This is because a downturn in China only affects export sector, while a recession in NZ will affect the whole economy. Further-more, the downturn in China only affects one component of aggregate demand, while a recession in NZ affects two. This will lead to a smaller decrease in aggregate demand, as shown in graph five, where AD is shifted slightly less than AD in graph four. A smaller de-crease in AD means a smaller decrease in the price level. Thus, a downturn in China is likely to have a smaller impact on price levels than a recession in NZ //

E8

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.

Deflation is the fall in the general price level //

Younger people saving to buy a first home will benefit from deflation. As deflation is the fall in the general price level, the value of money will increase. This makes the purchasing power of money increase, making a house more affordable. Furthermore, the reserve bank would lower interest rates to encourage spending, getting the rate of inflation back up. Mortgages would now be cheaper, making it easier for people to buy houses.

Older people in retirement who use their savings as a source of interest income will be worse off. Even though their savings are worth more then before, they cannot spend it because they want it as a source of interest income. However, the reserve bank would lower interest rates, meaning that their savings will be producing less income from interest //

New Zealand businesses producing for the New Zealand market will not lose or benefit from deflation. As they are producing for the domestic economy, their ~~sales~~ profits wouldn't change if there is deflation. People do buy more as they can afford more but the monetary value of goods & services have decreased, ~~leading to~~ balancing out the increase in sales. Firm's profits would remain the same //

New Zealand businesses producing for exports are better off during deflation. Because the price level ~~a~~ is falling, the price of their exports will become cheaper. Cheaper exports have better price competetivity, are more desirable and more affordable in the overseas markets. This leads to export sales going up, increasing businesses' profit margins. //

Their cost of production has decreased, because raw material brought domestically or workers' wages are cheaper //

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E7

Excellence Exemplar for AS91222 (2016)		Total Score	22
Question	**Grade**	**Comment**	
1	E7	This is an E7 because the candidate demonstrates a clear understanding of Economic concepts using correct Economic terminology. The discussion on the use of oil in the production of most goods and services is linked to a general price rise, while the development of the price competitiveness of exports receipts effectively uses the AD/AS model. It is not an E8, as the comparison does not discuss the number of firms affected from both scenarios.	
2	E8	This is a full and comprehensive explanation of two scenarios using correct Economic terms and an effective use of the AD/AS model. The effects on the components of Aggregate Demand (Consumption and Investment for (b) and Net Exports (d)) are explained with the required depth. The scenarios are compared and contrasted in a short but clear manner with links to the relative movements of the aggregate demand curves evident.	
3	E7	This is an E7, as the candidate has effectively discussed the effects of deflation on first home buyers and those who use savings as a source of interest income. For these arguments, the candidate has stated a clear point (e.g. houses are more affordable for younger people), given a reason (e.g. lower interest rates will make mortgages cheaper), and extrapolated with a another point or implication (e.g. the purchasing power of money has increased). It is not an E8 because the discussion on the effects of deflation on business does not adequately discuss the effect on costs and prices for each type of business.	