Money and Banking Pack

Mr Traynor©

Economics
Pack 5 • Leaving Cert

JT Economics

The Business Guys

Short Questions

1) 2016 Q7

The primary aim of the ECBs monetary policy is to maintain price stability.

(a) Define the term **monetary policy**.

_____

_____

(b) Outline **two** benefits of price stability for the Irish economy.

(i) _____

_____

(ii) _____

_____

(17 marks)

2) 2012 Q2

State **three** areas of responsibility of the European Central Bank (ECB).

(i) _____

(ii) _____

(iii) _____

(16 marks)

3) 2011 Q1

State **four** steps involved in constructing a Consumer Price Index (CPI).

Step 1 _____

Step 2 _____

Step 3 _____

Step 4 _____

(16 marks)

4) 2009 Q4

Define 'cost-push' inflation. Identify **two** sources of this form of inflation in the Irish economy.

Definition: _____

_____

Source 1: _____

Source 2: _____

(16 marks)

5) 2007 Q1

State **FOUR** possible economic effects of rising **price inflation** on the Irish economy.

(i) _____

(ii) _____

(iii) _____

(iv) _____

(16 marks)

6) 2007 Q5

Outline **THREE** functions/responsibilities of the **European Central Bank (ECB).**

(i) _____

(ii) _____

(iii) _____

(16 marks)

7) 2005 Q6

For a composite (weighted) price index covering the three types of expenditure given in the following table, calculate the price index for the current year. The base value is 100. **Show your workings.**

Category	**% income spent on item(s)**	**Prices of item(s) base year**	**Prices of item(s) current year**	**Calculation of Simple Price Index**	**Weight**	**Result**
		€	€			
Food	30%	10.00	11.50			
Clothing & Footwear	20%	40.00	36.00			
Other Items	50%	20.00	22.00			
	100%			**Price Index for the Current Year**	→	

(17 marks)

8) 2004 Q5

State **THREE** limitations on the power of banks to create credit.

(i) _____

(ii) _____

(iii) _____

(16 marks)

9) 2003 Q3

Define **Monetary Policy**. State **TWO** measures by which the European Central Bank implements monetary policy within the euro-zone countries.

Definition: _____

_____

Measure 1: _____

Measure 2: _____

(16 marks)

10) 2002 Q2

Outline **FOUR** steps involved in calculating a **Composite Price Index.**

Step 1: _____

Step 2: _____

Step 3: _____

Step 4: _____

(16 marks)

Long Questions

2015 Q5

(a) (i) Outline **three** factors that limit the ability of banks to create credit.
(ii) Discuss the economic reasons why the financial system in Ireland should be regulated.
(30)

(b) *In January 2015, the Central Bank of Ireland (CBI) introduced restrictions on residential mortgage lending (bigger deposit requirement for mortgage loans and upper limits on borrowing based on income).*

State and explain the possible economic impacts of these restrictions on the Irish property market.
(20)

(c) *The Strategic Banking Corporation of Ireland (SBCI) was set up to support SMEs (small and medium enterprises) by providing finance under favourable terms (e.g. lower cost credit).*

Discuss the possible economic benefits of increased access to funding for the SME sector in Ireland.
(25)
[75 marks]

2015 Q6 (a)

(a) "*Prices on average as measured by the Consumer Price Index (CPI) were 0.1% higher in November 2014 compared with November 2013.*" *(CSO statistics)*

(i) Do you consider the CPI an accurate measure of changes in the cost of living? Explain your answer.
(ii) Discuss **two** possible economic effects of price **deflation** on the Irish economy.

(25)

2014 Q4 (c)

(i) State and explain **three** factors that caused the price of residential property to fall considerably in Ireland in the years following 2007.

(ii) Mortgage arrears (i.e. the inability to meet mortgage loan obligations) is the biggest single personal debt issue for many households.

Discuss **one** possible economic impact of **mortgage arrears** on **each** of following:

- the household
- the banking sector
- the Irish Government.

(30)

2013 Q6

(a) (i) Explain, using a numerical example, how banks create credit in an economy.

(ii) Outline **two** factors which limit the ability of banks to create credit during recessionary times. (30)

(b) Some central banks have responded to the global financial crisis by introducing the monetary policy measure of 'Quantitative Easing' (i.e. buying financial assets from financial institutions using new money it has created).

(i) Outline **two** possible economic effects of this measure for an economy.

The European Central Bank (ECB) reduced interest rates in 2012.

(ii) Discuss **two** possible economic benefits of falling interest rates for the Irish economy. (20)

(c) The monetary policy of the ECB aims to maintain the annual euro area inflation rate at a very low level.

(i) State the rate of inflation in Ireland during 2013, as measured by the Consumer Price Index (CPI).

(ii) Outline **two** uses of the CPI, other than as a measure of the rate of inflation.

(iii) Discuss the possible limitations of the CPI as an accurate measure of changes in the cost of living in Ireland.

(25)

[75 marks]

2011 Q6

(a) Money is usually defined by reference to the functions it performs.

(i) Outline **four** functions of money.
(ii) Explain the term 'Monetary Policy'.
(iii) Explain a central bank's function as 'lender of last resort'.

(35)

(b) Many believe that a lack of supervision ('light-touch regulation') of financial institutions in Ireland contributed significantly to the banking crisis.

Discuss the economic reasons why commercial banks in Ireland should be regulated.

(20)

(c) It is being suggested that the ECB will increase interest rates in the 2011/2012 period. Explain the economic effects of rising interest rates on the Irish economy.

(20)

[75 marks]

2010 Q6 (a)

(a) It has been suggested that the main commercial (retail) banks in Ireland should be nationalised.

(i) Explain the underlined terms.
(ii) Outline **two** possible economic arguments for and **two** possible economic arguments against the nationalisation of the banks.

(30 marks)

2010 Q7 (c)

(c) Write a brief account on the role of the International Monetary Fund (IMF) **or** the World Bank in the world economy.

(15 marks)

2009 Q4

(a) 'Banks may fail by over-extending their loan book'.
Explain this statement within the context of a bank's twin requirements of liquidity and profitability.

(25 marks)

(b) Keynes' concept of 'Liquidity Preference' is based on three reasons why people desire to hold wealth in money form.
(i) State and explain **each** of these reasons.
(ii) Discuss the effect a fall in interest rates is generally expected to have on **each** of these reasons.

(30 marks)

(c) Outline how the recent tightening (reduction) in the availability of credit may affect:
(i) The Irish Motor Industry;
(ii) Inflation;
(iii) Ireland's Balance of Payments.

(20 marks)
[75 marks]

2008 Q8

(a) **(i)** Explain, with the aid of an example, how it is possible for banks to create credit.
(ii) Outline how a desire by banks to reduce their level of bad debts might affect their ability to create credit.
(iii) Explain **two** other factors which could affect their ability to create credit.

(30 marks)

(b) Irish citizens experienced an increase in the rate of price inflation during 2007.

(i) Explain the underlined term.
(ii) Discuss the economic effects of this development on the Irish economy.

(20 marks)

(c) For a composite (weighted) price index covering three categories of expenditure given in the following table, calculate the index for the current year.
The base year value is 100. (Show all your workings).

Category	% of Income spent on item(s)	Price of Item(s) in base year	Price of Item(s) in current year
		€	€
Food	40%	20.00	24.50
Clothing & Footwear	25%	42.00	40.00
Other Items	35%	30.00	36.00
	100%		

(25 marks)
[75 marks]

2006 Q7

(a) **(i)** What economic uses are made of a **Consumer Price Index**?
(ii) Explain how a Consumer Price Index is constructed.

(25 marks)

(b) Explain the likely economic effects on the Irish economy of a significant increase in the annual rate of price inflation.

(25 marks)

(c) Outline the economic role played by **TWO** of the following international banking organisations:

(i) The International Monetary Fund (IMF);
(ii) The World Bank;
(iii) The European Central Bank (ECB).

(25 marks)
[75 marks]

2005 Q7 (a) + (b)

(a) A bank needs to keep a balance between its twin objectives of **liquidity** and **profitability.**
Explain the underlined terms. How does the bank reconcile these twin objectives? *(20 marks)*

(b) The Central Bank (now called the Central Bank and Financial Services Authority of Ireland) continues to play a very important economic role in the Irish economy.
Explain the role it plays in the Irish economy. *(30 marks)*

2003 Q5

(a) Discuss the ways in which money can contribute to the smooth working of an economy.

(20 marks)

(b) Explain the likely economic effects if:

(i) the supply of money grows at a **faster** rate than a country's production of goods and services

(ii) the supply of money grows at a **slower** rate than a country's production of goods and services.

(20 marks)

(c) **(i)** Explain what is meant by the term **price inflation.**

(ii) Name the main index used to measure price inflation in the Irish economy.

(iii) Outline the economic consequences of a rise in the rate of price inflation in Ireland.

(35 marks)

[75 marks]

2003 Q7 (b)

(b) Outline the effects which a rise in the level of unemployment in Ireland may have on:

(i) Government current finances.
(ii) The Balance of Payments (Current Account).
(iii) Price Inflation.

(20 marks)

2002 Q5

(a) (i) Explain how it is possible for banks to create credit.

(ii) State and explain **THREE** limitations on the amount of credit which banks can create.

(30 marks)

(b) Explain how an increase in the use of 'plastic money' (credit cards, etc.) by customers affects the ability of banks to create credit.

(15 marks)

(c) The main objective of the European Central Bank's **monetary policy** is to control **inflation**.

(i) Explain the underlined terms.

(ii) The ECB reduced interest rates in 2001. Discuss the effects of this reduction in interest rates on the Irish economy.

(30 marks)

[75 marks]

2001 Q6

(a) For a composite (weighted) price index covering the three types of expenditure given in the following table, calculate the index for the current year. The base year value is 100. Show your workings.

Category	% of Income spent on Item(s)	Prices of Item(s) in base year	Price of Item(s) in current year.
		£	£
Food	35	8.50	12.75
Clothing & Footwear	15	37.50	45.00
Other Items	50	20.00	35.00
	100		

(20 marks)

(b) Does the **Consumer Price Index** (CPI) accurately measure changes in the cost of living in Ireland? Explain your answer. (30 marks)

(c) Over the past year the rate of inflation, as measured by the CPI, has fluctuated. Discuss the effects of this development on the Irish economy. (25 marks)

[75 marks]

Short Questions Answers

1) 2016 Q7

The primary aim of the ECBs monetary policy is to maintain price stability.
(a) Define the term **monetary policy**.
(b) Outline **two** benefits of price stability for the Irish economy. **(17 marks)**

(a) Define the term **monetary policy**.

Monetary policy is defined as: those actions by the ECB, which influence the **money supply** [3], **interest rates** [3] or the **availability of credit** [3].

9 marks

(b) Outline **two** benefits of price stability for the Irish economy

- Maintain value of money: People's purchasing power (those at work or those on fixed incomes i.e. pensioners) is maintained and as a result the people have a higher standard of living.
- Improved international competitiveness: If a country's rate of inflation is lower than their trading partners then exports would become cheaper and more competitive.
- Increased consumer demand: consumers may be more inclined to spend resulting in increased employment and economic growth.
- Wage restraint: Trade unions are less likely to look for pay increases to compensate their members for rising prices as prices are stable.
- Government revenue could increase with more direct and indirect taxes collected if spending rises.
- Businesses may be more likely to invest due to more stable costs of production, particularly wage rate increases.
- Savings may increase due to price stability as people can plan better for their expenses and so may decide to save more.

2 benefits x 4 marks each.

2) 2012 Q2

State **three** areas of responsibility of the European Central Bank (ECB).

1. **Price Stability:**
   Monitors inflation in member countries and adjusts the base ECB interest rate so as to adjust spending and maintain price stability.
2. **EU monetary policy:**
   ECB implements monetary policy - monitors and advises on rates of interest, money supply, credit availability & protects the value of the euro.
3. **Official reserves of the euro area countries:**
   It **holds and manages** the EUs official holdings of gold, foreign currencies and other reserves held as security against the issue of the euro. The ECB manages these reserves on behalf of the countries.
4. **Supervision:**
   The member central banks of the Eurozone countries must provide prudential supervision of credit institutions and ensure stability in the financial system / lending to Eurozone central banks.
5. **Issues euro currency:**
   The ECB has the exclusive / sole right to issue euro bank notes and coins within the euro area.

3 points: 6 + 5 + 5 marks.

3) 2011 Q1

State **four** steps involved in constructing a Consumer Price Index (CPI).

Step 1: Determine the commodities to be included in the index.
What the average Irish family buys frequently and in large quantities (National Average Family Shopping Basket).
Step 2: Determine prices in the base year.
Step 3: Calculate a Simple Price Index (SPI) for each commodity.
Step 4: Determine the weight to be attached to each commodity.
Step 5: Multiply the SPI for each commodity by its 'weight' and add to derive the CPI.

4 points x 4 marks each = 16 marks

4) 2009 Q4

Define cost-push inflation. Identify **two** sources of this form of inflation in the Irish economy.

Definition:

Any increase in the general level of prices due to an increase in the costs of production/costs of inputs faced by the producer.

Sources:

- Increased wage demands due to minimum wage or social partnership agreements.
- Indirect taxes imposed on business such as VAT and excise duties on goods.
- Increased prices for raw materials e.g. oil.
- Increased costs of production e.g. utility charges; costs of rent; insurances etc.

Definition: 8 marks. two sources @ 4 marks each.

(16 marks)

5) 2007 Q1

State **FOUR** possible economic effects of rising **price inflation** on the Irish economy.

1 **Reduced standard of living**: due to reduced purchasing power.
2. **Increased wage demands:** workers will try to negotiate wage increases.
3. **Loss of competitiveness:** if inflation in Ireland is higher than with our trading partners / ↓exports.
4. **Loss of employment:** Employers may be forced to reduce costs and reduce the numbers employed.
5. **Government Finances:** as prices rise, the government may collect increased indirect tax revenues/ if wages do increase people may move to a higher tax rate and revenue increases.
6. **Savings discouraged:** the real rate of interest available to savers may fall, discouraging savings. **Speculation encouraged:** people may invest in property to protect the value of their investment.
7. **Borrowing encouraged:** the real rate of interest charged on borrowings falls, encouraging borrowing
8. **Increased disparity between sectors of the population**: Poorer sections suffer most when inflation increases.
9. **Pressure on social partnership/ industrial relations unrest:** trade unions may want a free for all.
10. **Balance of Payments problems:** if our volume of exports falls & volume of imports rise.
11. **Uncertainty for investment decisions makers:** business planning & profit calculation difficult.

16 marks graded.

6) 2007 Q5

5. Outline **THREE** functions / responsibilities of the **European Central Bank (ECB).**

1. **Maintain Price Stability:**
   Monitor inflation in member countries and adjusts the base ECB interest rate so as to adjust spending.
2. **Implements EU's monetary policy**:
   ECB monitors and advises on: rates of interest, money supply, credit availability & protects the value of the euro.
3. **Holds and manages the official reserves of the euro area countries:**
   These are the EUs official holdings of gold, foreign currencies and other reserves held as security against the issue of the euro. The ECB manages these reserves on behalf of the countries.
4. **Financial stability and supervision:**
   The member authorities must provide prudential supervision of credit institutions and ensure stability in the financial system.
5. **Sole right to issue euro currency:**
   The ECB has exclusive right to issues euro bank notes and coins within the euro area.

16 marks graded.

7) 2005 Q6

For a composite (weighted) price index covering the three types of expenditure given in the following table, calculate the price index for the current year. The base year is 100.

Category	% income spent on item(s)	Prices of item(s) Base Year	Prices of item(s) Current Year	Calculation of Simple Price Index	Weight	Result
		€	€			
Food	30%	10.00	11.50	$\frac{11.50 \times 100}{10.00} = 115.00$	x 30%	34.5
Clothing & Footwear	20%	40.00	36.00	$\frac{36.00 \times 100}{40.00} = 90.00$	x 20%	18.0
Other Items	50%	20.00	22.00	$\frac{22.00 \times 100}{20.00} = 110.00$	x 50%	55.0
	100%			Price Index for the Current Year	→	107.5

17 marks graded.

8) 2004 Q5

5. State THREE limitations on the power of the banks to create credit.

1. Availability of creditworthy customers
Loans can only be given to those people who are in a position to repay them.

2. Availability of Cash Deposits
A bank can only give loans provided that they can attract cash deposits.

3. Customers' Demands for Cash [Liquidity Ratios – PLR & SLR]
The bank must keep sufficient cash so as to be able to meet the demands of its customers for cash

4.[European] Central Bank guidelines
Commercial banks must note the guidelines of the Central Bank.

5. Demand for loans by customers.
A bank is limited in the amount of loans it creates by the demand for loans.
In a recessionary period the demand for loans will fall.

3 points at 6 + 5 + 5 marks each = 16 marks.

9) 2003 Q3

3. Monetary Policy is defined as
Those actions by the ECB, which influence the money supply, interest rates or the availability of credit.

TWO measures by which the ECB implements monetary policy within the euro zone countries:

1. Monitoring the growth of the money supply (relative to its value)
2. Altering interest rates.
3. Engaging in Open Market Operations
   (incl. Main refinancing operations (MRO's) & Longer-term refinancing operations (LTRO's)
4. The use of Standing Facilities
   (the marginal lending facility and the deposit facility)
5. Minimum Reserve Requirements.

Correct definition: 12 marks graded + 2 examples

10) 2002 Q2

FOUR steps involved in calculating a Composite Price Index:

Step 1: Choose a base year/period.
Step 2: Select those goods which are to be included in the index.
Step 3: Determine the price of each item in the base period.
Step 4: Calculate a Simple Price Index for each individual commodity.
Step 5: Attach a weight to each commodity i.e. the proportion of income spent on each commodity.
Step 6: Multiply the SPI for each commodity by its appropriate weight and add to get the resulting Composite Price Index. **16 marks**

Long Questions Answers

2015 Q5

(a) (i) Outline **three** factors that limit the ability of banks to create credit.
(ii) Discuss the economic reasons why the financial system in Ireland should be regulated. (30)

(i) Outline **three** factors that limit the ability of banks to create credit.

Availability of creditworthy customers
Even if banks have money to lend they will be cautious in terms of lending as they will be concerned about the risk of the loans not being repaid. In a recession consumers might lose their jobs and be unable to repay their loans.

Cash deposits in the banks
A bank can only give loans provided that it can attract cash deposits. If it attracts more deposits then it can create more credit. As interest rates are low Irish banks may experience a difficulty in attracting deposits as customers seek better returns elsewhere.

Demand for loans / credit by customers
In times of uncertainty businesses are not likely to invest and individual consumers will not borrow if they are worried about their future income / job prospects.

Customers' demands for cash
The bank must keep sufficient cash so as to be able to meet the demands of its customers for cash. If people pay more of their bills in cash then their demand for cash will increase and this will reduce the ability of the banks to create credit.

Guidelines by European Central Bank
Banks must comply with the ECB regulations / rules re changing the bank rate / changing the required capital ratios (i.e. the amount of capital on the bank's balance sheet as a proportion of its loans) and the value of liquid assets banks must keep.
They can change the reserve requirement which would have an impact on the banks' ability to create credit.

3 factors at 6 marks each (3 + 3)

(ii) Discuss the economic reasons why the financial system in Ireland should be regulated.

To provide a degree of protection to depositors / customers with individual financial institutions.
Purpose of regulation is to promote a stable, safe / fair financial services market for consumers / to promote sound and solvent financial institutions giving depositors confidence that their deposits and investments are safe / customers have confidence in the financial system.

To ensure proper lending procedures are followed by the banks and to avoid reckless lending.
A cause of the Irish banking crisis was domestic, with Irish controlled credit institutions engaged in excessive risk-taking and reckless property-related lending. Irish credit institutions sought ever larger profits and market share in what had become a highly competitive market.

To maintain the stability of the financial system / restore confidence.
To foster a stable / healthy financial system. Regulation could ensure the financial sector will operate efficiently/public confidence will be restored allowing for financial stability, which can result in economic growth.

To reduce macro-economic instability (boom/bust).
If banks are left to their own devices then they may lend excessively in good times and little in bad times (pro-cyclical behaviour of banks). They may amplify the boom and bust of the cycle (i.e. make everything worse).

2 reasons at 6 marks each (3 + 3)
The expected responses given are not exhaustive

2015 Q5 Continued

(b) *In January 2015, the Central Bank of Ireland (CBI) introduced restrictions on residential mortgage lending (bigger deposit requirement for mortgage loans and upper limits on borrowing based on income).*

State and explain the possible economic impacts of these restrictions on the Irish property market. (20)

Possible responses include:

Could ease the trend of rising property prices
The restrictions may limit the increase in house prices by placing a limit on effective demand (purchasing power backed up by income).

Potential supply effect
The restrictions could result in increased demand for rental properties renting / increased rents. There may be a bias towards first time buyers. There may be an increase in the number of mortgages due to their smaller average size.

Could lead to lower levels of construction activity when new homes needed
This contradicts government housing policy which aims to encourage new home supply. The restrictions may discourage house building because developers and their financial backers will be put off.

Greater safety around the mortgage business
The restrictions may increase the resilience of the banking and household sectors to financial shocks / shocks in the Irish property market. Lenders will be less vulnerable in the event of property prices falling by reducing the losses in the event of default.

Help stabilise the business cycle / reduce the boom-bust in the cycle
Prudent lending activity may take place as the housing market activity begins to improve. It could ensure the goal of responsible borrowing is achieved/ the restrictions may eliminate the boom-bust cycle which has occurred.

Could hinder the recovery in the property market
High rents and tax increases have made savings difficult. These restrictions may make it difficult for people to move out of the rental market to home ownership.

3 impacts: 7 marks (4 + 3) + 7 marks (4 + 3) + 6 marks (3 + 3)

2015 Q5 Continued

(c) *The Strategic Banking Corporation of Ireland (SBCI) was set up to support SMEs (small and medium enterprises) by providing finance under favourable terms (e.g. lower cost credit).*

Discuss the possible economic benefits of increased access to funding for the SME sector in Ireland. (25)

Possible responses include:

Create job / training opportunities
Many SMEs are indigenous Irish-owned businesses. With additional finance they will help create employment. As business expands people will be offered more employment / training opportunities. Less than ¼ of the net increase in jobs came from the foreign-owned firms. The rest of the net jobs created in the economy occurred in Irish-owned SMEs. Ireland needs to grow the indigenous sector.

Encourage entrepreneurship
The SMEs will help create additional income and hence create economic growth /increased GDP.
In the case of Irish-owned firms, all of the value added in the sector adds to Irish GNP whereas in the case of foreign MNCs it is mainly the wage bill and the corporation tax paid that do so i.e. the multiplier effect will be greater because of SMEs.

Flexible/Able to adapt to changes in market conditions
SMEs make up a significant part of the Irish economy. They are more flexible and better able to adapt to changes in market conditions. They can spot opportunities and react to the changing market conditions quickly.

Local development improvements
SMEs are based throughout the country. They supply local markets and so any expansion in their services will benefit the local communities and so aid regional development.

Government finances improve
If business activity increases then employment increases, spending will increase and so the level of taxation revenue will increase with a decline in welfare payments by the government.

Balance of payments
As many SMEs are indigenous Irish-owned businesses the output they produce may help replace imports and/or they may begin to export some of their output thereby improving Ireland's balance of payments position.

Reduced reliance on FDI
By expanding the indigenous Irish-owned SMEs Ireland may become less reliant on FDI. Domestic firms have been quite successful in growing output and employment. This is possibly because they are more reliant on the growing British market.

4 benefits: 7 marks (4 + 3) + 3 at 6 marks (3 + 3)

2015 Q6 (a)

(a) "*Prices on average as measured by the Consumer Price Index (CPI) were 0.1% higher in November 2014 compared with November 2013.*" *(CSO statistics)*

(i) Do you consider the CPI an accurate measure of changes in the cost of living? Explain your answer.

(ii) Discuss **two** possible economic effects of price **deflation** on the Irish economy. (25)

(i) Do you consider the CPI an accurate measure of changes in the cost of living? Explain your answer.

No, for the following reasons:

Limitations of an average / relevance

The CPI is based on an average pattern of spending. The spending patterns are individual and might not be typical of the representative pattern on which the official figures are based. It may not accurately represent different groups in society e.g. non-smokers etc. The survey establishes the basket of goods of the average household only.

Introduction of new products

As it includes only those products in the base year it lags behind consumer trends and fashions. New products are not included in the index. It does not take into account increases in the purchasing power of money due to the introduction of new products. Greater variety makes each euro more valuable, so consumers need fewer euros to maintain any given standard of living.

Limited range of products

A limited range of products is included in the CPI. Most families spend their income on a very large range of products. Only twelve categories of products are included in the CPI comprising roughly 8,000 different products. However, there are tens of thousands of different products on the market at any given time.

Rural versus urban lifestyles

Both urban and rural households are represented by the present set of weights but this may not reflect accurately changes in their respective cost of living e.g. the cost of accommodation in urban areas is more expensive than in rural areas and this is not reflected in the CPI.

Switching by consumers to cheaper brands / substitution bias

When prices rise the CPI does not measure the extent to which people may switch to cheaper brands. People tend to substitute cheaper products when substitutes are available when prices rise. It does not take into account consumers' ability to substitute towards products that become relatively cheaper over time.

Quality bias of products / unmeasured quality changes

Changes in quality / technological progress are not taken into account. Newer products are constantly introduced as others become obsolete. The CPI cannot take account of the changes in the quality of goods. It is distorted by unmeasured changes in the quality of goods and services. If the quality of the good deteriorates from one year to the next, the effective value of the euro falls.

Price index not cost of living index

The CPI only measures changes to prices not changes in the cost of living because it doesn't take into account all the items which affect a person's living standards i.e. income tax, social welfare payments etc.

Unrepresentative weights / compositional bias

The weights used are those which apply in the base year the Household Budget Survey was taken. The base year may not be representative. The importance of some items in the base year changes over time because of changes in prices, taste and income. It does not allow for compositional changes in the basket because the weights are in the base year period not the current period.

No: 2 marks + 3 reasons at 5 marks each (2 + 3)

2015 Q6 (a)

(ii) Discuss **two** possible economic effects of price **deflation** on the Irish economy.

Income effect / increasing purchasing power
If the price level is falling, cash gains value over time therefore the amount of goods and services you buy with a given amount of cash increases.

Debt burden effect (mortgage debt and state debt)
The real cost of repaying loans rises/Lenders who are owed money gain under deflation. The real value of the borrowers' payments increases/ borrowers lose because the real burden of their debt rises.

Decline in spending / aggregate demand
Consumers may postpone spending because they expect prices to fall even further in the future and this reduces aggregate demand and could deepen a recession further. Hence economic growth declines.

A fall in investment
Business people may postpone investment due to the uncertainty and the reduction in demand. Companies will find it very difficult to operate in an economy where prices are falling. Profits are being eroded.

Increased competitiveness
Falling prices should make Irish goods more attractive abroad and so the demand for Irish exports may increase.

Long-term damage to the economy
Deflation can create a vicious spiral of negatives: falling profits; closing factories; shrinking employment and incomes and increasing defaults on loans by companies and individuals.

2 effects at 4 marks each (2 + 2)

2014 Q4 (c)

(c) (i) State and explain **three** factors that caused the price of residential property to fall considerably in Ireland in the years following 2007.

(ii) Mortgage arrears (i.e. the inability to meet mortgage loan obligations) is the biggest single personal debt issue for many households.

Discuss **one** possible economic impact of **mortgage arrears** on **each** of following:

- the household
- the banking sector
- the Irish Government. (30)

(i) State and explain **three** factors that caused the price of residential property to fall considerably in Ireland in the years following 2007.

Possible responses include:

Property market collapse
As a result of more and more land being rezoned and the construction boom, the supply of property exceeded the demand for it, except in the larger cities (Dublin). Many parts of the country now have ghost housing estates, particularly in areas in the West of Ireland.

The Banking Crisis
Due to a change in lending guidelines and greater credit controls following the banking collapse, many banks now are unable to lend out money as the criteria to secure loans makes it almost impossible for them to do so. There are also fewer banks operating in the Irish economy now.

Economic recession / Weaker demand in housing market
With the downturn in the economy and the accompanying drop in economic growth, there has been a decrease in the demand for housing. Increases in taxation have resulted in lower disposable incomes leading to reduced demand and prices. Economic uncertainty resulted in some people not trading up to larger houses.

Emigration
With the downturn in the economy and lack of job opportunities, many young people have been forced to leave the country, with a consequent drop in demand for residential property.

Speculation in housing
During the boom, increases in property prices fuelled speculative demand with more people seeking investment opportunities. With the onset of the recession, fewer people were willing to invest in property as it is deemed a very unstable investment.

3 factors: 5 marks each = 15 marks

2014 Q4 (c) Continued

(ii) Mortgage arrears (i.e. the inability to meet mortgage loan obligations) is the biggest single personal debt issue for many households.

Discuss **one** possible economic impact of **mortgage arrears** on **each** of following: the household / the banking sector / the Irish Government.

Possible responses include:

Households

Lack of consumer confidence
Increasing debt leading to less spending in the economy and less aggregate demand. Consumers are deleveraging rather than consuming. Mortgage arrears can therefore decrease consumer confidence and hence consumer spending. This can have a negative impact on the economy and society as a whole resulting in reduced spending and a reduction in aggregate demand.

Reduced creditworthiness
Mortgage arrears may mean that households' creditworthiness could be adversely affected thus limiting their ability to borrow.

Less houses for sale / depressed property market
People may be less willing to sell their homes because they will realise losses. This may also have implications on the 'mobility of labour' and the flexibility needed to move to areas where employment opportunities arise. There is little movement in the property market.

Social housing requirement
When people fall into arrears and their house is eventually repossessed, those people then end up on the social housing list, thus leading to an even longer waiting list. The burden on the tax payer becomes even greater.

The banking sector

Debt write-down deals
Banks may suffer loss of profits due to non-repayment of loans. They must develop strategies to deal with outstanding debt- the forced restructuring of loans into interest only, split mortgages and the extra cost of debt collection. This will have an impact on the banks' ability to lend and on its own indebtedness.

Subject to more regulation and legislation
Banks may be subject to more regulation on debt write-off /restructuring / insolvency legislation where it has to agree as a creditor to a solution. Their ability to meet the stress tests being carried out by ECB may also be affected.

Unemployment in the Banking Sector
Irish banks together with some foreign banks operating here, have pursued a policy of rationalisation, thus radically reducing the number of employees in the sector. The major banks have both pursued the policy of reducing staffing numbers in an effort to cut costs.

Collapse in share prices of bank stocks
Investors have lost confidence in the banks and so their share prices have fallen resulting in reduction in profits, reduction in the capital value of the banks, increase in bank debt and the nationalisation of some banks.

2014 Q4 (c) Continued

Irish Government

Reduced Tax Revenue for Government
Since many people have been unable to sell their property due to slowdown in property sales, there is a consequent loss of revenue from property transactions including stamp duty for the government etc. Also as people are not buying there is a loss of transaction taxes for the government. Consumers because they have reduced disposable incomes are not spending and so tax revenue to the government may be affected.

More debt write-offs / Guarantor for the Irish banks
The government have *de facto* become guarantor for the Irish banks. Bank losses are ultimately pushed onto the Irish taxpayers/ Recapitalisation of the banking sector due to non-repayment of capital. Thus, the government may be on the line for future bank liabilities (capital injections).

Increased demand for Social and Affordable Housing
As a consequence of debt default repossessions and the fact that consumers are finding it more difficult to secure a mortgage, a greater proportion of people are being forced to look to the government to provide social housing. In the greater Dublin area, the housing waiting list has increased dramatically.

New measures introduced by government to deal with banking/housing crisis
The government has had to introduce new legislation, increase regulation of the banking sector and try to help households to cope with mortgage arrears.
Measures include: a new Insolvency Act to aid banks to write down debt following bankruptcy /
More regulation of banks to deal with arrears / new codes of behaviour for debt collection / A national mortgage-to-rent scheme allows people in mortgage difficulties to switch from owning their home to renting it as a social tenant. People who take up this option no longer own their own home.

One possible economic impact per category: 5 marks each = 15 marks

2013 Q6

(a) (i) Explain, using a numerical example, how banks create credit in an economy.
(ii) Outline **two** factors which limit the ability of banks to create credit during recessionary times. (30)

(i) Explain, using a numerical example, how banks create credit in an economy.

Alternative A

1. Commercial banks accept cash deposits from their customers e.g. say €100, for safekeeping. **4 marks**
2. These banks know from experience that their customers will only demand back a small amount of these deposits in cash - say 10% because of their use of cheques as an acceptable method of payment**.** **4 marks**
3. So they now have surplus cash with which to give loans - €90. **4 marks**
4. The amount of loans they give is related to, but in excess of their cash deposits and is based on their reserve ratio

4 marks

or

$$\text{Increase in credit} = \text{Increase in Cash Deposits} \times \frac{1}{\text{Banks Reserve Ratio}}.$$

Numerical example: **4 marks**

A person deposits €100 into a bank. The bank's reserve ratio is 10%.
So the bank can create credit as follows:

$$€100^* \times \frac{1\ *}{10\%} = €1{,}000^* \ [\ - €100 = €\ 900^*]$$

(1 mark per asterisked figure)

Alternative B

Balance Sheet of a Bank - 4 marks

Assets	€	Liabilities	€
Cash lodged by X	100	X's deposit	100
Total Assets	100	Total Liabilities	100

Balance Sheet of a Bank – 6 marks

Assets		Liabilities	
Cash lodged by X	100	Deposits	100
Loan	900	New Deposits	900
Total Assets	1,000	Total Liabilities	1,000

1. Mr. X lodges €100 into the bank
2. It knows that only 10% is demanded in cash.
3. It has enough cash to support total deposits of €1,000.
4. The bank can create another €900 in deposits. It does this by giving out loans of €900.
5. So €100 cash is sufficient for this purpose. This is shown in the new balance sheet.

Explanation 10 marks: 5 at 2 marks each

2013 Q6 Continued

(ii) Outline **two** factors which limit the ability of banks to create credit during recessionary times.

1. Creditworthy customers / increased risks for banks
In times of recession many businesses experience cash flow difficulties. The risk of these companies failing can be quite high. Banks will be cautious in terms of lending as they will be worried about the risk of the loans not being repaid. Likewise, consumers' loans are riskier in a recession. Consumers might lose their jobs and be unable to repay their loans.

2. Cash deposits in the banks
A bank can only give loans provided that it can attract cash deposits. If it attracts more deposits then it can create more credit. Irish banks have experienced a difficulty in attracting deposits since the beginning of the recession as people favour the higher rates of return with state savings. Depositors have been wary of depositing money fearing that the banks might collapse.

3. Demand for loans / credit by customers
During a recession the demand for credit from businesses and consumers is reduced. Businesses are not likely to invest if they think that the recession is going to be prolonged. Likewise consumers will not borrow if they are worried about their job prospects.

4. Irish banks have weak balance sheets / Deleveraging
Irish banks, through reckless lending during the property boom, have weakened balance sheets. Their ability to create new money has been greatly reduced. Also, Irish banks are being encouraged to deleverage and shrink their balance sheets which may decrease their ability to create credit.

5. Customers' demands for cash
The bank must keep sufficient cash so as to be able to meet the demands of its customers for cash. If during a recession people pay more of their bills in cash then their demand for cash will increase and this will reduce the ability of the banks to create credit.

2 points at 5 marks (2+3) each

(b) Some central banks have responded to the global financial crisis by introducing the monetary policy measure of 'Quantitative Easing'
(I.e. buying financial assets from financial institutions using new money it has created).

(i) Outline **two** possible economic effects of this measure for an economy.

The European Central Bank (ECB) reduced interest rates in 2012.

(ii) Discuss **two** possible economic benefits of falling interest rates for the Irish economy. (20)

(i) Outline **two** possible economic effects of this measure for an economy.

1. Increased bank lending
With increased cash reserves the commercial banks may increase their lending.

2. Economic growth / jobs
Increased lending by banks should increase both consumer spending and investment spending which will boost aggregate demand and help create jobs.

2013 Q6 Continued

3. Possible inflation
If the money supply increases at a faster rate than the supply of goods and services then inflation may increase.

4. Interest rates
An increase in the money supply, after the creation of new money which has been used to purchase financial assets, may lead to a reduction in interest rates which may restore business confidence and help stimulate economic activity.

5. Government bonds
If government bonds are purchased then this may cause their market price to rise leading to a decrease in their yield.

2 points at 4 marks (2+2) each

(ii) Discuss **two** possible economic benefits of falling interest rates for the Irish economy.

1. Borrowing encouraged
Borrowing is now cheaper resulting in cheaper loan repayments which will increase spending power resulting in a higher standard of living.

2. Savings discouraged
With a lower rate of return people may find it less attractive to save and so they will increase their spending.

3. Reduced mortgage repayments
The cost of monthly repayments (on tracker mortgages) decreases resulting in increased disposable income and a higher standard of living.

4. Cost of Servicing the National Debt
With lower domestic interest rates the cost of repaying the internal portion of the national debt falls.

5. Costs of Production / increased competitiveness
Cost of production will decrease resulting in lower domestic prices. This will increase the competitiveness of Irish exports and may lead to an increase in sales.

6. Incentive to Invest
The MEC will rise resulting in increased profits and this may encourage investors. It becomes less expensive for businesses to borrow and so they may invest.

7. Economic Growth encouraged
With possibly increased investment / increased consumer spending future economic growth in Ireland may be encouraged.

8. Taxation revenues
With a possible reduction in savings the government may receive less revenue through DIRT.
However, with a possible increased spending the revenue from VAT and excise duties may rise.
If unemployment decreases there will be an increase in income tax revenue.

9. Employment
Increased consumer spending; rising demand for Irish exports; an increase in investment and an increase in economic growth may result in an increase in the numbers employed.

2 points at 6 marks (3+3) each

2013 Q6 Continued

(c) The monetary policy of the ECB aims to maintain the annual euro area inflation rate at a very low level.

(i) State the rate of inflation in Ireland during 2013, as measured by the Consumer Price Index

(ii) Outline **two** uses of the CPI, other than as a measure of the rate of inflation.

(iii) Discuss the possible limitations of the CPI as an accurate measure of changes in the cost of living in Ireland. (25)

(i) State the rate of inflation in Ireland during 2013, as measured by the Consumer Price Index.

May 2013: 0.4%

From January 2012 to January 2013: 1.2%

5 marks

(ii) Outline **two** uses of the CPI, other than as a measure of the rate of inflation.

1. **Measures International Competitiveness /International Comparisons**
By comparing our inflation rate with that of our trading partners we can determine whether our competitiveness on international markets is improving or getting worse.

2. **Indicator of economic performance**
The CPI, together with statistics on employment, economic growth, exchequer returns etc., provide an indicator of the country's economic performance.

3. **Indexation of savings / investments**
Some savings schemes have 'index-linked' returns meaning that the rate of interest will be equal to the rate of inflation. Individuals with insurance / pension policies may be able to increase their contributions so at to maintain the real value of these policies.

4. **Used by government indexing tax bands / social welfare payments**
The government may use decreases in the CPI to index tax bands so that taxpayers are paying more tax. Similarly the government may use decreases in the CPI to decrease rates of social welfare so as not to interfere with the standard of living of the recipients and thereby reduce government expenditure.

5. **Used in pay negotiations**
Historically trade unions / employees have used increases in the CPI as the basis for making claims for a wage increase.

2 points at 5 marks (2+3) each

2013 Q6 Continued

(iii) Discuss the possible limitations of the CPI as an accurate measure of changes in the cost of living in Ireland.

1. Limitations of an average
The CPI represents the average spending patterns of the total population. Hence it may not represent accurately particular groups in the population e.g. non-smokers; non-drinkers.

2. New products
As it includes only those products in the base year it lags behind consumer trends and fashions. New products are not included in the index.

3. Rural versus urban lifestyles
Both urban and rural households are represented by the present set of weights but this may not reflect accurately changes in their respective cost of living.

4. Switching by consumers
When prices rise the CPI does not measure the extent to which people may switch to cheaper brands.

5. Quality of products
The index does not take account of changes in the quality of products.
Higher prices may reflect an improvement in the quality of the product.

6. Measures changes to prices
The CPI only measures changes to prices not changes in the cost of living because it doesn't take into account all the items which affect a person's living standards i.e. income tax, social welfare etc.

7. Static weights
The weights used are those which apply in the base year.
The importance of some items in the base year changes over time because of changes in prices, taste and income.

2 points at 5 marks (2+3) each

2011 Q6

(a) Money is usually defined by reference to the functions it performs.

(i) Outline **four** functions of money.
(ii) Explain the term 'Monetary Policy'.
(iii) Explain a central bank's function as 'lender of last resort'. *(35)*

(i) Four functions of money:

1. Medium of exchange

- Money allows people to buy goods and services/ allows exchange between buyers and sellers
- Allows the buying and selling of goods/services to be broken into two distinct activities.

2. Measure of Value

- Money enables a price to be put on goods & services.

3. Store of Wealth

- Allows people to save for the future/can be used to make purchases in the future.

4. Standard for Deferred Payment

- Money is capable of measuring value for a future date.
- Money makes credit trading (i.e. buying & selling) possible.

4 functions x 5 marks each

(ii) Explain 'Monetary Policy'

Those actions by the ECB, which influences the money supply, interest rates and the availability of credit.

8 marks

(iii) Explain a central bank's function as 'lender of last resort'

The central bank offers credit to financial institutions experiencing financial difficulties / liquidity problems and are unable to obtain necessary funds elsewhere.

7 marks

2011 Q6 Continued

(b) Many believe that a lack of supervision ('light-touch regulation') of financial institutions in Ireland contributed significantly to the banking crisis.

Discuss the economic reasons why commercial banks in Ireland should be regulated. (20)

1. Protect consumers
Regulation will ensure that the interests of the banks' consumers are protected and that savers' deposits are secure.

2. Proper lending policies
Regulation will ensure that the banks follow correct lending procedures and that excessive / reckless lending is avoided.

3. Banking system stability
Regulation will ensure that the banking system should remain stable.

4. Economic stability / confidence
Proper regulation may ensure that the banks operate efficiently resulting in public confidence in the banking system/ allow for the flow of credit and for economic growth of the economy.

5. Less need for government intervention
If the banks are properly regulated then there will be less need for the government to become involved as it has had to do with the guarantees for savers deposits; nationalisation of Anglo Irish Bank; and the setting up of NAMA.

6. Less need for EU / IMF funds
If banks are properly regulated it should result in the government not having to resort to funds from the EU/IMF to capitalise the banks.

4 points x 5 marks each

2011 Q6 Continued

(c) It is being suggested that the ECB will increase interest rates in the 2011/2012 period. Explain the economic effects of rising interest rates on the Irish economy. *(20)*

1. Borrowing discouraged
Borrowing is more expensive resulting in higher loan repayments, which will reduce spending power, resulting in a lower standard of living.

2. Savings encouraged
With a higher rate of return people may find it more attractive to save, and so they will reduce their spending.

3. Increased mortgage repayments
The cost of monthly repayments increases, resulting in reduced disposable income and a lower standard of living.

4. Increased cost of servicing the National Debt
With higher domestic interest rates the cost of repaying the internal portion of the national debt rises.

5. Increased costs of production / reduced competitiveness
Cost of production will increase resulting in higher domestic prices. This will reduce the competitiveness of Irish exports and may lead to reduction in sales.

6. Disincentive to Invest
The MEC will fall resulting in lower profits and this may discourage investors /
it becomes more expensive for businesses to borrow and so they may not invest.

7. Economic Growth hindered
With possible lower investment, future economic growth in Ireland may be damaged.

8. Taxation revenue effects
With additional savings the government may receive additional revenue through DIRT.
However, with lower spending the revenue from VAT and excise duties may fall.
If unemployment increases there will be a reduction in income tax revenue.

9. Increases in Unemployment
Lower consumer spending, falling demand for Irish exports, a reduction in investment and a decline in economic growth may result in an increase in the numbers unemployed.

4 points x 5 marks each

2010 Q6 (a)

(a) It has been suggested that the main commercial (retail) banks in Ireland should be nationalised.
(i) Explain the underlined terms.
(ii) Outline **two** possible economic arguments for and **two** possible economic arguments against the nationalisation of the banks. (30 marks)

(i) Explain the underlined terms.

Commercial banks **5 marks**

Institutions which provide deposit / lending services to personal consumers / business.

Nationalisation **5 marks**

Taking an industry or assets into public ownership by a government.

(ii) **Two** possible economic arguments for and **two** possible economic arguments against the nationalisation

Economic arguments FOR	Economic arguments AGAINST
Stability to economy / investor confidence It may signal to domestic and international investors that the state seeks to protect an important resource and so attract investment.	**Unnecessary state interference** Too much state involvement in commercial businesses may discourage domestic / international investors.
Availability of credit It may ensure that credit would flow to those individuals and businesses which require it, unlike at present where credit restrictions apply.	**Shareholders penalised** They may be forced to sell their shares at a price deemed unfair.
Rationalisation of banking services It may lead to a rationalisation of banking services within the state, the elimination of wasteful practices / cost efficiencies.	**Increased taxation** Taxes may have to be increased to fund the purchase and running of the nationalised banks.
Employment / consumer protection Jobs currently under threat may be protected by state intervention. Consumers may be offered better protection by state banks.	**Opportunity costs** The money used for the nationalisation could have been put to alternative uses by the state e.g. provision of improved health services etc.
Development of ethical banking practices With nationalisation banking practices may be less motivated by the generation of profit and more towards the provision of those services required by consumers.	**Profit motive diminished** Should this occur then the pressure to improve services; achieve efficiencies and maximise profits maybe be diminished.
Continued provision of banking services to the community/ prevent foreign ownership The nationalised bank may continue to provide retail services to those communities which in the past were only provided if the branch was profitable/social objective	**Financial Cost** Large amount of funds needed to ensure their future and they could continue to be loss-making into the foreseeable future.
2 at 5 marks each. **State: 2 marks. Explain: 3 marks.**	**2 at 5 marks each.** **State: 2 marks. Explain: 3 marks.**

2010 Q7 (c)

(c) Write a brief account on the role of the International Monetary Fund (IMF) **or** the World Bank in the world economy. (15 marks)

The International Monetary Fund

Expansion of World Trade
The IMF encourages expansion in trade by encouraging member countries to adopt sound economic policies.
It monitors economic and financial developments in member countries and gives advice to its members.

Promote exchange rate stability.
The IMF promotes international monetary co-operation. It provides a forum for consultation on international monetary problems. It tries to maintain orderly exchange arrangements among countries and aims to avoid competitive devaluations.

Orderly correction of balance of payments problems.
The IMF lends to member countries with balance of payments problems to provide temporary financing and to support reform policies aimed at correcting the underlying problems.

Operation of a multilateral system of payments.
The IMF operates this system in respect of current transactions between members and aims to eliminate foreign exchange restrictions which may hamper the growth of world trade.

Provision of technical assistance and training.
Where a member needs help the IMP will provide this assistance and training. When the Soviet Union collapsed the IMF stepped in and set up treasury systems for their central banks to help the transition from centrally planned to market based economic systems.

The World Bank

Encourage investment funds to LDCs
Obtains funds from world's advanced countries and uses these resources to provide loans to LDCs so they can invest in roads, schools etc.

Finance capital projects in member countries.
The World Bank gives loans to member states and to private businesses in these countries to assist capital projects.
Examples in Ireland in the past included the building of the original community schools by the DES.

Debt relief for LDCs
The World Bank helps LDCs reduce their debt burden by extending the term of loans and /or re-negotiating interest rates.

3 points at 5 marks each.
State: 2 marks. Explain: 3 marks.

2009 Q4

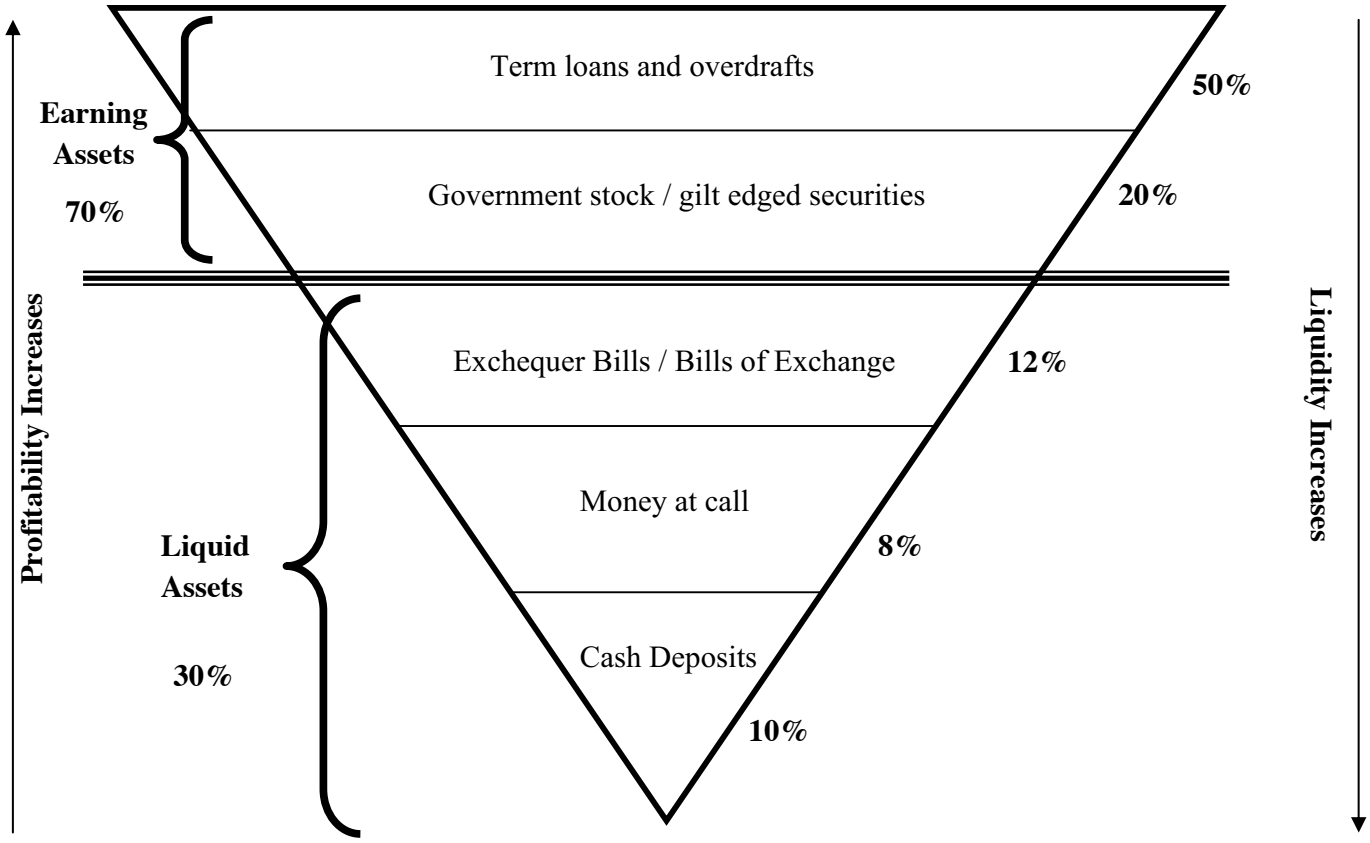
(a) **'**Banks may fail by overextending their loan book'.
Explain this statement within the context of a bank's twin requirements of liquidity and profitability.

A bank has twin requirements:

- **Profitability:** refers to the need for a bank to make as much profits as possible from its assets to satisfy its shareholders. The more profitable the asset is the less liquid it is.

- **Liquidity:** refers to the need by a bank to have liquid assets in order to meet the demand for cash by its customers. The more liquid the asset is the less profitable it is.

- Banks must strike a balance between the twin requirements of profitability and liquidity. As a result banks structure their holding of assets along the following lines:



- By focusing on profitability (extending credit) at the expense of liquidity a bank may give loans to high risk ventures e.g. commercial property development loans. Property loans are highly illiquid but can be very profitable. A bank may run the risk of increasing bad debts, falling share prices, a lack of capital and possible bank failure.

- By ignoring liquidity requirements, banks may not have enough cash to meet the demand of their depositors and this could result in a 'run' on the banks and result in bank failure.

25 marks graded

2009 Q4 Continued

(b) Keynes' concept of 'Liquidity Preference' is based on three reasons why people desire to hold wealth in money form.

(i) State and explain **each** of these reasons.

Transactionary motive	Precautionary motive	Speculative motive
People desire to hold money for day-to-day expenses e.g. buying goods & services	People desire to hold money for emergencies/rainy day e.g. illness, house repairs.	People desire to hold money for any possible profitable future investment opportunities.

3 reasons (stated and explained) @ 6 marks each graded

(ii) Discuss the effect, if any, a fall in interest rates is generally expected to have on **each** of these reasons.

Motive	Effect of fall in interest rates	Marks
Transactionary	The demand for money for transactionary reasons is **not affected** by the fall in the rate of interest. Why? People need to have cash for day-to-day spending and this, allied to their level of income, not rates of interest determines the motive.	**4 marks graded**
Precautionary	The demand for money for precautionary reasons is affected slightly (negatively) by the rate of interest. Why? As interest rates fall slightly more money will be held for precautionary purposes, due to the opportunity cost of lower rates of interest.	**4 marks graded**
Speculative	The demand for money for speculative reasons is greatly affected (negatively) by the rate of interest. Why? As interest rates fall more money will be held for speculative purposes as people will hold more wealth in cash form to profit from future higher rates of interest.	**4 marks graded**

2009 Q4 Continued

(c) Outline how the recent tightening (reduction) in the availability of credit may affect:

(i) The Irish Motor Industry:

- **Decreased demand for cars.**
  It is more difficult for customers to avail of credit in order to purchase cars. This has led to a fall in the demand for both new and second-hand cars.
- **Increased redundancies**
  With less demand for cars the numbers of people employed in the sale of cars has declined.
- **Business Closures/Consolidations**
  Many small independent car dealerships can not survive and close.
  Inability to get credit may result in cash flow problems for the firms, inability to pay suppliers and possible closure.

(ii) Inflation:

- **Inflation will decrease**
  The supply of money/credit will fall causing a decrease in the spending power of individuals. This fall will lead to a reduction in demand-pull inflation.
- **Deflation**
  The price of goods and services will fall due to falling demand and costs of production.

(iii) Ireland's Balance of Payments:

- **Imports decrease**
  If there is a reduction in the demand for goods and services then we can assume that there will be an automatic fall in the demand for imports.

OR

Imports Increase
Consumers with a lower spending power may switch consumption to cheaper imported substitute goods.

OR

- **Exports Decrease**
  Business will not be able to avail of credit in order to expand their business. This fall in investment may lead to a decrease in exports.
  The credit crunch on international markets may reduce aggregate demand resulting in reduced demand for goods produced in Ireland on export markets.

20 marks graded

2008 Q8

(a) (i) Explain, with the aid of an example, how it is possible for banks to create credit. (30 marks)

1. Commercial banks accept cash deposits from their customers e.g. say €100, for safekeeping.
2. These banks know from experience that their customers will only demand back a small amount of these deposits in cash - say 10% because of their use of cheques as an acceptable method of payment.
3. So they now have surplus cash with which to give loans - €90.
4. The amount of loan they give is related to, but in excess of their cash deposits and is based on their reserve ratio.

The amount it can create is calculated as follows:

$$\text{Increase in credit} = \text{Increase in Cash Deposits} \times \frac{1}{\text{Banks Reserve Ratio}}.$$

Plus a worked example of above.

OR

Alternative solution

Balance Sheet of a Bank

Assets		**Liabilities**	
Cash lodged by X	€100	X's deposit	€100
Total Assets	€100	Total Liabilities	€100

Balance Sheet of a Bank

Assets		**Liabilities**	
Cash lodged by X	€100	Deposits	€100
Loan	€900	New Deposits	€900
Total Assets	€1000	Total Liabilities	€1000

Plus explanation

1. Mr. X lodges €100 into the bank
2. It knows that only 10% is demanded in cash.
3. It has enough cash to support total deposits of €1,000. The bank can create another €900 in deposits. It does this by giving out loans of €900.
4. Only 10% of its total deposits will be demanded in cash. So €100 cash is sufficient for this purpose. This is shown in the new balance sheet.

Explanation plus example: 16 marks graded.

2008 Q8 Continued

(ii) Outline how a desire by banks to reduce their level of bad debts might affect their ability to create credit.

Reducing bad debts would reduce the banks' ability to create credit as they would become more cautious about lending and would therefore be holding more cash. If banks are not issuing loans this means less credit is being created.

Explanation 4 marks graded.

(iii) Explain **two other** factors which could affect their ability to create credit

1. **Availability of cash deposits**
   A bank can only give loans provided that it can attract cash deposits.

2. **Customers' demands for cash**
   The bank must keep sufficient cash to be able to meet the demands of its customers.

3. **European Central Bank guidelines**
   Commercial banks must follow the guidelines of the ECB.

4. **Demand for loans by customers**
   A bank is limited in the amount of loans it creates by the demand for loans. In a recessionary period the demand for loans will fall.

2 factors at 5 marks each graded.

2008 Q8 Continued

(b) Irish citizens experienced an increase in the rate of price inflation during 2007. (20 marks)

(i) Explain the underlined term

Price Inflation is defined as a sustained increase in the general level of prices.

Explanation 4 marks.

(ii) Discuss the economic effects of this development on the Irish economy.

1. Lower standard of living
Because of the higher cost of living, people have reduced purchasing power which causes a reduction in their standard of living.

2. Increased wage demands
Workers, experiencing a reduction in their standard of living, will try to negotiate wage increases to compensate for the higher cost of living.

3. Loss of competitiveness
If inflation is higher in Ireland than that of our trading partners it will result in a loss of competitiveness in our exports abroad possibly lowering our exports.

4. Loss of employment
Employers, faced with increased wage demands and a possible loss of exports may be forced to reduce costs and thereby reduce the numbers employed.

5. Government Finances
With higher prices the government may collect increased indirect tax revenues.

6. Savings discouraged/Consumption Encouraged
If the inflation rate is greater than the (nominal) rates of interest offered on savings, the real rate of interest available to savers falls thereby discouraging savings.

7. Borrowing encouraged
If the inflation rate increases the real rate of interest charged on borrowings falls and so the cost of repayments falls. This makes borrowing more attractive.

8. Increased disparity between different sectors of the population.
While those at work may seek a wage increase to compensate for the drop in their living standards, those on fixed incomes must wait for the government to decide to adjust their payments. This widens the gap between these sectors.

9. Pressure on social partnership/ industrial relations unrest
Falling living standards threatens the existence of social partnership agreements and may prevent future agreements.

10. Balance of Payments problems:
If the volume of exports falls and the volume of imports rises the Balance of Payments position will deteriorate.

11. Pressure on the ECB: Rising inflation may force the ECB to take corrective action to control it.

12. Uncertainty: Rising inflation rates in Ireland creates uncertainty for investment decisions.
Makes business planning and profit calculation difficult.

4 points at 4 marks each graded.

2008 Q8 Continued

(c) For a composite (weighted) price index covering three categories of expenditure given in the following table, calculate the index for the current year. The base year is 100.
(Show all your workings). (25 marks)

Category	Prices of Item(s) Base Year	Calculation of Simple Price Index x Weight						
	€							
Food	**20**	**$\frac{24.50 \times 100}{20}$**	**=**	**122.50**	**x**	**40%**	**=**	**49.00**
Clothing & Footwear	**42**	**$\frac{40.00 \times 100}{42}$**	**=**	**95.23**	**x**	**25%**	**=**	**23.80**
Other Items	**30**	**$\frac{36.00 \times 100}{30}$**	**=**	**120.00**	**x**	**35%**	**=**	**42.00**
Price Index for the Current year								**114.80**

1. Calculation of SPI for each category: 15 figures at 1 mark each = **15 marks**
2. Answers: 3 figures at 2 marks each = **6 marks**
3. Correct Answer: = **4 marks**

Total Marks = **25 marks**

2006 Q7

(a) (i) What economic uses are made of a Consumer Price Index? **12 marks graded**

1) **Measures the Rate of Inflation**.
Changes in the CPI from one month to the next gives us the official prevailing rate of inflation.

2) **Measures International Competitiveness.**
By comparing our inflation rate with that of our trading partners we can determine whether our competitiveness on international markets is improving or disimproving.

3) **Used in Partnership Agreements negotiations**.
Trade unions use any increase in the CPI as the basis for their wage claim increases.

4) **Indicator of economic performance**.
The CPI, together with statistics on employment, economic growth, exchequer returns etc., provide an indicator of the country's economic performance.

5) **Indexation of savings / investments**.
Some savings schemes have 'index-linked' returns meaning that the rate of interest will be equal to the rate of inflation. Individuals with insurance / pension policies may be able to increase their contributions so at to maintain the real value of these policies.

6) **Used by government indexing tax bands / social welfare payments**.
The government may use increases in the CPI to index tax bands so that taxpayers are not paying more tax. Similarly, the government may use increases in the CPI to increase rates of social welfare so as to maintain the standard of living of the recipients.

(ii) Explain how a **Consumer Price Index** is constructed **13 marks graded**

1. **Based on the 'National Average Family Shopping Basket'**
Those items which the average Irish family buys frequently and in large quantities are included.

2. **Expenditure patterns divided into various categories**
The CPI contains various categories of expenditure: food, alcohol, tobacco, clothing & footwear, fuel & light, housing, durable and non-durable household goods, transport, services and miscellaneous items etc.

3. **Calculation of 'Weight' (Household Budget Inquiry)**
The weight is the fraction of income which is spent on each category of expenditure and this information is obtained by means of the Household Budget Inquiry (random sample of all private households in the state).

4. **Prices in Base Year determined**
The average cost of the above items is taken to equal 100.

5. **Prices in Current Year determined**
The current prices of each item are collected from a fixed panel of retail and service outlets in various locations throughout the country.

2006 Q7 Continued

(b) The economic effects on the Irish economy of a significant increase in the annual rate of price inflation. (25)

1. Lower standard of living
Because of the higher cost of living, people have reduced purchasing power which causes a reduction in their standard of living.

2. Increased wage demands
Workers, suffering from a reduction in their standard of living, will try to negotiate wage increases to compensate for the higher cost of living.

3. Loss of competitiveness
If inflation is higher in Ireland than with our trading partners it will result in a loss of competitiveness for our exports abroad. Irish exports may be priced out of foreign markets.

4. Loss of employment
Employers, faced with increased wage demands and a possible loss of exports may be forced to reduce costs and reduce the numbers employed.

5. Government Finances
With higher prices the government may collect increased indirect tax revenues.

6. Savings discouraged
If the inflation rate is greater than the (nominal) rates of interest offered on savings, the real rate of interest available to savers falls thereby discouraging savings. Accumulated wealth is eroded by inflation.

7. Borrowing encouraged.
If the inflation rate increases the real rate of interest charged on borrowings falls and so the cost of repayments falls. This makes borrowing more attractive.

8. Increased disparity between sectors of the population.
While those at work may seek a wage increase to compensate for the drop in living standards, those on fixed incomes must wait for the government to decide to adjust their payments. This widens the gap between these sectors. The poorer sections suffer most when inflation is high.

9. Pressure on social partnership/ industrial relations unrest
Falling living standards threatens the existence of these agreements and may prevent future agreements.

10. Balance of Payments problems:
With falling volume of exports & rising volume of imports our Balance Of Payments position deteriorates. Exports become dearer and less competitive on foreign markets, while imports become more competitive on the home market.

11. Uncertainty:
Rising inflation rates in Ireland creates uncertainty for investment decisions.
It makes business planning and profit calculation difficult.

Marking scheme: 25 marks: 5 points at 5 marks each graded.

2006 Q7 Continued

(c) Outline the economic role played by TWO of the following international banking organisations. (25 marks)

The International Monetary Fund

Expansion of World Trade
The IMF encourages expansion in trade by encouraging member countries to adopt sound economic policies.
It monitors economic and financial developments in member countries and gives advice to its members.

Promote exchange rate stability.
The IMF promotes international monetary co-operation. It provides a forum for consultation on international monetary problems. It tries to maintain orderly exchange arrangements among countries and aims to avoid competitive devaluations.

Orderly correction of Balance of Payments problems.
The IMF lends to member countries with Balance of Payments problems to provide temporary financing and to support reform policies aimed at correcting the underlying problems.

Operation of a multilateral system of payments.
The IMF operates this system in respect of current transactions between members and aims to eliminate foreign exchange restrictions which may hamper the growth of world trade.

Provision of technical assistance and training.
Where a member needs help the IMP will provide this assistance and training. When the Soviet Union collapsed the IMF stepped in and set up treasury systems for their central banks to help the transition from centrally planned to market based economic systems.

The World Bank

Encourage investment funds to LDCs
Obtains funds from the world's advanced countries and uses these resources to make loans available to LDCs so they can invest in roads, schools etc.

Finance capital projects in member countries.
The World Bank gives loans to member states and to private businesses in these countries so as to assist with capital projects. Examples in Ireland included in the past the building of the original community schools by the DES.

Debt relief for LDCs
The World Bank helps LDCs reduce their debt burden by extending the term of loans and /or re-negotiating interest rates.

The European Central Bank (ECB)

Maintain Price Stability.
The key aim of the ECB is to maintain price stability and this it does by closely monitoring inflation in member countries and adjusting the base ECB interest rate so as to adjust spending.

Implements EUs monetary policy.
Through its member Central Banks the ECB monitors and advises on: rates of interest, money supply, credit availability & protects the value of the euro. Main measures: Refinancing operations, Standing Facilities, Minimum Reserve Requirements.

Holds and manages the official reserves of the euro area countries.
These are the EUs official holdings of gold, foreign currencies and other reserves held as security against the issue of the euro. The ECB manages these reserves on behalf of the countries.

Financial stability and supervision
The member authorities must provide prudential supervision of credit institutions and ensure stability in the financial system.

Euro bank notes and coins
The ECB has the exclusive right to authorise the issuance of banknotes within the euro area.

Marking Scheme: 25 marks – 2 organisations at 13 marks graded and 12 marks graded.

2005 Q7 (a) + (b)

(a) A bank needs to keep a balance between its twin objectives of **liquidity** and **profitability**. Explain the underlined terms. How does the bank reconcile these twin objectives? *(20 marks)*

Liquidity – 4 marks graded.

- Refers to the need by a bank to have liquid assets so as to meet the demand for cash by its customers.

Profitability – 4 marks graded.

- Refers to the need for a bank to make as much profit as possible from its assets for shareholders.

How does the bank reconcile these twin objectives? – 12 marks graded.

1. Banks must satisfy their customers need for cash i.e. they must have enough liquidity – they could do this by holding all, their assets in cash.
2. But cash doesn't earn interest and banks also wish to be profitable.
3. Banks have learned from experience that the compromise in having sufficient liquidity and yet earning profits is to hold their assets along the following portfolio:

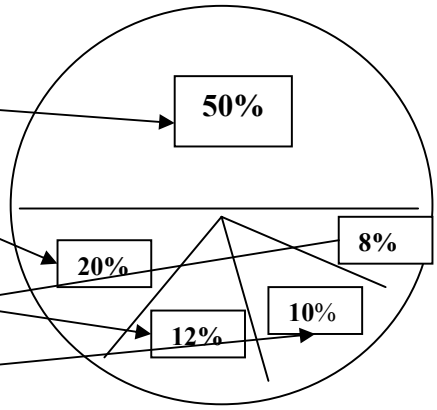
   (i) It will keep the majority of its assets in the form of Loans and Overdrafts. These assets earn profits but are not very liquid.

   (ii) It will require sufficient assets in cash and liquid form to meet the cash requirements of their customers. These assets are liquid but earn little profit.

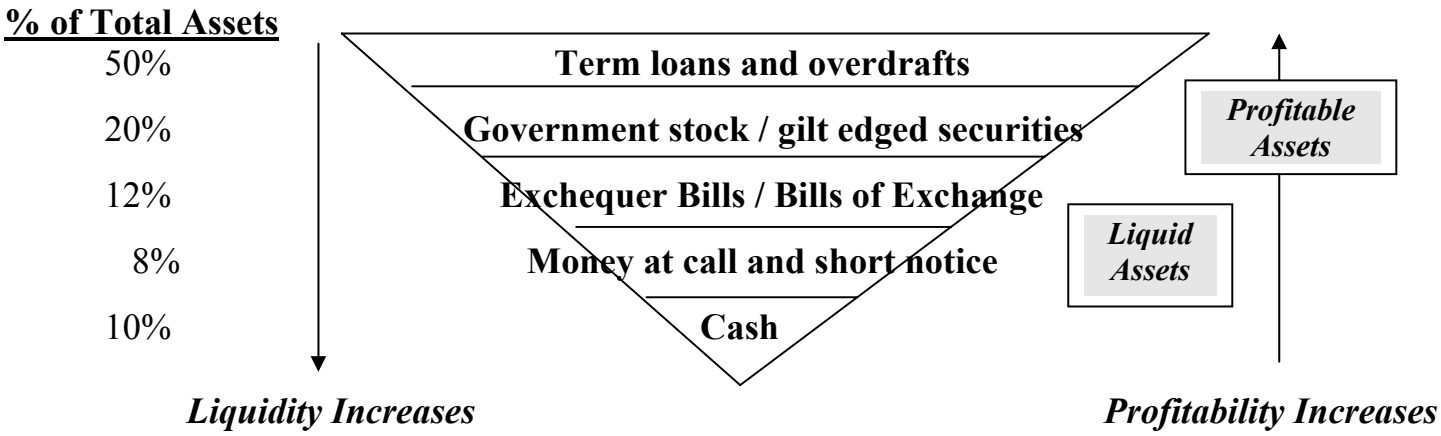
or

Profitable / Earning Assets are:
1. Term loans and overdrafts
2. Government stock / gilt edged securities.

Liquid assets are those which can be turned into cash quickly: incl.
1. Exchequer Bills / Bills of Exchange
2. Money at call and short notice: can be turned into cash quickly
3. Cash: on deposit in the banks.



or



2005 Q7 (a) + (b) Continued

(b) The Central Bank (now called the Central Bank & Financial Services Authority of Ireland) continues to play a very important economic role in the Irish economy. Explain the role it plays in the Irish economy. *(30 marks)*

(a) Prints / Issues legal tender.

- The Central Bank has the sole authority to print and mint euro currency in Ireland.
- It distributes the euro through the financial institutions within Ireland.
- Its mint is located in Sandyford in Dublin.

(b) Governments Bank.

All monies received by government are paid into the Government's account in the Central Bank and all monies paid out by Government are drawn from its account with the Central Bank.

(c) Bankers' Bank / Regulator of Financial sector / Issues licences to financial institutions.

- It acts as a Clearing House for the commercial banks who maintain accounts here.
- It regulates the financial sector in Ireland including credit unions, building societies, the IFSC operations, etc.
- The Central Bank acts as lender of last resort.

(d) Official external reserves.

- These are this country's official holdings of gold, foreign currencies and other reserves held as security against the issue of the euro.
- The Central Bank manages these reserves on behalf of the country.

(e) Maintains Price Stability.

The key role the Central Bank plays is to maintain price stability through its monetary policy operations so as to ensure competitiveness within the EU.
This it does through various measures: Main refinancing operations, Standing Facilities and Minimum Reserve Requirements.

(f) Provides Consumer Information / Economic Research – Central Bank Reports.

The Central Bank regularly provides information on all aspects of the economy through its Central Bank reports and provision of statistics relating to the Irish economy.
It also conducts research on various matters concerning the economy.

Marking: 5 points at 6 marks graded.

2003 Q5

(a) Discuss the ways in which money can contribute to the smooth working of an economy. (20 marks)

1) Medium of exchange
2) Measure of value
3) Store of wealth
4) Standard of deferred payment
5) Division of labour
6) Time saving
7) Increased wealth
8) Confidence
9) Demand management of the economy.

1. Medium of exchange
Money allows us to buy and sell goods & services independently of each other.

2. Measure of value
The use of money allows us to put a value on an item and relate the value of one item to the value of others.

3. Store of wealth.
The use of money allows us to save some of our wealth for the future.

4. Standard for deferred payment.
The use of money allows us to buy goods on credit now and to pay later.

5. Division of labour.
The use of money allows each person to specialise in one task and with the money received acquire those goods and services, which are needed to survive.

6. Time saving
The use of money saves time in not having to negotiate the relative worth of different items, unlike barter.

7. Increased wealth
Money allows for the specialisation of labour / firms, thus increasing society's wealth which allows for the provision of more services and for improvements in the state's infrastructure.

2003 Q5 Continued

8. Confidence
The use of money gives citizens confidence that the economy will operate effectively and hence consumers and firms will contribute to society and be rewarded.

9. Demand management of the economy
If aggregate demand needs to be boosted then the supply of money could be relaxed while a reduction in aggregate demand may require a tightening of the money supply.

Marking Scheme: 4 points x 5 marks each graded.

(b) Explain the likely economic effects if: -
(i) the supply of money grows at a **faster** rate than a country's production of goods and services;
(ii) the supply of money grows at a **slower** rate than a country's production of goods and services; (20 marks)

(i) the supply of money grows at a **faster** rate than a country's production of goods and services. ***10 marks graded***

1. Inflation - prices may rise because of insufficient supply/excess demand.
2. Imports - demand may be met by increased imports.
3. Savings - the insufficient supply of goods may force people to save.
4. Value of currency in a non-euro zone country may fall because of excess supply.
5. Rate of interest – under Keynes' Liquidity Preference if the supply of money grows then interest rates will fall.

2 points x 5 marks each graded

(ii) the supply of money grows at a **slower** rate than a country's production of goods and services. ***10 marks graded***

1. Deflation / Moderation in price levels - prices may fall because of excess supply.
2. Falling demand ⇒ declining economic growth ⇒ producers may rationalize, leading to rising unemployment.

2 points x 5 marks each graded

2003 Q5 Continued

(c) (i) Explain what is meant by the term **price inflation**. (35 marks)
(ii) Name the **main index** used to measure price inflation in the Irish economy.
(iii) Outline the economic consequences of a rise in the rate of price inflation in Ireland.

(i) Price inflation: ***5 marks graded***

- This is the continuous rise in the general price level.

or

- This is the fall in the value / purchasing power of money

(ii) Main index to measure inflation: **5 *marks***

- Consumer Price Index

(iii) Outline the economic consequences of a rise in the rate of price inflation in Ireland.

1.Lower standard of living
Because of the higher costs, people have reduced purchasing power, which causes a reduction in their standard of living.

2.Increased wage demands
Workers, suffering from a reduction in their standard of living, will try to negotiate wage increases to compensate for the higher cost of living.

3.Loss of competitiveness
If inflation is higher in Ireland than with the rest of our trading partners it will result in a loss of competitiveness in our exports.

4.Loss of employment
Employers, faced with increased wage demands and a possible loss of exports may be forced to reduce costs and thus reduce the numbers employed.

5. Government Finances
With higher prices the government may collect increased indirect tax revenues.

6. Savings discouraged
If the inflation rate is greater than the (nominal) rates of interest offered on savings, the real rate of interest available to savers falls thus discouraging savings.

2003 Q5 Continued

7. Borrowings encouraged.
If the inflation rate increases the real rate of interest charged on borrowings falls and therefore the cost of repayments falls. This makes borrowing more attractive.

8. Increased disparity between different sectors of the population.
While those at work may seek a wage increase to compensate for the fall in their living standards, those on fixed incomes must wait for the government to decide to adjust their payments. This may widen the gap between these sectors.

9. Pressure on social partnership/ industrial relations unrest
The lowering of living standards may threaten the existence of social agreements and may prevent future agreements.

10. Balance of Payments difficulties.
With falling exports and increasing imports our Balance of Payments position deteriorates.

11. Pressure on the European Central Bank (ECB)
Rising inflation may force the ECB to take corrective action to help curb it.

12. Uncertainty
Rising inflation rates in Ireland creates uncertainty for investors/entrepreneurs and may influence investment decisions.

5 points x 5 marks each graded

2003 Q7 (b)

(b) Outline the effects which a rise in the level of unemployment in Ireland may have on:

(i) Government current finances.
(ii) The Balance of Payments (Current Account).
(iii) Price Inflation. (20 marks)

	Effects of a RISE in UNEMPLOYMENT	Marks
Government Current Finances	1. Reduction in taxation revenues. 2. Increase in social welfare payments.	***7 marks graded***
Balance of Payments (Current Account)	1. Lower incomes leading to a reduction in imports. or 2. Rising unemployment may mean closures of business – some of which may be export orientated, hence lower exports.	***7 marks graded***
Price Inflation	1. Moderation in the rate of price inflation due to the reduction in spending power and a fall in demand pull inflation. Or 2.In the long term the increase in unemployment may lead to the need to increase taxation / rise in charges for certain services, resulting in a rise in the CPI.	***6 marks graded***
		20 marks

2002 Q5

(a) (i) Explain how it is possible for banks to create credit. **18 marks graded**

Accept deposits + Use of Cheques + Create Credit in excess of Deposits

1. Commercial banks accept cash deposits from their customers e.g. say €100, for safekeeping.

2. These banks know from experience that their customers will only demand back a small amount of these deposits in cash - say 10% because of their use of cheques as an acceptable method of payment.

3. So they now have surplus cash with which to give loans - €90.
   The amount of loans they give is related to, but in excess of their cash deposits and based on their reserve ratio.

or

2002 Q5 Continued

The amount it can create is calculated as follows:

$$\text{Increase in credit} = \text{Increase in Cash Deposits} \times \frac{1}{\text{Banks Reserve Ratio}}.$$

Or

Balance Sheet of a Bank

Assets		Liabilities	
Cash lodged by X	€100	X's deposit	€100
Total Assets	€100	Total Liabilities	€100

Balance Sheet of a Bank

Assets		Liabilities	
Cash lodged by X	€100	Deposits	€100
Loan	€900	New Deposits	€900
Total Assets	€1000	Total Liabilities	€1000

Plus explanation:

1. Mr. X lodges €100 into the bank .
2. It knows that only 10% is demanded in cash.
3. It has enough cash to support total deposits of €1,000. The bank can create another €900 in deposits. It does this by giving out loans of €900.
4. Only 10% of its total deposits will be demanded in cash. So €100 cash is sufficient for this purpose. This is shown in the new balance sheet.

2002 Q5 Continued

(ii) THREE limitations on banks' power to create credit. 12 marks graded

1. Availability of creditworthy customers / Need for collateral.
Loans can only be given to those people who are in a position to repay them.

2. Availability of Cash Deposits
A bank can only give loans provided that it can attract cash deposits.

3. Customers' Demands for Cash
The bank must keep sufficient cash to be able to meet the demands of its customers for cash

4. European Central Bank guidelines
Commercial banks must note the guidelines of the Central Bank.

5. Demand for loans by customers.
A bank is limited in the amount of loans it creates by the demand for loans.
In a recessionary period the demand for loans will fall.

2002 Q5 Continued

(b) Explain how an increase in the use of 'plastic money' (credit cards, etc) by customers affects the ability of the banks to create credit **15 marks graded**

- Banks will be able to increase the amount of credit they can create
- Therefore banks now have the use of an increased amount of their depositors' cash with which to extend the amount of credit created.

Or

$$\text{Increase in credit} = \text{Increase in Cash Deposits} \times \frac{1}{\text{Banks Reserve Ratio}}.$$

If customers use more plastic money, the banks can now decrease their banks reserve ratio and hence increase the amount of credit created

Q5 (c) (i)

Monetary Policy
Those actions, which influence the money supply, interest rates or the availability of credit.

Inflation
- This is the continuous rise in the general price level.
- This is the fall in the value / purchasing power of money

2 points at 5 marks graded

Q5 (c) (ii)

Effects of a reduction in interest rates on the Irish economy. **20 marks graded**

1. Borrowing encouraged
Borrowing is now cheaper resulting in lower loan repayments ⇒
increased spending power ⇒ increased inflation ⇒ increased demand for imports ⇒ higher standard of living.

2. Savings discouraged
With lower rate of returns people may find it less attractive to save ⇒higher spending.

3. Reduced mortgage repayments / Pressure on house prices to rise.
The cost of monthly repayments decreases resulting in higher standards of living.

4. Cost of Servicing the National Debt.
With lower domestic interest rates the cost of repaying the euro-zone portion of the national debt falls.

5. Costs of Production / Improved Competitiveness.
Costs will fall resulting in possible lower prices & / or an increase in the numbers employed.

6. Incentive to Invest.
The MEC will rise resulting in higher profits /investment encouraged/
it becomes cheaper for businesses to borrow and so businesses may invest.

2002 Q5 Continued

7. Economic Growth - encouraged.
With possibly higher investment, future economic growth in Ireland may be increased.

8. Revenue received from DIRT
With less savings the government may receive less revenue through DIRT.

9. Shift in emphasis in Government Policy
With lower interest rates the government could shift its emphasis from tax revenues more toward borrowing, as it is now cheaper for the government to borrow/ Introduction of government special savings scheme.

2001 Q6

(a) For a composite (weighted) price index covering the three types of expenditure given in the following table, calculate the index for the current year. The base year is 100. Show your workings.

Category	% of Income spent on Item(s)	Prices of Item(s) in base year	Price of Item(s) in current year.
		£	£
Food	35	8.50	12.75
Clothing & Footwear	15	37.50	45.00
Other Items	50	20.00	35.00
	100		

(20 marks)

Price index for the current year

Category	Prices of Item(s) Base Year	Calculation of Simple Price Index	X Weight
	£		
Food	8.50	$\frac{12.75 \times 100}{8.50} = 150.00$	150.00 X 35% = 52.50
Clothing & Footwear	37.50	$\frac{45.00 \times 100}{37.50} = 120.00$	120.00 X 15% = 18.00
Other Items	20.00	$\frac{35.00 \times 100}{20.00} = 175.00$	175.00 X 50% = 87.50
Price Index for the Current year			158.00

Or prices have risen by 58%.

Marking Scheme

1. Calculation of SPI for each category
   Per category: 4 figures @ 1 mark each = 3 x 4 marks = 12 marks
2. SPI x weight
   Per category: 2 figures @ 1 mark each = 3 x 2 marks = 6 marks
3. Correct Answer: 2 marks

2001 Q6 Continued

(b) Does the CPI accurately measure changes in the cost of living in? Ireland? Explain your answer (30 marks)

NO, the CPI does not accurately measure changes in the cost of living for the following reasons:

1	Limitations of an average As it represents the average spending patterns of the total population, it may not represent accurately particular groups in the population e.g. non-smokers.
2	Static weights The weights used are those which apply in the base year. The importance of some items in the base year changes over time because of changes in prices, taste and income. The information collected under the Household Budget Surveys may not be accurate e.g. respondents underestimating the amount of income spent on alcohol.
3	New products As it includes only those products in the base year it lags behind consumer trends and fashions. New products are not included in the index.
4	Quality of products The index does not take account of changes in the quality of products. Higher prices may reflect an improvement in the quality of the product.
5	Rural v. Urban lifestyles Both urban and rural households are represented by the present set of weights but this may not reflect accurately changes in their respective cost of living. It disregards consumption of own produce.
6	Switching by consumers When prices rise the CPI does not measure the extent to which people may switch to cheaper brands.
7	Measures changes to prices not changes in the cost of living because it doesn't take into account all the items, which affect people's living standards, i.e. income tax, social welfare etc.

State: 6 at 3 marks = 18. Explain clearly: 6 at 2 marks = 12marks (30 marks)

2001 Q6 Continued

(c) Over the past year the rate of inflation, as measured by the CPI, has fluctuated. Discuss the effects of this development on the Irish economy. (25 marks)

Note: The following sample answer outlines the effects of rising inflation on the economy. Alternative answers were also accepted.

1.Lower standard of living
Because of the higher cost of living, people have reduced purchasing power, which causes a reduction in their standard of living.

2.Increased wage demands
Workers, suffering from a reduction in their standard of living, will try to negotiate wage increases to compensate for the higher cost of living.

3.Loss of International competitiveness
If inflation in Ireland is high relative to our trading partners, it will result in a loss of competitiveness in our exports abroad – possibly lower exports.

4.Loss of employment
Employers, faced with increased wage demands and a possible loss of exports may be forced to reduce costs and reduce the numbers employed.

5. Government Finances
With higher prices, the government may collect increased indirect tax revenues.

6. Savings discouraged
If our inflation rate is greater than the (nominal) rates of interest offered on savings, the real rate of interest available to savers falls thus discouraging savings.

7. Borrowing encouraged.
If the inflation rate increases the real rate of interest charged on borrowings falls and so the cost of repayments falls. This makes borrowing more attractive.

8. Increased disparity between sectors of the population.
While those at work may seek a wage increase to compensate for the drop in their living standards, those on fixed incomes must wait for the government to decide to adjust their payments. This widens the gap between these sectors.

9. Pressure on social partnership/ industrial relations unrest.
The lowering of living standards threatens the existence of these agreements and may prevent future agreements.

10. Balance of Payments difficulties.
With falling exports and rising imports our BOP position deteriorates.

2001 Q6 Continued

11. Increased uncertainty/ Difficult to plan investment.
Rising inflation creates uncertainty, which is generally unfavourable to investment decisions.

Marking Scheme
State: 5 points @ 2 marks each = 10 marks
Explain: 5 points at 3 marks each = 15 marks