Money and Banking

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Economics
Pack

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Short Questions

1.

In September 2010 approximately 5.1% of mortgage accounts were **in arrears** (behind on mortgage payments) of 90 days or more. Outline **two** economic **reasons** for this development and **two actions** financial institutions could take to help mortgage customers.

Reasons:

(i) ______________________________

(ii) ______________________________

Actions:

(i) ______________________________

(ii) ______________________________

(17 marks)

2.

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

(i) ______________________________

(ii) ______________________________

(iii) ______________________________

(16 marks)

3.

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

(i) ______________________________

(ii) ______________________________

(iii) ______________________________

(16 marks)

4.

Monetary Policy is defined as

____

____

____

____

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

- ____
  ____
- ____
  ____
- ____
  ____

5.

State **THREE** contributions made to economic thought by the **Monetarist economists.**

(i) ....

(ii) ....

(iii) ....

(17 marks)

2011

(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

(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)

2009

(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

(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)

2006

(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)

2005

(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)*

(c) The **euro** is now well established as a currency in Ireland. Discuss the economic effects which the introduction of the euro has had on:
- Irish consumers;
- Irish exporters and importers. *(25 marks)*

[75marks]

2003

(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)

2002

(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]

Answers (Short Questions)

1.

In September 2010 approximately 5.1% of mortgage accounts were **in arrears** (behind on mortgage payments) of 90 days or more. Outline **two** economic **reasons** for this development and **two actions** financial institutions could take to help mortgage customers.

Two reasons:

1. Increased interest rates resulting in increased costs of borrowing.
2. Increased unemployment: resulting in a loss of income and difficulty in repaying mortgage.
3. Economic recession: employees have lower incomes resulting from tax increases/reductions in pay.
4. Reckless lending/ borrowing:

- 100% mortgages were issued and now lenders are unable to repay debt;
- People borrowed too much and now can't meet the repayments.

Two actions:

1. Re-schedule the loan contract:
Extend the loan repayment period, thereby reducing the monthly repayment.
2. Interest only payments: Defer capital repayments until a later day so monthly payment falls.
3. No penalty payments such as extra interest charges for those in arrears
4. Debt / equity swaps: Take part ownership of the property in return for reduced repayments.
5. Debt forgiveness for those with no foreseeable chance of repayment-cancel their debt.
6. Re-value properties at market value and base interest repayments on this value.

2.

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.

3.

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.

4.

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.

5.

8. State THREE contributions made to economic thought by the Monetarists
(17 marks)

1. Monetary policy
should be the main instrument used by the government to manage the economy.
2. Control of money supply
monetarists suggest strict control so as to control inflation.
3. Reduced inflation

this increases competitiveness and may lead to increased exports.
4. Laissez faire principles
favour a return to laissez faire principles - with minimum state intervention - e.g. they favour privatisation.

5. Supply side policies

do not favour attempts to influence the supply of labour i.e. reducing the ability of trade unions to interfere with the labour market.

Answers (Long Questions)

2011

(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

(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

(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

(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.**

2009

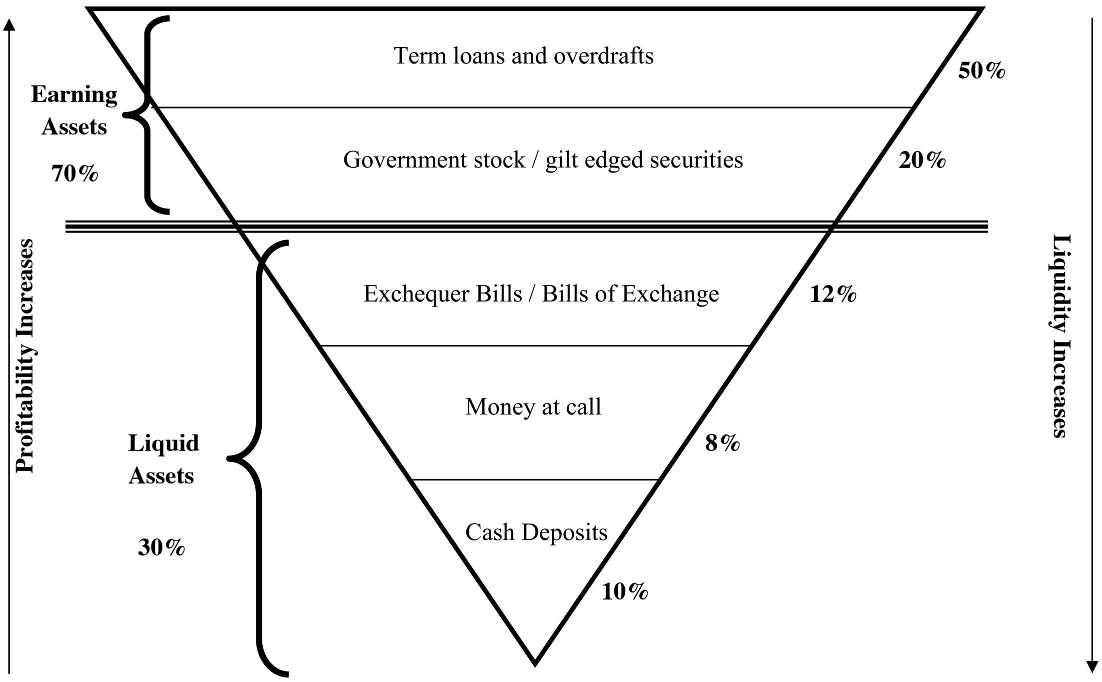
(a) **'**Banks may fail by overextending their loan book'.
Explain this statement within the context of a bank's twin requirements of liquidity and profitability.

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

(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**

(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.

2008

(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.

(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.

2006

(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

(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.

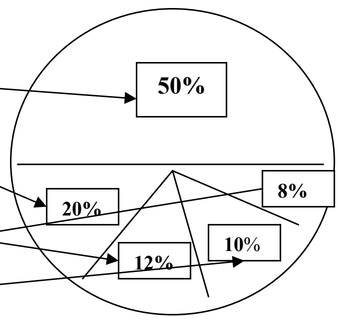
1. Banks must satisfy their customers need for cash i.e. they must have enough liquidity – they could do this by holding all, their assets in cash.
2. But cash doesn't earn interest and banks also wish to be profitable.
3. Banks have learned from experience that the compromise in having sufficient liquidity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

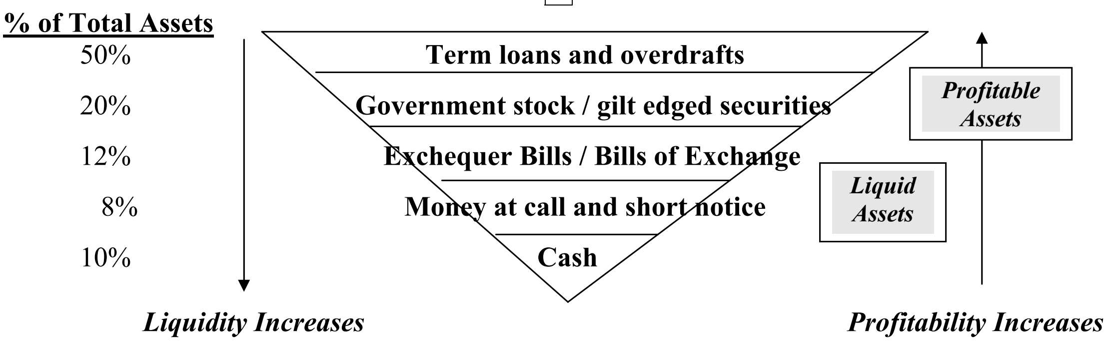
or

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



(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) <u>Prints / Issues legal tender</u>.

- 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) <u>Governments Bank</u>.

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) <u>Bankers' Bank / Regulator of Financial sector / Issues licences to financial institutions</u>.

- 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) <u>Official external reserves</u>.

- 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) <u>Maintains Price Stability.</u>

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) <u>Provides Consumer Information / Economic Research – Central Bank Reports</u>.

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.

(c) The **euro** is now well established as a currency in Ireland. Discuss the economic effects which the introduction of the euro has had on: Irish consumers; Irish exporters and importers. *(25 marks)*

Irish consumers	Irish exporters and importers
1. Foreign Travel. No foreign exchange costs / no conversion charges apply to those travelling within eurozone countries.	**1. Exchange risk eliminated.** No devaluation or revaluation has taken place resulting in increased certainty in international trade.
2. Inflation. The introduction of the euro led to inflation within this country in the immediate aftermath of its introduction.	**2. Easier payment for trading.** As no conversion charges apply to trade within the eurozone this facilitates speedier payment.
3. Price comparisons. Can now be made within all eurozone countries, allowing for greater transparency.	**3. Lower interest rates.** One of the major benefits of the euro has been access to lower competitive interest rates for firms.
4. Greater choice of financial products. Irish consumers can now choose where to save, borrow, invest and seek insurance thereby facilitating increased competition.	**4. Cost of imported raw materials / capital goods.** These should now be more competitive due to open competition, the absence of currency fluctuations and more transparency in international pricing.
5. Greater awareness / competition. The euro has resulted in greater awareness as regards prices and Irish consumers can now seek better value for their euro.	**5. Pressure for domestic competitiveness.** Employees are becoming increasingly aware that success as an economy depends on being competitive and this has ensured moderation in wage increases.
6. Prudent management of the economy. Membership of the euro constrains the government in relation to economic policy and ensures prudent management occurs.	**6. Increased trade opportunities.** Access to EU markets is easier and leads to greater opportunities.
7. Low interest rates. The lower interest rates since the introduction of the euro have benefited consumers, resulting in increased borrowings.	**7. Fluctuating value of the euro.** Companies whose main market is UK/US, have been affected by the fluctuating value of the euro resulting in a loss of competitiveness.

Marking: 5 points at 5 marks graded.

2003

(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.

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

(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

2002

(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.

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.

(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.

(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

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

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.

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.