Cambridge

IGCSE

Business studies

CODE: (0450)

Section 06

External influences on business issues

Chapter 27
Economic issues

Definitions to learn

Gross Domestic Product (GDP) is the total value of output of goods and services in a country in one year.

The wider economy and how it can affect businesses

The wider economy's external changes, such as business cycles and government policy changes, impact businesses directly or through customers. Businesses can decide how to react to these effects, such as exchange rates or unemployment rates.

The main stages of the business cycle

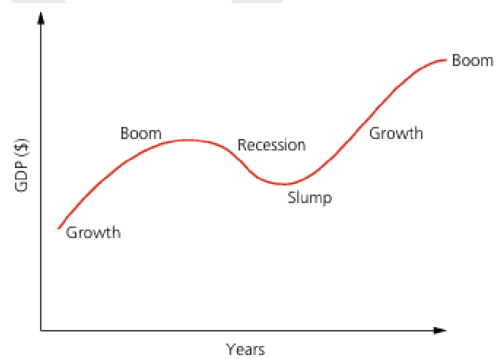
Economic growth may not be achieved steadily every year – there are often years when the economy does not grow at all or when the value of **Gross Domestic Product (GDP**) falls.

» **Growth** – This is when GDP is rising, unemployment is generally falling, and the country is enjoying higher living standards. Most businesses will do well at this time.

» **Boom** – This is caused by too much spending. Prices start to rise quickly and there are shortages of skilled workers. Business costs will be rising, and businesses will become uncertain about the future.

» **Recession** – Often caused by too little spending. This is a period when GDP falls. Most businesses will experience falling demand and profits. Workers may lose their jobs.

» **Slump** – A serious and long-drawn-out recession. Unemployment reaches very high levels and prices may fall. Many businesses will fail to survive this period.



▲ A business cycle diagram

Clearly, governments will try to avoid the economy moving towards a **recession** or a slump but will also want to reduce the chances of a boom. A boom with rapid inflation and higher business costs can often lead to the conditions that result in a recession.

Definitions to learn

A **recession** is when there is a period of falling GDP.

Impact on businesses of changes in employment levels, inflation and GDP

Changes in economic indicators will have an impact – either positive or negative.

- Employment levels impact businesses' recruitment and customer incomes. Increased unemployment may facilitate recruitment, while job losses may decrease income levels, reducing sales. Conversely, businesses selling cheaper products may see increased sales due to reduced spending.

- Inflation can increase business costs, leading to increased product prices and falling sales. The impact on businesses depends on the type of products sold.

- Increasing GDP means that the economy is growing. Generally, businesses will benefit from increasing sales as more people have jobs and have more income to spend buying products.

Government economic objectives

Most governments have the following objectives for the economy:

» Low inflation

» Low unemployment

» Economic growth

» Balance of payments between imports and exports.

Definitions to learn

Inflation is the increase in the average price level of goods and services over time.

Unemployment exists when people who are willing and able to work cannot find a job.

Economic growth is when a country's GDP increases – more goods and services are produced than in the previous year.

The **balance of payments** records the difference between a country's exports and imports.

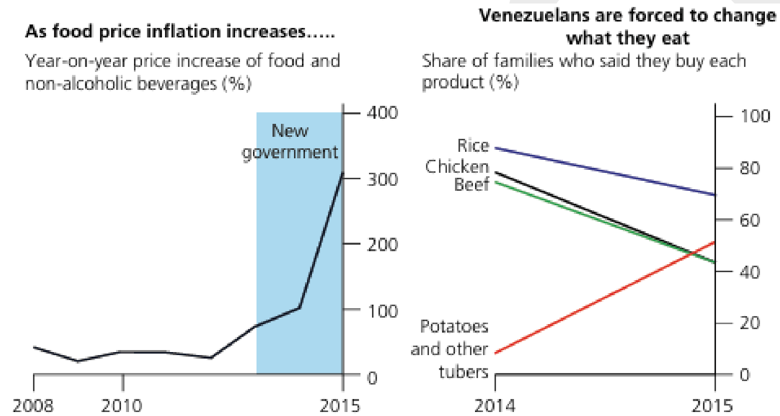
Low inflation

Inflation occurs when there is a rise in average prices over a period of time. Low inflation is an important objective. When prices rise rapidly it can be serious for the whole country. These are the problems a country will have if there is rapid inflation:

» Workers' wages will not buy as many goods as before. This means that people's real incomes will fall. Real income is the value, in terms of what can be bought, of an income – if a worker receives a 6 per cent wage increase but prices rise by 10 per cent in the same year, then the worker's real income has fallen by 4 per cent.

» Prices of the goods produced in the country will be higher than those in other countries. People may buy foreign goods instead. Jobs in the country will be lost.

» Businesses will be unlikely to want to expand and create more jobs soon. The living standards are likely to fall.



Source: Encuesta Sobre Condiciones de Vida en Venezuela, Instituto Nacional de Estadistica

▲ High rates of inflation reduce real incomes and lead consumers to change their spending patterns

Definitions to learn

Real income is the value of income, and it falls when prices rise faster than money income.

Low unemployment

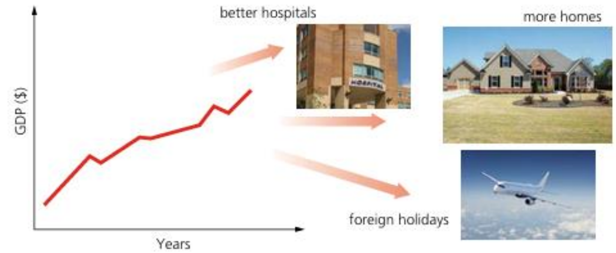
When people want to work but cannot find a job, they are unemployed. These are the problems unemployment causes:

» Unemployed people do not produce any goods or services. The total level of output in the country will be lower than it could be.

» The government pays unemployment benefit to those without jobs. A high level of unemployment will cost the government a great deal of money. This cannot be spent on other things such as schools and hospitals.

Economic growth

When a country's GDP is falling there is no economic growth. The problems this causes include the following: » As output is falling, fewer workers are needed, and unemployment will occur.



▲ Economic growth, makes a country richer and allows living standards to rise

» The average standard of living of the population – the number of goods and services they can afford to buy in one year – will decline. In effect, most people will become poorer.

» Business owners will not expand their business as people will have less money to spend on the products they make.

▲ A balance of payments deficit can lead to major problems for a country

Balance of payments

Exports are goods and services sold by one country to people and businesses in another country. These bring money (foreign currency) into a country. Imports are goods bought in from other countries.

If the value of a country's imports is greater than the value of its exports, then it has a balance of payments deficit. These are the problems that could result:

» The country could 'run out' of foreign currencies and it may have to borrow from abroad.

» The price of the country's currency against other currencies – the exchange rate – will be likely to fall. This is called exchange rate depreciation. The country's currency will now buy less abroad than it did before depreciation.

Definitions to learn

Exports are goods and services sold from one country to other countries.
Imports are goods and services bought in by one country from other countries.

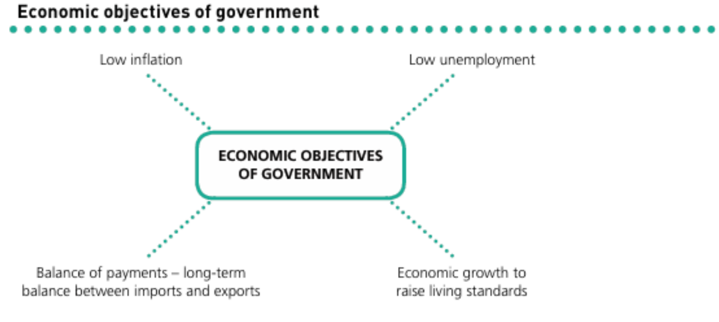
Definitions to learn

The **exchange rate** is the price of one currency in terms of another, for example, £1 : $1.5.
Exchange rate depreciation is the fall in the value of a currency compared with other currencies.

Government economic policies

Governments wield significant economic power by raising taxes and spending on services and state benefits, controlling 40-50% of a country's GDP. Their decisions significantly impact businesses, making it crucial for business managers to understand their business's potential impact.

Economic objectives of government



The main ways in which governments can influence the economy – sometimes called economic policies – are:

» Fiscal policy – taxes and government spending
» Monetary policy – interest rates
» Supply side policies.

Definitions to learn

Fiscal policy is any change by the government in tax rates or public sector spending.

Fiscal policy: taxes and government spending

All governments spend money. They spend it on schools, hospitals, roads, defence, and so on.

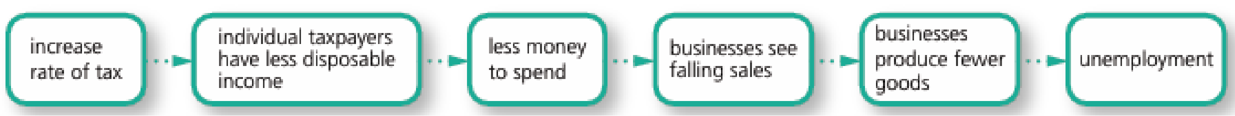
Q: Where do governments raise this money from?
A: Mainly from taxes on individuals and businesses.
Q: What are the main types of taxes?
A: **Direct taxes** on the income of businesses and individuals, and **indirect taxes** on spending.
Q: How do these taxes affect business activity? A: In several different ways.

Definitions to learn

Direct taxes are paid directly from incomes, for example, income tax or profits tax.
Indirect taxes are added to the prices of goods and taxpayers pay the tax as they purchase the goods, for example, VAT.
Disposable income is the level of income a taxpayer has after paying income tax.

Income tax

How would businesses be affected by an increase in the rate of income tax? Individual taxpayers would have a lower **disposable income**. They would have less money after tax to spend and save. Businesses would be likely to see a fall in sales. Managers may decide to produce fewer goods as sales are lower. Some workers could lose their jobs.



▲ Income tax flowchart

Profits tax (or corporation tax)

This is a tax on the profits made by businesses – usually companies. How would an increase in the rate of corporation tax affect businesses? There would be two main effects:

» Businesses would have lower profits after tax. Managers will therefore have less money or finance to put back into the business. The business will find it more difficult to expand. New projects, such as additional factories or shops, may have to be cancelled.

» Lower profits after tax is also bad news for the owners of the business. There will be less money to pay back to the owners who originally invested in the business. Fewer people will want to start their own business if they consider that the government will take a large share of any profits made.

Indirect taxes

How would businesses be affected by an increase in an indirect tax? Again, there would be two main effects:
» Prices of goods in the shops would rise. Consumers may buy fewer items as a result. This will reduce the demand for products made by businesses. However, not all businesses will be affected in the same way.

» As prices rise so the workers employed by a business will notice that their wages buy less in the shops. It is said that their real incomes have declined. Businesses may be under pressure to raise wages, which will force up the costs of making products.

Import tariffs and quotas

Many governments try to reduce the import of products from other countries by putting special taxes on them. These are called **import tariffs**, and they raise money for the government.

> **Definitions to learn**
> An **import tariff** is a tax on an imported product.
> An **import quota** is a physical limit on the quantity of a product that can be imported.

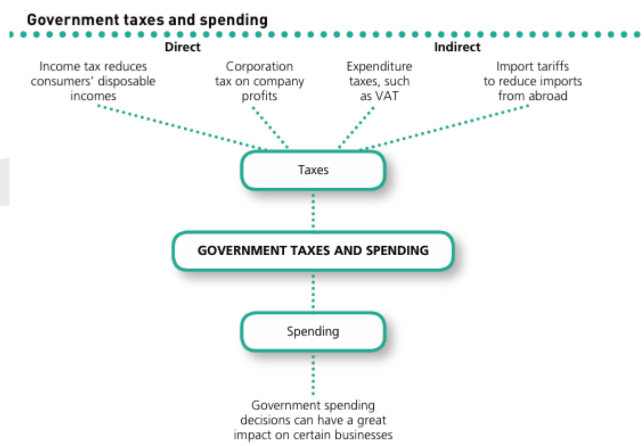
How would businesses in a country be affected if the government put tariffs on imports into the country? There are three possible effects:

» Businesses will benefit if they are competing with imported goods. These will now become more expensive, leading to an increase in sales of home-produced goods.

» Businesses will have higher costs if they have to import raw materials or components for their own factories. These will now be more expensive.

» Other countries may now take the same action and introduce import tariffs too. This is called retaliation. A business trying to export to these countries will probably sell fewer goods than before.

Another method a government can use to limit imports is to introduce an **import quota** or physical limit on the quantity of a product that can be brought in.



Changes in government spending

Governments in most countries spend the tax revenue they receive on programmes such as:

» Education
» Health
» Defence
» Law and order
» Transport – roads and railways.

Monetary policy – interest rates

An interest rate is the cost of borrowing money. In most countries, the level of interest rates is fixed by the government or the central bank via **monetary policy.**

> **Definitions to learn**
> **Monetary policy** is a change in interest rates by the government or central bank, for example, the European Central Bank.

The following are likely to be the main effects of higher interest rates:

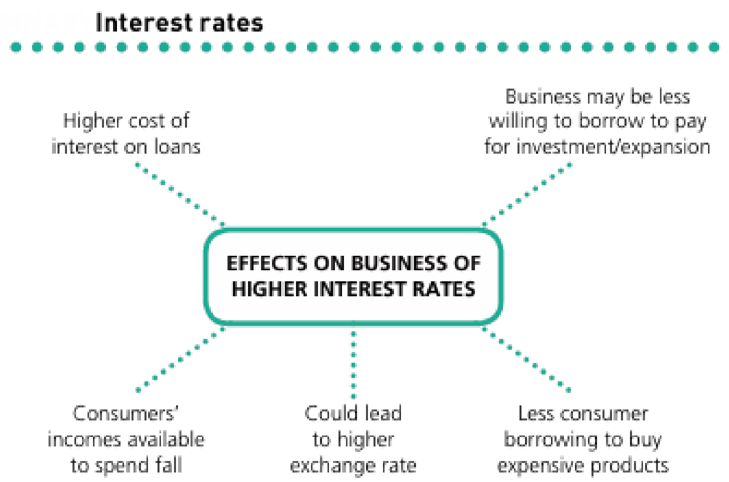
» Firms with existing variable interest loans may have to pay more in interest to the banks. This will reduce their profits. Lower profits mean less is available to distribute to the owners and less is retained for business expansion.

» Managers thinking about borrowing money to expand their business may delay their decision. New investment in business activity will be reduced. Fewer new factories and offices will be built.

If consumers have taken out loans such as mortgages to buy their houses, then the higher interest payments will reduce their available income. Demand for all goods and services could fall as consumers have less money to spend.

» In addition to the point above, if a business makes expensive consumer items like cars or if it builds houses, then it will notice that consumer demand will fall for another reason. Consumers will be unwilling to borrow money to buy these expensive items if interest rates are higher.

» Higher interest rates in one country will encourage foreign banks and individuals to deposit their capital in that country. They will be able to earn higher rates of interest on their capital. By switching their money into this country's currency, they are increasing the demand for it. The **exchange rate** will rise – this is called exchange rate appreciation.



Definitions to learn

Exchange rate appreciation is the rise in the value of a currency compared with other currencies.

Definitions to learn

Supply side policies try to increase the competitiveness of industries in an economy against those from other countries. Policies to make the economy more efficient.

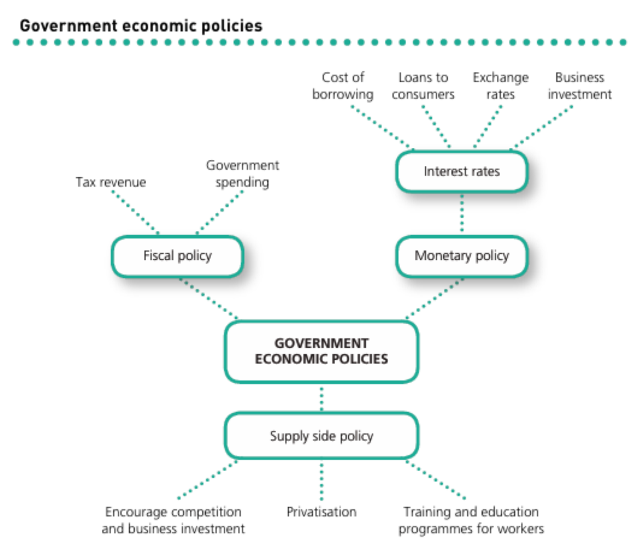
Supply side policies

Some of the policies which have been used to achieve these aims are listed below – they are called **supply side policies** because they are trying to improve the efficient supply of goods and services.

» Privatisation – privatisation is now very common. The aim is to use the profit motive to improve business efficiency.

» Improve training and education – governments plan to improve the skills of the country's workers. This is particularly important in those industries such as computer software which are often very short of skilled staff.

» Increase competition in all industries – this may be done by reducing government controls over industry or by acting against monopolies.



How business might react to changes in economic policy

The following table explains how businesses might react to some major changes in government economic policy. The business decisions and effects could be reversed if the government decided to reduce taxes, government spending or interest rates.

Government policy change	Possible business decision	Problems with this decision
Increase income tax – this reduces the amount consumers have to spend	Lower prices on existing products to increase demand Produce 'cheaper' products to allow for lower prices	Less profit will be made on each item sold (reduces gross profit margin) The brand image of a product might be damaged by using cheaper versions of it
Increase tariffs on imports	Focus more on the domestic market as locally produced goods now seem cheaper Switch from buying imported materials and components to locally produced ones	It might still be more profitable to export Foreign materials and components might be of higher quality
Increase interest rates	Reduce investment so future growth will be less Develop cheaper products that consumers will be better able to afford Sell assets for cash to reduce existing loans	Other companies might still grow so market share will be lost Depends on the product but could consumers start to think that the quality and brand image are lower? The assets might be needed for future expansion
Increase government spending	Switch marketing strategy to gain more public-sector contracts e.g. building or equipping schools and hospitals	May be great competition if other businesses take same action

Chapter 28

Environmental and ethical issues

How business activity can impact on the environment

Consider these two statements by different factory managers:

» Manager A: 'I know that my factory pollutes the air and the river with waste products, but it is very expensive to use cleaner methods. We make a profit from making cheap products and these are what consumers want.'

» Manager B: 'We recently spent $10 million on new low energy boilers that produce 90 per cent less pollution than the old ones. We now recycle 75 per cent of our waste – consumers prefer businesses that are aware of their social **responsibility**.'

Definitions to learn

Social responsibility is when a business decision benefits stakeholders other than shareholders, for example, a decision to protect the environment by reducing pollution by using the latest and 'greenest' production equipment.

Environment is our natural world including, for example, pure air, clean water and undeveloped countryside.

▲ Air pollution damages the environment

▲ Dirty rivers are expensive to clean up

▲ Road transport creates noise and air pollution and adds to global warming

Definitions to learn

Global warming is a gradual increase in the overall temperature of the Earth's atmosphere, generally thought to be caused by increased levels of carbon dioxide, CFCs, and other pollutants in the atmosphere.

Business activity aims to satisfy customers' demand for goods and services – but it often has an impact on the **environment**. The 'environment' means our natural world.

Transport of goods by ship and trucks burns fossil fuels such as oil, which create carbon emissions and may be linked to **global warming** and climate change.

Argument A: **Business should produce goods and services profitably and not worry about the environment**	**Argument B:** **Businesses have a social responsibility towards the environment and this can benefit them too**
Protecting the environment can be expensive. Reducing waste, recycling waste and reducing polluting smoke all cost businesses money and this reduces profits	Global warming and global pollution affect us all and businesses have a social responsibility to reduce these problems
Firms might have to increase prices to pay for 'environmentally friendly' policies	Using scarce natural resources which are non-renewable, such as rainforest timber, leaves less for future generations and raises prices
This could make firms uncompetitive and they could lose sales to businesses, perhaps located in other countries, that are not environmentally friendly	Most scientists and environmentalists believe that business activity can damage the environment permanently
Consumers will buy less if they have to pay higher prices	Consumers are becoming more socially aware – they are increasingly demanding products from 'environmentally friendly' businesses, and this can become a marketing advantage
If pollution is a problem, then governments should pay to clean it up	If a business damages the environment, then **pressure groups** could take action to harm the business's reputation and sales
Some business owners claim there is not enough proof that business activity is doing permanent damage to the environment	

Definitions to learn

External costs are costs paid for by the rest of society, other than the business, as a result of business activity.

External benefits are the gains to the rest of society, other than the business, as a result of business activity.

Definitions to learn

Private costs of an activity are the costs paid for by a business or the consumer of the product.

Private benefits of an activity are the gains to a business or the consumer of the product.

Definitions to learn

A **pressure group** is made up of people who want to change business (or government) decisions by taking action, such as organising consumer boycotts.

Definitions to learn

Social cost = external costs + private costs.

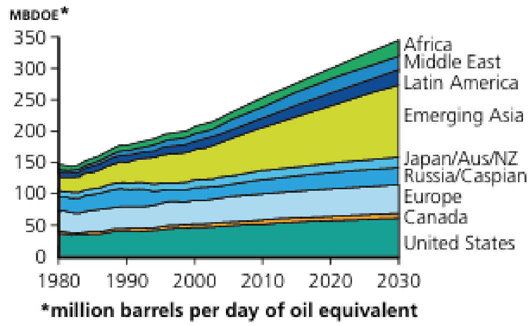
Social benefit = external benefits + private benefits.

The concept of externalities

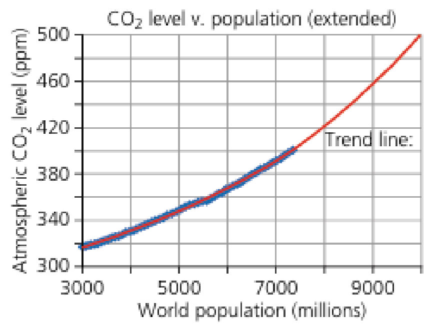
Most business activities – such as locating a factory or producing goods and services – lead to many different costs and benefits. It is important to distinguish between private costs and benefits and external costs and benefits. The following case study explains these differences.

Sustainable development

Look at the following information about the world's demand for energy and carbon dioxide emissions:



▲ World energy demand



▲ Global population and carbon dioxide emissions since 1900 with predictions for the future

Sustainable development means trying to achieve economic growth but without damaging the environment and society for future generations.

> **Definitions to learn**
> **Sustainable development** is development which does not put at risk the living standards of future generations.

Sustainable development: what can business do?

1 Use renewable energy – by fitting solar panels or buying energy that uses renewable sources such as wind or tidal power.

2 Recycle waste – by re-using water and other products that would otherwise be wasted or disposed of, total use of resources is reduced.

3 Use fewer resources – lean production (see Chapter 18) is about managing production so efficiently that the minimum quantity of resources is used. 4 Develop new 'environmentally friendly' products and production methods,

How and why business might respond to environmental pressures and opportunities

How can society make business give the environment a higher priority? There are three main influences:

» Consumers
» Pressure groups
» Government, through legal controls.

> **Definitions to learn**
> **Pressure groups** are groups of people who act together to try to force businesses or governments to adopt certain policies.
> A **consumer boycott** is when consumers decide not to buy products from businesses that do not act in a socially responsible way.

Consumers

Bad publicity is bad news! If a business is reported as destroying an important natural site or dumping waste in the sea, then many consumers will stop buying its products.

Pressure groups

Pressure groups are becoming increasingly powerful. They can take some very effective actions against businesses that are not socially responsible. Pressure groups such as Greenpeace and Earth First! have tried to block up businesses' waste pipes or organise **consumer boycotts.**

Pressure group activity is likely to change business actions when:
» It has popular public support and receives much media coverage
» Consumer boycotts result in much reduced sales for the business
» The group is well organised and financed. Pressure group activity is unlikely to result in a change in business actions when:

» What the firm is doing is unpopular but not illegal, such as testing drugs on animals
» The cost to the business of changing its methods is more than the possible cost of poor image and lost sales
» The business sells to other businesses rather than to consumers – public pressure will be less effective.

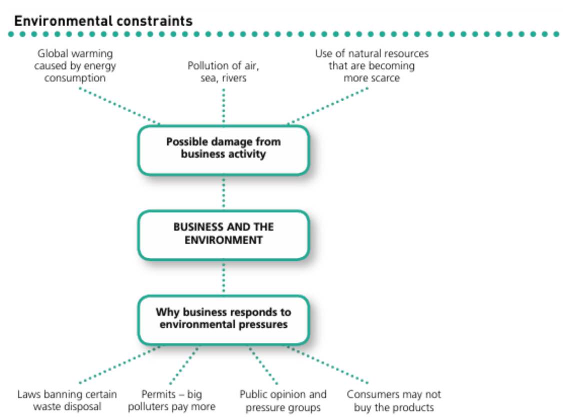
The role of legal controls over business activity affecting the environment

Governments can make business activities illegal. Manufacturers often complain that these laws make it more expensive for them to produce. This raises prices to consumers. For this reason some governments do not pass strict laws on the environment, hoping that this will encourage firms to produce in their country to create jobs.

▲ It is often difficult for governments to find out which firms are responsible for dumping chemical waste

Governments can impose financial penalties on businesses, such as pollution permits

Pollution permits are licences to pollute up to a certain level. Governments can sell a permit to a factory that produces pollution. If it produces more pollution than the permit allows, it must either buy more permits from 'clean' businesses or pay large fines. Either way, the costs of the business increase.



Should businesses always 'do the right thing'? Should businesses always take decisions that are fair and moral? Should businesses ever:

» Take or offer bribes to government officials or people working for other businesses,

» Employ child workers, even though it might not be illegal in some countries?

» Buy in supplies that have led to damage to the environment,

» Agree to 'fix high prices' with competitors?

» Pay directors large bonuses and owners of businesses large profit payouts at the same time as reducing the workforce?

These are all examples of **ethical decisions** that many businesses have to face up to very frequently.

> **Definitions to learn**
> **Ethical decisions** are based on a moral code. Sometimes referred to as 'doing the right thing'.

The two most extreme views are:

1. 'As long as a business does not deliberately break the law then any decision it makes is acceptable. Businesses want to make profits, after all.'

2. 'Even if certain activities are not illegal, it is unethical and therefore wrong to do them despite any increase in profits that might occur.

How businesses might react and respond to ethical issues

Assume a large multinational clothing business – Company X – bought clothes from a factory in a low-income country. The managers of Company X know that the factory employs child labour – it is not illegal to employ workers as young as 12 years old in the country it is based in.

Potential benefits of ethical decisions – Company Y	Potential limitations of ethical decisions – Company Y
Consumers may be against buying clothing products made by children and increase purchases from Company Y and reduce purchases from Company X	Higher costs – adult workers will be paid more than child workers and good working conditions add to business costs too
Good publicity about Company Y's ethical decisions will provide 'free promotion' – Company X may suffer from bad publicity	Company Y's prices might have to be set higher than those of Company X because of higher costs
Long-term profits of Company Y could increase	If consumers are only interested in low prices – and not how products are made – then sales of Company Y could fall
Some workers and investors may want to be linked to an 'ethical' business – Company Y may find it easier to recruit the best workers and raise capital from investors	Short-term profits of Company Y might fall
There is less risk of legal action being taken against Company Y	It could be argued that, in some countries, if children are not employed the incomes of their families will fall to very low levels

> **Definitions to learn**
> **Globalisation** is the term now widely used to describe increases in worldwide trade and movement of people and capital between countries.
> **Free trade agreements** exist when countries agree to trade imports/exports with no barriers such as tariffs and quotas.

Chapter 29
Business and the international economy

The concept of globalisation and reasons for it

There are several reasons for this increase in global trade and movement of products, people and capital (**globalisation**).

» Increasing numbers of free trade agreements and economic unions between countries have reduced protection for industries.

» Improved and cheaper travel links and communications between all parts of the world have made it easier to transport products globally.

» Many 'emerging market countries' are industrialising very rapidly. China and countries in South-east Asia used to import many of the goods they needed.

Opportunities and threats of globalisation for business

Globalisation: potential opportunities for businesses

Opportunity	Impact on businesses
Start selling exports to other countries – opening up foreign markets	This increases potential sales, perhaps in countries with fast-growing markets. Online selling allows orders for goods to be sent in from abroad
	But it can be expensive to sell abroad and will foreign consumers buy products, even if they were popular 'at home'?
Open factories/operations in other countries (become a multinational)	It could be cheaper to make some goods in other countries than 'at home'
	But will the quality be as good? Might there be an ethical issue (for example, over poor working conditions)? It is expensive and/or difficult to set up operations in other countries
Import products from other countries to sell to customers in 'home' country	With no trade restrictions it could be profitable now to import goods and services from other countries and sell them domestically
	But the products will need maintenance and, perhaps, repairs – will the parts and support be available from the producer in the foreign country?
Import materials and components from other countries – but still produce final goods in 'home' country	It could be cheaper to purchase these supplies from other countries now that there is free trade – this will help to reduce costs. These supplies could be purchased 'online'
	But will the suppliers be reliable? Will the greater distance add too much to transport costs?

Globalisation: potential threats to businesses

Threat	Impact on businesses
Increasing imports into home market from foreign competitors	If these competitors offer cheaper products (or of higher quality) sales of local business might fall
	But the increased competition could force the local businesses to become more efficient
Increasing investment from multinationals to set up operations in home country	This will create further competition – and the multinational may have economies of scale and be able to afford the best employees
	But some local firms could become suppliers to these multinationals and their sales could increase
Employees may leave businesses that cannot pay the same or more than international competitors	In some professions, employees will now have more choice about where they work and for which business – businesses will have to make efforts to keep their best employees
	But this might encourage local businesses to use a range of motivational methods to keep their workers

Why governments might introduce import tariffs and import quotas

In Chapter 27, **import tariffs** were explained as being one form of taxes that governments can use to raise revenue. There is another important reason why governments might introduce tariffs and **quotas** on imports. They are forms of **protectionism** – to protect domestic industries from competition that might otherwise close them down.

» An import tariff is a tax put on the imported goods when they arrive into the country. They usually lead to the price of the imported goods being increased, making them less competitive than locally produced goods.
» An import quota is a regulation which limits the import of a good to a certain fixed quantity. This reduces the amount of these goods that can be imported and often leads to an increase in the price of imported goods as they become less available.

Definitions to learn

An **import tariff** is a tax placed on imported goods when they arrive into the country.
An **import quota** is a restriction on the quantity of a product that can be imported.
Protectionism is when a government protects domestic businesses from foreign competition using tariffs and quotas.

Multinational businesses

It is important to remember that a **multinational business** (or multinational corporation – MNC) is not one which just sells goods in more than one country.

Multinational businesses are some of the largest organisations in the world. They include:

» Oil companies: for example, Shell, BP, Exxon Mobil

» Tobacco companies: for example, British American Tobacco, Philip Morris

» Car manufacturers: for example, Toyota, General Motors.

Definitions to learn

Multinational businesses are those with factories, production or service operations in more than one country. These are sometimes known as **transnational businesses**.

Benefits to a business of becoming a multinational and the impact on its stakeholders

Some benefits to a business from becoming a multinational are that it is able to:

» Produce goods in countries with low costs, such as low wages.
» Extract raw materials which the company may need for production or refining.
» Produce goods nearer the market to reduce transport costs.
» Avoid barriers to trade put up by countries to reduce the imports of goods.
» Increase market share and expand into different market areas to spread risks.
» Remain competitive with rival businesses which may be expanding abroad
» Gain government grants given to the business to set up operations in particular countries.

The impact on its stakeholders of a business becoming a multinational

» Shareholders are likely to receive increased dividends from higher profit.
» Employees may have increased opportunities to gain promotion as the business gets larger and has operations across many countries; opportunity to live and work abroad.
» Suppliers may have increased or decreased sales to the multinational depending on where it operates and is located.
» Government may gain higher tax revenue if profits from operations abroad are repatriated, or it may lose tax revenue if the multinational locates its head office elsewhere.

Potential benefits to a country's economy where a multinational operates

» Jobs are created, which reduces the level of unemployment.

» Increased investment – new investment in buildings and machinery increases output of goods and services in the country. New technology can benefit the country by bringing in new ideas and methods.

» Increased exports – some of the extra output may be sold abroad, which will increase the exports of the country. Also, imports may be reduced as more goods are now made in the country.

» Taxes are paid by the multinationals, which increases the funds to the government.

» Increased consumer choice – there is more product choice for consumers and more competition.

Potential drawbacks to a country's economy where a multinational operates

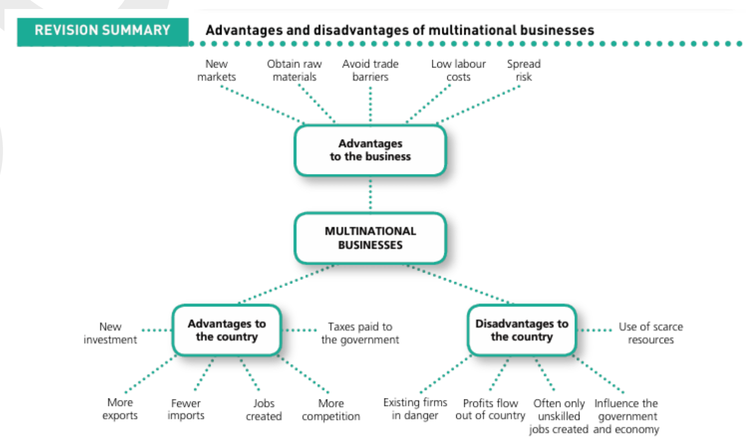
» The jobs created are often unskilled assembly-line tasks. Skilled jobs, such as those in research and design, are not usually created in the 'host' countries receiving the multinationals.

» Reduced sales for local businesses – local firms may be forced out of business. Multinationals are often more efficient and have lower costs than local businesses.

» Repatriation of profits – profits are often sent back to a multinational's 'home' country and not kept in the country where they are earned.

» Multinationals often use up scarce and non-renewable primary resources in the host country.

» As multinational businesses are very large they could have a lot of influence on both the government and the economy of the host country.



Exchange rates

The **exchange rate** between your local currency and the foreign currency you wish to buy depends on the value of your own currency in exchange for the foreign currency.

Definitions to learn

Exchange rate is the price of one currency in terms of another currency, for example £1 = $1.50.

How exchange rates are determined and depreciation and appreciation of an exchange rate

Depreciation of the exchange rate is when the exchange rate is worth less against other currencies, The effect of this is to:

» Make exports cheaper

» Imports are more expensive and do the opposite,

Appreciation of the exchange rate is when the exchange rate is worth more against other currencies,

» Raise the price of exports,

» Import prices fall and demand for them might rise.

How exchange rate changes can affect businesses as importers and exporters of products

Exporting businesses

The change in the exchange rate described in the case study on page 358 is called a $ **appreciation** because the value of the $ has increased. Exporters have a serious problem when the currency of their country appreciates as they become less competitive in foreign markets and may lose sales, revenue and/or profit.

Definitions to learn

Currency appreciation occurs when the value of a currency rises – it buys more of another currency than before.

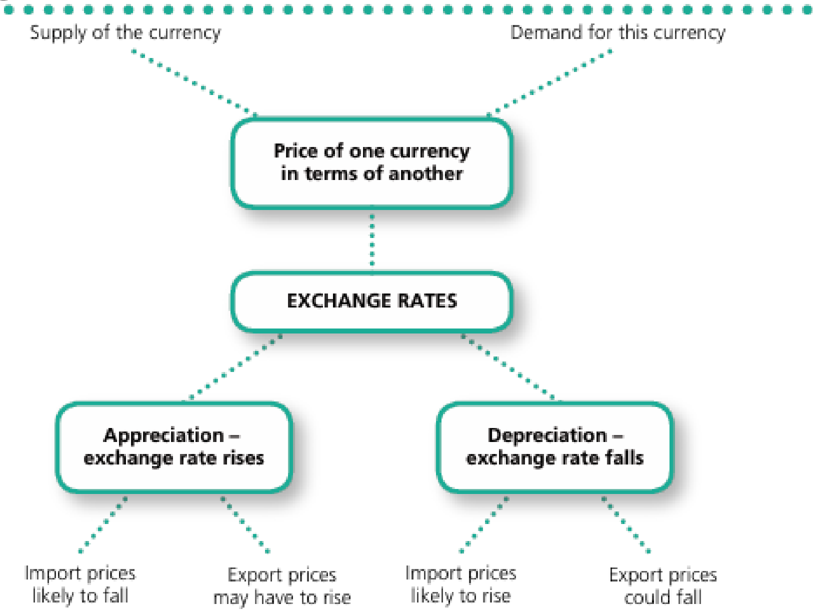
Importing businesses

Now consider how an importing business – one which buys goods and services from abroad – might be affected by changing exchange rates.

Definitions to learn

Currency depreciation occurs when the value of a currency falls – it buys less of another currency.

REVISION SUMMARY **Exchange rates**



Revision questions

1. The economy of country A is in recession. To deal with the problems caused by the recession, the Government has cut interest rates and reduced taxes. These changes have had a big impact on businesses in country A. The Government has also introduced laws to protect employees at work. Some people have suggested that the Government should give grants and subsidies to private sector businesses to help them survive.

(a) What is meant by the term 'recession'?
(b) Identify two ways in which consumers might be affected by a recession.
(c) Identify and explain two consequences of a fall in interest rates on businesses in Country A.
(d) Identify and explain three ways by which employees can be protected at work by Government laws.
(e) Do you think that Governments should give financial support to private sector businesses to survive in a recession? Justify your answer.

2. The Government of country Z has decided to invest a large amount of capital in building a new road system. Some people don't like the decision because of the social costs that it will create. However, most businesses think the decision is a good one. The business sector would also like to see the Government lower taxes on goods and remove some of the consumer protection and employment laws that it claims increase business costs.

(a) Identify two ways that employees may be protected at work by employment laws. Way 1
(b) Identify two reasons why Governments put taxes on goods.
(c) Identify and explain two reasons why many business managers think the decision to build more roads is a good one
(d) Identify and explain three social costs that the road building programme might create.
(e) The management of many businesses in the private sector think that consumer and employment legislation increase business costs. Do you think society would benefit from a reduction in such laws? Justify your answer.

3. Extracto is a multinational mining business. It has recently found mineral deposits in country X. The Managing Director hopes that the deposits found are large enough for them to make a good profit. Some pressure groups in country X think that Extracto has only considered the financial benefits of its plans and has ignored the social costs.
(a) What is meant by a 'financial benefit'?
(b) Identify two examples of social costs that extraction of minerals might create.
(c) Identify and explain two ways in which pressure groups could influence Extracto's decisions.
(d) Identify and explain three factors that Extracto should consider before deciding whether to begin mining in country X.
(e) Governments often aim to attract multinational companies into their countries. Do you think that they should do this? Justify your answer

4. Country W has a mixed economy. Herio is a government economist. He said: 'Business activity in the private sector can lead to external costs, such as pollution. It can also create external benefits. I believe that businesses that create external benefits should be encouraged and those that create external costs should be closed.' Country W has low economic growth and rising inflation.
(a) What is meant by 'the private sector'?
(b) What is meant by 'rising inflation'?
(c) Most businesses set objectives. Identify and explain two reasons why having objectives may be important for a business.
(d) Identify three external benefits and explain how business activity can create each benefit.
(e) Herio believes businesses that create external costs should be closed. Do you agree with him? Justify your answer.

5. Greenfield manufactures furniture. The company imports wood and other raw materials from several countries. Marcos is the Managing Director of Greenfield. Marcos said that his company was affected by import quotas and changes in exchange rates. He said: 'Greenfield has to buy its raw materials from other countries as there are no timber (wood) resources in our own country?'
(a) What is meant by 'import quota'?
(b) Identify two ways that Greenfield's business might harm the environment.
(c) Identify and explain two ways in which changes in exchange rates could cause problems for Greenfield.
(d) The Government in Greenfield's country is introducing consumer protection laws. Identify and explain three ways in which Greenfield's business could be affected by these new laws.
(e) Greenfield's management is thinking of expanding the business by taking over another furniture manufacturer. Do you think this is a good idea for Greenfield? Justify your answer.

6. BRZ sells outdoor clothing, such as waterproof trousers and coats, in country X. It imports most of its inventory (stock) from low wage countries. 'Globalisation has changed how we do business. It offers many opportunities but I have to consider import quotas and exchange rates' said the Operations Director. BRZ tries to act in an ethical way with all its stakeholders. The Operations Director is not sure if it is possible for BRZ to be both ethical and profitable.
(a) What is meant by an 'import quota'?
(b) What is meant by 'inventory (stock)'?
(c) Explain how a depreciation in the value of country X's currency might affect the profits of BRZ.
(d) Identify and explain two opportunities that globalisation might offer BRZ.
(e) Do you think it is possible for companies such as BRZ to be both ethical and profitable?
Justify your answer.

7. Nellis is a public limited company. It specialises in building large luxury houses. Over the past 3 years its profits have increased as the country is experiencing an economic boom. 'It's not all good news - the Government has announced plans to increase interest rates and introduce new legal controls to protect the environment' said the Managing Director. He believes these new legal controls to protect the environment will only make businesses (such as Nellis) less profitable.
(a) What is meant by an 'economic boom'?
(b) Identify two stages (other than boom) of the business cycle.
(c) Explain how a rise in interest rates might affect Nellis.
(d) Identify two stakeholder groups. Explain why each group is important to this business.
(e) The Managing Director believes that the new legal controls to protect the environment will only make business (such as Nellis) less profitable. Do you agree? Justify your answer

8. The economy of country U is in recession. The Government has cut interest rates to attract businesses to set up in country U. JWR is a large multinational energy company. JWR may decide to open a power station in country U. The Government thinks that opening a new power station will create many external benefits. Some pressure groups do not want companies like JWR operating in their country.
(a) Identify two features of a recession.
(b) Identify two effects of a cut in interest rates on businesses like JWR.
(c) Identify and explain two actions that pressure groups could use to influence JWR's decision.
(d) Identify and explain two external benefits as a result of opening a new power station in country U.
(e) Do you think that the Government of country U should try to attract multinational businesses? Justify your answer.

9. The economy of country U is enjoying an economic boom. Many new businesses are being set up in country U. There are many sources of external finance available for new businesses.
GGC is a multinational mining company. Its directors have agreed to form a joint venture with another mining company that is already based in country U. All mine workers are members of a trade union.
(a) Identify two features of an economic boom.
(b) Identify two possible advantages to mine workers of being members of a trade union.
(c) Identify and explain two possible advantages to GGC's management of its mine workers being members of a trade union.
(d) Identify and explain two sources of external finance that GGC might use when setting up a new mine.
(e) Do you think it is a good idea for GGC to form a joint venture in country U? Justify your answer.