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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.

Merit

TOTAL 15

ASSESSOR'S USE ONLY

QUESTION ONE: Impact of monetary policy on growth and inflation

ASSESSOR USE ONLY

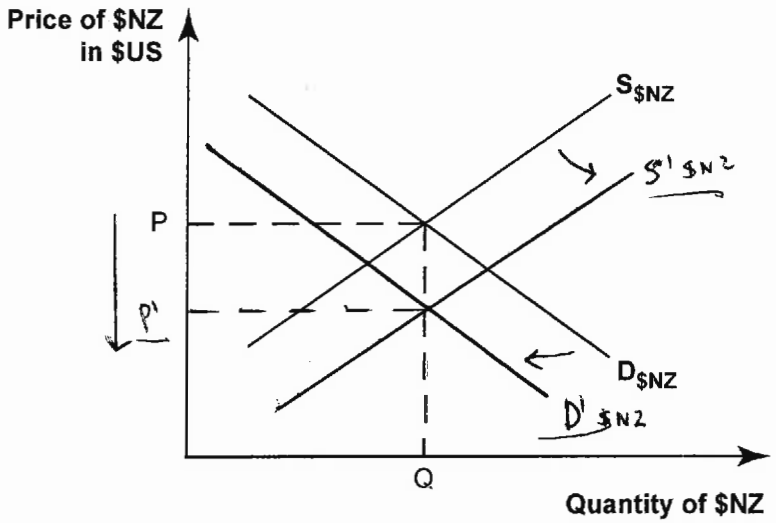
On 10 September 2015, the Reserve Bank reduced the Official Cash Rate (OCR) by 25 basis points to 2.75 per cent.

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

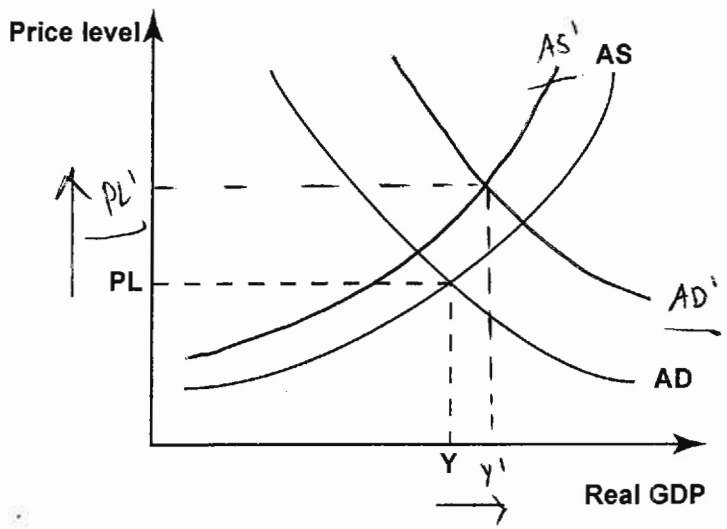
Graph One: The Market for the New Zealand dollar



(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.

(1)

Graph Two: The New Zealand economy



(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.

(2)

(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.

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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 on the OCR means that the interest rates will fall in NZ banks. As a result foreigners will not want to invest in NZ banks as the returns on funds will now be less than in overseas banks. Therefore the demand for the NZ dollar now falls from $D_{\$NZ}$ to $D'_{\$NZ}$. NZers will now be wanting to invest in overseas funds as the returns are now relatively higher than NZ banks so the supply of NZ dollars now increase from $S_{\$NZ}$ to $S'_{\$NZ}$. As NZers will now supply more NZ dollars in exchange for foreigne dolars in order to invest in overseas banks. As a result the price of $NZ in $US falls from P to P1, so there has been a depreciation of the NZ dollar. //

(3)

Due to the reduction of the OCR, the NZ dollar has depreciated. This now means that export earnings are now converted into more ~~NZ dollars~~ so exporters may experience an increase in revenue & profits. So they may be further increase production causing the aggregate demand curve to increase from AD to AD'. As exports receipts will further increase. Also households who work in the export sector may also have pay rises so they will have increased disposable income to spend so consumer spendings may also increase causing AD to increase to AD'. //

(4)

M6

QUESTION TWO: Impact on the Current Account of an increase in the Terms of Trade and a depreciation of the New Zealand dollar

ASSESSOR'S USE ONLY

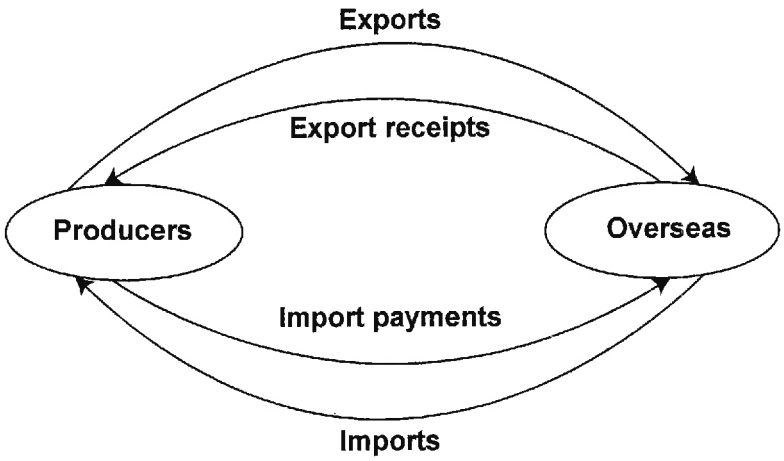
New Zealand's Terms of Trade index increased from 1 319 to 1 353 between January 2015 and July 2015. In New Zealand, the Terms of Trade (ToT) is the ratio of the price of exportable goods to the price of importable goods.

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.

The current account is calculated by the inflows - outflows. An increase in the terms of trade means that the same amount of exports can fund for more imports, as a result producers will increase exports to the oversease Seeter. With an increase in exports, exports receipts will also increase from the oversees sector to the producers sector the balance on goods & services will improve as ~~ex~~ inflows of export receipts will increase while outflows of import payments will decrease. Resulting in an ~~decrease~~ improvement on the balance. So the NZ's current account balance will improve. //

(1)

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

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A depreciation of the NZ dollar means expat earnings will be converted to more NZ dollars. So expat receipts will increase from the overseas sector to the NZ producer sector. Import payments will increase as more NZ dollar is needed to fund for the same amount of imports. So import payments will increase from the producer sector to overseas current account balance = inflows − outflows. NZ exports more goods than imports so the increase in expat receipts will be larger than increase in import payments, as a result the balance on goods and services will more closer to zero. So the current account will be improved. // (2) (3)

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

The depreciation of the New Zealand dollar will have a greater impact on the current account balance for New Zealand than the increase in Terms of Trade. This is because the Terms of trade is the ratio of the price of exportable goods to the price of importable good. The price of these exportable and importable goods will also depend on the NZ dollar. As a depreciation in NZ dollar ~~[illegible]~~ will cause import prices to rise which will worsen the terms of Trade. While an appreciation of NZ dollar will cause import prices to fall which will improve the terms of trade. So change in NZ exchange rate will have a greater impact as it can also affect ToT which can also further affect the current account. // (4)

A24

QUESTION THREE: Impact of fiscal policy on growth and employment

ASSESSOR'S USE ONLY

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.

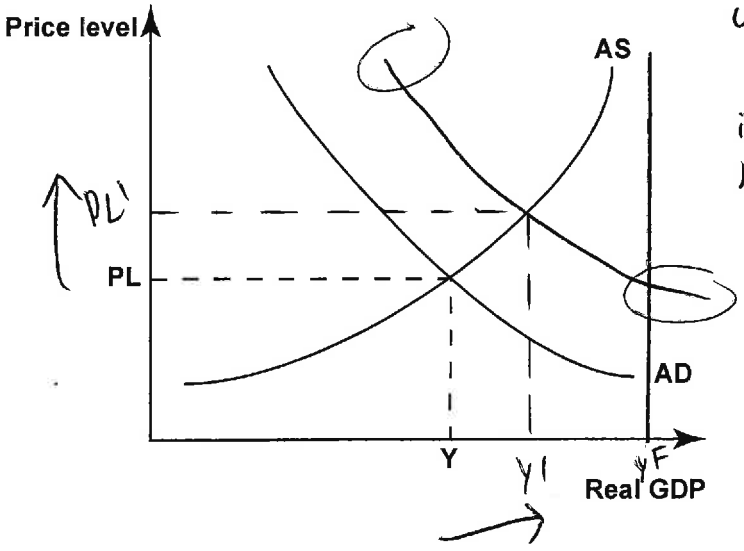
Source (adapted): http://www.stats.govt.nz/browse_for_stats/economic_indicators/NationalAccounts/RegionalGDP_HOTPYeMar14.aspx

(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.

spending multiplier = $\frac{1}{1-MPC} = \frac{1}{1-0.7} = 3.33 = 3$ // (1)

If there is an additional $40 billion of spending, then increase in real GDP is 3 times the orginal amount (3x40 = $120b). As the $40 billion becomes income for producers + households of which 70% is spent and 30% is saved. So 70% of $40b which is $28 billion is then re-spent which becomes the income of other households, Of which 70% is spent and 30% is saved. This occurs until the multiplied effects add up to $120 billion increase in real GDP. // (2)

Graph Three: The New Zealand economy



(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.

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(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.

Increased government spending will encourage production and help to increase income for households & producers. With more produced and increased income, it means there will be more spendings and investments. $AD = C + I + G + (X - M)$. government spending is a component of AD and so is consumer spending and investments. So increase in government spending, consumer spending and investments will cause Aggregate demand to increase from AD to AD'. Also as seen on the previous page, the additional spending of $60 billion will result in a total of $120 billion increase in real GDP as the multiplied effects are 3 times the original amount. So real GDP will increase also. The government's goal of economic growth is achieved as real GDP increases from Y to Y' which means more goods and services are produced in the NZ economy and this is increased economic growth. The government also further increases employment as moves the economy closer to full employment. As with more G+S produced, more labour is required so employed workers increases from Yey' And the number of unemployed falls from $(Y - Y^F)$ to $(Y' - Y^F)$. //

(4)

(5)

M5

Extra space if required.
Write the question number(s) if applicable.

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QUESTION NUMBER

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1c) However the depreciation of the NZ dollar means more NZ dollars is needed to pay for import payments. So it is now more relatively expensive to pay for imports. So imports may decrease so import payments may decrease in the long run if the NZ dollar gets weaker as its too expensive to purchase goods. Imported goods are also raw materials for firms such as al. So if it is more expensive to purchase, costs of production will increase and so AS will decrease to AS'. As a result price level increases from PL to PL' and real GDP increases from Y to Y'. The gaiernment's goal of price stability is to maintain the inflation range between 1-3%. ~~[illegible]~~ on average over a medium term keeping it as close to 2% as possible. So if PL' is greater than 3%. then gaiernment goal of price stability has not been met. However economic growth increases as real GDP increases from Y to Y', means more goods & services are produced in NZ economy so gaiernment goal of economic growth has been achieved. //

(5)

(6)

Merit exemplar 2016

Subject:	Economics	Standard:	91403	Total score:	15

Q	Grade score	Annotation
1	M6	This candidate has received M6 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)** 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)**. While partial explanations regarding the effectiveness of the reduction in the OCR in achieving the goals of economic growth and price stability are provided **(6)**, more comprehensive explanations would have contrasted the opposing impact on economic growth of the AD and AS shifts and/or 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.
2	A4	This candidate has received A4 for this question because they: a) Provided a partial explanation on how an increase in the Terms of Trade will improve NZ's Current Account. **(1)** A more detailed answer would have explained how an increase in export prices relative to import prices (or vice versa) had improved NZ Terms of Trade and how this will improve NZ's Current Account. 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)** Provided a partial explanation of how the NZ dollar depreciating will impact NZ's Import Payments. **(3)** A more complete answer would have explained that the Import Payments would increase if the quantity of imports remained unchanged, despite the decreased price competitiveness. c) Failed to provide an explanation of which event (increase in Terms of Trade or Depreciation of the NZ dollar) will have the bigger impact on the Current Account. **(4)**
3	M5	This candidate has received M5 for this question because they: a) Used the multiplier to correctly calculate the increase in real GDP although rounded it down unnecessarily. **(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 (the rounding is allowed as a follow through error) **(2)** b) Shifted and partially labelled the AD curve correctly on Graph Three. **(3)** c) 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**(4)** Provided a partial explanation of the impact of government spending on the Christchurch earthquake recovery on the goal of full employment. **(5)** A more complete explanation would have explained in detail how the government spending would lead to increased spending and that firms need to employ more workers due to the need to increase output to meet the increased demand for goods and services.