

93402



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TOP SCHOLAR



NEW ZEALAND QUALIFICATIONS AUTHORITY
MANA TOHU MĀTAURANGA O AOTEAROA

Scholarship 2013 Economics

2.00 pm Wednesday 27 November 2013

Time allowed: Three hours

Total marks: 24

Check that the National Student Number (NSN) on your admission slip is the same as the number at the top of this page.

Pull out Resource Booklet 93402R from the centre of this booklet.

Answer 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 2–20 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.

You have three hours to complete this examination.

This paper consists of three structured essay questions. For each question, use appropriate economic models to illustrate key points, and integrate information from the resource material to support your argument/evaluation.

QUESTION ONE

The New Zealand airline industry (domestic and international) could be considered highly competitive.

Using information from **Resources A to I**, and your knowledge of microeconomic theory, analyse how an airline operator could estimate the elasticity of demand for its services.

Evaluate the significance of this knowledge for the firm in making its **pricing decisions to maximise its revenue** when operating in the highly competitive New Zealand airline industry.

In your answer:

- analyse how an airline operator can benefit from knowledge of each of the three elasticities of demand when making its pricing decisions
- discuss the factors that might help an airline operator determine the level of elasticity of demand for its services (ie price elasticity of demand, cross elasticity of demand, and income elasticity of demand)
- evaluate the importance of this knowledge for an airline operator in **maximising its revenue** in the long run.

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Is the market highly competitive?
 - Duopolistic
 - Oligopolistic
 - Monopolistic competition

Elastic or Inelastic?
 Competitive 'not' competitive

- certain services are like
- some are unlike
- overall

Calculate

low = cost price
 = most profitable

Maximising revenue
 $MC = MR$

(owning price, more than proportionate income in demand /
 less than proportionate income in demand?)

Begin your essay here.

New Zealand's airline industry could be considered highly competitive. Particularly internationally, there is a wide range of operators (from Qantas to Air New Zealand to Emirates) offering more-or-less a similar service to each other. Air travel — from point A to point B. Given that these operators are offering more-or-less a highly similar service, and the number of them, competition inevitably arises. Operators attempt to differentiate their services in the perception of the buyer (the market). Airlines would brand themselves as 'higher quality', or as offering a 'more efficient' and 'more enjoyable' service. However, the extent to which differentiation can occur within the airline industry is certainly very limited — the New Zealand Herald in Resource I outlines this in stating that airline travel is essentially a commodity service. "Airlines, when it comes down to the core of the service, offer more-or-less the same ^{service} — transport from point A to point B — regardless of the operator. Thus, price competition — ~~for price competition~~ becomes the most effective way by which to attract customers."

Services can be divided either elastic or inelastic. Elastic services are services which are not entirely necessary, and have a range of substitutes available. As a result, for elastic services, a change in price will result in a More than proportionate change in demand. Inelastic services are essentially the opposite of this. In the eyes of the consumer, inelastic services could be seen as

necessity with no ready substitutes easily available. It is therefore important for an airline, in determining its pricing structure, to understand its elasticity — thereby understanding the extent to which lowering prices could have on its long - term profits.

One could argue that the total airline industry is inelastic, whereas the individual airline company faces a relatively elastic demand curve. This could be argued because, as a whole, the industry is more of or less a necessity to consumers. That is, if ~~consumer~~ A wishes to visit ~~in~~ ^{her "cousin"} San Francisco, the only way of making ^{the} journey quickly is by air travel. Airlines offer these invaluable services. Of course, there will be a point in the pricing structure at which ~~airlines~~ becomes a more "elastic" service (That is, reasonable common sense applies in any pricing structure — the consumer will only demand a good if it is within ^{an affordable} price range).

On the other hand, the individual airline company could face a relatively elastic demand curve. This is because the individual service that the individual ^{airline} company offers (e.g. route A to B), can be easily substituted by the service of another airline operator offering the exact same or a very similar route. For this reason, one could expect that were an airline to raise its prices, it would suffer a more than proportionate decrease in demand, as consumers will instead seek the service from alternative airline operators.

For this reason, the airline companies must understand the extent to which they can alter their pricing structures to attract consumers and maximize their profits. Ideally, the airline operator should wish to calculate its elasticity using the three models (price elasticity of demand, income elasticity of demand, and cross elasticity of demand). H

Rates for elastic services, such as the individual airline company could be expected to be — to an extent — lowering prices would result in a more than proportionate increase in demand, and therefore an increase in revenue for the airline company, and subsequently a likely increase in profit.

To gain a comprehensive understanding of its elasticity, an airline operator should calculate its demand elasticity of price, income, and con (ie comparing it with substitutes and complements). L

The airline should first understand to what extent the routes which it offers are seen as "unique." That is: Is a similar route, offered by a competing firm, seen as a substitute? The formula for this equation can be seen below:

$$\frac{\left(\frac{\Delta QD}{\Delta \text{midpoint QD}} \right)}{\left(\frac{\Delta P}{\text{midpoint P}} \right)} \} \text{ of said airline}$$

$$\} \text{ of competing airline}$$

A positive figure as a result would suggest that as the price of a competing airline's service either decreased or increased, the price quality demand of the given airline doing the calculation would head in the some opposite direction.

Put simply, were a competing airline to raise its prices, and another airline to, as a result of this, ~~have~~^{experience} an increase in ~~the~~^{the} demand for its service, then the 2 airline services offered could be considered to be substitutes.

The reason that one would expect airline routes to be substitutes is because that more often the same service is offered. I.e. if Air New Zealand lowers its prices for a route from Auckland to Bangkok, the demand of Emirates for this identical route is likely to fall, as their consumers would see Air New Zealand's offer as relatively more attractive due to its increased affordability.

Income elasticity of demand calculates whether the service offered by the airlines is a luxury or a necessity, and to what extent. One would expect the demand for air travel to rise with an increase in consumers' income. As a result, for airlines to maintain their competitiveness in the times of ~~for~~ economic downturn, where consumer wealth is relatively low, to maintain revenue, an airline could expect to lower its prices — thereby being a smaller portion of the consumers' ~~already decreasing~~ income.

This last model can also be shown by the price elasticity of demand. An airline, given the conclusions that can be drawn from the above two measures of elasticity, could expect its service to be elastic ^{by the price elasticity of demand} that is, when prices fall, demand rises ^{more than proportionately}, and when prices rise, demand falls more than proportionately. The equation is elasticity

this

$$\left(\frac{\Delta QD}{\text{mid. } QD} \right) = \frac{\Delta P}{\left(\frac{\Delta P}{\text{mid. } P} \right)} = \text{price elasticity of demand}$$

where the result is >1 , the change in QD relative to change in P is more than proportionate, thus suggests elasticity. Given the nature of the airline industry — in which many close substitutes are available in a highly competitive marketplace, one could expect elasticity.

This suggests that to increase revenue, a firm should decrease its prices (because the increase in revenue should be more than proportionate). However, given the limited marketplace and the ~~yearly~~ availability of prices for consumers (such as on the internet and through web-based services such as Webjet in Resource B), this increase in demand will come at the cost of the demand for alternate suppliers / alternate ^{airline} companies. This loss in demand for these companies will be felt. As a result, to recoup this ^{cost} demand, these companies must also decrease their prices (as there is little alternative in the way of service differentiation). However, this can spark a dangerous price war which may result in the ~~revenue~~ ^{price} for all airline operators decreasing in the long-run.

Thus, unless an ^{airline} wishes to start a price-war, it would be in its best intentions to not differentiate its services by way of price.

QUESTION TWO

Concern has been expressed in the media, and by community groups, regarding the number of children growing up in poverty in New Zealand.

Using information from **Resources J to O**, and your knowledge of microeconomic theory, discuss and evaluate the impact that high levels of child poverty may have on efficiency and equity in New Zealand.

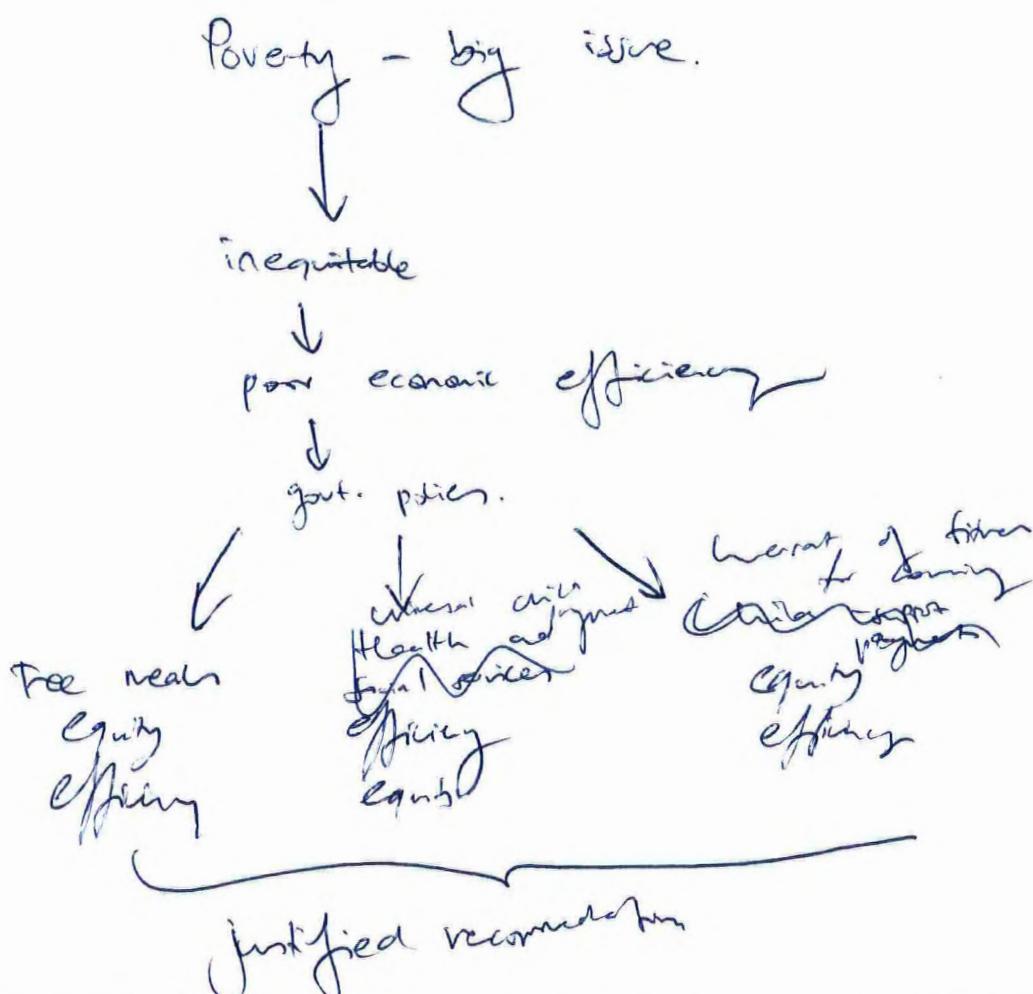
Discuss the case for government intervention, and evaluate possible government interventions to reduce levels of child poverty in New Zealand.

In your answer:

- discuss how high levels of child poverty may impact on equity and economic efficiency in New Zealand
- evaluate the case for government intervention to reduce the level of child poverty in New Zealand
- analyse and evaluate the relative effectiveness of differing government policies to reduce the level of child poverty, and their impact on equity and efficiency
- make justified recommendations as to what, if any, action government should take to reduce the level of child poverty in New Zealand.

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Poverty is not strictly a 'New Zealand' issue. Rather it is a persistent global one. However, in order to ensure the highest quality of life for all New Zealand citizens — especially for children who have little or no control over their life quality of life — it is the absolute responsibility of all New Zealand citizens, through the New Zealand government, to seek to alter this current situation. It is undoubtedly in the long-run interests of New Zealand citizens to seek to minimise (or if not to completely eradicate) child poverty in New Zealand.



The flow-on effects of poverty are significant and negative for all New Zealanders, even when the issue is looked at from a purely economic point of view. A child in poverty is less likely to succeed at school, is more likely to come from a troubled background, and therefore, as a result, is more likely to rely on greater government assistance for their entire life, as a result of many factors, including, but not limited to things like teenage pregnancy, and e.g. unemployment due to lack of education. It is therefore easy for one to see how, through not addressing poverty in children this issue can have a greater long-term cost on the government's social services. It is within the best interests of all New Zealanders to create a desirable long-term outcome, even if this means increased costs for the short-term.



A resource K outlines, 230,000, or 22% of New Zealand children in the years 2006 and 2007 were defined as living

in poverty. This is a completely inequitable situation for these children. Equity implies fairness. Arguably, from a pure economic viewpoint adult low-incomes are 'fair'. However, what is not possible to argue is that this is somehow 'equitable' for children who are unable to, in any way, influence the living standards in which they have been born. Instead, by failing to remove these children from the cycle of poverty, it is only too easy to become trapped, & the government is able to create a long-term equitable outcome by this short-term reallocation of resources.



Child poverty also creates long-term inefficiency. Long-term inefficiency because these children who grow-up in poverty, often never escape this situation. As a result, the reliance of these ^{individuals} ~~adult~~ in adulthood on government resources and government social services — funded through taxes — is greater. This long-term reliance on government resources, due to long-term poverty results in a long-term reallocation of resources to deal with (but not solve) this recurring issue. This long-term reallocation of resources to address ^{the} persistent poverty results in long-term inefficiency of the government. By reallocating these resources, and solving the core of the poverty issue — child poverty — in the short term, one is able to ensure long-term equity, and the long-term efficiency of the economy and of the government.

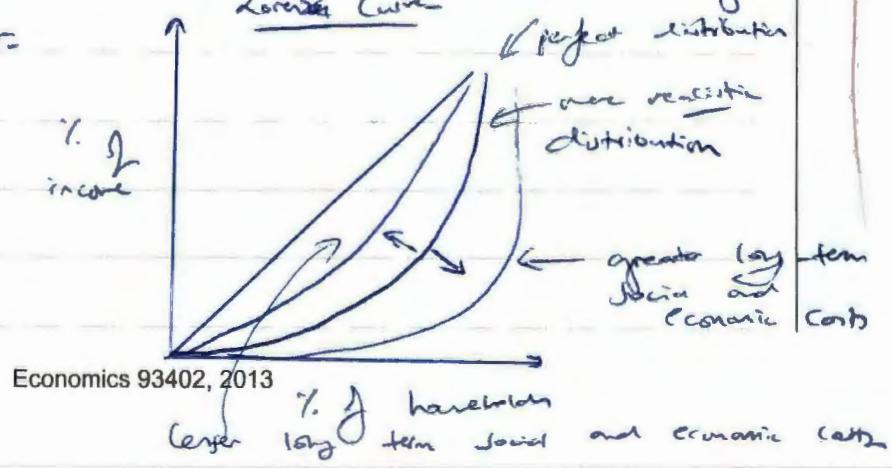
For these reasons as discussed above, it is therefore imperative that the government intervenes to address ^{the indicator rates of} child poverty in New Zealand.

There is a range of government policies available to address this issue, three of which are: free meals in schools, Universal Child payment, and a necessary 'warranty of fitness' for all rental housing.

The above policies may be in the short-run costly, however, in the long run, this short term increase in costs should be balanced about by long-run equity and efficiency within the New Zealand economy.

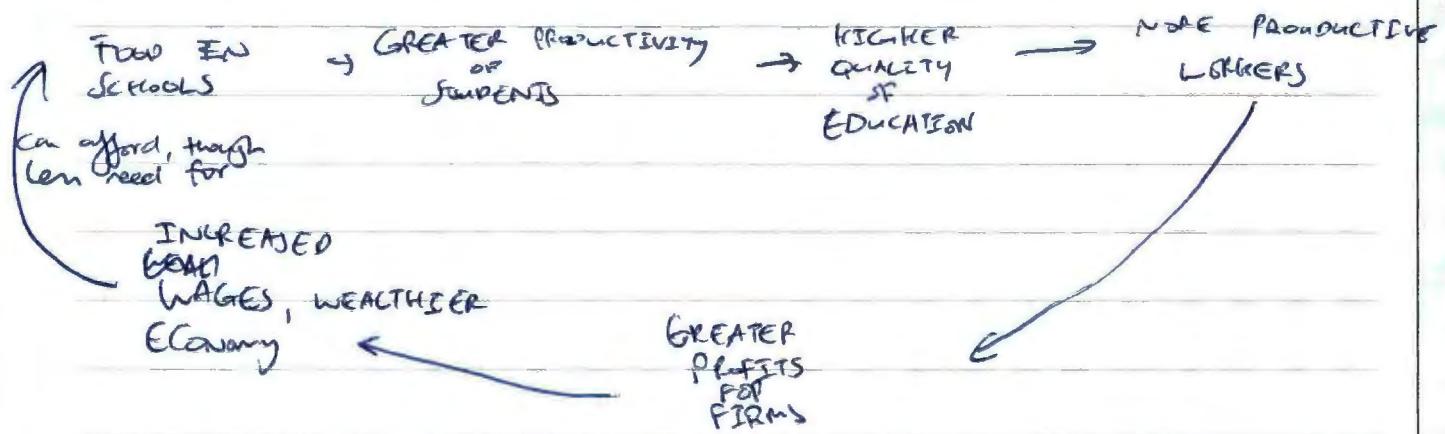
Currently, child poverty costs New Zealand — and the New Zealand taxpayer — as much as \$10 billion pa. There can be in the form of the effect of poor education on productivity, health, crime, and social welfare. In the interests of reducing and minimising the effect of poverty on New Zealand and its long-term costs to society, the short-term increased costs and reallocation of resources is completely justified.

The Lorenz Curve shows the distribution of wealth within an economy — a perfect perfect distribution (represented by a 45° line) is unattainable in a capitalist economy and impractical in any economy. However, to prevent the further disproportionate allocation of wealth and resources within the economy, these government interventionist policies are entirely necessary and justified.



By reducing income inequality (eradication is impractical, and unnecessary), one reduces the long-term cost to the government. In the long-term, this can result in a better allocation of resources, and decreased government and economic costs, thus resulting in long-term sustainability and an increased ~~gdp~~ standard of living in the long-term. As Phil O'Ferally states: "Countries that are prepared to invest in children... will reap the rewards later on.")

The suggested policy of government intervention is to provide food for children in schools. The argument for this is that the cost will pale in comparison to the \$20B cost of poverty to the economy each year, whilst it will increase student productivity, thereby raising the standard of workers in our economy in the short run. The Stiglitz ~~areas~~ suggest that inefficiency is rampant in any economy, however, this can be combated by increased levels of education and higher wages. Subsequently, increased levels of education in turn lead to higher wages.



However, the argument against this is that families will be inclined to free-load off this service. However, freeloading is most likely to occur in the families who have the

greatest need to save money — thereby, to an extent, justifying the free-loading. Any unnecessary free-loading, however, is likely to pale in comparison to the huge and significant long-run policies that this policy is likely to reap.

Another policy is a universal child payment — made to all parents for children up to 6 (approximately \$150 per week). This would be estimated to potentially cost the government \$750M pa. However, much like the previous policy of food in schools, the positive long-term effect that this policy is likely to have in combating child poverty should be expected to outweigh this cost. This extra income can be used by families to provide better education for children, food, and other necessities. Again, the argument against this policy, considering the redundancy of the "cost" argument, is the argument that this increased disposable income of families will be abused and not go towards the children. Stronger social policies brought in, in conjunction with these outlined policies, could combat negligent parents and reduce the and minimize the effect of this occurring — potentially.

A third policy is that of giving rental houses as "warrants of fitness" — any child is entitled to live in a safe and comfortable home. However, the benefit provided by this extends beyond this idea of "safety." Substandard living leading to illness annually costs the "public" healthcare system \$3 + \$4.5 billion (Resource M). By addressing the problem at its core, costs can be saved in the long-run once again.

QUESTION THREE

The New Zealand exchange rate has risen significantly since 2009 against most currencies. As a consequence, there is currently a debate as to the desirable level of the New Zealand exchange rate, with concerns (expressed by some key sectors) that the New Zealand dollar is too high.

With reference to **Resources P to U**, and using your own economic knowledge, discuss how the New Zealand exchange rate is determined, and analyse the key factors that influence the current level of the New Zealand exchange rate.

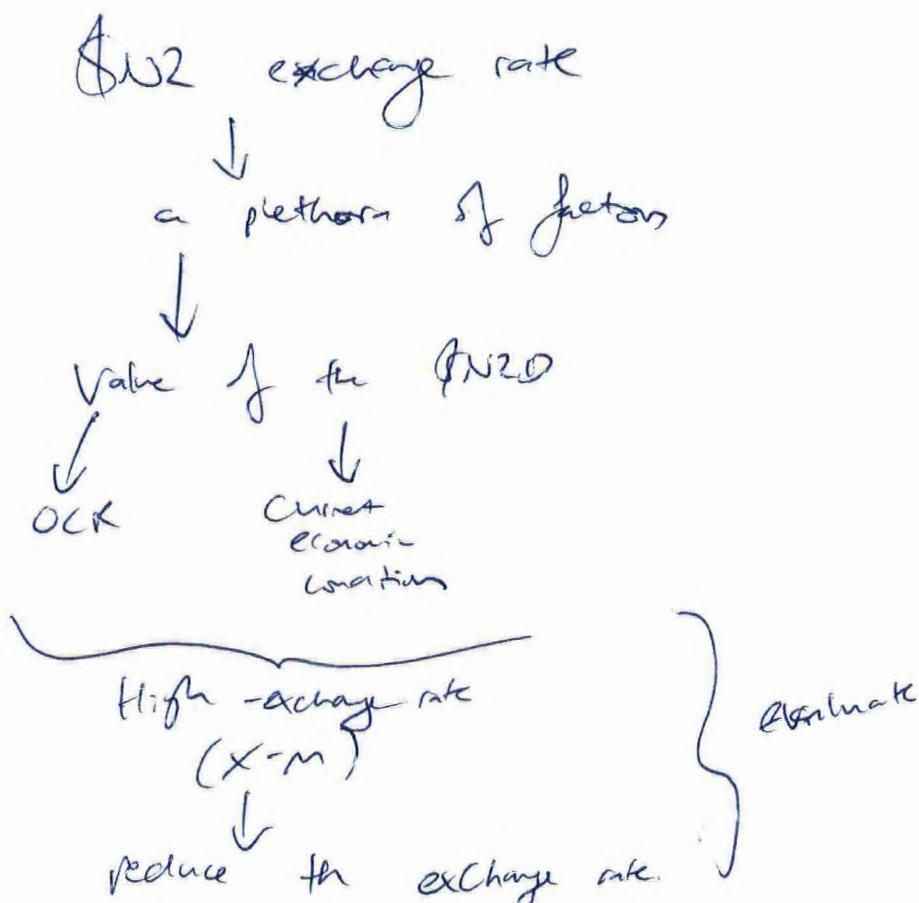
Evaluate the case for government intervention to lower the New Zealand exchange rate, and possible methods of intervention.

In your answer:

- illustrate and explain how the New Zealand exchange rate is determined
- identify and explain the main factors that affect the New Zealand exchange rate, including the impact of current economic conditions
- evaluate both the positive and negative effects of a high exchange rate on sectors of the New Zealand economy, and for New Zealand's macro-economy
- analyse and evaluate government policies that could be utilised to reduce the New Zealand exchange rate.

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The New Zealand exchange rate is essentially a measurement of the value of the New Zealand Dollar (\$NZD), as is determined by a range of supply and demand factors. Currently, the New Zealand exchange rate is high, given the high value of our dollar as the world recovers from the recession and subsequent economic austerity. This high value of our \$NZD is determined by a range of factors within our economy, which include, but are not limited to, our official cash rate (OCR) and the overall positive 'health' and wellbeing of our economy post-recession. However, the appreciated value of the New Zealand Dollar is having negative effects upon various aspects of the economy - particularly our exporters who require a depreciated \$NZD in order to maintain their competitiveness in the world markets. As a result, it is important that government policies are used to reduce the New Zealand exchange rate — or to at least limit the appreciation of the value of our \$NZD. ↴

The "soaring" ~~reserve~~ \$NZD, as outlined and visualised by the TWI graph of Resource P (a measure of the relative strength of our dollar against those of our trading partners), can be linked, in a large part, to the official cash rate (OCR), as is set by the Reserve Bank of New Zealand (RBNZ).

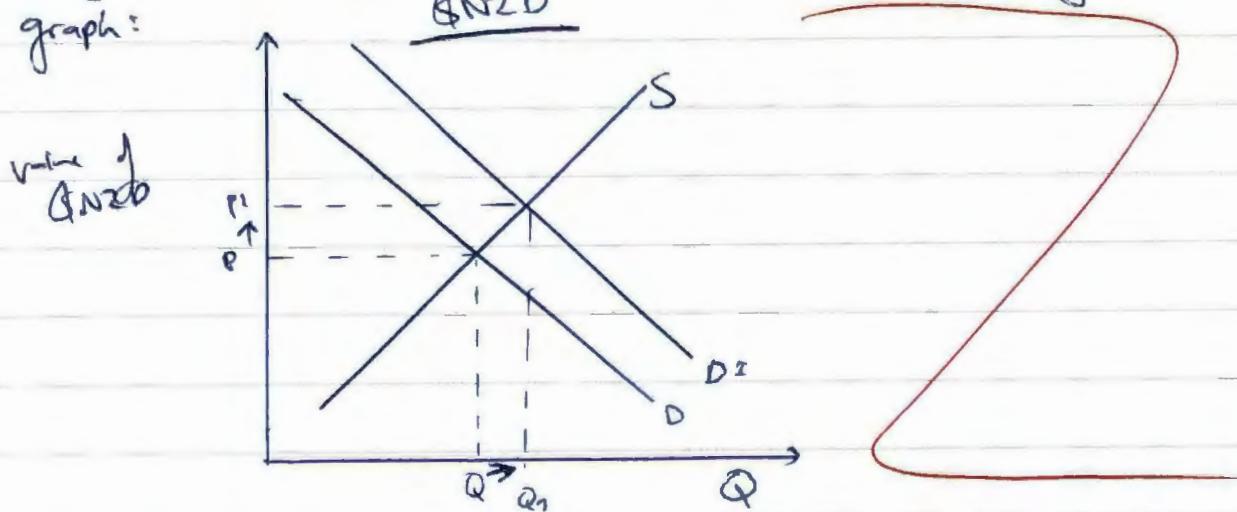
Resource S shows our relatively high OCR — at 2.5% in comparison to other OECD countries. Of those listed, only Australia has a higher OCR than New Zealand, at 3.0%. The OCR of a country's economy has a large influence over the demand for that country's dollar.

Not only does a stronger OCR indicate a lesser need for stimulatory pressures by the Reserve Bank (which in turn indicates the relative well-being of an economy, and its relative growth to that of other countries), but the OCR of the RBNZ ~~essentially~~ ^{is set} the exchange rates within ~~an~~ an economy, thereby setting the value for the dollar.

The RBNZ lends to ^{private} bankers at 0.25% interest above the OCR (and receives settled payments from these banks paying 0.25% below the OCR). For this reason, there is a strong correlation between the 90-day interest rates of bankers and the OCR.

Higher interest rates allow greater returns on investments in the \$NZD, and for this reason, with a higher OCR, the demand for the \$NZD increases, thereby subsequently increasing its value.

A hypothetical increase in the OCR is outlined by the below graph:



An increase in demand for the \$NZD, increases its "price," thus resulting subsequently in the \$NZD's appreciation.

Whilst, an OCR of 2.5% is still relatively low, it is still relatively high considering those of other economies (USA = 0.25%). In the post-recession state, this OCR indicates how New Zealand has fared well relative to other nations, who have had to lower their OCRs for an increased stimulatory effect. New Zealand has not needed to, to the same extent.

This indicates the second major contributing factor to the demand of the \$NZD — "Confidence". The relatively high OCR indicates a relatively healthy economy with a steady rate of growth. As a result of this, investment in the New Zealand economy is seen as a desirable alternative to investment in other 'first-world' economies, such as those of the United States of America, and England.

This increased felt investor confidence subsequently results in an outward shift of the demand curve for the \$NZD — this can be visualised on the graph on page 26.

Thus, as can be seen above, the New Zealand exchange rate is determined by the supply and demand for the \$NZD. This supply and demand is turn affected by a plethora of factors acting upon the economy. However, these factors are primarily the OCR and the current ^{relative} economic conditions of New Zealand's economy (i.e. growth and decreasing unemployment, as well as promising returns on increasing foreign investment in New Zealand, thereby increase the foreign demand for the \$NZD, subsequently increasing its marketplace value). Essentially, New Zealand is currently seen

as a safe investment. It is therefore difficult for the government to work to lower the exchange rate and to depreciate the \$NZD, in the interests of our exporters without compromising the attractiveness of the New Zealand economy as safe for foreign investors. A delicate balance must be attained.

In terms of macro-economics, there are both positive and negative effects of a high exchange rate. Growth in the New Zealand economy can be measured by the macroeconomic equation:

$$\text{RGDP} = G + I + G + (X - M)$$

(Real Gross Domestic Product)

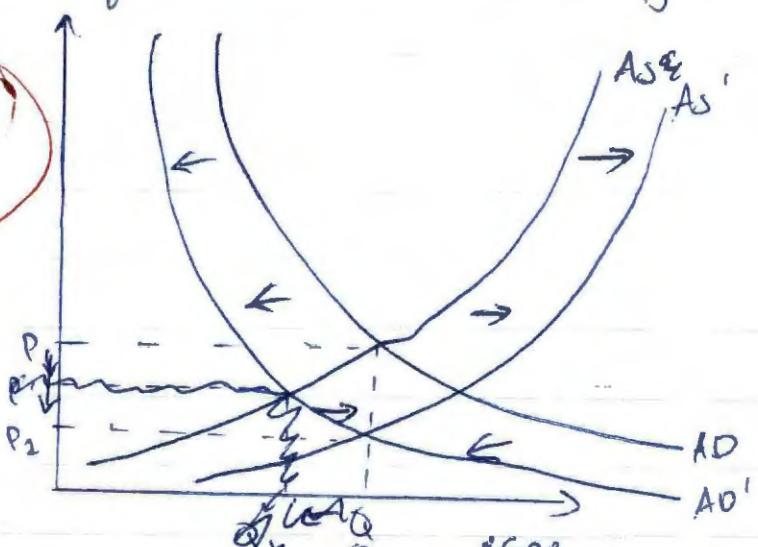
where, X = export receipts, and M = import payments.

Therefore, when $X > M$ acts as a pressure to shift AD (aggregate demand) in the New Zealand economy outwards and subsequently increase RGDP.

However New Zealand's current situation is where $M > X$, as we operate a current account deficit — that is, the value of our exports is less than the value of our imports.

However, this does not necessarily suggest that growth will be inhibited. A high exchange rate can be positive for firms as the cost of importing materials necessary for production is decreased, due to the relative value of our \$NZD. However, in a large part, this is often offset as overseas suppliers of the same goods and services, which are being produced by the New Zealand producer, become more attractive to consumers when purchasing

power has increased in international markets due to the high value of the NZD. Thus, again a balance is reached:



The graph above shows the expected effect of an appreciated NZD on the New Zealand aggregate economy.

Whilst the graph above shows a decrease in the general price level with little or no effect on gross economic output, one must remember that this is simplified to highlight the effect of an appreciated NZD, and that the economy as a whole is far more complicated than this.

The largest negative effect of a high exchange rate comes to the exporters. Exporters become relatively less competitive in the international marketplace, as the demand for our dollar has also increased its price. As a result, the same quantity of exported product becomes relatively more expensive for an overseas buyer. As a result, exporters sell less, and receive less income. Unfortunately (or fortunately) for New Zealand, much of our economy is based upon our export market — primarily that of agriculture. Therefore, any appreciation of the New Zealand Dollar is felt throughout the entire economy.

QUESTION
NUMBER

Extra space if required.
Write the question number(s) if applicable.

1. Therefore, to decrease its prices without sparking a subsequent price-war, it may portray itself as a budget airline. Budget airlines, such as Spirit Airlines and Ryanair are, as Resource I states, among the industries most profitable given their lower prices and relatively similar services, to all other airlines.

Thus, this knowledge of elasticity is highly important to an airline operator in terms of the long-term maximisation of its profits. Price-cutting will only result in a short-term increase in profit until other competitors follow suit to recoup the demand 'stolen' from them by this airline's price-cutting. Therefore, if an airline operator must look for alternative solutions to maximising profit, given an increased profit and an increased efficiency. Again, because other airline operators will be inclined to follow suit. Therefore, in the long-run, as all airlines are highly competitive, and cannot offer highly differentiated services (to a large extent, by price or by any other means), then the profit made by an airline operator in the long-run should be expected to be close to normal. (Not normal completely close $AC = AR$ because airlines offer some differentiation of services and prices → but close to normal because this differentiation of services and prices is still severely limited.) Therefore, price manipulation, in the long-run is not likely to maximize an firm's operator's revenue, but instead decrease the net revenue of the entire industry by creating price wars. As a result, in order to maximize profit, and to produce at where $MC = MR$, an airline operator must maintain its price practices in co-ordinating with those of other

Supervisor must print name & sign here:

An appreciation of the New Zealand Dollar → Decrease consumption or exports

Decreased income ←

Decreased employment.

Decreased consumer disposable income

Decreased overall economic welfare, decreased growth

As are visualised above, due to the significant role of our export industry (primarily agriculture), it is crucial to the welfare of the New Zealand economy that any appreciation of the New Zealand Dollar (\$NZD) is limited.

Therefore, there is a completely justified case for government intervention in the economy in order to decrease our exchange rate — in order to protect our export industry, and in order to therefore protect the welfare of the entire New Zealand economy.

The RBNZ could implement ~~present~~ monetary policy measures, such as decreasing the OCR. The RBNZ, due to the Policy Targets Agreement (PTA), must seek to keep inflation within 2%. This is its primary goal, and the primary purpose of the OCR. However, given that inflation is at the lower end of this band, decreasing the OCR would have the twofold effect of stimulating inflationary pressures (by stimulating borrowing from banks), as well as decreasing the demand for the \$NZD, and subsequently decreasing its value.

Go to NEXT EXTRA SHEET

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T.J. GARVEY

Government

Government expenditure comes in many forms, ^{healthcare} ~~but~~ being one of them. By reducing the need for this expenditure in the long run, the government may save itself billions of dollars ~~per~~ per year — ~~but~~ money that can in turn benefit the taxpayer as the government has an increased ability to reduce taxes, or may be reallocated to raise the standard of living across the country.



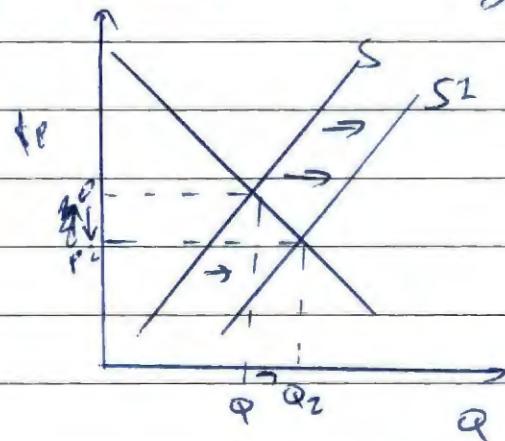
Therefore, government intervention to address poverty in New Zealand in the form of numerous suggested policies (found in schools, universal child payment, "warrant of fitness" for rental housing) is fully justified — as shown by the long-term positive flow-on effect outlined by the flow-diagram on page 12. This short-term increase in costs (or long-term, such as the universal child payment — a policy ^{already} implemented by most the OECD countries) will in the long-term have a positive effect on the economy in terms of a more productive workforce (Joseph Stiglitz), ^{great} firm profit, higher wages and overall ^{substantially} growth as measured by an overall ^{substantially} increased standard of living. As outlined by the Lorenz Curve on page 12, incomes will be distributed in a more equitable manner. In turn this creates a decrease in class-resentment (the poor can despite the exorbitantly wealthy, and for these wealthy, the workers are better educated and more productive).

Therefore, the implementation of these policies is fully justified. For, the long-term well-being of any economy, and of any society, is of greater importance than any short-term austerity or unnecessary cut-cutting for ^{the sake of} short-term

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The government itself could also discourage foreign purchase of the NZD, thereby decreasing demand for it. This could be achieved through the discouragement of foreign investment through taxation (such as a capital gains tax). However, this also has many adverse consequences. Whilst decreasing the demand for the NZD, it decreases the willingness of foreign investment — an aspect upon which our relatively small economy so heavily relies.

Another alternative is for the RBNZ (as regulated by the New Zealand Government) to decrease the value of the NZD by increasing its supply.



Again, this, to a large extent is draconian. For whilst having the desired effect upon the exchange rate, it stimulates inflation. (Though in New Zealand's inflation is still low, this may have effect for a limited time in increasing New Zealand's inflation rate to be within the target range)

$MV = PQ$

} shows how an increase in the money supply (n) must either increase the general price level or growth. For this reason, it is not an entirely ineffective policy to moderation.

Supervisor must print name & sign here :

All of the above policies, in moderation together can achieve the desired effect of limiting the appreciation of the \$NZD, thereby stimulating export-led growth.

However, any policy not in moderation (such as over-printing money, or discouraging foreign investment to a far too great extent) can have the reverse effect upon the economy as was intended.

A balance is necessary. A balance is also attainable through the reasonable use of a range of policies to achieve the desired outcome for the New Zealand economy.

