

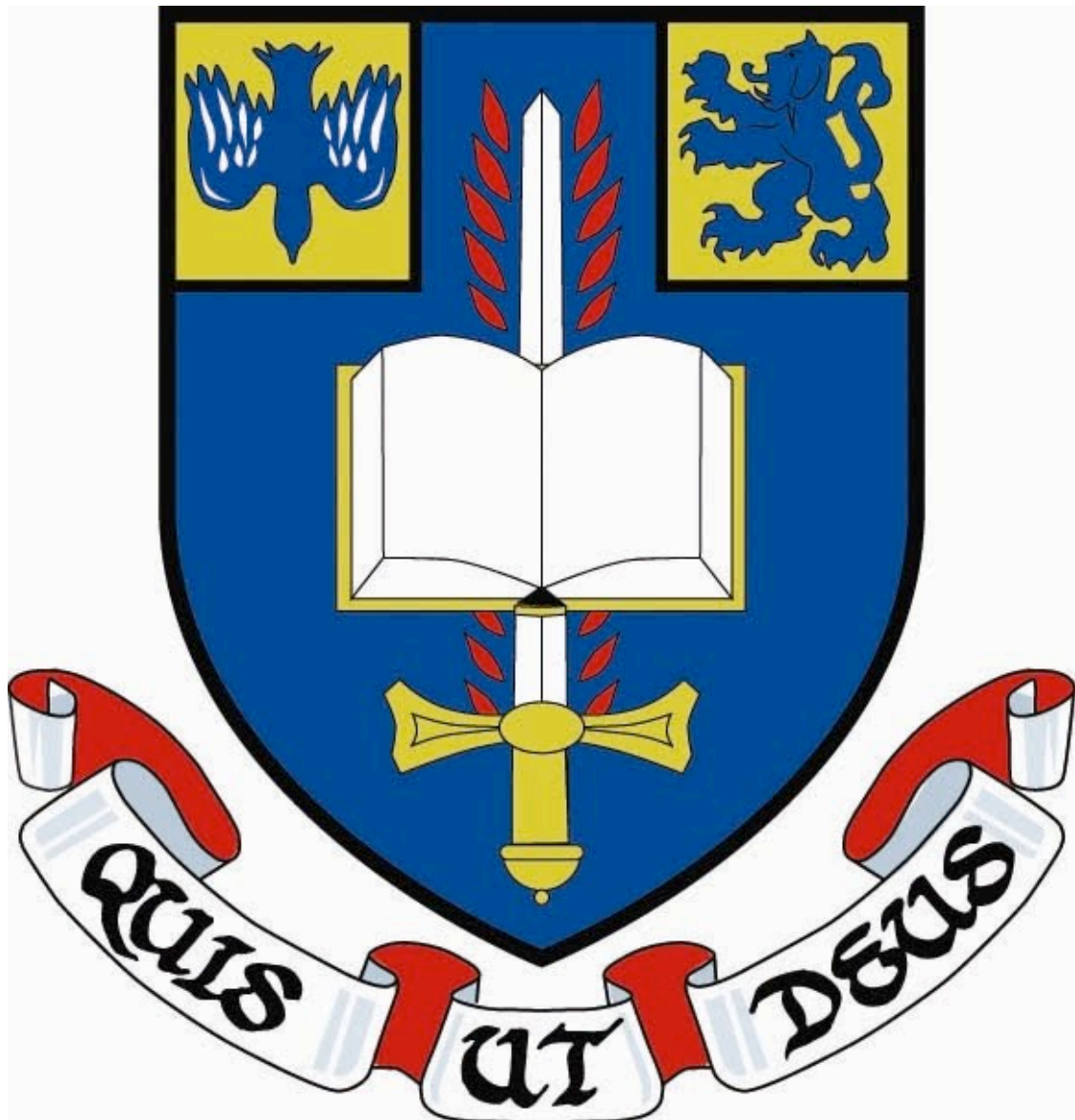
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# Inflation Pack

Mr Traynor©

Economics  
Exam Prep • Leaving Cert • 6<sup>th</sup> Year

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**SHORTS**

1.

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

**Step 1** \_\_\_\_\_

**Step 2** \_\_\_\_\_

**Step 3** \_\_\_\_\_

**Step 4** \_\_\_\_\_

**(16 marks)**

2.

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

**Definition:** \_\_\_\_\_

\_\_\_\_\_

**Source 1:** \_\_\_\_\_

**Source 2:** \_\_\_\_\_

**(16 marks)**

3.

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

**(i)** \_\_\_\_\_

**(ii)** \_\_\_\_\_

**(iii)** \_\_\_\_\_

**(iv)** \_\_\_\_\_

**(16 marks)**

4.

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%			<b>Price Index for the Current Year</b>	→	

5.

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

Step 1: \_\_\_\_\_

Step 2: \_\_\_\_\_

Step 3: \_\_\_\_\_

Step 4: \_\_\_\_\_

**(16 marks)**

**LONG QUESTIONS****2008**

- (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**

- (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)

**2003**

- (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**. (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.

**2001**

- (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]**

## Answers (Short Questions)

1.

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**

2.

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.**

3.

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.

4.

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.

5.

**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**

## Answers (Long Questions)

### 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	$\frac{24.50 \times 100}{20} = 122.50 \times 40\% = 49.00$
Clothing & Footwear	42	$\frac{40.00 \times 100}{42} = 95.23 \times 25\% = 23.80$
Other Items	30	$\frac{36.00 \times 100}{30} = 120.00 \times 35\% = 42.00$
<b>Price Index for the Current year</b>		<b>114.80</b>

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**

(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 as 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.**

**2003**

(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  $\Rightarrow$  declining economic growth  $\Rightarrow$  producers may rationalize, leading to rising unemployment.

***2 points x 5 marks each graded***

- (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.

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*

**2001**

- (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	$\frac{12.75 \times 100}{8.50} = 150.00$	$150.00 \times 35\% = 52.50$
Clothing & Footwear	37.50	$\frac{45.00 \times 100}{37.50} = 120.00$	$120.00 \times 15\% = 18.00$
Other Items	20.00	$\frac{35.00 \times 100}{20.00} = 175.00$	$175.00 \times 50\% = 87.50$
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

<p>(b) Does the CPI accurately measure changes in the cost of living in Ireland? Explain your answer (30 marks)</p>
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NO, the CPI does not accurately measure changes in the cost of living for the following reasons:

1	<p><u>Limitations of an average</u></p> <p>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.</p>
2	<p><u>Static weights</u></p> <p>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.</p>
3	<p><u>New products</u></p> <p>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.</p>
4	<p><u>Quality of products</u></p> <p>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.</p>
5	<p><u>Rural v. Urban lifestyles</u></p> <p>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.</p>
6	<p><u>Switching by consumers</u></p> <p>When prices rise the CPI does not measure the extent to which people may switch to cheaper brands.</p>
7	<p><u>Measures changes to prices</u></p> <p>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.</p>
<p>State: 6 at 3 marks = 18. Explain clearly: 6 at 2 marks = 12marks (30 marks)</p>	



(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.

**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**