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91222



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NEW ZEALAND QUALIFICATIONS AUTHORITY  
MANA TOHU MĀTAURANGA O AOTEAROA

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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.**

**Achievement**

**TOTAL**

**11**

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## QUESTION ONE: CAUSES OF INFLATION

"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.

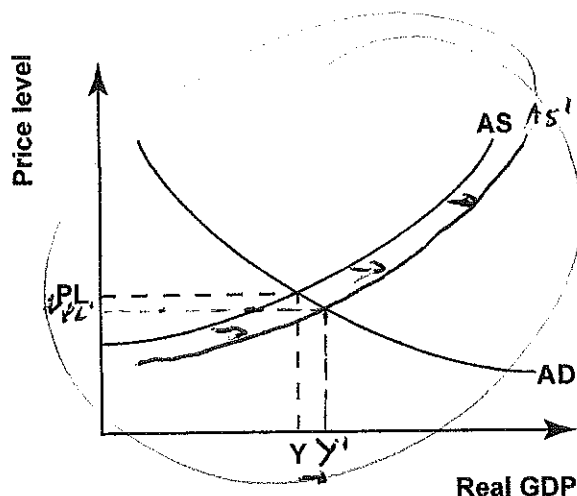
- (a) Fully explain the different effects on the general price level measured by the Consumer Price Index (CPI) of weaker oil prices and an increase in the price of cigarettes. In your answer, explain:
- how weaker oil prices can result in a change in inflation
  - why an increase in the price of cigarettes may not cause a change in inflation.

If there are weaker prices of oil, the cost of production would decrease leading to ~~an~~ an increase in Aggregate Supply. This causes a decrease in the price level ~~then~~. Since the price level is a measure of inflation, inflation is effected. An increase in cigarette prices will not have an effect however. They are their own market and are not affecting every producer unlike oil. This increase is not able to increase inflation.

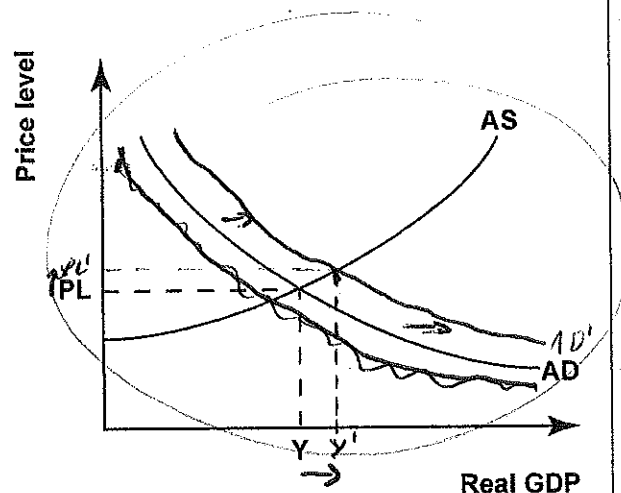
- (b) (i) On Graph One below, show the impact of weaker global oil prices.

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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.

If the value of the New Zealand dollar decreases, New Zealand's aggregate demand will increase. This is because our goods become more competitive overseas as our dollar is cheaper to buy. This increases our exports which is a component of Aggregate demand from AD to AD<sup>1</sup> which increases. This causes an increase in the price level of goods and services from PL to PL<sup>1</sup>. This causes inflation as the price level is a way to measure inflation.

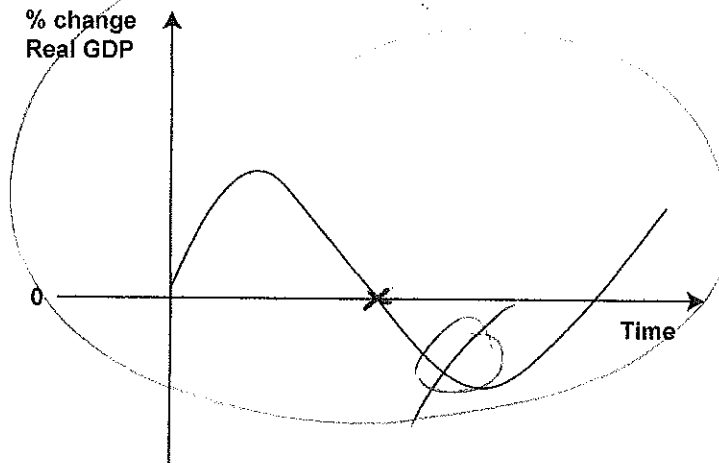
More space for this answer is available on the following page.

The impact of the lower dollar is different to the lower oil prices in two ways. First the shift different curves. Both change increase a curve but the lower dollar affects demand and oil affects supply. Second is their effect on inflation. The lower oil prices lead to a ~~lower~~ disinflation or even deflation if the numbers are low enough whereas the lower dollar causes inflation.

## QUESTION TWO: THE BUSINESS CYCLE AND DEFLATION

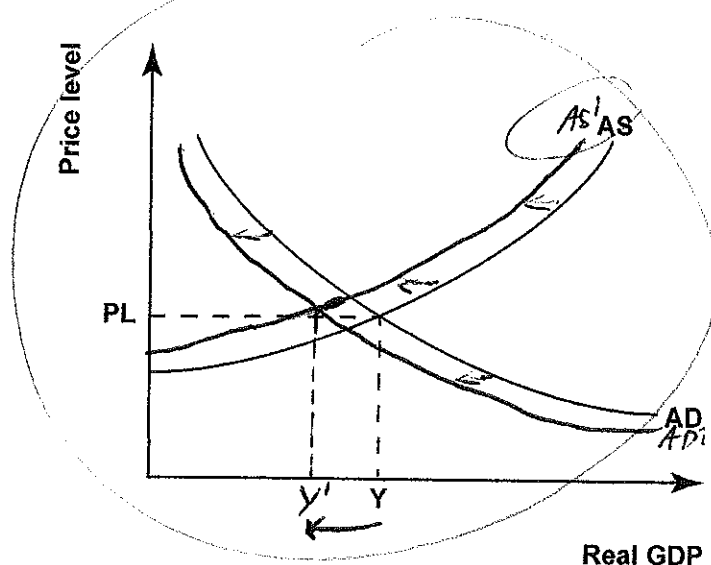
- (a) On Graph Three below, clearly label an example of a recession. Label this point X.

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.

In the recession, there is low employment and low productivity. This leads to lower GDP numbers. In order to recover, productivity would need to increase. This would increase Aggregate Supply. This will cause deflation for a period of time.

time. Deflation is when the general price that \$1 can buy increases so your dollar is worth more. However this increased productivity will need workers which will increase disposable incomes. This causes an increase in Aggregate demand where there will be inflation, ending the period of deflation.

### A slowdown of growth in China

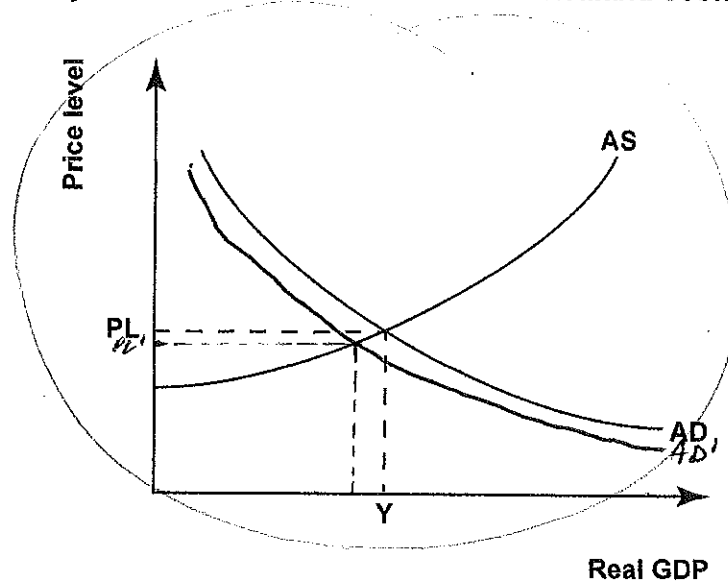
China is important to New Zealand as a trading partner. Australia and China are our main trading partners, and China is Australia's main trading partner. Therefore, any downturn in China will impact directly or indirectly on demand for our exports.

Source (adapted): [http://www.rbnz.govt.nz/research\\_and\\_publications/speeches/2015/6012526.html](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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When China's downturn occurs, New Zealand's aggregate demand decreases from  $AD$  to  $AD'$ . This is caused by lower exports as China is one of New Zealand's main trading partners. This leads to a lower price level from  $P_2$  to  $P_1$ . This will not leave as big of an impact as a recession would. The recession would lead to lower supply every year over a period of time whereas the downturn in China would only effect the economy that year. Even though this will cause deflation, the recession will continue over years causing even more deflation than the Chinese downturn. //

A3

### QUESTION THREE: THE IMPACTS OF DEFLATION

ASSESS!  
USE C

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.

*Earthquake 5.8 //*

*When this period of deflation occurs, younger people will benefit greatly when saving to buy a home. The deflation will increase the buying power of what they have saved up and even could encourage them save more. This leads to lower.*

*When this deflation occurs, young buyers are able to save for their first homes faster than before. This is because deflation makes your dollar worth more so their current savings are worth more. Whereas for older people, it is benefiting them as they are now able to do more with their retirement funds as it is now worth more. The young ones will however be encouraged to save more leading to further deflation whereas elderly will be spending more leading to more consumer spending and causing inflation.*



For New Zealand business producing for New Zealand, this ~~lower~~ deflation leads to lower costs of production creating a larger aggregate demand. This is benefit for them as with everyone's dollar worth more, the businesses are able to sell a lot more causing higher profits. Whereas for New Zealand business producing for overseas, this is harmful. The deflation cause our dollar to be worth more, which lead to higher exchange rates overseas. This makes our exports less competitive which lowers their profits. //

Achievement Exemplar for AS91222 (2016)			Total Score	11
Question	Grade	Comment		
1	A4	This response demonstrates two clear points that contribute towards Achievement. The candidate explains the inability of a single good to affect other production and, hence, will not create inflation. They also clearly demonstrate understanding of the effect of a depreciation of the New Zealand dollar on aggregate demand, using labels effectively. However, the response is not an M5, as the use of the correct Economic terminology is not evident (e.g. exports receipts are the component of Aggregate Demand not exports).		
2	A3	This response meets the minimum requirement of an Achievement grade. The candidate indicates the effect on aggregate demand from the downturn in China, but Economic terminology is again incorrect. The response does not meet the requirement for an A4, as the supporting evidence (changes to graphs and the definition of deflation) is incorrect.		
3	A4	This is an A4, as the candidate makes two clear explained points on the effects of deflation. Thus, for first home buyers the candidate states an effect (e.g. save for their first homes faster) and gives a reason (their current savings are worth more). However, it is not an M5, as a third point or an implication of the effect is not discussed. It is an A4, as a second point for a different scenario is also stated and explained (there is a link between lower costs and profits).		