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NOTES TO THE STUDENT

- (i) Do all the activities set by your teacher, making sure you mark these accurately and correct any errors. Ask questions and ask for assistance with topics or questions that you have difficulty with, it is the way to improve your understanding of topics or questions you are unsure of.
- (ii) The solutions to all activities are in the Teachers' Guide. All the best.
- (iii) For further help, notes and activities visit www.elearneconomics.com and become a premium member.

Contents

AS 91224: Analyse economic growth using economic concepts and models (2.3)

1	Overview – economic growth	2
2	The AD/AS model – economic growth	6
3	The production possibility frontier	14
4	Measures of economic growth	20
5	The circular flow model	28
6	Causes of economic growth	36
7	The impacts of economic growth	42
8	Review (exam) questions	50

Questions: Economic growth

1 a What is economic growth and explain the impact of growth on employment?

When there is an increase in real output GDP, this means that an economy has produced more goods and services than the previous year and the economy has experienced economic growth. As an economy expands, employment increases because firms hire additional workers to increase the output needed to satisfy the increase in demand, or they will use existing staff and pay overtime. There will be fewer redundancies in the workplace because fewer firms close down. Also, more firms will start up, because the perceived risks of operating a business in a buoyant environment are lower. The increase in business confidence will lead to increased investment because the chances of the venture being successful and profitable are higher. Overall, in an expanding economy, fewer individuals will lose jobs and, with new firms hiring staff, the unemployment rate in the economy will decrease. Greater job opportunities for some workers arise because of shortages of certain skills in some sectors or industries.

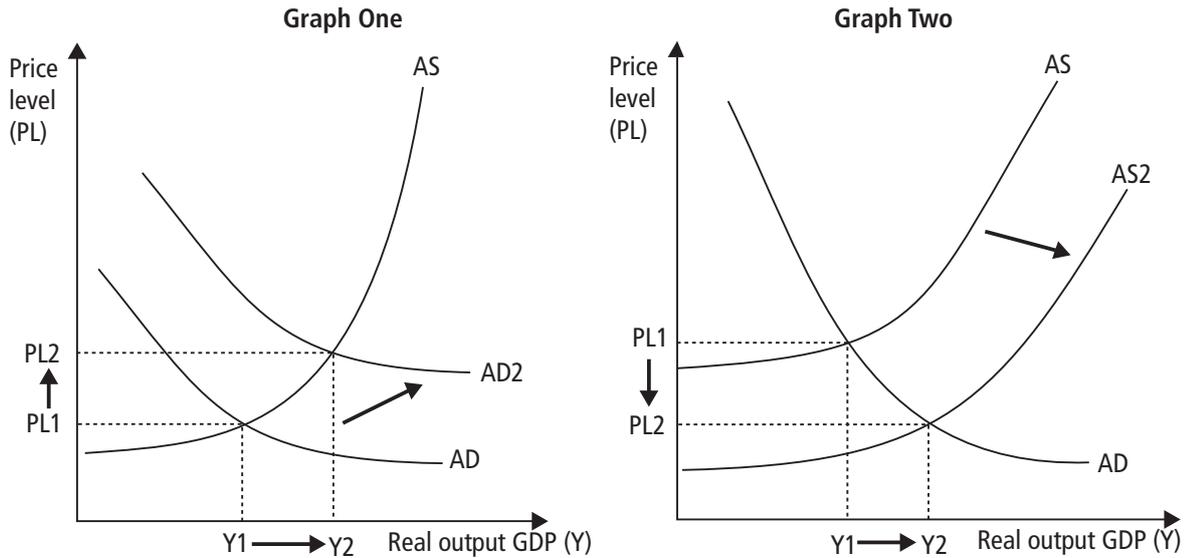
b Why is economic growth an objective of government?

For the government, economic growth is desirable because it brings in increasing revenues from a given structure of tax rates. It means that more and better roads, schools, hospitals and other social services can be provided without resorting to raising the rates of taxation. Growth is an objective of government economic policy because it is one of the keys to higher standards of living. Economic growth makes it easier for the government to carry out policies of income redistribution and achieve greater equity (fairness) of income distribution.

c What is the difficulty in using changes in the nominal value of GDP to measure economic growth?

Nominal GDP exaggerates economic growth when prices rise due to inflation. The nominal value of national output may increase without an increase in the real output of goods and services.

Questions



1 a Explain which diagram(s) above illustrate economic growth.

Economic growth is an increase in actual output which means that more goods and services are produced in an economy. Economic growth occurs when there is an increase in real output GDP. Therefore, both graphs illustrate economic growth because the increase from Y1 to Y2 illustrates an increase in real output.

b Complete the table with a tick (✓) to match the situation with the appropriate graph above.

Situation	Graph One	Graph Two
(i) Increased domestic demand	✓	
(ii) A decrease in saving	✓	
(iii) An increase in export receipts	✓	
(iv) A government operating deficit	✓	
(v) The impact of increased infrastructure investment spending	✓	✓
(vi) Decreased costs of production		✓
(vii) Reducing income tax rates	✓	
(viii) Wages decrease		✓
(ix) Increased productivity		✓
(x) Increased net migration	✓	✓

c Explain your answer to b (x)

When new migrants arrive in a country they will look to set up house and buy whiteware (appliances) and other household effects. They will also buy or build houses. Aggregate demand will therefore shift outward.

The AS curve shifts right (outward) because there is an increase in the supply of workers, so more resources are available and wages will fall. Costs of production to firms will fall. Costs decrease, profits increase, so firms plan to produce more, therefore AS shifts right.

A change in the Official Cash Rate (OCR) impacts on retail bank interest rates.

6 a Explain the impact of a decrease in interest rates on economic activity.

In your answer you should:

- Explain the effect of a decrease in interest rates on consumers.
- Explain the effect of a decrease in interest rates on producers.
- Explain why the changes may not be as significant as you predict.

As the OCR decreases interest rates would fall. Household consumption spending would increase because savings would decrease as households receive lower returns. Borrowing would increase because the cost of a loan would fall. As some households pay less on mortgage repayments, their discretionary incomes would increase and increase the funds they have to spend or save. These changes will cause AD to shift outward.

As interest rates fall firms are likely to increase spending on capital goods because the lower cost of borrowing will reduce the risks involved and increase the profitability of new activities. AD will shift outward. The decrease in interest rates is likely to cause the dollar to depreciate. Firms that export will find that their products are more price competitive and they are able to swap forex for more \$NZ. Incomes of exporters increase, causing AD to shift outward.

The changes in consumer and producer responses to a decrease in interest rates may not be as significant as I predicted because there will be a 'time lag', i.e., there will be a delay of time between the announcement of a change to the OCR and the effect on interest rates that apply to households and firms. Also, when interest rates fall, some households and firms have fixed mortgages so the change in the OCR has no effect on them. Firms will not necessarily invest more as interest rates fall because they may not be confident about the future and unwilling to take the risk of investing despite the cheaper loans available.

b State, for each situation, which event or situation will have a larger impact on economic activity and explain why.

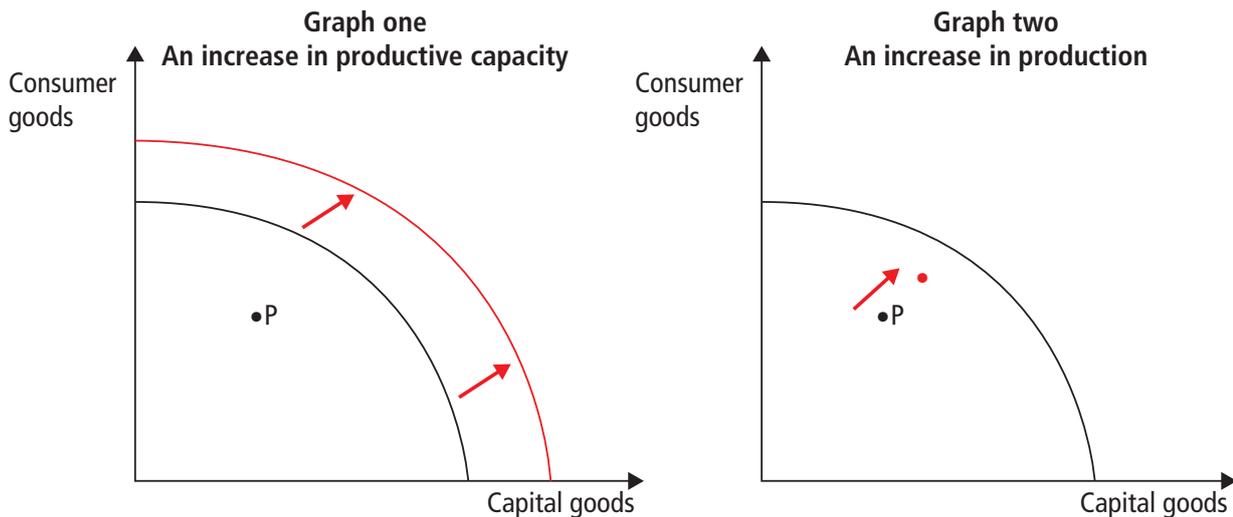
(i) A decrease in interest rates or an increase in house prices.

A decrease in interest rates will have a larger impact on economic activity because it will impact on consumption spending, investment spending and net exports. An increase in house prices only impacts on consumption spending if households take out loans against the increased equity of their houses and increase spending.

(ii) A decrease in transfer payments or an increase in direct taxes.

An increase in direct taxes will have a greater impact on economic activity because most households earn an income while there are fewer people on a benefit (transfer payments).

3 a Assume the economy is operating at point P. Illustrate the effect on the diagrams indicated by the title.



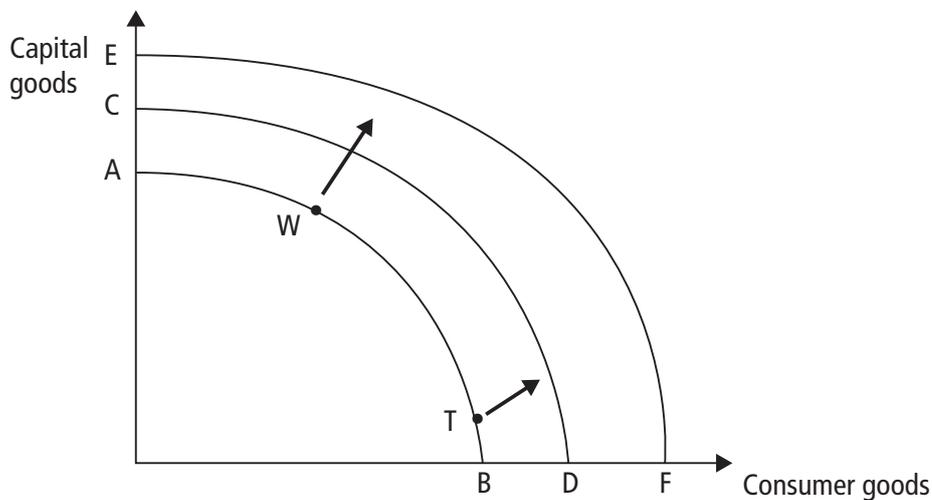
b (i) Define the term 'physical capital'.

Manufactured goods used in production.

(ii) Describe how an increase in physical capital impacts on economic growth.

An increase in physical capital increases productive capacity and productivity increases. Firms can produce more with the same number of workers, production increases, therefore growth increases.

c Refer to the diagram below to explain how future growth comes at the cost of present consumption.



Idea that if more resources are used to satisfy present consumption (position T), it will limit future growth, shown as the PPC CD, while if more resources are put into the production of capital goods now (position W), or investment, future growth will be much greater, shown as the PPC EF.

d (i) Which position is likely to result in the highest future growth in New Zealand?

T or **W** circle your choice

(ii) Which position is likely to result in a higher standard of living in New Zealand?

T or W circle your choice

- 4 Explain how events (rugby, netball, rowing and orienteering world cups) contribute to increased economic activity. In your answer you should state the injection flows in the circular flow model and explain how each injection flow will increase because of events. Explain how events will cause economic growth directly and indirectly.

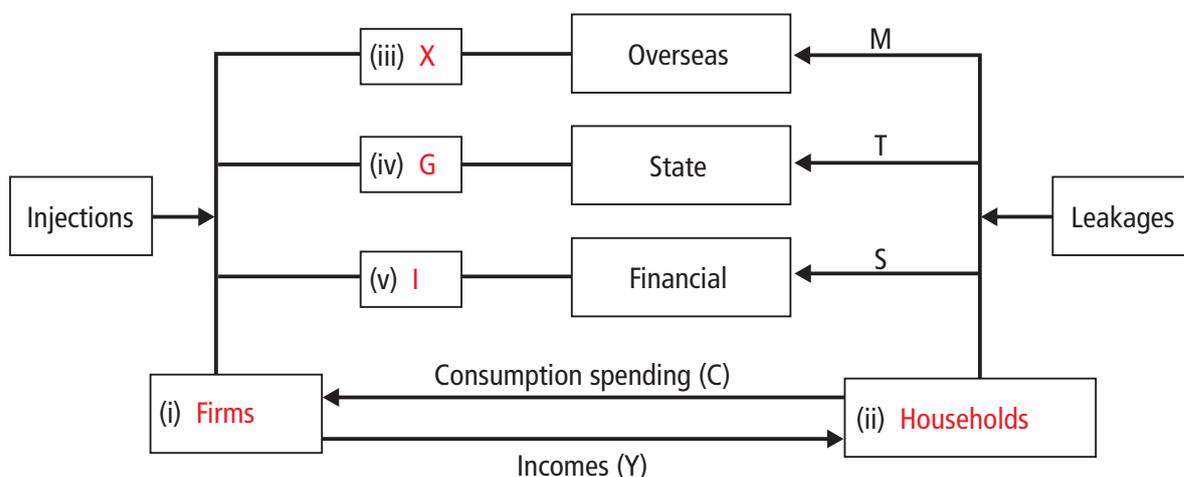
The injection flows in the circular flow model are investment spending (I), government spending or subsidies (G) and export receipts (X).

Investment spending (I) by firms will increase before the events take place so that firms can take the opportunities that will arise when the event is on. Visitors will need a place to stay (accommodation), food and transport, therefore firms in these industries will look to replace old plant and machinery and increase capacity to satisfy additional demand. Because infrastructure needs to be built for these events (stadiums, roading) firms in the construction industry will also increase investment spending.

Government spending (G) will increase because government and local authorities are involved in funding some of the costs of infrastructure. Export receipts (X) will increase as visitors (tourists) and competitors come to participate in or watch the events, they will consume goods and services in New Zealand such as food, accommodation and transport.

A direct effect is the actual spending on the events as they take place, for example, taxis or train trips to the games or spending on merchandise sold during the events. An indirect effect will arise as firms hire additional workers while the events are on or pay existing workers overtime. As their disposable incomes rise then it is likely that consumption spending by households will increase. Both the direct and indirect effects will see AD shift outward and an increase in real output GDP, which is economic growth, as output in the economy increases.

- b Label the missing spaces (i), (ii), (iii), (iv) and (v) on the diagram below (note some are sectors and the rest are money flows).



QUESTION FIVE: CONSUMPTION SPENDING AND GROWTH

Complete (a) and (b) to analyse the effect consumption spending has on economic growth.

Despite interest rates falling, savings have increased as concern for the future rises.

- a Explain the statement above. In your answer you should:
- Identify the sectors (i) and (ii) in the diagram below. Write your answer in the space provided.
 - Define savings and explain why when interest rates fall it is likely that savings decrease.
 - Explain the effect of increased savings on financial institutions.
 - Explain how savings may affect economic growth.



Savings are income not spent. As interest rates fall then saving is likely to decrease because people (households) will be getting a lower return on funds set aside, therefore saving less.

As savings fall consumption spending will increase. Consumption spending is a component of aggregate demand. As aggregate demand increases, real output GDP will increase, this increase in actual output is economic growth.

When financial institutions collect greater deposits from household savings they will have greater funds available to lend out to firms for investment. Financial institutions will look to make advances to credit-worthy businesses that want to expand/buy capital goods.

Investment spending is a component of aggregate demand. As aggregate demand increases, real output GDP will increase, this increase in actual output is economic growth.