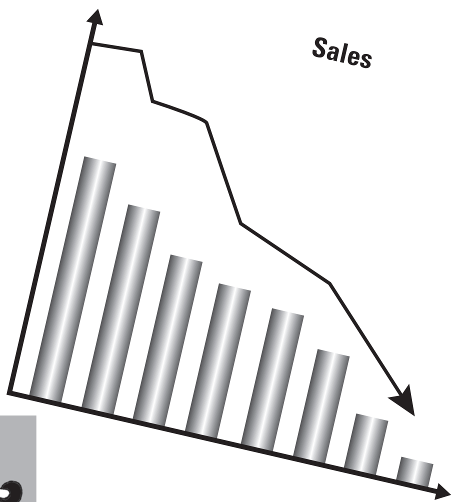
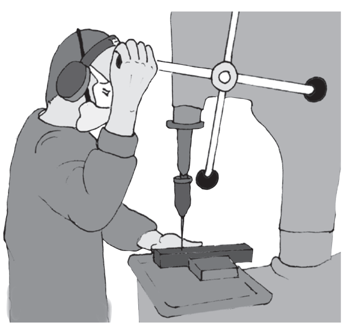
Contents

Core: Investment spending (I)

- Investment spending (I) or capital formation takes place when firms buy capital. For example, a farmer buys a quad bike, a horticulturist builds a dam for irrigation purposes or a manufacturer installs new machinery.
- Investment spending (I) is a component of aggregate demand (AD).
- Businesses are more likely to increase their level of investment spending (capital expenditure) if they are confident about the prospects of a venture or project being successful. As part of this process of deciding to invest (purchase new capital items) or not, firms will consider the cost of borrowing the funds required (i.e., interest rates), the level of risk involved as well as the profitability of the decision.
- As interest rates increase then firms are less likely to invest because the risk is higher and the profitability is reduced because the cost of borrowing funds has increased. Investment spending will fall and decrease aggregate demand.
- There exists a link between investment spending and the balance of payments on the current account because some capital items have to be purchased from overseas suppliers if New Zealand does not produce these items (machinery, equipment, tools). As imports of capital goods from overseas rise it will increase the current account deficit or make a current account surplus smaller.
- A stable exchange rate will make business decisions more predictable because firms will be more assured about their costs and incomes. This is likely to increase business confidence in future profits and increase their willingness to buy capital goods (investment). Greater investment will result in an increase in aggregate demand and an increase both in real output GDP (economic growth) and the general price level (inflation).
- Before investment funds are available to firms, those funds need to be saved by households with financial institutions, this enables financial institutions to have funds available to advance (lend) to firms who want to buy capital. When interest rates fall investment should increase, however this is not always the case. Financial institutions may be unable to find credit worthy firms to make advances to, or firms may not wish to invest despite lower interest rates because they are not confident about the future or simply have little or no desire to expand because they have a goal of satisficing. Satisficing is a business goal of being content with a certain profit or sales target rather than maximising profit or sales.





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Questions: Investment (I)

(a) In economics what is meant by the term investment and who will undertake it?

Investment spending (I) or capital formation takes place when firms buy capital.

(b) In what circumstances is investment likely to increase?

Investment is likely to increase when firms are confident about new business ventures. When interest rates fall firms are more likely to invest because the risk is lower and the profitability of new ventures increased because the cost of borrowing funds has decreased.

(c) When interest rates fall investment should increase. Explain why this is not always the case.

Investment may not take place when interest rates fall because firms are not confident about the future and perceive the risks to be higher and the profitability of ventures as being lower. Some firms may be content will the status quo and not desire to expand the size of their business and/or market. Banks may find they are unable to find credit worthy firms to make advances to, despite interest rates falling.

(d) Explain the possible link between an increase in investment spending and the current account balance.

Investment spending involves the buying of capital goods, some of which will need to be imported from overseas. This will cause import payments in the balance of goods to increase. As import payments increase the current account deficit could increase or a current account surplus become smaller.

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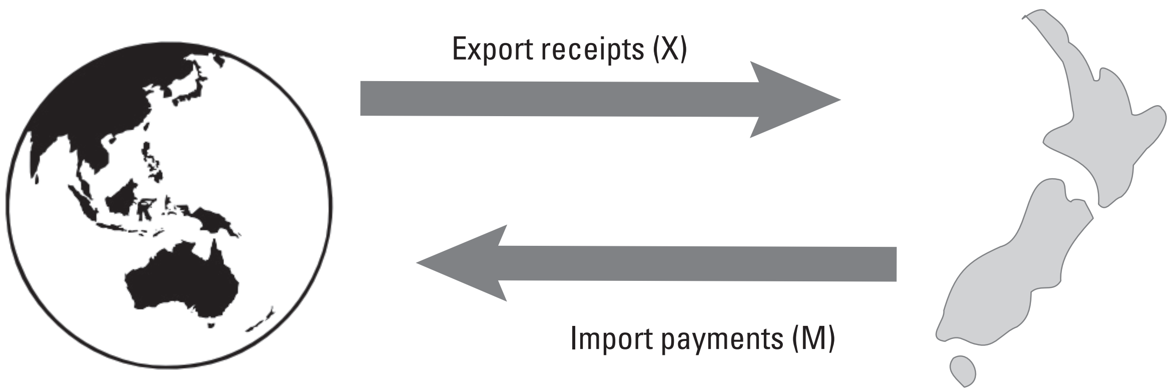
Core: The current account

- The current account consists of the following four accounts:
  (i) The balance of goods which is the export of goods minus the import of goods, e.g., meat, oil, timber, cars.
  (ii) The balance of services which is the export of services minus the import of services, e.g., tourism, education, insurance, transport.
  (iii) The balance on income from profit, interest and dividends.
  (iv) The balance on current transfers which includes gifts, foreign aid and money sent to relatives and friends.
- An improvement in the current account (a greater surplus or a smaller deficit) will arise if export receipts increase, import payments fall and/or export receipts rise faster (or fall slower) than import payments.
- The quantity of goods and services that New Zealand exports depends on several factors, i.e., the value of the New Zealand dollar, the quality of New Zealand-made products, overseas countries' incomes, tastes and preferences, the price of overseas countries' substitute goods and services. When the New Zealand dollar appreciates, New Zealand goods and services become less price competitive and the quantity demanded for them may fall. As incomes rise in overseas countries then these countries may demand more New Zealand goods and services. The demand for New Zealand dairy and meat products can depend on the perceived real or imagined quality of these products by overseas consumers. Bad press or publicity over the quality of commodities will influence the demand for exports and therefore export earnings.
- The quantity of goods imported into New Zealand depends on the factors similar to those that determine the demand for our exports. As New Zealand household incomes rise households may buy a greater number of luxury items such as a new car or electrical goods, or decide to travel.
- Economic growth in New Zealand will result in higher disposable incomes with some of this increased income spent on imported goods (e.g., cars, electrical products) and services (e.g., overseas travel), this will impact on the current account.
- Inflation in New Zealand will impact on the current account because an increase in the rate of inflation in New Zealand will mean that New Zealand firms will have to increase prices to cover costs and maintain profit margins. As prices increase for New Zealand-made products they will be less price competitive overseas. Export sales are likely to fall causing lower export receipts. Imported products are likely to be more price competitive compared with New Zealand made products, with consumers buying more imports. As import payments increase and export receipts fall the current account balance is likely to deteriorate, i.e., there will be a smaller surplus or greater deficit.



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Questions: The current account

(a) List the components of the current account balance of the balance of payments.

The balance of goods, the balance of services, the balance on income and the balance on current transfers.

(b) Which component of the current account would the following transactions be recorded.

Transaction	Component of current account
(i) New Zealand apples.	Balance on goods
(ii) A foreign film crew working in the South Island.	Balance on services
(iii) Honey from Hawke's Bay.	Balance on goods
(iv) Competitors for a world championship event in New Zealand.	Balance on services
(v) Transport by Maesrk (a foreign owned shipping firm).	Balance on services
(vi) Australian owned bank profits.	Balance on income
(vii) Dividends earned by overseas shareholders of a New Zealand power company.	Balance on income
(viii) Dairy products from the Waikato.	Balance on goods
(ix) Overseas students attending a university in New Zealand.	Balance on services

(c) State some factors that will determine the level of exports.

The quality of New Zealand made goods and services, overseas countries' tastes and preferences, the price of overseas countries' substitutes, goods and services, the value of the New Zealand dollar, overseas countries' income.

(d) With reference to low inflation in New Zealand explain how the current account could improve.

Inflation in New Zealand will impact on the current account because a decrease in the rate of inflation in New Zealand will mean that New Zealand firms who export will become more price competitive because they are less likely to increase their prices to cover costs and maintain profit margins. Exports will be more price competitive. Export sales are likely to increase causing higher export receipts. Imported products are likely to be less price competitive compared with New Zealand-made products, with consumers buying fewer imports. Overall, as export receipts increase and import payments decrease the current account balance is likely to improve, i.e., be a smaller deficit or greater surplus.

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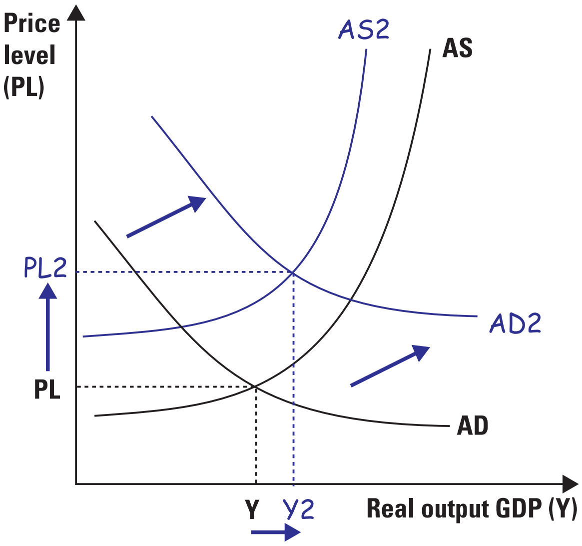
QUESTION THREE: THE AD/AS MODEL

A change in interest rates and business confidence will have an impact on inflation…

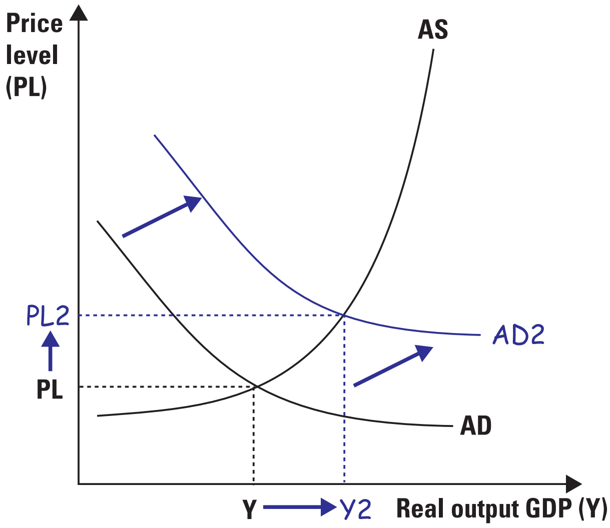
Compare and contrast the effects on inflation of a decrease in interest rates and an increase in business confidence. In your answer, you should:

- show the change on each AD/AS model indicated by the title on **Graph One** and **Graph Two**
- explain in detail the changes made on both graphs
- explain in detail why a decrease in interest rates may have a greater effect on inflation than an increase in business confidence. Refer to the diagrams in your answer.

Graph One
A decrease in interest rates



Graph Two
An increase in business confidence



A fall in interest rates will increase consumption spending because households will pay less on mortgage repayments. Discretionary incomes will increase, some of which will be spent. OR households will borrow more because the cost of borrowing has decreased. People will also save less because the return on saving is lower.

Investment is likely to increase when firms are confident about new business ventures. When interest rates fall firms are more likely to invest because the risk is lower and the profitability of new ventures increases because the cost of borrowing funds has decreased.

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As interest rates fall the New Zealand dollar is likely to depreciate.

A falling New Zealand dollar results in exporters swapping foreign earnings for more New Zealand dollars. The increased earnings enable more spending so cause AD to increase and therefore demand-pull inflation. Also a falling New Zealand dollar results in an increase in the cost of importing raw materials. The increased costs faced by firms will cause AS to decrease and cause cost-push inflation.

An increase in business confidence will result in an increase in investment spending. This will shift the aggregate demand curve (shown on Graph Two as the change from AD to AD2) outward causing inflation (shown as the change from PL to PL2).

Both events cause an increase in inflation. A decrease in interest rates will have a larger impact on inflation than an increase in business confidence because a fall in interest rates affects more components of AD, such as consumption spending and exports. Also the decrease in aggregate supply will further increase inflation, caused by the New Zealand dollar depreciating due to the decrease in interest rates. The price level change is greater on Graph One than that shown on Graph Two.

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QUESTION THREE: THE NEW ZEALAND DOLLAR.

Portfolio diversification towards the American dollar and Euro by forex dealers has weakened the New Zealand dollar.

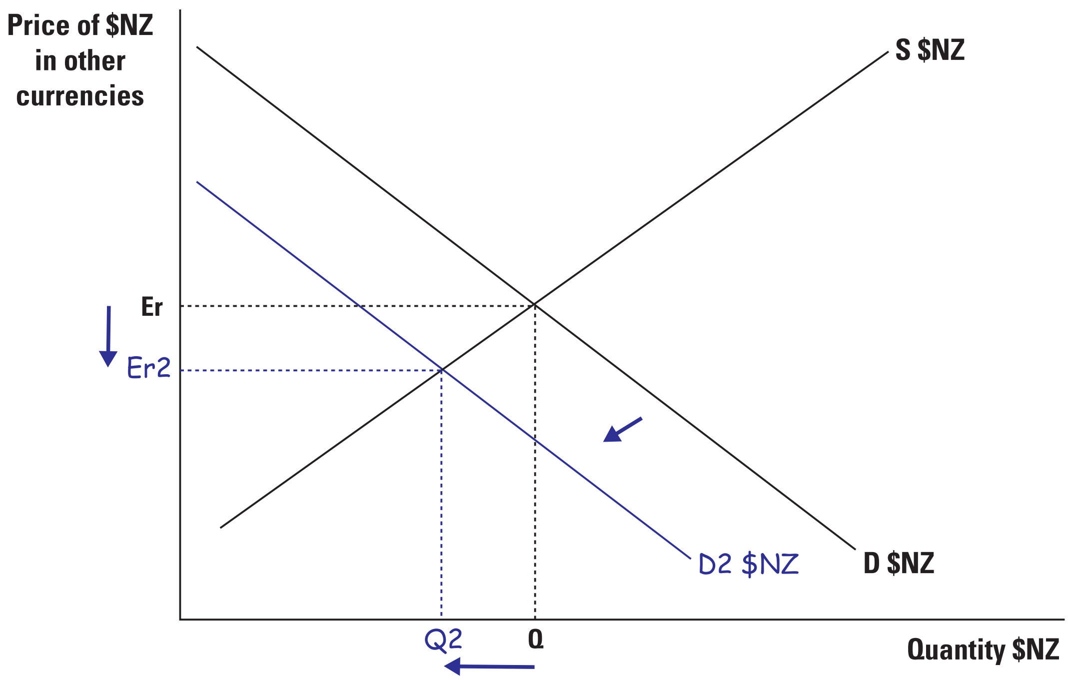
Complete **(a)** and **(b)** to comprehensively analyse the effects of decreased foreign investment and free trade agreements on the value of the New Zealand dollar.

(a) Explain in detail the impact on the value of the New Zealand dollar of decreased investment in New Zealand by overseas investors.

In your answer:

- Show on **Graph One** the impact of decreased investment by overseas investors on the market for the New Zealand dollar.
- Explain the changes you made on **Graph One**.

Graph One: Market for the New Zealand dollar



The demand for the New Zealand dollar will decrease from D $NZ to D2 $NZ because decreased investment by overseas investors will mean fewer overseas investors want to buy New Zealand dollars for portfolio investment purposes. This will cause the New Zealand dollar to depreciate from Er to Er2.

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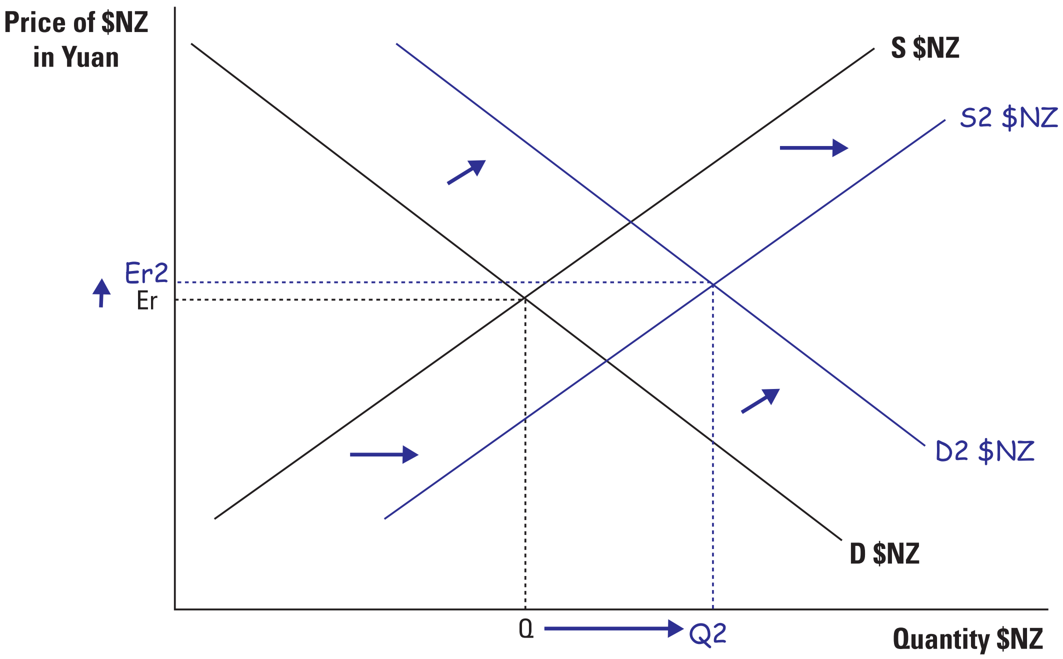
(b) Compare and contrast the impact on the New Zealand dollar of decreased investment in New Zealand by overseas investors with the impact of increased trade between New Zealand and China.

In your answer:

- Explain how increasing imports from China would affect the value of the New Zealand dollar.
- Explain how increased exports to China would affect the value of the New Zealand dollar.
- On **Graph Two**, show the effects of increased imports and exports.
- Explain why decreased investment in New Zealand by overseas investors may have a greater impact on the New Zealand dollar than increased trade with China. Refer to **Graphs One** and **Two** in your answer.

Graph Two: Market for the New Zealand dollar



With increased imports from China, New Zealand firms will need to sell $NZ to obtain Yuan to buy Chinese goods and services. The supply of the New Zealand dollar will increase (shown as S $NZ to S2 $NZ).

As New Zealand exports to China increase, there will be an increase in demand for New Zealand dollars from Chinese buyers/or New Zealand exporters who need to swap Yuan for New Zealand dollars. This is shown as D $NZ increasing to D2 $NZ.

The increase in demand for $NZ offsets the increase in supply of $NZ so the New Zealand dollar appreciates from Er to Er2. (Student answers may vary as the two effects could offset each other, resulting in no change in the exchange rate.)

The change in trade with China could result in no change to the exchange rate or cause it to appreciate or depreciate. Decreased foreign investment will cause the New Zealand dollar to depreciate and will have a larger impact on the New Zealand dollar because it considers the impact of a large group of investors rather than just New Zealand's trade with one country.

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