Government and the Economy:

A. State and explain two reasons for state borrowing?
B. 3 ways by which the Irish govt. might attempt to reduce the National Debt and outline briefly the likely economic effects of these measures?

Solution A:

Productive investment
The government may need to borrow to finance self-liquidating projects (projects that yield proceeds/profits sufficient to cover the initial investment) e.g. infrastructural projects, tolls roads. These investments make for good economical investments for the future as the tax received will cover cost of borrowing.

Social investment
The government may borrow to finance socially desirable projects such as the building of hospitals, schools etc. These investments will be unlikely to be self-liquidating but the society will benefit from a higher educated, healthy population. This in turn may increase employment in the form of foreign direct investment (FDI's) due to the workforce being better educated and then leads to an increase in revenue for the government from direct taxes.

Solution B:

Increase tax
- Increase indirect tax (VAT) which increases the selling price of the goods which leads to inflation (if demand is present) which reduces competitiveness which may adversely affect the balance of payments. Imposing higher taxes on inelastic goods such as cigarettes and alcohol will generate massive revenue for the government.
- Increase direct tax (PAYE) reduced power for individuals, reduced demand for goods. Therefore the firm may close down causing unemployment which results in more govt. current expenditure i.e. social welfare. High PAYE rates discourage the work effort therefore the government should leave well alone.
- Corporation tax rises on company profits will discourage foreign investment in Ireland which will negatively affect job creation.

Reduce expenditure
- The government could downsize the public sector/reduce public sector pay; this would save the govt. a lot of money as it is the largest employer in the country. However this may lead to standard of living falling and the effects of which would permeate throughout the entire economy.
- Cut social welfare, this is one of the govt. largest costs however such a decision would make the political party in power unpopular. In the budget 2013, the Government did not reduce any primary social welfare rate. However, the duration of Jobseeker's Benefit will be reduced by three months, from twelve to nine, which will save the exchequer millions.

Selling off semi-state bodies
- This would increase government revenue initially but overall they would lose a valued asset. These funds from the sale could then be used to reduce national debt. The government may no longer have to keep funding the semi-state body but it would be losing out on annual profits.

Money and banking:

A. **If the supply of money grows at a faster rate & a slower rate than a country's production of goods and service, what are the economic effects of this?**
B. **Explain how banks create credit?**

Solution A:

Inflation:
There is an excess of money entering the economy than is being taken out. This inefficient supply of goods and services cannot satisfy consumers' needs/wants, which would result in inflation. Disposable income of families will now increase and prices will rise as demand is now greater than supply. This resulting inflation means that demand for scarce resources will rise. Due to this imports will increase thus negatively affecting our balance of payments greatly.

Savings:
If this situation occurred, consumers would not be satisfied with the amount of goods/services in circulation therefore they may have no option but to save for the future purposes. This may reduce the prospect of inflation occurring, as they will be less money in circulation causing this. The standard of living will fall also, due to less spending, which may cause further unemployment resulting in less revenue for the government in the form of taxes.

Other options; Availability of credit, imports, balance of payments

If the supply of money grows at a slower rate than a country's production of goods and services, what are the economic effects of this?

Deflation:
Less money is being put into the economy then being taken out. This results in lower incomes which lowers aggregate demand for goods/services. If too many goods remained unsold in the market place, then prices would need to be reduced to attempt a sale. For a short period of time, consumers are attracted to the reduction in price, but this will not last e.g. sales.

Unemployment:
This decrease in aggregate demand will reduce sales and profits for firms. As this is the main aim of most firms, they will choose to cut jobs instead of suffering the loss. This will decrease government revenue also. Irish citizens will have to rely on social welfare payments and the government will no longer receive as much tax revenue as expected e.g. PAYE.

Solution B:

Explain how banks create credit?

- Commercial banks create credit by maintaining sufficient cash reserves to meet the demands of the small minority of customers that will wish to draw out their deposits in cash form at any given time. According to banks reserve ratio, credit can be given to customers far in excess of the banks cash reserves.

- Suppose there is a bank with a reserve ratio of 10% (only needs to keep 10% of total deposits in cash format) and this bank receives a deposit of €1,000 from a customer. The bank can service deposits of €10,000 with cash of €1000.

- This is because the bank knows only 10% of deposits will be demanded by customers in cash form.

- Therefore banks can create deposits of €9000 only. 10% of the banks total deposits will be demanded by customers in cash format and the bank has the initial 1000 cash deposited to meet this demand.

Balance Sheet appears as follows:

Balance Sheet			
Assets		**Liabilities**	
Cash	1000	Deposit	1000
Loans	9000	New deposit	9000
	10,000		**10,000**

A. Cash: initial €1000 deposited by the customer is seen above.

B. Loans: This is the €9000 created by the bank on the strength of the cash reserve of €1000. This €9000 is owed to the bank by borrowers and is therefore an asset of the bank.

C. Deposits: This €10,000 is the total amount the bank owes its customers. It is composed of the €1000 cash owed to initial depositor and the €9000 worth of obligations; because the bank must honour the cheques written by the borrower on his/her loan account.

The amount of credit created by the bank depends on the banks reserve ratio i.e. how much money must be held in cash form. The amount it can create is calculated as follows:

"Increase in credit =

$$\text{Increase in cash deposits} \times \frac{1}{\text{Bank Reserve Ratio}}$$

Make notes here: