Economics
Leaving Certificate
Higher Level

Past Exam Questions
Marking Scheme on
Inflation

Q6 Section B 2013

Q6 Banking / Interest Rates / CPI

(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

(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.

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

(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

(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

Q4 Section A 2009

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

<u>Definition</u>:

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)

Q8 Part (b) & (c) Section B 2008

(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.

(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**	**24.50 x 100 / 20**	=	**122.50**	**x**	**40%**	=	**49.00**
Clothing & Footwear	**42**	**40.00 x 100 / 42**	=	**95.23**	**x**	**25%**	=	**23.80**
Other Items	**30**	**36.00 x 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**

Q1 Section A 2007

1. 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.

Q7 Part (a) & (b) Section B 2006

Q7 Consumer Price Index, Inflation and International Banking Organisations

(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.

(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.