NZQA

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MANA TOHU MĀTAURANGA O AOTEAROA

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Level 3 Economics, 2016

91403 Demonstrate understanding of macro-economic influences on the New Zealand economy

2.00 p.m. Friday 25 November 2016
Credits: Six

Achievement	Achievement with Merit	Achievement with Excellence
Demonstrate understanding of macro-economic influences on the New Zealand economy.	Demonstrate in-depth understanding of macro-economic influences on the New Zealand economy.	Demonstrate comprehensive understanding of macro-economic influences on the New Zealand economy.

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 2–8 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 **21**

ASSESSOR'S USE ONLY

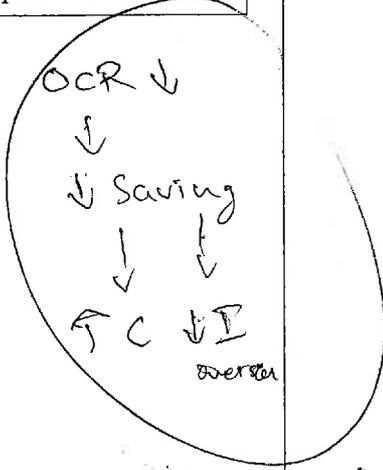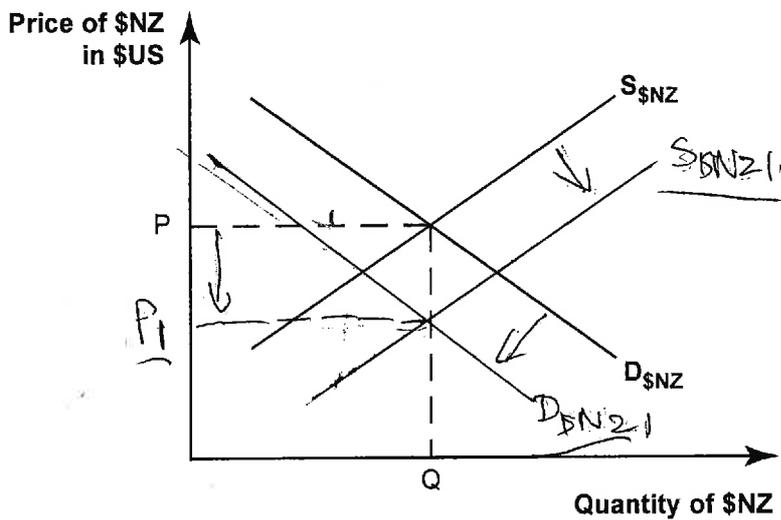## QUESTION ONE: Impact of monetary policy on growth and inflation

> On 10 September 2015, the Reserve Bank reduced the Official Cash Rate (OCR) by 25 basis points to 2.75 per cent.
>
> Inflation remains below the price stability target of 1 to 3 per cent due to the previous strength in the New Zealand dollar.
>
> A reduction in the OCR is warranted by the softening in the economy and the need to keep future average CPI inflation near the 2 per cent target midpoint.
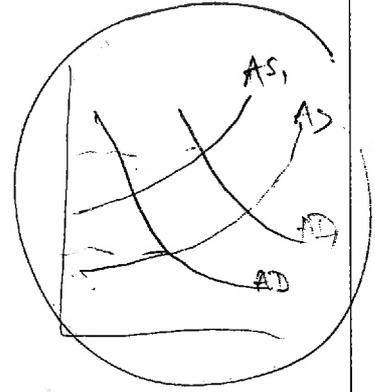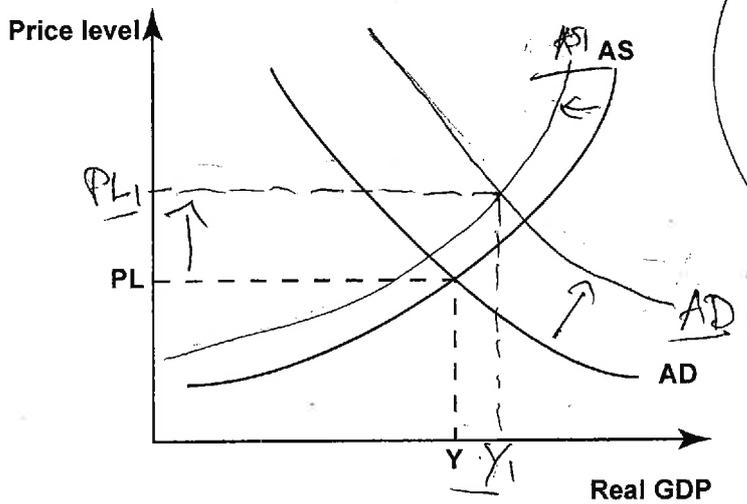>
> Source (adapted): http://www.rbnz.govt.nz/monetary-policy/monetary-policy-statement/mps2015-09

Graph One: The Market for the New Zealand dollar

OCR ↓
↓
↓ Saving
↓   ↑
↓   ↑
↑ C ↓ I
overseas

(i)

(a) On Graph One above, shift both curves to illustrate how a reduction in the OCR could affect the value of the New Zealand dollar. Clearly label any changes you make.

Graph Two: The New Zealand economy

(2)

(b) On Graph Two above, shift both curves to illustrate how a reduction in the OCR could affect the New Zealand economy. Clearly label any changes you make.

$$AD = C + I + G + (X \cdot M)$$

(c) Referring to the resource material on page 2 and to Graphs One and Two, compare and contrast the impact that a reduction in the OCR would have on the Government's goals of economic growth and price stability.

In your answer, fully explain:

- the impact of a reduction in the OCR on the value of the New Zealand dollar
- the impact of a reduction in the OCR on aggregate demand and aggregate supply
- the effectiveness of a reduction in the OCR in achieving the goals of economic growth AND price stability.

The reduction in OCR to 2.75 per cent cause the value New Zealand dollar to depreciate. This is because there will be less oversea investment in New Zealand bank as the fall in interest rate would give them less return thus it's not profitable to invest in NZ bank. So the demand for New Zealand dollar will decrease from $D_{\$}NZ$ to $D_{\$}NZ_1$ because to save money in NZ bank, the oversea investor need to exchange their currency to get hold of NZD.

The fall in OCR decrease NZ's interest rate differential (foreign) so these investors that's currently (exchange NZD for other currency) holding onto NZD will give up NZD, as they will find somewhere else to invest in the world that would give them greater return therefore the supply for NZD will increase from $S_{\$}NZ_2$ to $\$.S_{\$}NZ_4$. Overall the decrease in demand and increase in supply of NZD will cause NZD to depreciate from P to A.

Reduction in OCR will increase in aggregate demand because there will be less saving as the fall in interest rate create less return from saving and borrowing increase as lower interest rate means lower cost of borrowing. This cause consumption spending and investment spending to increase become saving become less profitable and borrowing

(3)

E7

* to extra page

for consumption spending

QUESTION TWO: Impact on the Current Account of an increase in the Terms of Trade and a depreciation of the New Zealand dollar
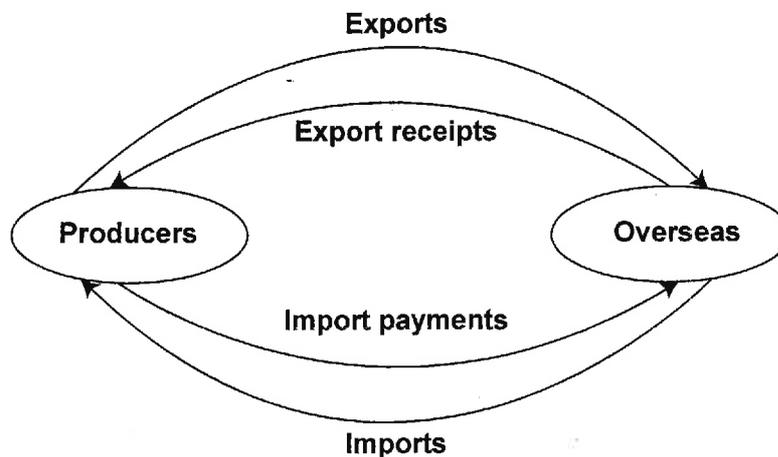
New Zealand's Terms of Trade index increased from 1 319 to 1 353 between January 2015 and July 2015. In New Zealand, the Terms of Trade (ToT) is the ratio of the price of exportable goods to the price of importable goods.

Source (adapted): http://www.tradingeconomics.com/new-zealand/terms-of-trade

During the same time period, the value of the New Zealand dollar depreciated as New Zealand's Trade Weighted Index (TWI) decreased from 75.44 (30 January 2015) to 70.14 (31 July 2015).

Source: Reserve Bank of New Zealand.

Model One: Simple circular model showing New Zealand producers and the overseas sector

(a) Referring to Model One, fully explain how an increase in the Terms of Trade could improve New Zealand's Current Account balance.

Increasing in ToT means that the price of export receipt (from oversea to producers) is rising faster than the price of import payments. This means that less exports from producers to overseas have to be given up for the import thus cause New Zealand to have a trade surplus as the export receipt received from oversea will be greater than the import payment we have to pay to oversea. So the current account improve due to increase in net export (X−M)

volumn Vs price

(b) Referring to Model One, fully explain how a depreciation of the New Zealand dollar could improve New Zealand's Current Account balance.

The depreciation of NZD could also increase net export (X - M) thus current account balance improve. This is because depreciation in NZD makes NZE's goods and services become more price competetive as it become cheaper for oversea buyer therfore they would want to purchase more so the exports from producers to oversea increase, this will results in increase in export receipt. The import payment from producer to overseas decrease as NZ's producer find oversea's goods and services become less affordable due to our weak currency, this results in NZ's producer to import less from oversea //

(2)

(3)

(c) Explain which of these two events is more likely to have a greater impact on New Zealand's Current Account balance.

Depreciation in NZD will have greater impact on NZ's current account balance this is because increase in ToT only means that the price of export receipt increase faster than import payment but the volumn of the export and import remains the same. In constrast, depreciation in NZD can cause export volumn to rise combine with the falls in import volumn. Overall It create greater effect of increasing the net export as the X will rise in direct proportion of the rise in export volumn and the M will fall in direct proportion of the fall imported volumn //

(4)

QUESTION THREE: Impact of fiscal policy on growth and employment

Government spending on the recovery of Christchurch includes spending on key building projects in the CBD, fixing of roads and sewers, the repairs of schools and hospitals, and insurance pay-outs. The Christchurch City Council has estimated that this spending will generate additional spending by consumers and businesses.

Source (adapted): http://www.stuff.co.nz/the-press/business/the-rebuild/70084887/How-much-is-the-Government-really-spending-to-fix-Christchurch

The contribution of the Canterbury region (which includes Christchurch) to national GDP rose 0.9 percentage points to 13.1 per cent between March 2009 and March 2014.

Source (adapted): http://www.stats.govt.nz/browse_for_stats/economic_indicators/NationalAccounts/RegionalGDP_HOTPYeMar14.aspx
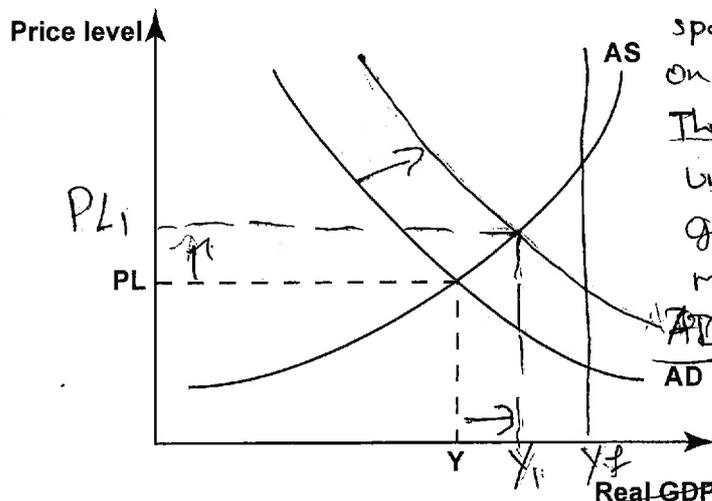
(a) Using the multiplier, fully explain the increase in real GDP that would occur if there were an additional $40 billion of spending and the marginal propensity to consume (mpc) in Christchurch is 0.70.

$$\frac{1}{1-MPC} = \frac{1}{1-0.70} = 3.33 //$$

$$3.33 \times \$40b = \$133.3 \text{ billion} //$$

The initial government spending of $40b will become another person's income as the government will spend on goods and service like construction company, hospital and etc. and the $40b will be pass down to the household in term of wages. And the household will spend 70% of the 40 billion and 30% of it save because MPC is 0.70. The $28b will become another person income as the household will spend their income on goods and services. These cycle continue until $133.3b generate as the multiplier is 3.33

Graph Three: The New Zealand economy

(Graph showing Price level on vertical axis, Real GDP on horizontal axis, with AS curve, AD and AD₁ curves, PL and PL₁ price levels, and Y, Y₁, Yf points marked)

(1)

(2)

(3)

(b) Use Graph Three on page 6 to illustrate how the government spending on the Christchurch earthquake recovery would affect the New Zealand economy. Clearly label any changes you make.

(c) Referring to Graph Three, the multiplier, and the resource material, compare the effectiveness of government spending on the Christchurch earthquake recovery on the goals of economic growth and full employment for the New Zealand economy.

The increase in government spending on fixing road, sewer, schools and etc will create more also creating the multipliers affect as It canalso cause the consumption and spending to increase. Consumption spending increase because the $40b government spending created more job opportunity in the economy therefore the employment rate increase and the demand for labour will also derive from the demand of goods and services. because the aggregate demand increase due to the increase in G_A and C component of the AD equation. So the AD curve shift outward from AD to AD_1. This will cause the real GDP to increase from X to Y_1 so increase in economic growth to 13.1%. And the employment rate increase as the recessionary gap decrease from $(X-Y_f)$ too $(Y_1$ to $Y_f)$ pushing the employment rate closer to full employment. //

investment investing

(4)

(5)

The increase in government spending is more effective on the goals of economic growth than full employment, this is because increase in government spending can also help to increase in consumption spending and have the multiplier effect of 3.33 that generate $133.36. Where even though full employment increase but It may still far from the actual economy's full employment as the job may limited to little occupation so It doesn't means that everyone can get a job If you don't have the profession in building or reconstructing. //

(6)

E7

1 c become more affordable. The The investor will invest more because Investing will become more profitable due to lower cost of borrowing. The net export will increase as X will increase because NZ's goods & service become more price competetive, making it more $ affordable for oversea buyers. M will fall as oversea's goods & services become less affordable for NZ's buyers. The increase in (X-M), C, and I cause AD ~~cu~~ curve to shift outward from AD to AD, (because they are part of the AD equation).

Aggregate supply will fall as the AS curve shift inward from AS to AS, because the fall in M means that imported raw material become less affordable so firm's cost of production increase. //

Reduction in OCR is very effective in achieving economic growth as the real GDP increase because of fall in AS and rise in AD cause real GDP to increase from Y to Y, (assume that fall in AS in smaller than rise in AD because decrease in OCR affect 3 component of AD equation so the shift in AS curve is smaller than shift in AD curve). It also help to bring the inflation rate back into the 1-3% targeted range as the price level increase from P to P. so the goal of price stability and economic growth can be achieve with reduction in OCR. But the increase in real GDP is smaller than the increase in price level as the decrease in AS hindrace the growth that cause by increase in AD. Where the price level will rise no matter how big the effect of ~~de~~ increase in AS compare to increase in AD. //

(4)

(5)

(6)

(7)

Excellence exemplar 2016

Subject:	Economics		Standard:	91403	Total score:	21

Q	Grade score	Annotation
1	E7	This candidate has received E7 for this question because they: a) Shifted and labelled the S$NZ and D$NZ curves correctly on Graph One. **(1)** b) Shifted and labelled the AS and AD curves correctly on Graph Two. **(2)** c) Provided detailed explanations for the impact of a reduction in the OCR on the value of the NZ dollar **(3)**, the Aggregate Demand curve **(4)** and the Aggregate Supply Curve **(5)**. Provided a detailed explanation of the effectiveness of the reduction in the OCR in achieving the goal of economic growth **(6)**. A more comprehensive answer would have explained the combined impact of the AD and AS shifts on the Price Level and linked this to inflation and the price stability goal more clearly. **(7)**
2	E7	This candidate has received E7 for this question because they: a) Explained in detail how an increase in the Terms of Trade due to export prices rising faster than import prices will improve NZ's Current Account. **(1)** b) Explained in detail how a depreciation of the NZ dollar will make NZ's exports more competitive and lead to an increase in Export Receipts and improve NZ's Current Account. **(2)** Explained in detail how a depreciation of the NZ dollar will make imports into NZ more expensive and lead to a decrease in Import Payments and improve NZ's Current Account. **(3)** c) Explained why a depreciation of the NZ dollar will have a bigger impact on NZ's Current Account Balance than an increase in the Terms of Trade **(4)**. Further explanation contrasting the differing impact of improving Terms of Trade, which relates to the relative prices of exports and imports and may not change export receipts and import payments as significantly, compared to a depreciation of the NZ dollar where increasing export payments and decreasing import payments are likely to have a bigger impact on NZ's Current Account, would lead to a more comprehensive answer.
3	E7	This candidate has received E7 for this question because they: a) Used the multiplier to correctly calculate the increase in real GDP. **(1)** Used the multiplier and the idea of re-spending to explain in detail how the initial $40 billion of spending would increase real GDP. **(2)** b) Shifted and labelled the AD curve correctly on Graph Three. **(3)**

| | | c) Explained that employment would increase as more workers are required due to the increased demand for goods and services **(4)**. Explained the impact of government spending on the Christchurch earthquake recovery on the goal of economic growth using the AD increase and its components of government spending, consumer spending and investment **(5)**.
Explained the impact of government spending on the Christchurch earthquake recovery on the goal of full employment by referring to the decreasing recessionary gap and explaining that full employment would still not be reached due to most jobs created being in specific rebuild-related industries. **(6)**
A more comprehensive explanation would have used the multiplier to explain in detail how the government spending would lead to increased incomes and then the re-spending of a proportion of this would lead to the large increase in real GDP, and thus economic growth. |