

Macro Issues in the New Zealand Economy

(2015 Edition)



YEAR 13 ECONOMICS

Covering NCEA Level 3 Achievement Standard 3.5

by
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Aggregate Economic Activity and the Rest of the World (External Sector)

Introduction

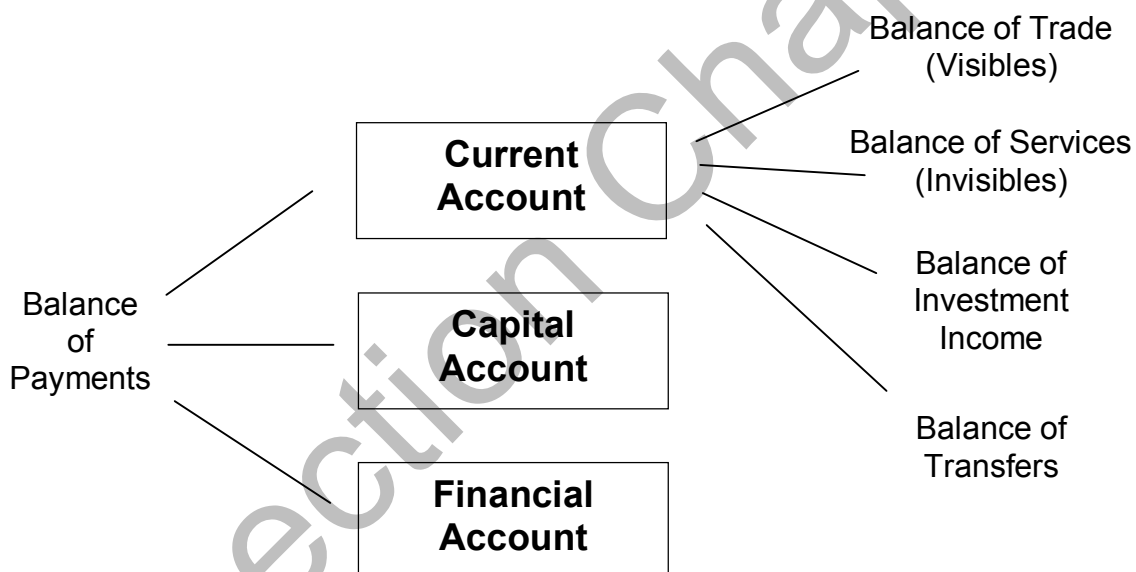
This section examines the factors that affect net exports (export receipts less import payments). This is a key part of New Zealand's economy because of our small domestic market. A simple way of thinking about it is that we put wool, meat, dairy products, logs and various other products in ships and send them overseas. Ships come back full of cars, oil, computers, mobile phones, washing machines, wide screen TVs and clothing. We export to allow us to buy imports.

Measuring Trade with Overseas

International trade is the buying and selling of goods and services between countries. Some of the goods New Zealand sells include dairy products, meat, wool, fish and logs. The services we sell include tourism, education and shipping.

The balance of payments is used to measure all transactions between a country and the rest of the world. This includes transactions by individuals, firms and government.

The diagram below shows the main parts of the balance of payments for a country.



- **The current account** measures net exports (export receipts less import payments).
- **The balance of trade** (visibles or goods) measures export receipts from selling goods less import payments for buying goods from overseas.
- **The balance of services** (invisibles) is export receipts from services, e.g. tourism, less import payments for services.

- **The balance of investment income** is dividends and interest received from overseas less dividends and interest paid to overseas.
- **The balance of transfers** is transfers from overseas less transfers to overseas. A transfer is a payment with no economic activity in return. Examples include foreign aid or a Samoan family living in New Zealand sending money to relatives in Samoa.
- **The Capital Account** measures transfers of capital. An example may be a family migrating to New Zealand who transfer their funds into New Zealand. The Capital Account is a relatively minor part of the Balance of Payment.
- **The Financial Account** measures all borrowing and lending and the buying and selling of assets such as shares and property.

A **Current Account Deficit** is when a country's import payments are greater than its export receipts ($M > X$).

A **Current Account Surplus** is when a country's export receipts are greater than import payments ($X > M$).

NZ Current Account Components (Year to March 2012)
(\$ million)

Balance of trade	2,741
Balance of services	-1,254
Balance of investment income	-10,765
Balance of transfers	-460
Current account balance	-9,738

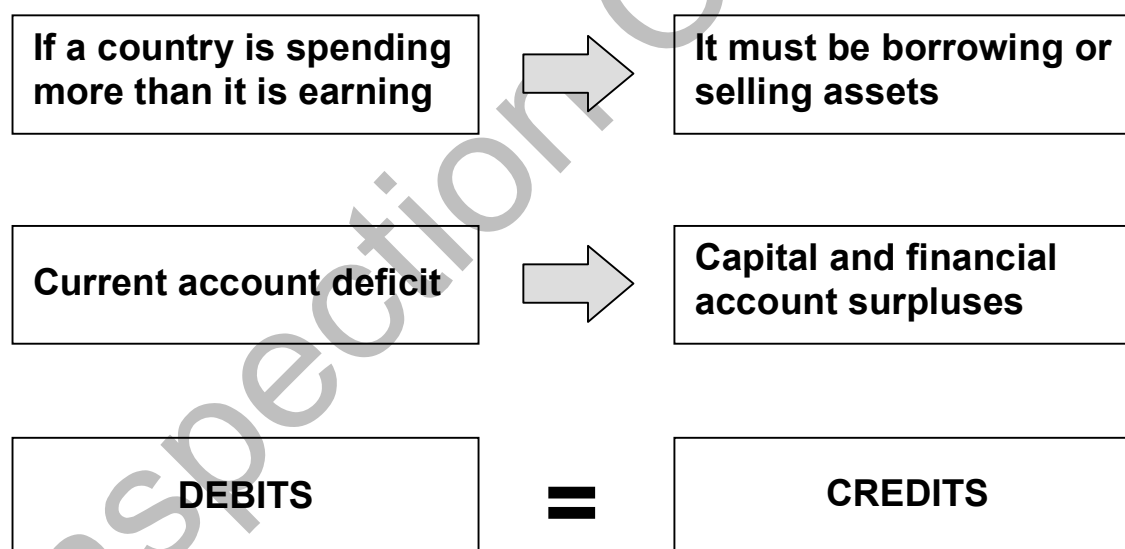
The Relationship between the Parts of the Balance of Payments

The balance of payments is an accounting document. This means the debits (outflows) must match the credits (inflows) otherwise the accountants will start to panic.

The reason for this is simple.

If a country is spending more (on imports) than it is earning (from exports) it must be either borrowing or selling assets to pay the difference.

A current account deficit must therefore be matched by a surplus on the financial (and capital) accounts.



New Zealand's Current Account Deficit – The Blowfly on our Economy

New Zealand has had a large current account deficit in recent years. This means we are spending much more on imports than we are earning from exports.

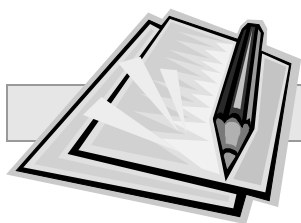
We are only able to do this by borrowing from overseas and selling assets such as local companies to overseas buyers.

Because many of our companies are owned by overseas interests their dividend payments are recorded as an outflow (debit) in the Balance of Investment Income.

Because we have a large amount of overseas debt the interest paid on this debt is also recorded as an outflow in the Balance of Investment Income.



The negative balance of investment income is the worst part of our current account. This is because a large chunk of New Zealand's national income is paid to overseas lenders and shareholders as interest and dividends.



Review Exercise

1. Complete the glossary:

- (a) _____ is the buying and selling of goods and services between countries.
- (b) _____ is export receipts less import payments.
- (c) _____ records all transactions between a country and the rest of the world.
- (d) _____ is made up of the balance of goods and services and investment income and transfers.
- (e) _____ records all borrowing and lending and the buying and selling of assets such as shares and property.
- (f) A _____ occurs when export receipts are greater than import payments.
- (g) A _____ occurs when import payments are greater than export receipts.

2. Complete the following table to show which part of the Balance of Payments would record each transaction.

Transaction	Part of Balance of Payments	Debit (outflow of money) or credit (inflow)
(a) The sale of logs to Japan	Balance of trade	Credit
(b) A New Zealand bank borrows from Japan		
(c) The bank pays interest on its loan		
(d) German tourists travel on Air New Zealand		
(e) A US firm buys Telecom		
(f) Telecom pays dividends to its shareholders		
(g) The Government sends funds to help Tsunami victims in Samoa		
(h) Korean students pay fees to study in New Zealand		
(i) A New Zealand shipping firm carries Australian products to Europe		
(j) A UK firm insures the Sky Tower		
(k) A New Zealand family migrates to Australia taking the money from the sale of their house		
(l) Fonterra sells milk powder to China		

3. Use the following information to answer the questions below.

New Zealand Balance of Payments 2012 (\$ Millions)	
Balance of Trade	2,741
Services Balance	-1,254
Investment Income Balance	-10,765
Transfers Balance	-460

- (a) The current account balance is _____.
- (b) What is this situation called? _____.
- (c) Explain how a country finances a current account deficit?

- (d) How does this impact on the current account balance in the future?

4. Complete the following passage:

The balance of payments records all _____. The current account contains the balance of trade and _____ and _____ and _____.

An example of a transaction in the balance of trade would be _____. Revenue from tourists travelling to New Zealand would be recorded in the _____ as a _____. Interest and dividends are recorded in the _____. A transaction recorded in the balance of transfers could be _____.

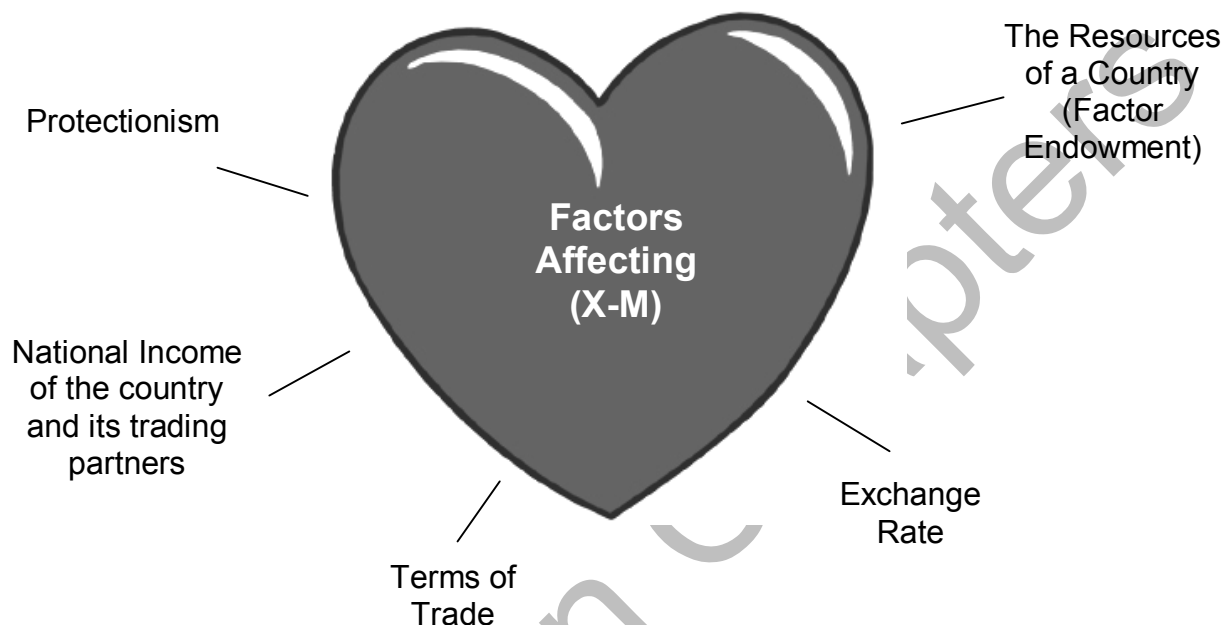
If a country's export receipts are less than its import payments it has a current account _____. To pay for this deficit it must be _____ or _____. This will be recorded in the financial account as a _____.

New Zealand has a large current account _____. A key reason for this is the negative balance of _____. This is due to large payments of _____ and _____ to overseas lenders and shareholders.

Inspection Chapters

Factors Affecting Net Exports (Export Receipts Less Import Payments)

The level of export receipts and import payments for a country are affected by a variety of factors.



Factor (Resource) Endowment

A country will export a good only if local production is greater than local consumption. The level of production is largely determined by the resources of that country.

New Zealand is an exporter of agricultural goods such as dairy products and meat because we have a relative abundance of fertile land.

Japan exports high tech products because of its relative abundance of capital.

India exports labour intensive products because of its abundance of workers.

National Output/Income

The national income (real GDP) will impact on the level of imports of a country. During a recession imports fall as national income falls.

A recession in other countries will affect the demand for a country's exports. The demand for New Zealand exports such as dairy products fell sharply during the 2008/2009 world recession.

Protectionism

Protectionism is when a country uses artificial barriers such as tariffs, quotas or subsidies to protect local producers from competition from imports. New Zealand has struggled to sell its agricultural exports to Europe because of high levels of protectionism that the European Union uses to protect its farmers from competition.

New Zealand's trade policy is free trade. This is because as a country that relies heavily on exports it is in our interests to promote the removal of artificial barriers to trade.

New Zealand is a member of the World Trade Organisation (WTO). The main aim of the WTO is to reduce trade barriers between countries to encourage free trade.

New Zealand has also signed a number of free trade agreements with other countries. These are bilateral (two country) agreements to remove trade barriers between New Zealand and the other country. New Zealand has a free trade agreement with Australia (Closer Economic Relations) as well as China. These agreements have significantly increased exports, imports and financial flows with these countries.

The Terms of Trade

The terms of trade measure average export prices compared to average import prices for a country. It illustrates the purchasing power of exports in terms of imports.

$$\text{Terms of trade index} = \frac{\text{Export price index}}{\text{Import price index}} \times 1000$$

A rise in world dairy prices will improve New Zealand terms of trade. This means it is possible to purchase more imported computers or wide screen televisions with a given amount of milk.

A rise in world oil prices will cause New Zealand terms of trade to deteriorate. This means New Zealand would have to sell more milk, logs and fish to buy the same amount of oil.

Illustration of Terms of Trade

Year	Export Price Index	Import Price Index	Terms of Trade Index
1	1,000	1,000	1,000
2	1,200	1,150	$\frac{1,200}{1,150} \times 1,000 = 1,043$
3	1,250	1,300	$\frac{1,250}{1,300} \times 1,000 = 962$

The Exchange Rate

The exchange rate is the price of a currency in terms of another currency. Since 1985 the value of the New Zealand dollar against other currencies has been determined by supply and demand in the foreign exchange market. This is called a floating exchange rate.

If an exchange rate appreciates (increases in value) this is generally harmful to exporters for several reasons.

Either they have to increase their prices overseas to maintain their revenue in local currency

OR If they cannot increase their prices overseas then when they convert their foreign earnings into local dollars their income has fallen.

Most New Zealand firms are price takers on world markets so their income in \$NZ falls as the New Zealand dollar appreciates.

If a currency appreciates then imports become relatively cheaper for local buyers because their currency has increased in value.

**An appreciation of the \$NZ tends to cause net exports (X-M) to fall.
This would increase the current account deficit.**

The Trade Weighted Index (TWI)

The trade weighted index is the value of the New Zealand dollar against a basket of currencies of our major trading partners. The weightings of other currencies in the index are determined by the level of trade with that country.

New Zealand's Trade Weighted Index

Base Year 1979 = 100	
	TWI (September)
2007	67
2008	62
2009	65
2010	67
2011	72
2012	74

The TWI shows the value of \$NZ against a group of currencies of our major trading partners.

(Statistics New Zealand)

How Does a Floating Exchange Rate Work?

A Little Bit of History

Until 1985 New Zealand had a fixed exchange rate. This meant the value of the New Zealand dollar was fixed against the US dollar which was the dominant world currency.

In 1944 the Allied Powers who were winning the war, met in Bretton Woods to try to establish a system for the international economy that would operate after the war. They were determined to prevent another Great Depression like the 1930s which had led to the war. A dominant figure at this conference was John Maynard Keynes.

The Bretton Woods Conference agreed that most currencies would be fixed against the US dollar. The US dollar would be fixed in value against gold. This gave everyone certainty about the value of all major currencies.

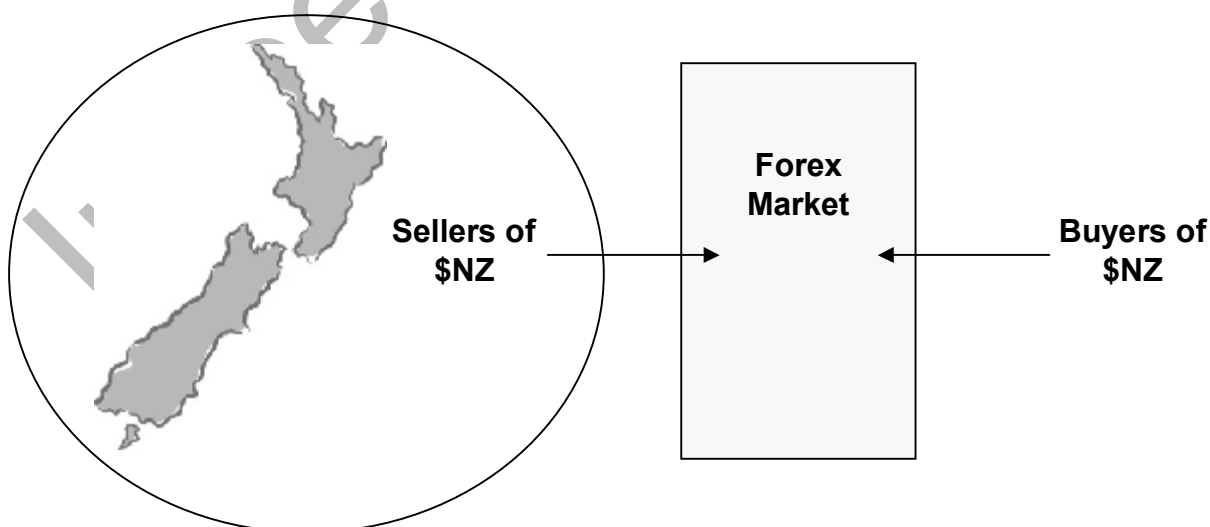
Unfortunately the US Government started printing dollars to help pay for the Vietnam War in the late 1960s. Some countries lost confidence in the value of the \$US. The system of fixed exchange rates fell apart. New Zealand finally floated its exchange rate in 1985.

What is a Floating Exchange Rate?

A floating exchange rate is determined by supply and demand for a currency in the foreign exchange market.

The foreign exchange (forex) market can be imagined as a doorway between the New Zealand money supply and the rest of the world as shown below.

The Forex Market for New Zealand Dollars



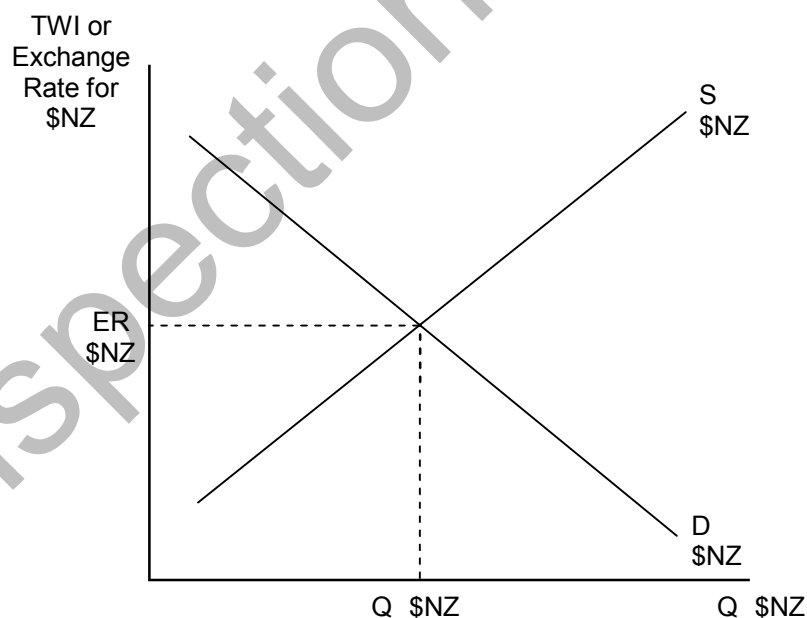
Who Sells (Supplies) \$NZ?	Who Buys (Demands) \$NZ?
1. Investors who want to take money out of New Zealand.	1. Investors wanting to invest in New Zealand.
2. New Zealand importers who need foreign currency to buy imports.	2. New Zealand exporters wanting to change their overseas earnings into \$NZ.
3. New Zealand tourists wanting to travel overseas.	3. Overseas tourists coming to New Zealand.

The forex market sets the price of the New Zealand dollar against other currencies based on supply and demand.

Depreciation is when a currency decreases in value against another currency in the Forex market.

Appreciation is when a currency increases in value against another currency in the Forex market.

The Forex Market for \$NZ



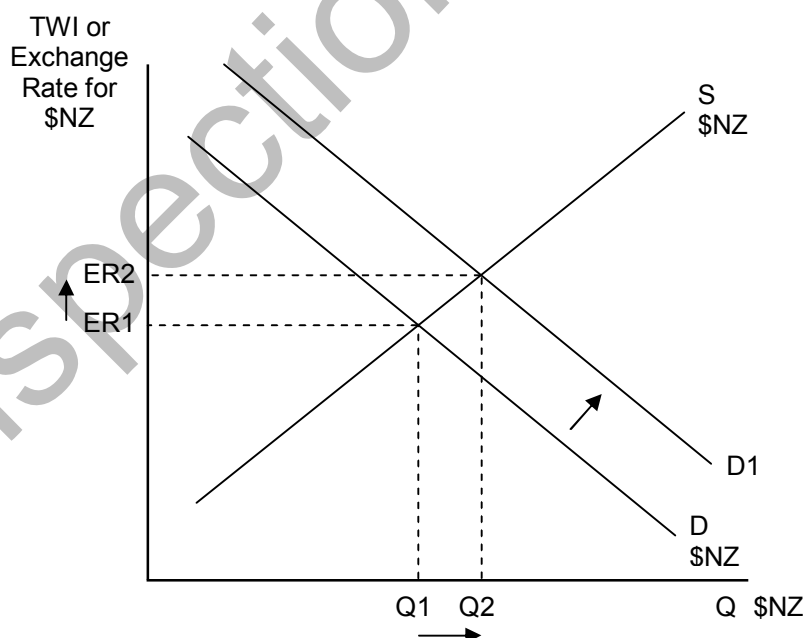
REMEMBER!!

Demand for \$NZ	Supply of \$NZ
- Investors in.	- Investors out.
- New Zealand exporters.	- New Zealand importers needing foreign currency.
- Tourists coming here.	- New Zealand tourists going overseas.

What Affects the Demand for New Zealand Dollars in the Forex Market?

The level of export receipts – when New Zealand sells exports this creates demand for New Zealand dollars. Either New Zealand firms get foreign currency and need to convert it back to \$NZ or overseas buyers need \$NZ to buy direct from New Zealand. This also includes overseas tourists or students coming here.

Forex Market for \$NZ showing the Effect of Increased Exports



Investors putting money into New Zealand will cause more demand for \$NZ in the forex market. These are people who want to buy assets such as property or shares in companies in New Zealand or who want to put money into New Zealand banks or bonds to get our higher interest rates.

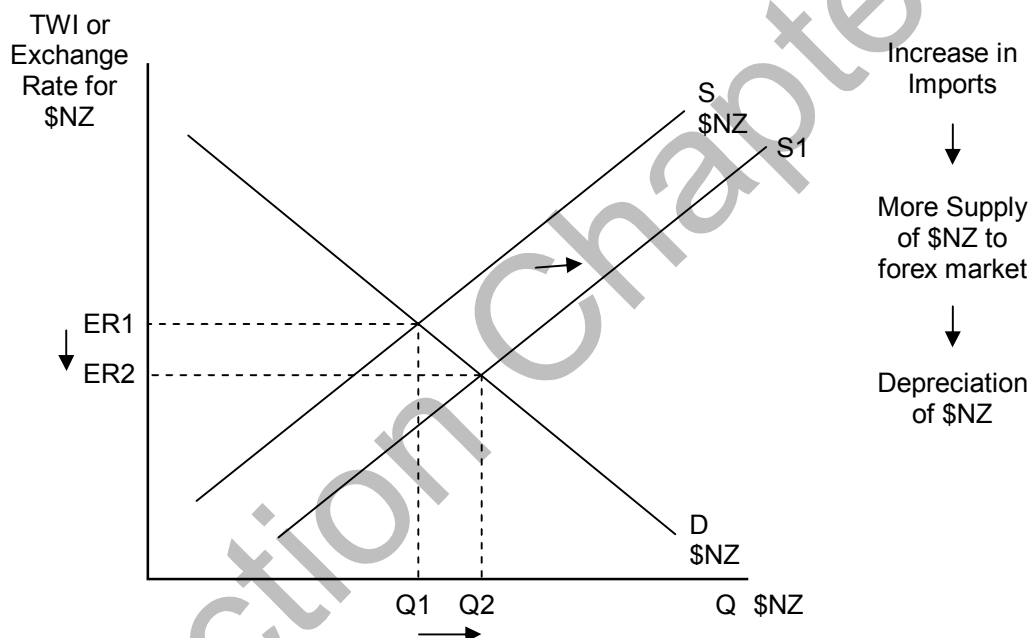
The Carry Trade

In recent years New Zealand has had relatively high interest rates compared to many other countries. This has encouraged people to borrow cheaply overseas and put their money into bank accounts or bonds in New Zealand. This is called the “carry trade”. This has created more demand for \$NZ in the forex market.

What Affects the Supply of New Zealand Dollars to the Forex Market?

- The level of imports will affect the supply of New Zealand dollars in the Forex market. If a New Zealand car dealer wants to buy cars in Japan it supplies New Zealand dollars to buy yen. If New Zealand tourists want to travel overseas they supply New Zealand dollars to buy foreign currency.

Forex Market for New Zealand Dollars Showing the Effect of Increased Import Payments



- Investors wanting to take funds out of New Zealand will affect the supply of \$NZ. If New Zealand interest rates fall compared to other countries then the supply of New Zealand dollars in the forex market will increase as investors change to other currencies seeking higher returns.

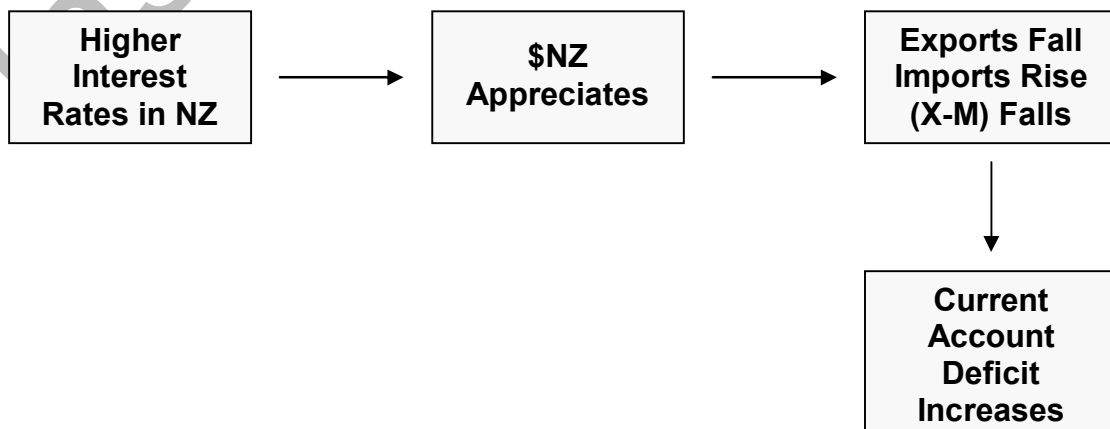
Summary of Demand and Supply for New Zealand Dollars in the Forex Market

More Demand for \$NZ	More Supply of \$NZ
1. Higher interest rates in New Zealand (or lower rates overseas) (Investors In)	1. Lower interest rates in New Zealand (or higher rates overseas) (Investors Out)
2. More export revenue	2. Increased import payments
3. More tourists coming to New Zealand	3. New Zealand tourists going overseas

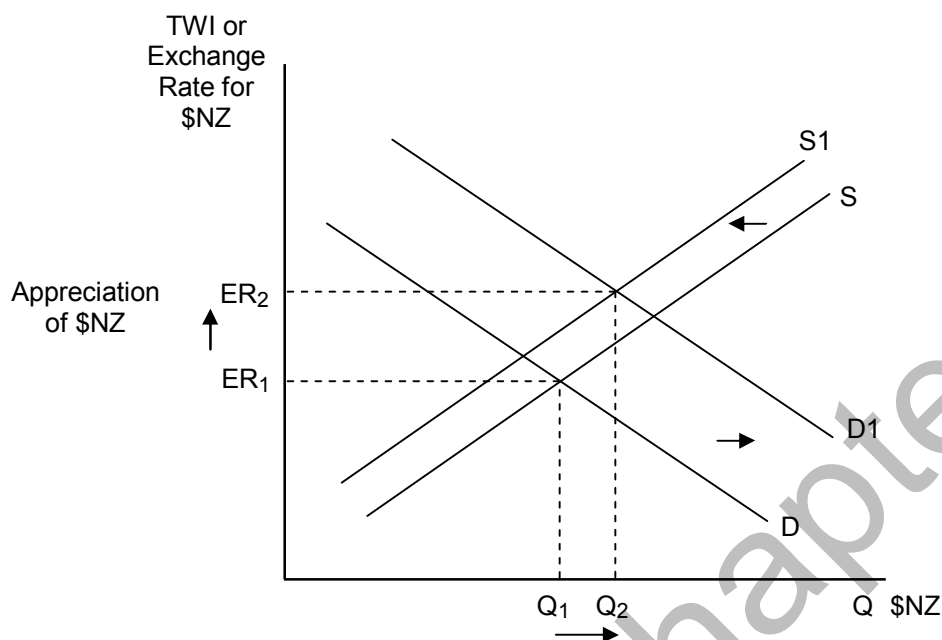
Recent Issues with the \$NZ Exchange Rate

In 2012 there was much debate about the high value of the New Zealand dollar against many of our trading partners. This made it difficult for New Zealand exporters to compete on world markets. The reasons for the appreciation of the New Zealand dollar against some of our trading partners were as follows:

1. Other countries had lower short term interest rates and some resorted to quantitative easing which virtually means printing money in an effort to stimulate their economies.
2. New Zealand's short term interest rates are largely determined by the OCR set by the Reserve Bank. Although the OCR is set at an historical low of 2.5% this is still above many of our trading partners (e.g. US 0.5%). New Zealand is therefore seen as an attractive country to park money (see carry trade page 157).

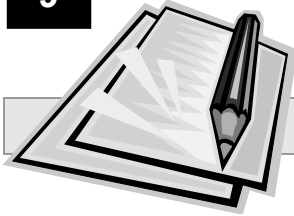


The Effect of Higher NZ Interest Rates on the Forex Market for \$NZ



Increased demand - because overseas investors want New Zealand dollars to get higher interest rates.

Less Supply – people with New Zealand dollars hold on to them to get the higher interest rates.



Chapter Review Test

1. Define the following terms:

(a) Net exports:

(b) Balance of payments:

(c) Current account:

(d) Balance of visibles:

(e) Current account deficit:

(f) Balance of investment income:

(g) Financial account:

(h) Terms of trade:

(i) Exchange rate:

(j) Trade weighted index:

(k) Floating exchange rate:

(l) Appreciation:

2. The following information is for the economy of Zeathopia.

Item	\$billion
Exports of goods	56
Imports of goods	64
Balance of services	12 credit
Investment income balance	45 debit
Balance of transfers	3 debit

- (a) Calculate the balance of trade.
- _____
- (b) Calculate the current account balance.
- _____
- (c) What is this situation called?
- _____
- (d) Do you think this country is a net borrower or lender? Explain.
- _____
- _____
- _____

3. Explain fully how a worldwide recession could affect New Zealand's net exports (X-M).

4. Explain what has happened to New Zealand's terms of trade in each situation below.

(a) World dairy prices fall

(b) Oil prices fall

(c) Export prices rise 10% and import prices rise 12%

(d) Import prices fall 5% and export prices fall 7%.

5. Explain how an improvement in the **terms of trade** could affect a current account deficit.

6. Complete the following table:

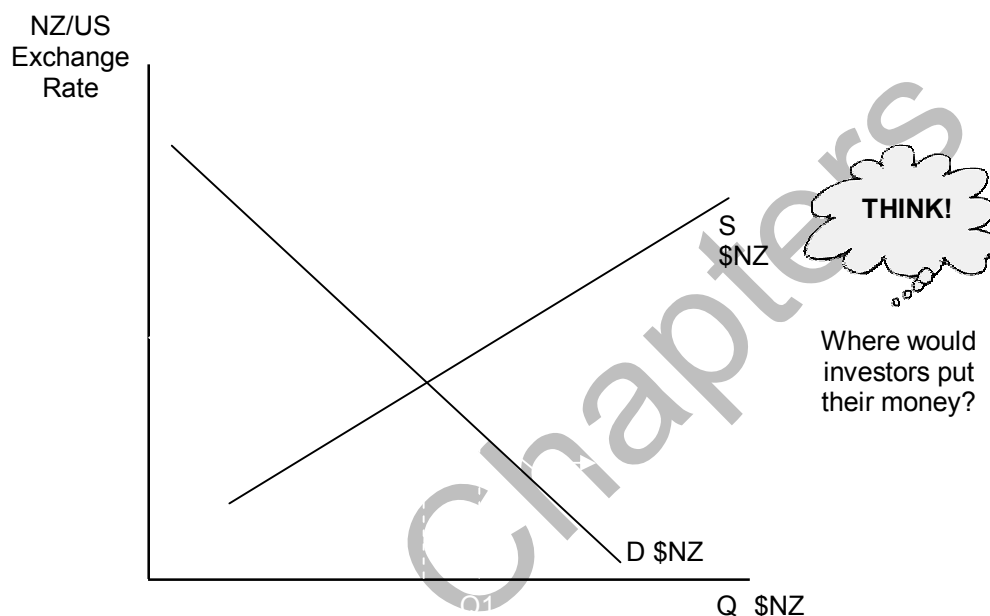
Change	Effect on Demand and/or Supply of \$NZ in Forex Market	Appreciation or Depreciation of \$NZ
(a) A rise in exports	Increase in demand	Appreciation
(b) A fall in imports		
(c) New Zealand hosts the Commonwealth Games		
(d) Increase in world dairy prices due to more demand from China		
(e) The Reserve Bank cuts the OCR		
(f) A rise in oil prices		
(g) US Federal Reserve lowers interest rates		
(h) New Zealand voted world's number one tourist destination		

7. Complete the following statements:

- (a) An increase in New Zealand interest rates will cause demand for \$NZ to _____ and supply to _____. The exchange rate for \$NZ will _____.
- (b) An increase in exports will cause demand for \$NZ to _____ and the exchange rate to _____.
- (c) A rise in imports will cause _____ of \$NZ to _____ leading to a _____ of the exchange rate.
- (d) If the \$NZ depreciates this should cause exports to _____ because _____. Imports will _____ because _____. The current account deficit should _____ because net exports have _____.
- (e) If the New Zealand dollar depreciates then net exports should _____. This will cause aggregate demand to _____.

8. In recent years the Reserve Bank has set the OCR at 2.5%. The Federal Reserve in the United States has set its cash rate at 0.5%.

- (a) On the axis below show the likely effect on the NZ/US exchange rate.



- (b) In 1997 the NZ/US exchange rate was 0.50. What was NZ\$1,000 worth in US\$?

- (c) What was US\$1,000 worth in NZ\$?

- (d) The NZ/US exchange rate appreciated to 0.80 from 0.50. If a New Zealand exporter sold his product for US\$1,000 how much would he now be getting in NZ\$?

- (e) Is the exporter better or worse off?

Aggregate Economic Activity and the Government

Introduction

The Government can play a key role in influencing aggregate economic activity through its taxation and spending policies.

The role of government in economic management is one of the most controversial topics in economics.

Classical and neoclassical (including monetarists) economists believed the role of government should be to ensure that markets operate efficiently. Adam Smith believed the roles of government should be limited to law and order, national defence and certain public works.

Keynesian economists believe that governments should ensure full employment during a recession by creating effective aggregate demand through government spending and tax policies.

This section explores how government can influence aggregate economic activity using fiscal policy.

What is Fiscal Policy?

Fiscal policy is the use of government taxation and spending to achieve economic objectives.

A contractionary fiscal policy is when government increases taxes and/or reduces spending. This will reduce aggregate demand and economic activity.

An expansionary fiscal policy is when a government reduces taxes and/or increases government spending. This increases aggregate demand and the level of economic activity.

Government Revenue and Expenditure and the Operating Balance

The main source of government revenue is taxation. A direct tax is a tax on incomes such as PAYE.

An indirect tax is a tax on goods and services such as GST.

The main sources of revenue for the New Zealand Government are shown in the table below.

Projected Sources of Government Revenue 2012

	\$ Billion
PAYE	21.2
Company tax	8.6
GST	14.7
Other revenue	10.2
Total cash revenue	54.7

(Source: Treasury)

The main areas of government spending in New Zealand are social welfare, education and health. Social welfare spending includes superannuation payments for the elderly.

The main areas of government spending are shown below.

Projected Areas of Government Spending 2012

	\$ Billion
Social welfare	22
Health	14
Education	12
Other	22
Total crown spending	70

(Source: Treasury)

The operating balance is the difference between government revenue and spending for a period. If the Government revenue is greater than its spending this is called an operating surplus. If government spending is greater than its revenue this is called a operating deficit.

Use the information in the two tables to calculate the expected operating balance for 2012

Recent Trends in the New Zealand Government Operating Balance

Prior to the global financial crisis in 2007/2008 the New Zealand Government was operating budget surpluses. This meant Government income was greater than its spending.

The economic downturn led to a rapid turnabout in Government finances. The lengthy recession resulted in lower tax revenues from GST and company and income tax. Government efforts to boost the economy in 2006-2010 through spending on infrastructure also contributed to the emergence of a large deficit.

Reductions in income tax rates and increases in GST as part of the Government tax package in 2009 increased the size of the deficit.

The Christchurch earthquakes and rebuild also led to increased Government spending adding to the size of the deficit.

Fiscal Austerity

In 2011 the Government announced that it was aiming to achieve a budget surplus by 2014. This required cuts in government spending in an effort to reduce the large budget deficit.

This approach of cutting government spending to reduce the need for the Government to borrow has become known as “fiscal austerity”. It represents a contractionary fiscal policy. The likely effect of a contractionary fiscal policy is to reduce aggregate demand in the economy.

Why has the Government adopted a Policy of Fiscal Austerity?

Government deficits require the Government to borrow either within New Zealand or from overseas. This borrowing increases public (government) debt. The Government is concerned that excessive borrowing and public debt may lead to a credit downgrade by the international ratings agencies. This would increase the future cost of borrowing.

Government borrowing also means that the Government is competing with the private sector for loans. This can push up interest rates in the economy. It can create a situation called a “crowding out effect” where government borrowing reduces the ability of private firms to borrow, i.e. crowds them out.

The New Zealand Government is also required to follow the Public Sector Amendment Act (2004) which requires it to be prudent (careful) in its level of borrowing.

The Public Finance Amendment Act 2004

New Zealand has had an unfortunate history of governments trying to spend their way out of a recession using borrowed money. The Public Sector Amendment Act 2004 aims to prevent reckless management of public finances by politicians.

Key features of the Act are:

- The Government must maintain a prudent level of government debt, i.e. not borrow too much money to pay for its spending.
- Over the long term, government revenue should cover spending, i.e. a balanced budget.
- Government spending and tax policies should be clearly communicated to avoid sudden major policy changes particularly in tax rates.

The Government Sector and the Business Cycle

Modern governments play a key role in managing aggregate economic activity using monetary and fiscal policy. Although monetary policy is operated independently by the Reserve Bank in New Zealand, both policies are usually synchronised to ensure similar outcomes.

During the 2008 recession the New Zealand Government operated an expansionary fiscal policy (reduced T and increased G). The Reserve Bank also introduced an expansionary monetary policy by cutting the OCR.

Since 2010 the Government has adopted a contractionary fiscal policy with the aim of achieving a budget surplus by 2014/2015.

The Business Cycle of an Economy

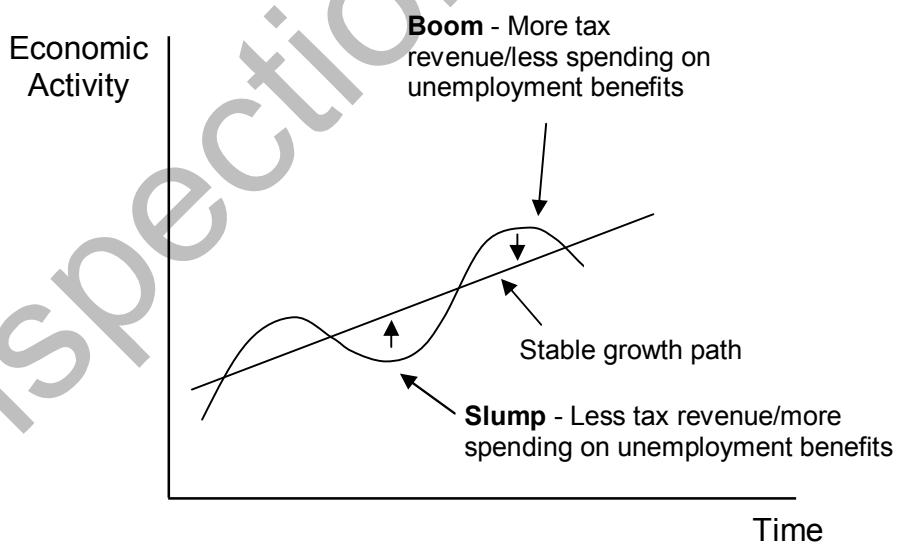
The New Zealand Government budget also contains automatic stabilisers. Automatic stabilisers affect aggregate demand during a boom or a slump to move the economy towards a more even growth path.

During a slump (recession) government tax revenue falls and spending on unemployment benefits rises. This reduces withdrawals and increases injections in the economy helping to automatically increase aggregate demand.

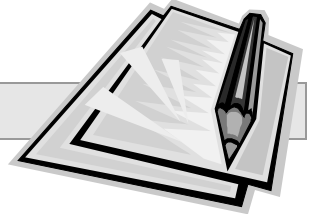
During a boom period, government tax revenue rises and spending on unemployment benefits fall as more people find jobs.

Automatic stabilisers are those parts of the Government budget that automatically move an economy to a more stable growth path.

Automatic Stabilisation and the Business Cycle



Chapter Review Exercise



1. Complete the following glossary:

- (a) _____ is the use of government tax and spending to influence economic activity.
- (b) _____ is when a government increases taxation and/or reduces spending to reduce economic activity.
- (c) _____ is when government reduces taxes and/or increases spending to increase economic activity.
- (d) _____ is the difference between government revenue and spending.
- (e) _____ is when government spending is greater than government revenue.
- (f) _____ is when government revenue is greater than government spending.
- (g) _____ is a plan of future government income and spending.
- (h) _____ is when government activity such as borrowing, reduces private sector activity in the economy.
- (i) _____ are those parts of government budget that move the economy to a more stable growth path.
- (j) _____ is the law that requires the New Zealand Government to keep public debt at prudent levels and avoid sudden major changes in tax or spending policies.

2. Complete the following passage.

The New Zealand Government is currently operating a _____ fiscal policy. This involves reductions in _____. The main areas of government spending are _____, _____ and _____. The likely effects of this fiscal policy are to _____ aggregate demand in the economy. The main aim of this policy is to achieve a _____ by 2014/2015. The Government is concerned about increases in _____ due to current budget _____ which require the Government to _____.

3. Explain how a recession can affect:

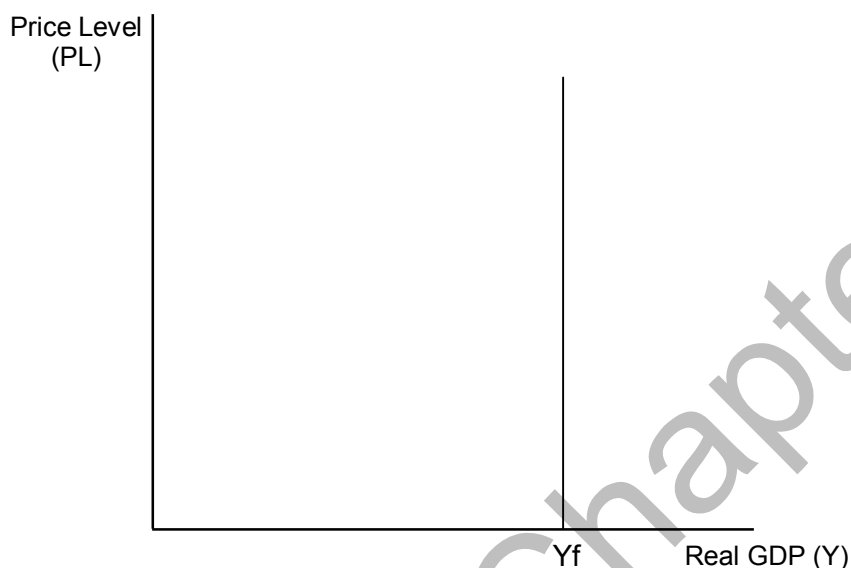
(a) Government income:

(b) Government spending:

(c) Operating balance:

Current Trends in Government Activity

4. Use the axis below to show the current situation of the New Zealand economy.



5. Since 2010 the Government has adopted a policy of fiscal austerity. Illustrate the likely effects of this on your graph.

6. Explain the likely effects on:

(a) Economic growth

(b) Unemployment

(c) Inflation

7. Explain what is meant by “fiscal austerity”.

8. Explain how this policy of fiscal austerity could have a multiplier effect on the New Zealand economy.

9. Compare and contrast the economic effects of reduced government spending rather than increasing tax rates as a means of achieving a government budget surplus by 2015. Refer to the likely impacts of each approach on:

- Economic growth.
- Unemployment.
- Inflation.

Explain and use a graph to illustrate your answer.

Inspection

Inspection Chapters

