

FREE SAMPLE: THE FIRST QUESTION

Question One (15 marks)

(a) The table shows price indexes for New Zealand's exports and imports (illustrative figures). Then world oil prices rise, raising the price of imported fuel and goods: the import price index rises by 6%.

Calculate the terms of trade index (export prices $\div$ import prices $\times$ 100) before and after, and the percentage change in the terms of trade. State whether the terms of trade have improved or deteriorated.

Price index (base year = 1000)	Before
Export prices	1,040
Import prices	1,000

[3 marks]

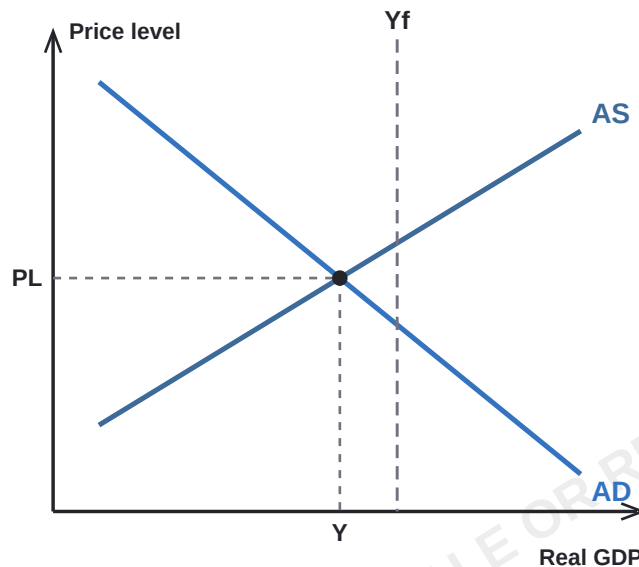
(b) Explain how this change in the terms of trade would affect New Zealand's real national income, the current account and the goals of economic growth and price stability. Use your calculation in your answer.

[4 marks]

(c) New Zealand's real GDP (Y) is below the full-employment level of real GDP (Y_f), so there is a recessionary gap, as shown on Graph One. Then a recession in China and Australia reduces demand for New Zealand exports.

On Graph One, show the effect on the economy: draw the new curve (label it AD_2), label the new real GDP (Y_2) and price level (PL_2), and label the change in the recessionary gap. State what happens to the size of the recessionary gap.

[3 marks]



Graph One: The New Zealand economy with a recessionary gap

(d) Using your changes to Graph One, compare the effect of this event on the government's goal of full employment with its effect on the goal of price stability.

[5 marks]

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THE WORKED ANSWER TO THAT QUESTION

Question 1 (15 marks) [External influences on the economy]

(a) The table shows price indexes for New Zealand's exports and imports (illustrative figures). Then world oil prices rise, raising the price of imported fuel and goods: the import price index rises by 6%. Calculate the terms of trade index (export prices $\div$ import prices $\times$ 100) before and after, and the percentage change in the terms of trade. State whether the terms of trade have improved or deteriorated.

(a) Answer: Terms of trade 104 $\rightarrow$ 98.1 (–5.7%): deteriorated

- Evidence level: Merit (calculates both indexes and the percentage change).
- Before: $1,040 \div 1,000 \times 100 = 104$.
- After: the import index becomes $1,000 \times 1.06 = 1,060$, so the terms of trade = $1,040 \div 1,060 \times 100 = 98.1$.
- Percentage change = $(98.1 - 104) \div 104 \times 100 = -5.7\%$: the terms of trade have deteriorated.

KEY TAKEAWAY

Terms of trade = export price index $\div$ import price index $\times$ 100; a rise means each unit of exports buys more imports.

(b) Explain how this change in the terms of trade would affect New Zealand's real national income, the current account and the goals of economic growth and price stability. Use your calculation in your answer.

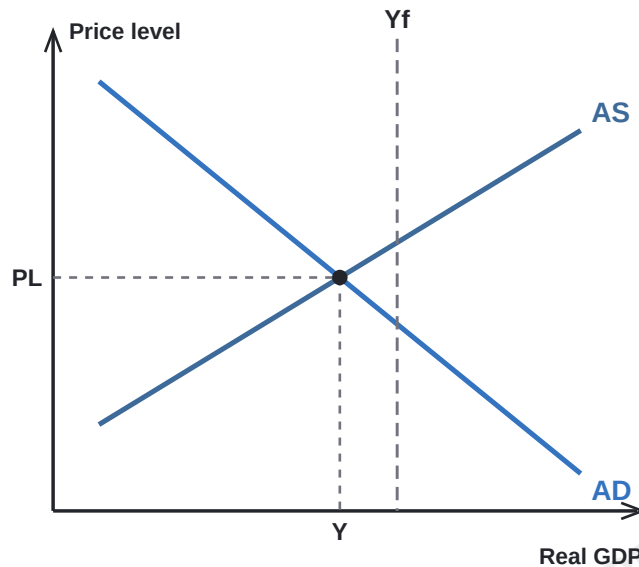
(b) Answer: Terms of trade deteriorate: income, AD and the current account move down; exchange rate offsets over time

- Evidence level: Excellence (links the terms of trade to income, AD, the exchange rate and two goals).
- Achievement: The terms of trade deteriorate (import prices rise, so New Zealand has to pay more for the goods it buys), so real national income falls and the current account worsens.
- Merit: The terms of trade deteriorate (import prices rise, so New Zealand has to pay more for the goods it buys), so real national income falls and the current account worsens. The terms of trade fell by 5.7%, so incomes (Y) and spending (C) fall, shifting aggregate demand left and lowering real GDP and employment.
- Excellence: The terms of trade deteriorate (import prices rise, so New Zealand has to pay more for the goods it buys), so real national income falls and the current account worsens. The terms of trade fell by 5.7%, so incomes (Y) and spending (C) fall, shifting aggregate demand left and lowering real GDP and employment. Lower demand reduces demand for the New Zealand dollar, so the exchange rate falls: exports become cheaper overseas and imports dearer, which offsets part of the damage to the current account over time, but dearer imports raise the price level. A fall in output together with rising import prices makes the goals of growth and price stability conflict.

KEY TAKEAWAY

Better terms of trade raise real national income and export receipts; worse terms of trade do the opposite, and the exchange rate partly reverses the current account effect.

(c) New Zealand's real GDP (Y) is below the full-employment level of real GDP (Y_f), so there is a recessionary gap, as shown on Graph One. Then a recession in China and Australia reduces demand for New Zealand exports. On Graph One, show the effect on the economy: draw the new curve (label it AD_2), label the new real GDP (Y_2) and price level (PL_2), and label the change in the recessionary gap. State what happens to the size of the recessionary gap.



Graph One: The New Zealand economy with a recessionary gap

(c) Answer: AD shifts left; $Y_2 < Y_1$; the recessionary gap widens

- Evidence level: Achieved (shifts AD the correct way and labels the new equilibrium and the gap).
- A recession in China and Australia reduces demand for New Zealand exports changes aggregate demand (net exports or spending): AD shifts left to AD_2 .
- The new equilibrium is where AD_2 cuts AS: real GDP Y_2 is below Y_1 and the price level PL_2 is below PL_1 .
- The recessionary gap = $Y_f - Y$. It widens ($Y_f - Y_2$ is larger than $Y_f - Y_1$).

KEY TAKEAWAY

Decide whether the event raises or lowers aggregate demand; the new equilibrium and the gap $Y_f - Y$ follow from the new AD curve.

(d) Using your changes to Graph One, compare the effect of this event on the government's goal of full employment with its effect on the goal of price stability.

(d) Answer: Full employment: worsens (gap widens); price stability: price level falls a little

- Evidence level: Excellence (compares the effect on two goals using the graph labels).
- Achievement: Output falls further below Y_f , so unemployment rises (the goal of full employment moves further away), and the price level falls slightly.
- Merit: Output falls further below Y_f , so unemployment rises (the goal of full employment moves further away), and the price level falls slightly. Real GDP falls from Y_1 to Y_2 , so firms cut jobs and cyclical unemployment rises; the recessionary gap widens. The price level falls from PL_1 to PL_2 , so inflation slows (there is downward pressure on prices).
- Excellence: Output falls further below Y_f , so unemployment rises (the goal of full employment moves further away), and the price level falls slightly. Real GDP falls from Y_1 to Y_2 , so firms cut jobs and cyclical unemployment rises; the recessionary gap widens. The price level falls from PL_1 to PL_2 , so inflation slows (there is downward pressure on prices). The damage to employment is large relative to

the effect on prices: with spare capacity, falling demand cuts output and jobs more than prices. The slower inflation (or even falling prices) is a small gain for the price stability goal, but if prices fall persistently households may delay spending (deflation), which could deepen the recession. Overall the event harms the full-employment goal far more than it helps price stability.

KEY TAKEAWAY

A change in aggregate demand with spare capacity changes output and employment by more than it changes the price level.

LOS: External influences on the economy (91403)

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