Edexcel (B) Economics A-level

Theme 1: Markets, Consumers and Firms

1.2 Enterprise Business and the Economy

1.2.5 The wider economic environment

Notes

Implications for firms of changes in:

○ Interest rates

An increase in interest rates makes it more expensive to take out a loan and borrow money, which could result in a fall in spending and investment. It also encourages saving, since the reward for keeping money in a bank is higher. This might result in lower profits for firms if they make fewer sales.

However, if firms have a lot of financial capital, it could earn a high return. The level of investment might not fall if firms have a lot of retained profits which can be used instead of a loan.

If profits fall due to lower sales, firms might reduce the size of their workforce.

○ Exchange rates

A depreciation in the pound means that UK exports become more price competitive. Firms could then reduce the price of the good in the export market to increase sales, or they can keep the price the same to increase their profit margins.

However, if UK goods are relatively price inelastic, a depreciation in the pound will not increase sales in the export market significantly. Moreover, it depends on the rate of economic growth in the export market. The higher the level of consumer and firm confidence, and the more disposable income they have, the more likely they are to purchase UK exports.

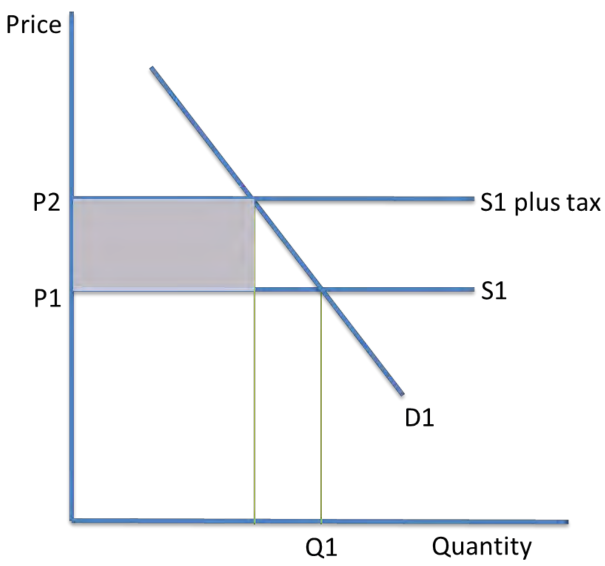
If firms are net importers of raw materials, costs of production will increase because imports are relatively more expensive when the pound is weaker. This could make the firm less internationally competitive, and it could mean they make lower profits. However, if firms have fixed contracts for how long they import materials from another country, then changes in the exchange rate will not affect quantity purchased or the price paid. This reduces uncertainty of production costs for firms.

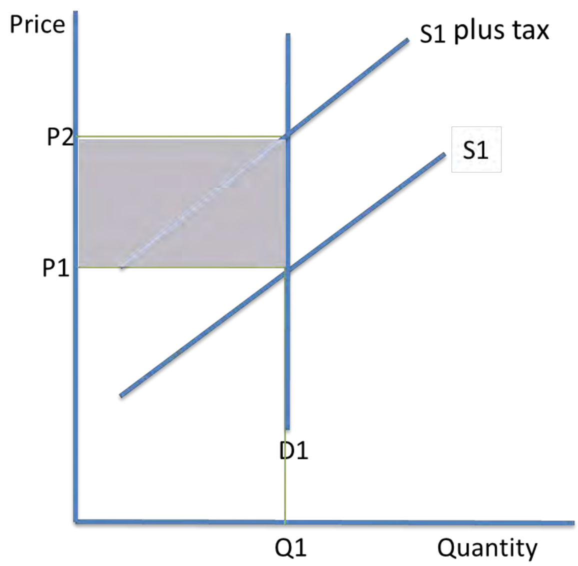
If the pound depreciates, firms might think that they can increase their profit margins by keeping the price the same, without having to increase efficiency or productivity to lower their average costs.

- **Taxation**

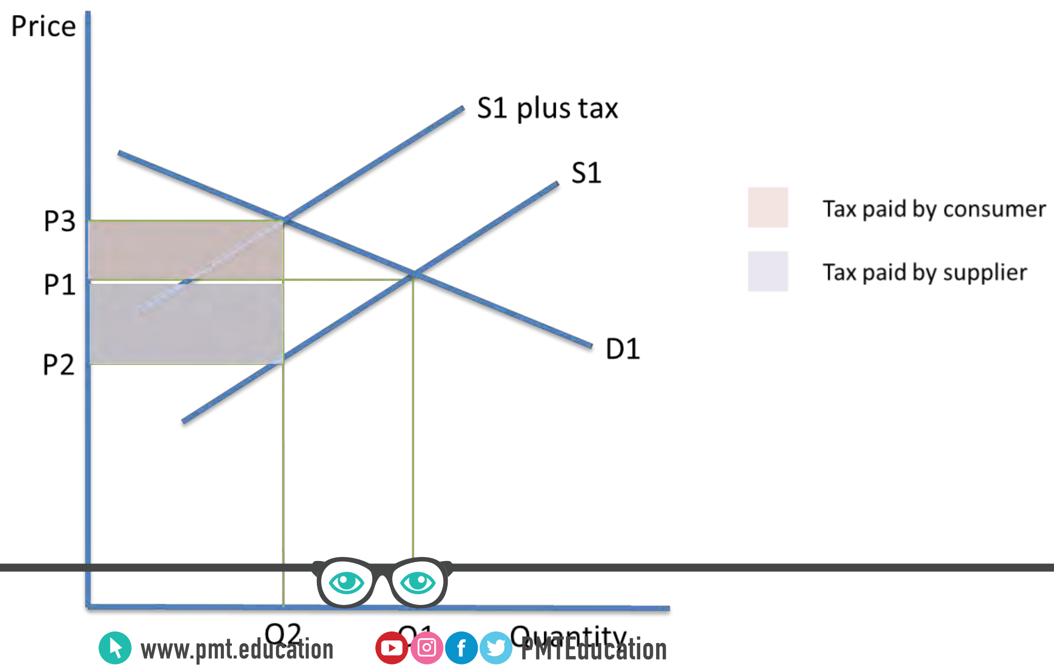
Indirect taxes are imposed by the government and they increase production costs for producers. Therefore, producers supply less. This increases market price and demand contracts.

Diagrammatically, it is shown by the vertical distance between two supply curves. When demand is perfectly inelastic, or supply is perfectly elastic, the incidence of the tax falls wholly on the consumer. The shaded area shows the size of the tax paid by the consumer.

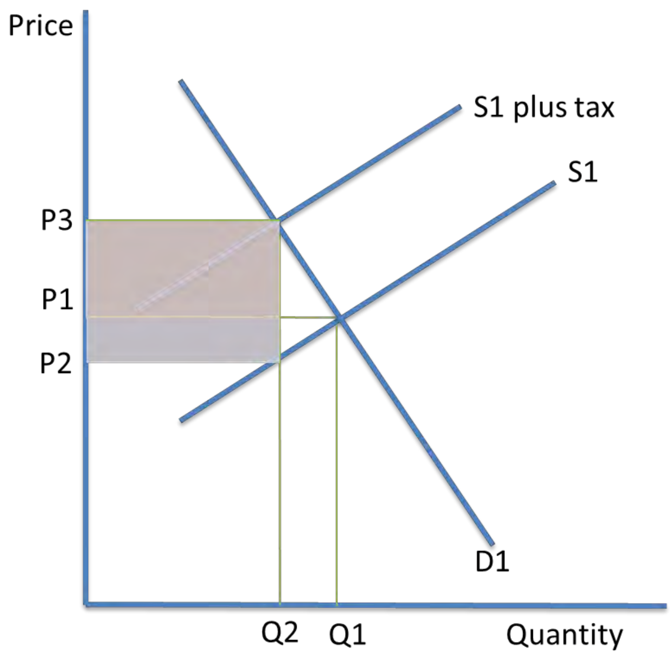




If demand is more elastic (PED>1), the incidence of the tax will fall mainly on the supplier.



If demand is more inelastic (PED<1), the incidence of the tax will fall mainly on the consumer.



- **Unemployment**

With a higher rate of unemployment, firms have a larger supply of labour to employ from. This causes wages to fall, which would help firms reduce their costs.
However, with higher rates of unemployment, since consumers have less disposable income, consumer spending falls so firms may lose profits. Producers which sell inferior goods might see a rise in sales.
It might cost firms to retrain workers, especially if they have been out of work for a long time.

- **Inflation**

Low interest rates means borrowing and investing is more attractive than saving profits. With high inflation, interest rates are likely to be higher, so the cost of investing will be higher and firms are less likely to invest.

Workers might demand higher wages, which could increase the costs of production for firms. This could cause inflation to increase further, since firms have to put up prices to make up for the higher costs of labour.

Firms may be less price competitive on a global scale if inflation is high. This depends on what happens in other countries, though.

Unpredictable inflation will reduce business confidence, since they are not aware of what their costs will be. This could mean there is less investment.