



National Certificate of Educational Achievement
TAUMATA MĀTAURANGA Ā-MOTU KUA TAEA

Exemplar for Internal Assessment Resource

Economics Level 2

Resource title: Government policies that could lift the economy out of recession, without jeopardising the policy objective of price stability

This exemplar supports assessment against:

Achievement Standard 91227

Analyse how government policies and contemporary economic issues interact

Expected responses

The moderators have developed expected student responses from a wide variety of sources

Date version published by
Ministry of Education

December 2011
To support internal assessment from 2012

	Grade Boundary: Low Excellence
1.	<p>The student has comprehensively analysed how government policy and contemporary economic issues interact, which is required for Excellence.</p> <p>The student has comprehensively explained the objectives of government policies relating to price stability, to help achieve sustainable economic growth and full employment.</p> <p>The student has fully explained how the Reserve Bank operates monetary policy to achieve price stability and explained the direct impacts of inflation on households and producers and flow-on effects of monetary policy on growth and trade, integrating the changes shown on the AS/AD and FOREX market models into the explanations. Although, when explaining the significant cuts to the OCR to help lift the economy out of recession, the term 'loose' or 'expansionary' monetary policy was not mentioned. Refer to part A.</p> <p>The analysis included supply side economic policies which were explained in detail and justified using economic concepts, and changes shown on the circular flow, FOREX market and AS/AD models were integrated into the explanations. But the student did not explain government 'fiscal' policies; how supply side economic policies are part of the tools used in fiscal decision-making to help achieve their objectives. Refer to part B.</p> <p>A more secure Excellence would be attained if the above points were addressed, and the fiscal policies to minimise negative flow-on effects to trade were better explained. For example; <i>The government can use supply side fiscal policy to minimise the negative flow-on effects that a tight or contractionary monetary policy has on trade. A reduction in company (T) enables companies (including exporting firms) to distribute more after tax income to shareholders in the form of dividends, increasing (Y) or encourages investment (I) of retained profit. The government could also consider more targeted supply side policies; using protection policies like import tariffs or subsidies to protect domestic exporters from overseas competition and to protect jobs and allow infant industries to develop and improve the balance of trade. Although, this is unlikely as NZ promotes free trade, so a reduction in exporting firm's taxes (T) or increased (G) in research & development to help exporting firms are more likely government policies.</i></p>

The government's key objective in maintaining price stability is to keep inflation between the target bands of 1-3% on average over the medium term. Price stability goals are outlined in the Policy Target Agreement (PTA) between the Minister of Finance and the Governor of the Reserve Bank (RB). The PTA, coupled with the Reserve Bank Act 1989 makes price stability the key goal of the RB. The RBNZ utilises monetary policy tools such as the OCR to maintain inflation between 1-3%, however, this is not the sole economic policy that can be implemented to maintain price stability.

The government can implement supply side policy; policies that encourage increases in producer productivity or innovation with the aim of increasing aggregate supply (AS). Supply side policy can be introduced in the form of cutting regulations i.e. Alterations to the RMA, investment or infrastructure, increase in research and development or company tax cuts. All these methods of supply side policy aid to maintain price stability of inflation between 1-3%.

Price stability is a desirable objective as it enables the economy to grow steadily and sustainably, as prices are not wildly fluctuating. The absence of price stability would have a negative impact on households. Inflation would lower the real value of their wages as things cost more and money is worth less, leaving households with a lower real disposable income. As prices of goods increase households cannot afford the necessities, lowering their standard of living. Added to this, inflation would cause the decrease in value of household savings. As commodities rise in price due to inflation the savings are worth less as their purchasing power decreases. The negative trend prompted by inflation would flow through to companies. Inflation would raise the costs of production for firms as the price of raw materials increase. To maintain a

A

similar profit margin prices of goods and services would increase, which would result in a decrease in aggregate demand (AD). Inflation cause firms to redirect their funds towards speculative investment as opposed to capital equipment, as items such as artwork hold their value. This would result in a decrease in the productive capacity of firms and effectively the economy as efficiency is lowered and output and economic growth is therefore stunted.

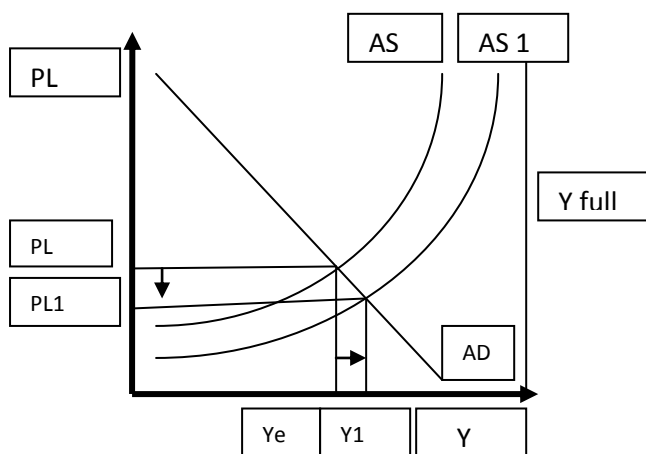
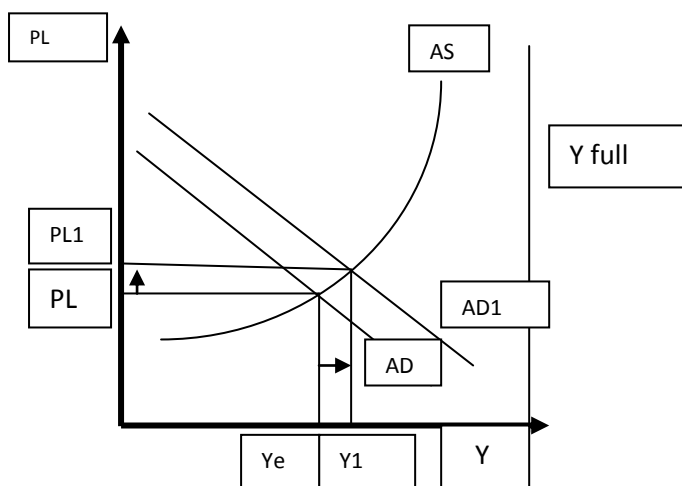
Price stability is an imperative objective for the government because it helps to promote its policies of sustainable and continuous economic growth. This incorporates firms as capital investment raises productivity and output, lifting real GDP and

prompting growth in the economy. Its goal of full employment and maintenance of real incomes considers consumers in ensuring their purchasing power remains relatively constant and will not decrease due to the presence of price stability, and full employment as productivity from capital investment opens new job vacancies. Thus, the government can advocate these policies confidently under the condition of price

stability which makes them realisable. The OCR as it stands at 2.5% is ensuring that price stability is maintained. The risk of deflation that was brought on by the recession was combatted by the RBNZ; significant cuts were made to the OCR in an attempt to increase national demand. The cuts in the OCR leave consumers with a higher disposable income as these cuts reduced interest rates, lowering their mortgage and loan repayments.

Households can spend this extra money, increasing consumer expenditure and AD as illustrated in the graph where the AD curve shifts to the right from

AD to AD1, increasing (Y) but there is also an increase in prices (PL). Alternatively, OCR cuts to 2.5% have reduced business loan repayments. Thus they have higher profits that can be allocated towards investment in capital goods. Added capital goods will raise the productive capacity of firms, effectively cutting their



costs of production as they become more efficient. This efficiency will allow them to produce higher output with the same level of input, resulting in an increase in AS as demonstrated in the graph above where the AS curve shifts to the right from AS to AS1, increasing output from Y_e to Y_1 , with a decrease in price level from PL to PL1. The cuts in the OCR have lowered NZ's interest rates. As a result, foreign investors in NZ receive lower returns on their investment and withdraw their funds to seek a higher return elsewhere. This withdrawal of funds will lower the demand for the NZD that will cause a depreciation in the exchange rate (student included a Forex market model, showing NZD curve shifted left). This will benefit the economy as NZ exports, which constitute around 30% of NZ's revenue, will become more competitive in the overseas market as they receive higher returns on sales due to a lower NZD. This allows them to either increase their efficiency or produce more or lower prices in the market. Thus, as it stands, the OCR of 2.5% is benefiting the NZ economy. However, depreciation will mean import sales will decrease, as they become more expensive costs of production will increase, due to rising prices of imported resources used in production. These costs will get passed onto consumers as firms attempt to maintain profit margins. The balance of trade at present is in deficit. But as shown by recent statistics the deficit is changing to positive figures. The OCR of 2.5% will aid this climb as it results in a depreciation of the NZD and increase NZ exports price competitiveness. The inflow from export sales exceeds the outflow of import payments, increasing the balance of trade.

The implementation of supply side economic policy will result in a more productive economy through ways of increasing AS, and help get the economy out of recession without causing an increase in price level. Take investment and infrastructure as examples, government spending in infrastructure industries will result in producers investing in capital goods to increase productivity in order to meet the demand by the government. Increased investment in capital goods raises productive capacity, making firms more efficient. This in turn lowers costs of production as firms generate a higher output with the same inputs, allowing them to lower their prices, and resulting in the increase of AS, as demonstrated by the graph above. This maintains price stability as goods and services become cheaper where demand and supply meet at equilibrium. This increase in productivity and supply will create job opportunities, aiding the government objective of full employment. With more households employed, more consumers will have a disposable income. Spending of this income will raise consumer expenditure, installing national demand in the economy that can be reciprocated by firms due to increased productivity. Thus, as part of the multiplier effect stimulated by the supply side policies, the government will receive higher revenue in the form of company tax as firm's profits rise and income tax as more households are employed. With supply side policy promoting efficiency in the economy goods become cheaper, more households will be employed and price stability can occur as AD and AS meet at equilibrium, where government objectives are realised. The impacts of supply side policies can be best demonstrated on a circular flow model of the economy (student included a full circular flow model, with arrows showing increases for sectors impacted by supply side policy- I, C, G, T, factor Y).

Tight monetary policy is implemented with the aim of reducing AD and inflationary pressures; via a rise in the OCR by the RB. This results in an appreciation of the NZD as higher interest rates entice investors to invest in NZ (student included a Forex market model). This is detrimental to exporters as they receive lower returns for their goods. The increased OCR will reduce AD as households mortgage repayments increase leaving them with less disposable income, and consumption decreases. This would have a negative effect during a recession as the aim is to stimulate AD and raise Real GDP and create economic growth. To minimise the negative flow-on effects of tight monetary policy on economic growth and trade, the government can introduce company and income tax cuts. Cutting company tax means exporters will keep more profits, and help combat the decline in export sales due to a stronger NZD. This will allow exporters to lower their prices in the markets and attract more sales that way or invest in capital goods that will make them more efficient. This will help to minimise the negative effect of tight monetary policy on trade. Cutting income tax means consumers have more disposable income, and compensate for increased mortgage repayments from a higher OCR. This income can be used to purchase goods and services, raising consumer expenditure and creating demand in the market, raising real GDP and creating economic growth during the recession, increasing AD as shown on the graph (student included an AS/AD model).

B

	Grade Boundary: High Merit
2.	<p>The student has analysed in depth how government policy and contemporary economic issues interact, which is required for Merit.</p> <p>The student has explained in detail the objectives of government policies relating to price stability, to achieve sustainable economic growth and full employment.</p> <p>The student has fully explained how the Reserve Bank operates monetary policy to achieve price stability and the direct impacts of inflation on households and producers and flow-on effects of monetary policy on growth and trade. Refer to part C.</p> <p>The AS/AD and FOREX market models were used to support the explanations. Refer to part D.</p> <p>The analysis included explanations of how supply side economic policies can help achieve price stability using the AS/AD model, and the flow-on effects to growth and trade were fully explained. Refer to part E.</p> <p>The combination of government policies were supported with economic concepts, and the AS/AD model was referred to in support of the growth policies, but justification would include integrating changes shown on an economic model into the explanations of the suggested policies to minimise the negative flow-on effects to trade, which is required for Excellence. Refer to part F.</p>

The main objective of government policy in relation to price stability is to keep the inflation rate between 1-3% on average over the medium term. This is stated in the Policy Target Agreement (PTA). The Reserve Bank's (RB) main tool of achieving price stability is using monetary policy, using tools such as the Official Cash Rate (OCR) to control inflationary pressures and keep prices stable and in between the target. This however is not the only way to control or influence prices.

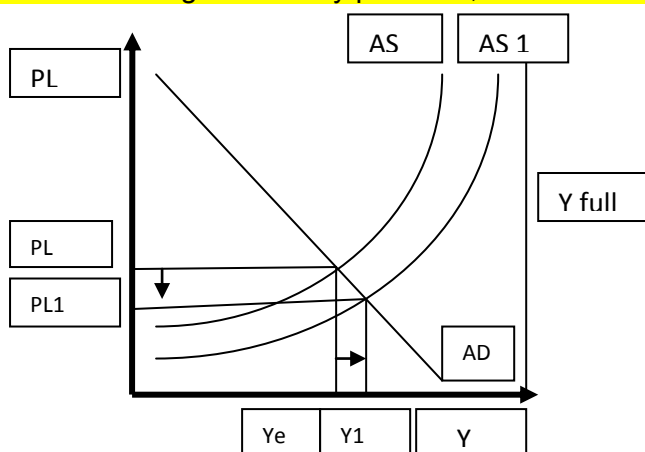
An alternative policy the government can use to maintain price stability is supply side economic policy. The objective of this is to achieve growth and stable prices by increasing aggregate supply (AS), which increases efficiency and productivity. The ways in which this can be implemented are cutting regulations, cutting company tax, investing in research and development, and investing in infrastructure. These all increase AS which keeps inflation down and therefore between the 1-3% target.

Price stability is desirable because if there is inflation the impact on households is that the value of their savings decrease. This is because as prices and wages rise the amount of savings doesn't increase to match inflation. This means their purchasing power has decreased. Another negative effect on households is as prices increase the wages may be delayed to increase to match the inflation or are inadequately increased, causing consumer expenditure to decrease therefore consumer demand and standard of living may decrease as families can't afford as many goods and necessities.

Price inflation on producers has a negative effect because costs of production will increase meaning there is less profit and/or prices have to be increased. Another negative effect is planning becomes difficult as inflation and unstable prices means that the economic environment is unpredictable. This means businesses are reluctant to make decisions such as investment. Price stability is an objective because of the effects which come from when inflation goes outside the 1-3% limits. If inflation exceeds 3% prices become too high. The competitiveness in NZ is reduced which causes exports, NZ highest source of income to decrease. Savings are more focused on real estate investment which doesn't attribute to government taxes and are diverted from investment in productive capacity. On the other hand, when inflation is under 1% consumers are discouraged to spend as they wait for prices to fall further, decreasing consumer spending. Maintaining price stability promotes sustainable economic growth and full employment.

C

The current OCR is set at 2.5% which is comparatively low after years of a rate as high as 8%, because of the recession. When there is little inflationary pressure the RB may choose to put the OCR rate down to stimulate the economy, this means banks will put interest rates down which makes it less expensive to borrow. Consumers and firms borrow more money and spend more (C & I increases) which increases AD, therefore increasing inflationary pressure, but it also results in an increase in economic growth (student included an AS/AD model, AD curve shifts right).



Another effect of a decrease in the OCR is that overseas investors will be less attracted to the lower interest rate, which causes demand for the NZD to decrease (student included a Forex market model, showing NZD curve shifted to the left). This causes depreciation in the exchange rate which increases export incomes as NZ goods cost less to sell for the same amount of input. This causes an increase in demand for exports (X) and more expensive imports, thus increasing inflationary pressure.

D

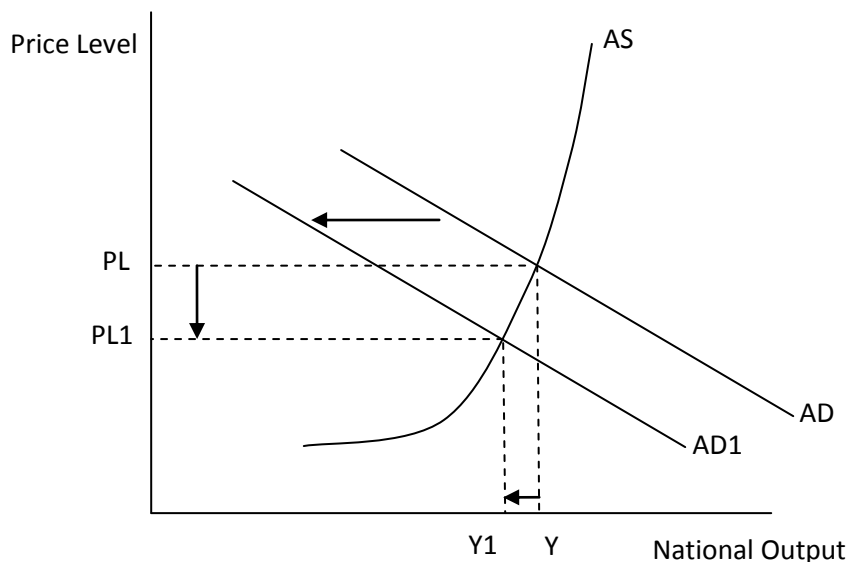
The impact of using supply side policy on the different sectors is that the efficiency and productivity is increased. This is achieved by using methods to increase AS to AS1 as shown on the graph. One method is cutting company tax, when this is implemented the producer sector is directly affected because they will be receiving more revenue in profits which they may put towards investment in capital goods or expansion. These actions will increase productivity because newer machinery can produce more products with the same amount of resources. As productivity is increased and producers can sell their goods cheaper they

E

become more competitive as exporters. This affects the overseas sector as demand for exports are increased therefore demanding more production. With a cut in the OCR, the flow-on effects spread through the overseas sector. As banks interest rates decrease, overseas investors looking to invest in NZ are deterred as they would get a smaller return. This decreases demand for the NZD which causes the exchange rate to depreciate (*student included a Forex market model, showing NZD curve shifted left*). The effect of a depreciation of the NZD on exports is that they will be benefited. This is because they will become more competitive overseas as they can decrease the prices but are not affected. They can also gain more in NZD as the value of the product is increased when converting from overseas dollars. This encourages exporting, but the effect on imports is negative. This is because importers need to pay more in NZD when purchasing goods and will have to increase the sale price in NZ. This decreases demand for imports, which discourages importing. These effects on exports and imports will increase the balance of trade. This is because as exports are increased and imports are decreased, the overall difference will be a surplus in net exports. If the OCR is increased however, effects will be reversed (that is a decline in the balance of trade as exports decrease and imports increase).

A tight or contractionary monetary policy is used to close an inflationary gap in an economy i.e. reducing inflation. The OCR is increased; demand for NZD is increased as overseas investors put money in NZ to get a high return. This has a negative effect on trade as exports fall due to an appreciation, exports become less competitive overseas because of our higher price, and therefore bringing in less NZD (*student included a Forex market model, showing NZD curve shifted right*). This decreases the balance of trade so is a

negative flow-on effect of a tight monetary policy. When interest rates are increased, AD is decreased because interest on loans such as mortgages are increased, which means households have less disposable income as they have to repay more. This decreases consumer demand. Firms have to pay more on loans to purchase capital goods, meaning firms are not becoming more productive (I decreases). These two coupled would decrease AD, as seen on the graph as AD has shifted left to



AD1, which causes a decrease in price level, but national output has also decreased and therefore there is a slowdown or a decrease in growth.

I recommend that the government uses supply side fiscal policy and expansionary fiscal policy, because supply side fiscal policy helps to shift AS to the right through increasing government spending in infrastructure and development to increase productivity, which increases national output as we are producing more goods with the same amount of resources. This increases output or Real GDP without the price level increase that demand side policy results in. It also means that producers need more workers as production increases and this helps increase consumer expenditure anyway, but more importantly lowers the unemployment rate. However expansionary policy like tax cuts also stimulates consumer expenditure and investment helps to shift the AD curve to the right and creates economic growth. Ideally a mixture of both that shifts both curves right is best as it will create economic growth without a huge increase in price level and maintain price stability. A policy that can be used to minimise the negative flow-on effects of the fall in competitiveness of the exporters in NZ is to cut trade barriers, such as import tariffs and implementing more trading schemes such as free trade agreements and better foreign policy. This would encourage trade with NZ and help boost competitiveness. The balance of trade will have a more positive figure, and will lower the deficit in the current account as export receipts become higher than import payments.

	Grade Boundary: Low Merit
3.	<p>The student has analysed in depth how government policy and contemporary economic issues interact, which is required for Merit.</p> <p>The student has explained in detail the objectives of government policies relating to price stability, to achieve economic growth and full employment in the analysis. Refer to part G.</p> <p>The student has explained in detail how the Reserve Bank operates monetary policy to achieve price stability and the direct impacts of inflation to households and producers and flow-on effects of monetary policy on growth and trade. Refer to part H.</p> <p>The AS/AD and FOREX market models were used to support the explanations. Refer to part I.</p> <p>The analysis included explanations of how monetary and fiscal policies can help achieve price stability, with positive and negative flow-on effects to growth explained, using the AS/AD and circular flow models to support the explanations. Refer to part J.</p> <p>A more secure Merit would be attained if the flow-on effects of fiscal policies on trade had been fully explained; using an economic model and the impact of monetary policy on the balance of trade had been fully explained.</p>

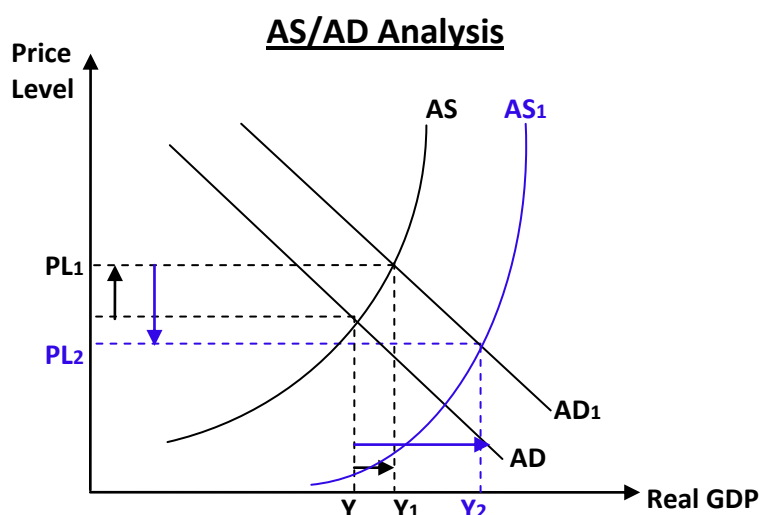
	Grade Boundary: High Achieved
4.	<p>The student has analysed how government policy and contemporary economic issues interact, which is required for Achieved.</p> <p>The student has explained in detail the objectives of government policies relating to price stability, and full employment was initially mentioned but then not explained in the analysis. Refer to part K.</p> <p>The student has explained how the Reserve Bank operates monetary policy to achieve price stability and the direct impacts of inflation to households and producers and flow-on effects of monetary policy on growth and trade. The AS/AD model was used to support the explanations. Refer to part L.</p> <p>The analysis included explanations of how fiscal policies can achieve price stability and the AS/AD model was used, but the flow-on effects of expansionary or contractionary fiscal policies on growth and trade were not fully explained in the analysis, which is required for Merit. Refer to part M.</p> <p>Additionally, the explanation of flow-on effects of tight monetary policy on trade requires more depth and the FOREX market model used to support the explanations for Merit. Refer to part N.</p>

The RBNZ serves as the nation's central bank. It is designed to oversee the banking system. It also indirectly controls the quantity of money and the interest rate in the economy. The main objective of the RBNZ is to ensure price stability. Under the current Policy Target Agreement (PTA 2002) the RBNZ is supposed to keep the inflation rate within a band of 1-3% in the medium term without causing excessive fluctuations in the rest of the economy.

Key functions of the RBNZ include implementing the monetary policy objectives set out by the PTA; issuing notes and coins, providing banking services to registered banks and the government; conducting prudential supervision to maintain a healthy financial system. The official cash rate (OCR) is a simple and a primary tool for implementing monetary policy in NZ. The OCR is the interest rate set by the RBNZ which determines the interest rate banks earn on their deposit with the RBNZ (settlement cash balance) as well as the interest that banks pay to borrow overnight cash from RBNZ. The RBNZ lets the trading Banks borrow 0.25% above the OCR, and trading banks can receive interest on their surplus reserves with the RBNZ at a margin of 0.25% lower than the OCR. In addition, RBNZ sets no limit on the amount of overnight cash demanded or supplied, at the rate of 0.25% above or below the OCR.

An alternative economic policy (apart from monetary policy) that the government could use to maintain price stability is fiscal policy. Fiscal policy is a government policy regarding its revenue (mainly taxation) and spending to influence economic activity. A change in taxation and government spending influences the level of aggregate demand or aggregate supply in order to meet the government's economic objectives, such as increasing economic growth or employment.

K



A key reason for an emphasis on stable prices is to keep export prices competitive. Rising prices and costs in NZ make exports more expensive compared with competing products. If NZ prices raise more slowly than in other countries, NZ products become more competitive overseas and NZ industries become more competitive with imports. Savers suffer from inflation because the value of their savings fall, and the economy suffers as savings are diverted away from investment in productive capacity (factories, etc) and towards speculation in real estate (borrowers benefit as the value of their debt falls). Inflation reduces the

international competitiveness of the economy. When inflation occurs firms will produce more than they can sell and will have to reduce prices back to PL_e.

The government has price stability as an objective because it enables businesses to plan for the future, and encourages people to save rather than borrow, encourages firms to invest in new production instead of speculative investment, and avoids wage/price spirals.

L

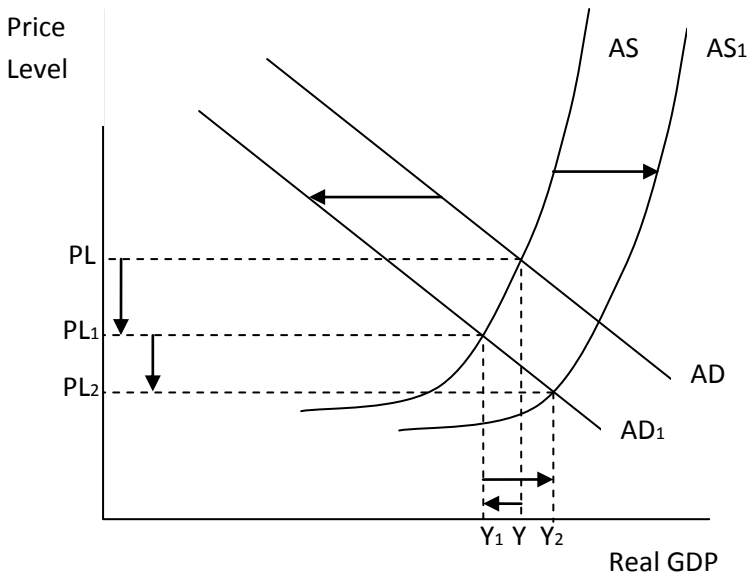
Loose or expansionary policy is where interest rates are being reduced, thereby increasing AD and expanding the economy. This may occur when RBNZ believes there is little danger of inflation. Aggregate demand shifts to the right as consumers would most likely borrow money from the banks because of reduced interest rates, and consumer expenditure increases. Firms will also most likely borrow money to fuel their own resources or to invest. Both the AD and AS curves shift to the right, and the price level decreases from PL₁ to PL₂ and output or Real GDP increases from Y to Y₂ showing significant economic growth.

The depreciation of the NZD is caused by a decrease in foreign investors as the interest rates are low. The fall in demand for NZD causes depreciation in the value of NZD. NZ importers are worse off as they now have to pay more NZD to import goods, because of the depreciation of the NZD in the foreign exchange

market. However, the depreciation has a positive effect for NZ exports, the exporters are better off as they will receive more NZD for the same overseas prices.

Through fiscal policy the government injects money into the economy by increasing government spending or reducing taxation. This in turn increases the consumer expenditure and shifts the AD curve to the right, increasing economic activity; this is called expansionary fiscal policy (*student included an AS/AD model*). Contractionary fiscal policy is a policy to reduce government spending and/or increase taxes to reduce economic activity. This affects the consumers as they will have less disposable income to spend, therefore decreasing AD, shifting the curve to the left (*student included an AS/AD model*).

M



Tight or contractionary monetary policy is where interest rates are being increased with the aim of reducing AD and inflationary pressures. AD would shift to the left as there will be a fall in consumer expenditure, a fall in investments and a fall in exports due to the increase in the OCR. Exporters would have to increase overseas prices (losing demand) or accept a lower income.

N

AS would shift to the right as there will be a fall in the cost of imported materials because of the increase in the OCR, reducing producer's costs of production. Importers are also able to buy more imports for fewer NZD; imports should therefore become cheaper for consumers. The price level decreases in both shifts of the curves, and with the increase in AS the national output or Real GDP increases.

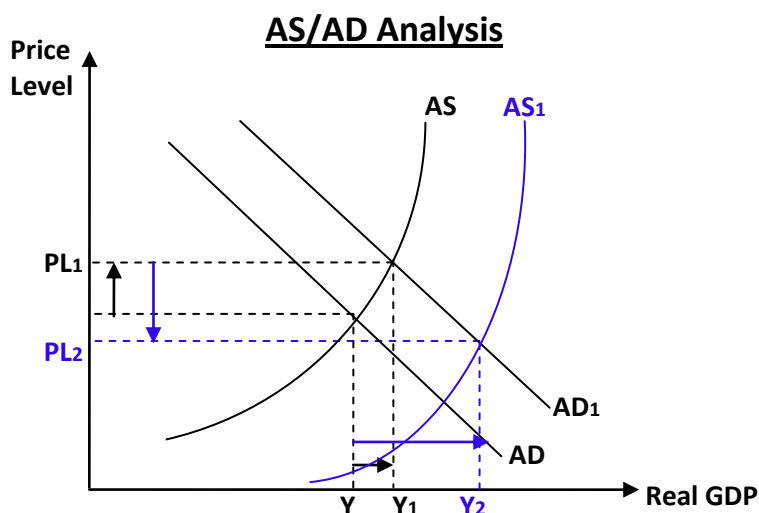
	Grade Boundary: Low Achieved
5.	<p>The student has analysed how government policy and contemporary economic issues interact, which is required for Achieved.</p> <p>The student has explained the objectives of government policies relating to price stability.</p> <p>The student has explained how the Reserve Bank operates monetary policy to achieve price stability and the direct impacts of inflation to households and producers and flow-on effects of monetary policy on growth and trade. Refer to part O.</p> <p>The AS/AD model was used to support the above explanations. Refer to part P.</p> <p>However, the student has not identified government fiscal policies as another important part of achieving price stability, or the flow-on effects to growth and trade of these fiscal policies, illustrating these on an economic model.</p> <p>A more secure Achieved would address the above point and include the FOREX market model to support the explanation of the flow-on effect of monetary policy on trade. Refer to part Q.</p>

The objective of the government policy in relation to price stability is to allow the people of the country to have a consistent disposable income to buy goods and services, save their money for future spending and for the economy to have steady growth. The government's main policy to achieve this goal is monetary policy, which is used to control interest rates, the money supply and the availability of credit. The Reserve Bank (RB) is the main controller of monetary policy and is by extension the stabiliser of prices. One way the RB tries to keep prices stable is via the Reserve Bank Act 1989, under this act there is the Policy Target Agreement (PTA) which states that the inflation target is set and must be kept between 1-3% on average over the medium term, this will allow the economy to grow and for the country to succeed. The PTA agreement is made between the Governor of the RB, Dr Allan Bollard and the current Minister of Finance, Bill English. If the government is successful in keeping prices stable then they can try to get sustainable economic development, full employment, higher real wages and equitable distribution of incomes. Price stability is a very desirable objective because it means the economy can grow and this will give consumers and producers confidence to invest and save, and it will mean more national income. If prices are rising it will cause inflation which is a general rise in price level, this has a negative effect on the economy and most especially on consumers and producers.

For consumers inflation is negative for many reasons but two important reasons are that with the price level rising the costs of goods and services go up, but their incomes may not. This means consumers may not be able to buy essentials like groceries or pay household bills. They will also be able to buy fewer products as the value of money they are receiving will now be of less value causing consumer expenditure to decrease dramatically. Another major negative for consumers is that if inflation occurs then producers may cut the number of workers they employ as they do not have as much need for them. Unemployment rates may increase, which means that more consumers will not be able to buy essential products and the demand for goods and services will fall even more.

Inflation causes major negative effects for producers as well, because sales levels depend on the market demand for goods and services. If consumer demand has dropped due to higher prices then the producers are forced to cut their output of their products. If the output is cut then they lose their income and profit from the goods and services that were not produced. Another negative is producers will not be able to invest in capital goods and employ workers which helps the business to grow and helps the economy to grow. Business confidence is lowered due to unstable prices and uncertainty about the future prices will effect planning.

The main tool the RB uses is the OCR, the interest rate that the RB lends to registered banks. The current OCR is 2.5%, due to the recession. With a cut in the OCR NZ's economy is less attractive to foreign investors and so the NZD depreciates and exporter's income increases due to increased demand for their products from overseas consumers. This may cause more inflationary pressure but it is a pressure that



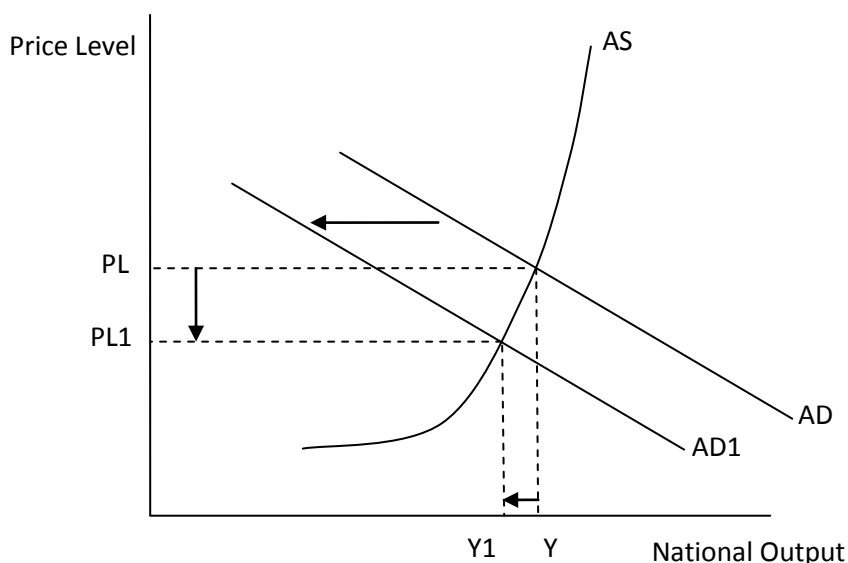
would be good for the economy in the long run as long as the RB keeps inflation between 1-3% on average over the medium term.

AS is affected as well with changes in the OCR, if the OCR is cut the AS will increase as producers will be able to invest in capital goods which will increase their productive capacity, cut costs of production and make them more efficient, and produce more so increasing AS to AS1. Additionally, the cut in OCR will mean registered banks lower their interest rates, so household's mortgage repayments will be lower and they may borrow more money, so consumption will

increase and the AD curve will shift to the right from AD to AD1. Price level will initially increase with an increase in AD, but the increase in AS counteracts this and lowers price level to about the same or less

than before, easing inflationary pressure. The positive change is that with both shifts of the curve output or Real GDP increases and this shows economic growth.

Tight monetary policy includes raising the OCR so short-term interest rates go up, increasing the cost of borrowing and decreasing spending from consumers and producers. The flow-on effect is that prices will decrease from PL to PL1, so there is less inflationary pressure. However, this is not good for economic growth because national output or Real GDP falls from Y to Y1. Demand has fallen due to increased interest rates, which makes it more expensive to borrow money and consumers have less disposable income to spend. Producers cannot borrow as much money to invest in capital goods, so this decreases growth as they will not become more efficient in creating the goods and services they specialise in.



For trade it will be bad for exporters but good for importers, this is because the interest rates have gone up so it will cost less for importers, they will be able to buy more imports for NZD. It is bad for exporters because they receive less money from overseas because the NZD has appreciated as foreign investors are attracted to the higher interest rates.

Q

	Grade Boundary: High Not Achieved
6.	<p>The student has not adequately analysed how government policy and contemporary economic issues interact, which is required for Achieved.</p> <p>The student has explained the objectives of both monetary and fiscal government policies relating to price stability. Refer to part R.</p> <p>The student has explained how the Reserve Bank operates tight monetary policy to achieve price stability and the direct impacts of inflation to households and producers and flow-on effects of monetary policy on growth and trade, but not loose or expansionary policy, which is currently being used. Neither the AS/AD nor FOREX market models were included in the analysis to support the explanations. Refer to part S.</p> <p>Additionally, the student has not explained the flow-on effects of fiscal policies on growth and trade using an economic model.</p> <p>The analysis is limited due to a lack of economic model(s) used to support the explanations, so overall the student has not met the requirements of Achieved.</p>

NZ's central bank's (RBNZ) key functions are implementing monetary policy and supervising the banking sector and issuing currency. The PTA sets out the monetary policy framework giving autonomy to the RBNZ to achieve price stability. It followed the Reserve Bank Act 1989, which makes goals for monetary policy, with an agreed target range of 1-3% inflation on average over the medium term.

The key reason why there is need for price stability is to keep our export prices competitive, so if the prices rise the cost in NZ exports become more expensive compared with other competing goods. In addition if NZ prices rise more slowly than other countries our products become more competitive overseas and NZ industries become more competitive with imports. Low inflation enables NZ businesses to plan for the future and encourages people to save instead of borrow, encourages firms to invest in new production instead of speculation investment and it avoids wage/price spirals.

R

Fiscal policy can be an alternative policy that the government could use to maintain price stability because it is a policy which gives the government decisions about its revenue and spending which can influence the level of economic activity in NZ. It follows the Public Finance Act that requires the NZ government to disclose how its fiscal decisions will affect NZ economy over the next 3 years, in regular updates. It presents all financial information under generally accepted practices and orders the treasury to prepare forecasts about the impact of this policy. This Act gives a greater certainty about the future leading to more business confidence and gives the government a clear understanding about its intentions and their probable impact.

Price stability is a desirable objective because it helps consumers to keep the value of their income and savings and helps them plan for the future more easily and the economy is more likely to keep growing at a constant speed and sustainably. In contrast, changes in price levels can have a lot of negative effects for an individual consumer and the economy as a whole. If there is price inflation on households, savers suffer because the value of their savings fall and it becomes more expensive for banks to borrow from the RBNZ so the banks raise interest rates, so firms and consumers borrow less and spend less, so C and I both fall. Savings are also diverted away from investment in productive capacity to speculative investment as borrowers benefit as the value of their debt falls. Inflation reduces the international competitiveness of NZ companies which export. Inflation reduces consumer's purchasing power, and they purchase fewer essentials for their money so the standard of living falls, especially those on fixed incomes.

S

Tight monetary policy: when the RB adjusts the OCR, when they see the economy reaching full capacity where inflationary pressure is high, they increase the OCR, and this adjustment affects the interest rates and exchange rate.

When the OCR increases the interest rates increase and it is more expensive to borrow so consumers and firms borrow and spend less, C and I both decrease, AD decreases and inflationary pressure eases. The higher interest rates attracts foreign investors and the demand for NZD goes up and the dollar appreciates, so imports become cheaper but export receipts fall and the government receives less company tax, and export competitiveness falls, less income means less spending so AD decreases and there is less inflationary pressure. But there is also a drop in national output a decrease in growth, there is also an increase in unemployment as firms do not need as many workers. In terms of trade import prices are increasing relative to export prices so there is more outflows than inflows so it's unfavourable for the balance of trade.