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Candidate surname <i>StemUp Model Solution</i>		Other names	
Centre Number		Candidate Number	
Pearson Edexcel Level 3 GCE			
Monday 8 June 2020			
Morning (Time: 2 hours)		Paper Reference 9EB0/03	
Economics B Advanced Paper 3: The economic environment and business			
You must have: Insert (enclosed)			Total Marks

Instructions

- Use **black** ink or ball-point pen.
- **Fill in the boxes** at the top of this page with your name, centre number and candidate number.
- Answer **all** questions.
- Answer the questions in the spaces provided
– *there may be more space than you need.*

Information

- The total mark for this paper is 100.
- The marks for **each** question are shown in brackets
– *use this as a guide as to how much time to spend on each question.*
- Calculators may be used.

Advice

- Read each question carefully before you start to answer it.
- Try to answer every question.
- Check your answers if you have time at the end.

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Answer ALL questions.

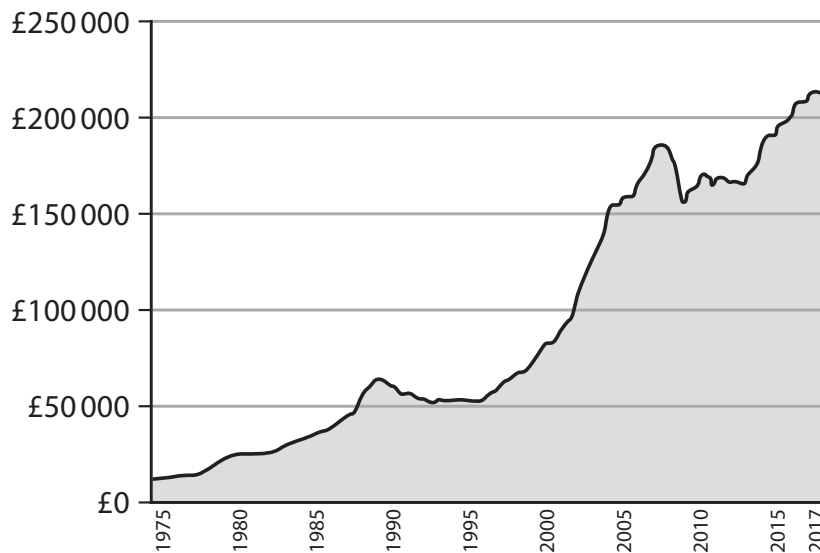
SECTION A

Read the following extracts (A to E) before answering Question 1.

Write your answers in the spaces provided.

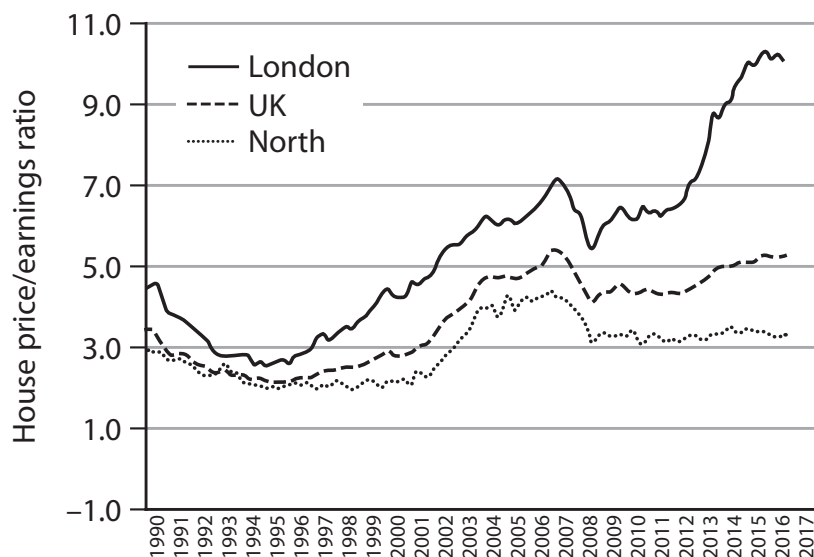
Extract A

UK average house prices



(Source: <https://www.economicshelp.org/blog/2197/housing/rising-house-prices/>)

UK house price to earnings ratio



(Source: adapted from <https://www.economicshelp.org/blog/2197/housing/rising-house-prices/>)

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Extract B**Skills shortages harming UK business, employers warn in 2018**

Britain's employers have warned that severe skills shortages are holding back the economy. The latest official figures showed the biggest fall in the number of workers from Eastern Europe since modern records began.

The British Chambers of Commerce (BCC) and the Federation of Small Businesses (FSB) urged the government to deliver a post-Brexit migration system to meet their needs amid signs that the fall in unemployment in recent years was putting upward pressure on wages.

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Suren Thiru, head of economics at the BCC said: "There is clear evidence of a deep-rooted skills gap across the UK which is harming business growth."

In its latest update on the state of the labour market, the Office for National Statistics revealed that during 2018, the number of workers in the UK from former Soviet bloc countries had fallen by 154,000 to 881,000.

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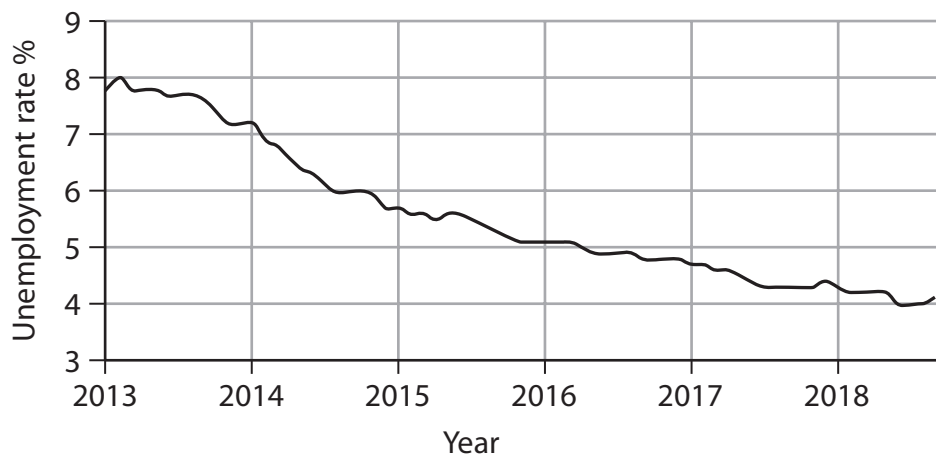
The additional 132,000 fall in the number of workers from the EU as a whole was also unprecedented. Employment from the rest of the world grew by 34,000.

(Source: adapted from <https://www.theguardian.com/business/2018/nov/13/workers-eastern-europe-uk-eu-employment-pay-growth>)



Extract C

UK unemployment rate 2013–2018



(Source: tradingeconomics.com
Office For National Statistics)

UK inflation rate 2013–2018



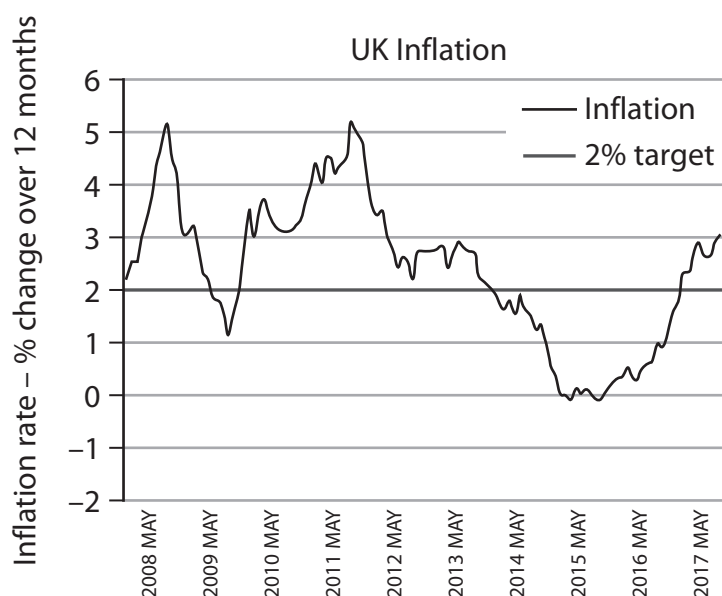
(Source: tradingeconomics.com
Office For National Statistics)

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Extract D

(Source: www.economicshelp.org
Office For National Statistics – D7G7 – 17 October 2017)

Extract E**Bank of England raises alarm over surge in high-risk lending**

The Bank of England has issued a stark warning over the rapid growth in high-risk lending to indebted companies around the world. It draws parallels with the US sub-prime mortgage market that triggered the 2008 financial crisis. The US market for such loans has more than doubled since 2010 to surpass \$1tn (£763bn). Though far from the scale of the US market, the total of high-risk loans to UK companies reached a record £38bn in 2017, while a further £30bn has been issued so far this year.

5

The rapid growth in high-risk lending comes as investors search for higher returns as a result of rock-bottom interest rates and billions of pounds of quantitative easing from central banks, used to stimulate their economies during the great recession that followed the 2008 financial crisis.

10

The Bank's financial policy committee (FPC) noted that lending standards were falling and that it would more closely monitor the risks to Britain.

Philip Hammond hands Bank of England new powers

The Bank of England will be allowed to provide more than £500bn in lending to the economy without seeking the Treasury's permission, in a move that reinforces the strength of the UK financial system.

15

Philip Hammond, the chancellor, said the changes would help to improve the resilience of the central bank. It would also help with its "ability to meet its monetary and financial policy objectives in the future", he said.

The move also gives the Bank of England greater autonomy in lowering interest rates to zero and providing more money to commercial banks during times of need, without requiring Treasury permission.

20

(Source: adapted from <https://www.theguardian.com/business/2018/oct/17/bank-of-england-high-risk-lending-leveraged-loans>
and <https://www.theguardian.com/business/2018/jun/21/philip-hammond-hands-bank-of-england-new-powers>)



- 1 (a) Discuss the extent to which the UK housing market can be described as a market bubble.

(8)

A market bubble occurs when rising demand drives prices far beyond the level that the underlying fundamentals, such as incomes and costs, would normally justify. Speculation is all one way: buyers expect prices to keep rising, so they buy to make a capital gain, and emotion and peer pressure overcome rational analysis. As more buyers join in, prices are forced higher and higher in an upward cycle until confidence breaks and prices suddenly collapse, as with the dot.com bubble and the bitcoin bubble.

Extract A suggests that the UK housing market shows signs of a bubble. Average house prices rose from about £12,000 in 1975 to over £210,000 in 2017, and they roughly quadrupled between 1987 and 2015. The steepest rise, from about £55,000 in 1996 to about £185,000 in 2007, was followed by a sharp drop to about £157,000 by 2009, which looks like a bubble bursting. In London the house price to earnings ratio has risen from about 2.5 in the mid 1990s to over 10 in 2016, so prices have clearly moved away from what earnings can support, which is a classic sign of a bubble. However, the 2007 to 2009 fall may have been caused by the financial crisis and the collapse in mortgage lending rather than a speculative bubble bursting, and prices recovered quickly to new highs. Unlike shares or bitcoin, the demand for housing is mainly a genuine need for shelter, not speculation. Steeply rising prices may simply reflect supply lagging behind demand, as housebuilding has not kept up with population growth, so high prices could be sustained rather than collapse. Furthermore, the ratio for the UK as a whole is only about 5.2 and for the North about 3.3, little higher than in 2007, so the evidence outside London is much less conclusive. Overall, the UK housing market as a whole is better described as a market with a persistent shortage of supply, but the London market does show strong signs of a bubble, so the extent depends on the region considered.



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- (b) Assess the effectiveness of supply-side policies to ease skills shortages in the labour market.

(10)

A skills shortage occurs when employers cannot find enough workers with the particular skills and qualities they need in the available labour force. Supply-side policies are government policies designed to increase the productive capacity of the economy, for example by improving the skills and quality of the labour force, shifting LRAS to the right.

Extract B shows that the BCC warns of a deep-rooted skills gap that is harming business growth. Firms that cannot recruit skilled staff have to pay higher wages to attract them, which raises costs and reduces profitability. In some cases skilled labour is simply unobtainable, so a firm cannot increase output even when demand is rising, which constrains economic growth.

Government training schemes and apprenticeship schemes can re-equip unemployed workers with the skills employers need. Although unemployment is low at about 4% (Extract C), this still means there is some spare capacity in the labour market, but these workers lack the skills demanded. Training them raises their productivity and occupational mobility, increasing the supply of skilled labour and easing upward pressure on wages. In the longer term, schools, colleges and universities can introduce more vocational and practical courses to provide the workforce of the future, and subsidies for firms that train staff would encourage on the job training.

However, these policies require both time and investment to implement. A training course or apprenticeship can take one to three years, and education reform takes even longer to affect the workforce, while British employers are facing the problem now and do not have time to wait. There is also an opportunity cost to the government budget, and there is no guarantee that the skills taught will match those employers need.

Geographical immobility is a further limiting factor, as trained workers may not be able



to move to where the jobs are because of high housing costs, as Extract A shows in London.

Moreover, the current problem is largely a fall in the total supply of labour rather than only a lack of skills. In 2018 the number of workers from former Soviet bloc countries fell by 154,000 and the number from the EU fell by a further 132,000, which was only partly offset by 34,000 more workers from the rest of the world. Traditional supply-side policies cannot replace these workers quickly.

In conclusion, supply-side policies such as training and apprenticeships are effective in easing skills shortages in the long run, but they are of limited effect in the short run unless they are combined with an addition to the total supply of labour, such as a migration system that meets employers' needs, as the BCC and FSB are urging.



- (c) Using Extract C, assess the extent of the trade-off between unemployment and inflation.

(12)

A trade-off is when an increase in one variable leads to a decrease in another connected variable. The Phillips curve suggests a trade-off between unemployment and inflation: as unemployment falls, inflationary pressures build up, and when inflation is reduced, unemployment rises.

The reasoning is that when there are fewer unemployed workers, firms must compete for labour, so wage rates tend to rise. Extract B confirms that the fall in unemployment has been putting upward pressure on wages. Higher wages increase firms' costs, leading to cost-push inflation. Also, when more people are employed, incomes and consumption rise, so AD increases, and if AS does not keep pace, demand-pull inflation occurs. In the opposite direction, to counter inflation the government or central bank may use contractionary fiscal or monetary policy, such as higher interest rates. This reduces AD, so less output is needed and unemployment rises.

Extract C shows that UK unemployment fell steadily from about 8% in 2013 to just 4% in 2018, its lowest level in over 40 years. If the trade-off held, inflation should have been rising over the same period. However, this was not the case at first: inflation fell from about 3% in 2013 to around 0% in 2015, at the same time as unemployment fell from about 7% to 5.5%. This suggests there was no trade-off between 2013 and 2015.

From 2015 onwards inflation did increase, reaching a high of about 3% at the end of 2017, while unemployment continued to fall to around 4.3%. This could indicate that the trade-off only appears once unemployment falls below a certain level, as spare capacity in the labour market is used up and the economy approaches full employment, so wage pressures become significant.

However, other factors may explain the pattern better. The fall in inflation to 2015 was



largely caused by the collapse in oil and commodity prices, and the rise from 2016 was fuelled by rising input costs following the depreciation of sterling after the Brexit referendum, which made imports more expensive. These are supply-side and external causes that have nothing to do with unemployment. Also, wage growth stayed weak after 2008 because of flexible labour markets, zero-hours contracts and low productivity, so low unemployment did not create the expected wage inflation. Expectations of inflation have also been anchored by the Bank of England's 2% target. The data covers only five years, so it is too short to establish a reliable relationship.

In conclusion, Extract C provides only weak evidence of a trade-off. There was no trade-off from 2013 to 2015, and the link after 2015 may reflect rising input costs rather than falling unemployment, so the trade-off appears weak or non-existent unless unemployment falls to very low levels.



(d) Evaluate the role of the central bank in reducing economic risk and uncertainty.

(20)

A central bank is the bank responsible for a country's monetary policy and for the stability of its financial system. The Bank of England became independent in 1997 so that it could make decisions without political interference. It has several key roles in maintaining economic stability: it determines monetary policy, provides banking and financial services to the government, acts as banker to the banking system (lender of last resort) and regulates the banking system. Central banks also communicate with each other and with the IMF to keep the global economy as stable as possible.

Firstly, the Bank reduces uncertainty by controlling inflation. The Monetary Policy Committee (MPC) meets regularly to set the base rate in order to meet the government's inflation target of 2% CPI, with a deviation of 1% either side permitted.

If inflation goes outside this range the Governor must write a letter to the Chancellor explaining why. The base rate influences other interest rates in the economy, which affect borrowing, saving, consumption and investment, and therefore the level of AD.

Stable, low inflation means firms can plan ahead with confidence, so they are more willing to invest, and consumers can predict their real incomes. Because the Bank is independent, its target is credible, which anchors inflation expectations and reduces the risk of a wage-price spiral. Since 1997 inflation has not been a major problem compared with the 1970s and 1980s.

Secondly, the Bank can use quantitative easing (QE). This involves the Bank buying government bonds and other assets with newly created money. This increases liquidity, so banks have more money to lend to businesses and households at low interest rates, which stimulates AD and economic growth. Extract E notes that QE and rock-bottom interest rates were used to stimulate the economy during the great recession after the 2008 financial crisis, which prevented a deeper recession and deflation, reducing the risk



of mass unemployment.

Thirdly, the Bank regulates the financial system through the Financial Policy Committee (FPC), which identifies and monitors risks such as excessive lending. Extract E shows the FPC warning about the rapid growth in high-risk loans to indebted companies, which reached a record £38bn in 2017 in the UK, with a further £30bn issued in 2018. By issuing such warnings and conducting stress tests on banks, the Bank can require banks to hold more capital so that they can absorb losses. In addition, Extract E shows that the Bank has been given new powers to provide more than £500bn of lending to the economy without seeking Treasury permission, and greater autonomy to lower interest rates to zero. As lender of last resort, this means it can act quickly to provide emergency funding to the financial system if another shock like the 2008 crisis occurs, which prevents bank runs and reinforces confidence.

However, the Bank's success should not be exaggerated. Although inflation has not been a serious problem, it has not been smoothly controlled either: Extract D shows peaks of over 5% in 2008 and 2011, well above the 3% upper limit, and deflation in 2015.

These were mainly caused by external cost shocks such as oil prices and the depreciation of sterling, which interest rates cannot control without causing a recession, so monetary policy is a blunt instrument. There are also time lags of up to two years before interest rate changes take full effect.

Moreover, QE has its critics, who worry that it creates too much liquidity in the economy, inflates asset prices such as houses and shares, and widens inequality. Extract E notes that the increase in high-risk lending is partly caused by QE and rock-bottom interest rates, as investors search for higher returns. This means the Bank's own policies may be creating new risks, with Extract E drawing parallels with the US sub-prime mortgage market that triggered the 2008 crisis. With interest rates already close to zero, the Bank also has little room to cut rates in a future recession.



In addition, although the FPC is monitoring high-risk lending and noted that lending standards are falling, it cannot stop or control it, especially as much of this lending is global and comes from outside the regulated banking sector. Although the Bank conducts stress tests and has increased powers, it is not certain that the economy would cope with another global financial crisis, and much risk comes from external events, such as Brexit or a global slowdown, which a central bank cannot prevent.

In conclusion, the central bank plays a vital role in reducing economic risk and uncertainty, particularly through credible inflation targeting and its role as lender of last resort, and its new powers make the UK financial system more resilient. However, its effectiveness depends on the type of shock: it works well against demand-side shocks but is limited against supply-side shocks and global risks, and some of its tools, such as QE, may create new risks in the long run. Nevertheless, the Bank does have considerable influence over economic stability and does much to reduce risk and uncertainty, so its role is significant, though not sufficient on its own.

(Total for Question 1 = 50 marks)

TOTAL FOR SECTION A = 50 MARKS



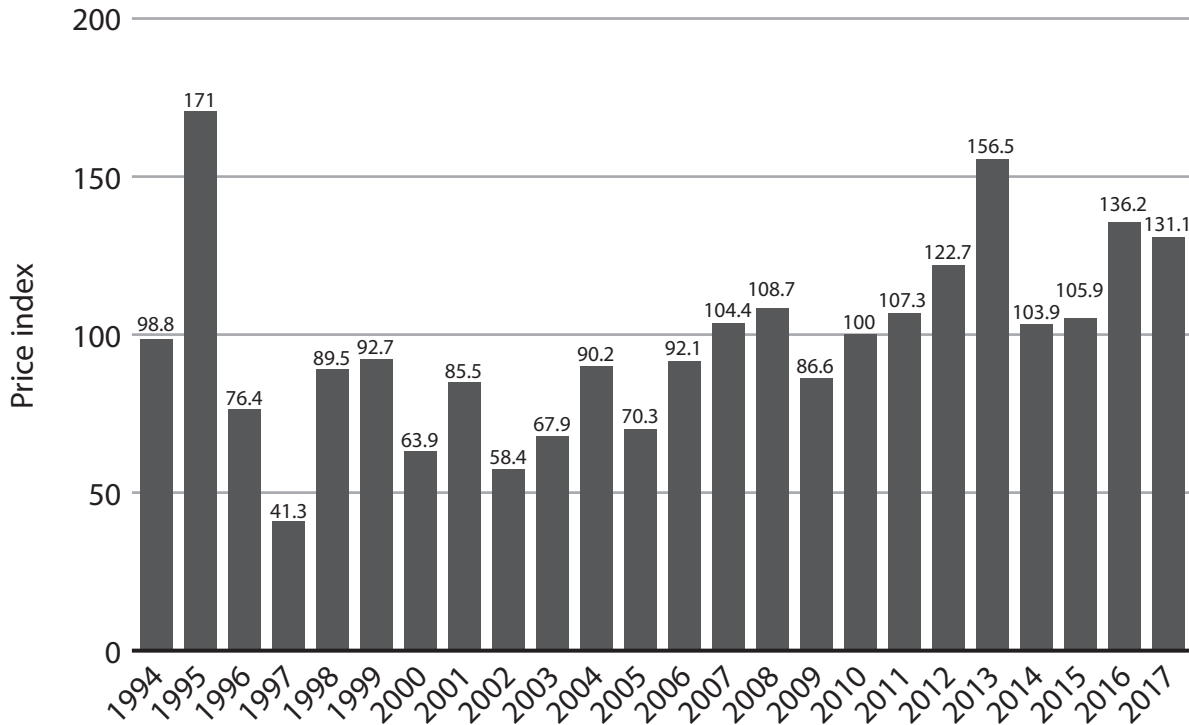
SECTION B

Read the following extracts (F to J) before answering Question 2.

Write your answers in the spaces provided.

Extract F

Average output price of potatoes in the United Kingdom (UK)



This statistic shows the average annual output price of potatoes in the United Kingdom from 1994 to 2017 in an index format (2010 = 100 index points).

(Source: adapted from <https://www.statista.com/statistics/314505/potatoes-price-index-of-in-the-united-kingdom-uk/>)

Extract G

Inside Walkers – the biggest crisp factory in the world

Walkers, a subsidiary of *Pepsico*, is the most popular crisp manufacturer in the United Kingdom. It makes different varieties of potato and maize-based snacks, selling about 60 million bags every week. *Walkers* produces over 120 different products with new products being developed regularly, such as the six new flavours launched in 2018 to celebrate its 70th anniversary.

5

The firm has six manufacturing sites around the UK, employing 4,000 people. The biggest plant is in Leicester, where 1,100 people work in two enormous factories and a huge, fully-automated warehouse where enough crisps are stored to sustain a small country.

(Source: adapted from <https://www.potatopro.com/news/2017/inside-walkers-biggest-crisp-factory-world>)



Extract H**Excerpt from the Agricultural Price Index (API) – September 2018**

Item	Yearly change from September 2017	Monthly change from August 2018
Crop products	+ 19%	+ 7.1%
Cereals	+ 24%	+ 4.5%
Potatoes	+ 36%	– 8.6%
Fresh fruit	+ 24%	+ 46%
Fresh vegetables	+ 26%	+ 5.2%
Forage plants	+ 19%	+ 1.8%
Animals and animal products	+ 0.6%	+ 0.3%

The Agricultural Price Index (API) is an index of the price of agricultural outputs and inputs for the UK used to show change over time.

(Source: adapted from https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/757515/api-statsnotice-20nov18.pdf)

Extract I**Competitiveness of food and drink manufacturers hindered by rising costs**

The Food and Drink Federation (FDF) recently published a survey, which reveals that more than three quarters of manufacturers expect input prices to continue to rise throughout 2018. Increased ingredient costs and exchange rate volatility remain a concern for food and drink businesses over 2018.

More than half of those polled had cited increased ingredient costs, increased packaging costs and increased energy costs as having the biggest impact on their businesses.

5

Despite this, respondents felt general business confidence had remained static during the first half of 2018. Looking to the second half of the year, many companies said they were still hoping to invest, with investment in new machinery and product launches.

(Source: adapted from <https://www.newfoodmagazine.com/news/72673/competitiveness-of-food-and-drink-manufacturers-hindered-by-rising-costs-says-fdf-survey/>)



Extract J**Currency risk**

Prior to the Brexit referendum in 2016, sterling was trading at €1.30. In the first half of 2018, the average rate has been about £1 to €1.12, close to post-2008 crisis lows.

Weak sterling is a major concern for Irish companies exporting their goods and services to the UK, including Northern Ireland. The total value of Irish goods destined for the UK in 2017 was €14bn (or 11.5% of total exports). The UK remains Ireland's single largest trading partner for the agrifood sector, which exported €5.2bn worth of goods to Britain last year. That leaves the sector highly exposed to currency risk. 5

Sterling's depreciation has devastated the Irish mushroom industry, forcing many producers out of business. The casualties include *McDonald Mushrooms* in Tipperary, which reportedly lost an average of €11 000 a week from adverse currency movements. 10

In contrast, Irish importers have been enjoying a "Brexit boom" – evidenced in the construction and automotive industries – as spending on "bargain" imports from Britain has soared since 2017.

In response to sterling's weakness, Irish producer *Codd Mushrooms Ltd* plans to expand operations into the UK to take advantage of lower production costs. Similarly, *Kepak Group*, one of Ireland's largest meat processors, has acquired four production sites in Britain. These operational moves offset sterling costs and revenues thus mitigating currency exposure. 15

(Source: adapted from <https://www.irishtimes.com/business/work/hedging-your-bets-how-smes-can-manage-currency-risk-1.3635929>)



2 Walkers buys 350,000 tons of potatoes each year.

(a) Discuss the benefits to Walkers of using forward markets to buy potatoes.

(8)

A forward market is a market in which a buyer agrees to purchase a commodity at a fixed price now, for delivery at a set date in the future. This is particularly useful in commodity markets such as potatoes, where prices vary constantly over time because supply depends on weather and harvests. Extract F shows the potato price index swinging from 171 in 1995 to just 41.3 in 1997, and from 156.5 in 2013 to 103.9 in 2014.

Walkers buys 350,000 tons of potatoes each year, so potatoes are one of its largest costs. By buying forward, Walkers knows in advance exactly what its expenditure and costs will be, which makes budgeting, cash-flow forecasting and pricing much easier. It can set the price of its crisps and plan production with confidence.

Most importantly, Walkers is protected if there is a sudden rise in the price of potatoes, as it will still pay the agreed forward price. For example, the potato price index increased by 36% in the year up to September 2018 (Extract H). By buying forward, Walkers could have avoided this rise, protecting its profit margins without having to raise prices or shrink packs, which could lose customers to rival brands.

However, if the price of potatoes goes down, Walkers still has to pay the higher, previously agreed price, so it misses out on savings that competitors buying at the spot price could enjoy, as when prices fell by about a third in 2014. There is also a charge for using forward markets, which adds to costs. On balance, since Walkers sells about 60 million bags a week, the certainty and protection from price rises are likely to outweigh these costs, so forward buying is a sensible way to manage risk.



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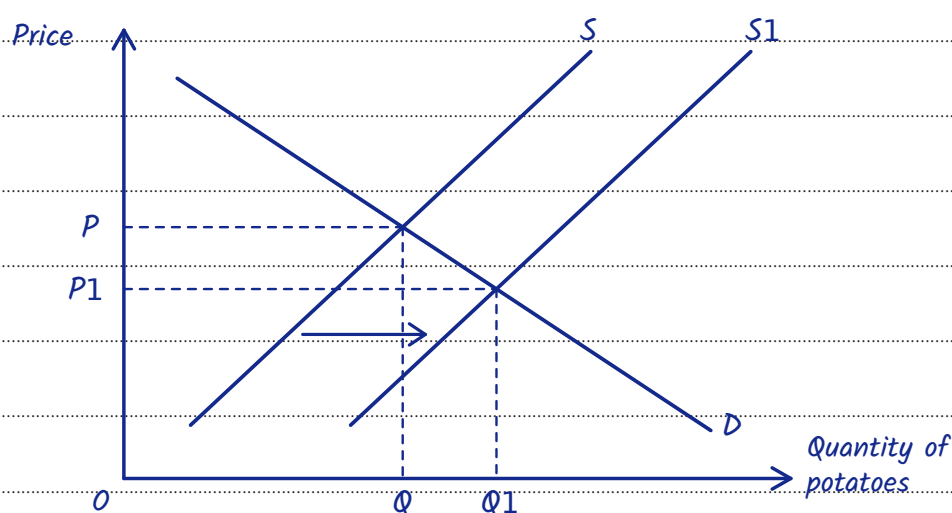
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In 2017 the potato price index rose by 36%.

- (b) Using an appropriate diagram, assess the possible impact of this on the potato market in 2018.

(10)

A 36% rise in the potato price index signals to farmers that potatoes have become much more profitable to grow than other crops such as cereals.



As shown in my diagram, in 2018 more farmers are likely to switch land into potato production, increasing the supply of potatoes. This shifts the industry supply curve to the right from S to $S1$. At the original price P there is now excess supply, so the price falls, and the equilibrium price decreases from P to $P1$ while the quantity traded increases from Q to $Q1$. This is the price mechanism working as a signalling and incentive device, and if demand for potatoes is price inelastic, the fall in price will be large relative to the rise in quantity. Extract F suggests this pattern happens in practice: after the index peaked at 156.5 in 2013, it fell to 103.9 in 2014, and the high of 171 in 1995 was followed by 76.4 in 1996.

However, the extent to which this happens depends on several factors. Not all farmers can grow potatoes, as they require a certain soil type and climate, so the supply response may be limited. Farmers may also be reluctant to invest in specialist planting and harvesting machinery given the volatile nature of potato prices shown in Extract F. Supply is also price inelastic in the short run because of the time lag between planting



and harvesting, and the 2018 crop may already have been planted before the price rise was known, so the main effect may not be felt until 2019.

If farmers do switch land into potatoes, the supply of other crops such as cereals may fall, and the following year higher cereal prices may result, which shows the risk of a cobweb pattern of price swings between crops.

Furthermore, the increase in potato prices may have been caused by supply factors such as poor weather and a bad harvest, rather than an increase in demand. In that case, the supply of potatoes is likely to return to previous levels in the following season with normal weather, without more land being planted, and the price would fall back anyway.

Also, large buyers such as Walkers may have bought forward, so the price rise may not affect them immediately.

Overall, the most likely impact in 2018 is a rise in supply and a fall in potato prices, but the size of the fall depends on how quickly farmers can respond and on the weather, which remains the dominant influence on the potato market.



(c) Assess the extent to which rising input costs are a problem for food and drink firms.

(12)

Input costs are the costs involved in producing a good or service, including raw materials such as ingredients, labour, energy, packaging and overheads. Extract I shows that more than three quarters of food and drink manufacturers expect input prices to continue rising throughout 2018, and more than half cite increased ingredient, packaging and energy costs as having the biggest impact on their businesses. Extract H shows that potato prices rose by 36%, cereals by 24% and fresh fruit and vegetables by 24% and 26% over the year to September 2018.

Rising input costs increase the average cost of each unit produced. If the selling price stays the same, profit margins are squeezed or may disappear and turn into a loss. For a crisp maker like Walkers, which buys 350,000 tons of potatoes a year, a 36% rise in potato prices would add significantly to costs. Lower profits mean less retained profit for investment, so competitiveness suffers. If firms cannot increase prices, or only to a limited extent, they may experience financial difficulties and ultimately cease trading, especially small firms with low margins.

Firms could pass the higher costs on to consumers by raising prices, but whether this is possible depends on the PED for the particular foodstuff and whether competitors do the same. Branded products such as Walkers crisps may have relatively inelastic demand due to brand loyalty, so revenue could be protected, but for products with many substitutes, such as supermarket own brands competing with branded goods, demand is price elastic and sales would fall sharply.

However, if all food and drink manufacturers are facing similar cost increases, they will all have to raise prices, so no single firm loses competitiveness relative to its domestic rivals. Firms can also respond in other ways. They may find cheaper ingredients or suppliers, although quality may suffer, which may be crucial for some types of food and



drink. They could develop more energy efficient means of production, though this takes time and requires considerable investment. Many manufacturers have reduced the size of the product while maintaining the price, so called shrinkflation. Extract 1 shows that many firms still plan to invest in new machinery and launch new products, and Walkers, for example, is developing six new flavours to increase sales. Business confidence also remained static, suggesting firms are coping.

The extent of the problem also depends on how long the rise lasts. Agricultural prices are volatile, so a 36% rise in one year may be reversed by a good harvest, and firms can use forward contracts to delay the impact. If real wages increase, consumers can afford higher prices, so increased prices may not be a problem.

In conclusion, rising input costs are a significant problem for food and drink firms in the short run, particularly for small firms selling products with elastic demand. However, for large firms with strong brands, inelastic demand and the ability to innovate, the problem is manageable, so the extent depends on the firm's market power and on how long the cost increases last.



(d) Evaluate the implications of exchange rate volatility for firms.

(20)

An exchange rate is the price of one currency in terms of another. When international trade takes place, currencies need to be exchanged. Exchange rate volatility means the exchange rate fluctuates frequently and unpredictably, so the prices of traded goods and services cannot always be predicted accurately. Extract J shows that sterling fell from €1.30 before the 2016 Brexit referendum to an average of about €1.12 in the first half of 2018, a depreciation of about 14%.

A relatively strong or appreciating currency, such as the euro against the pound, means that firms that export find their products more expensive in foreign markets than competitors' products, and so see lower sales and revenue. Irish firms export €14bn of goods to the UK, 11.5% of total exports, and the agrifood sector exported €5.2bn, so they are highly exposed to currency risk. A mushroom priced in euros costs UK buyers about 16% more in pounds than before the referendum, so UK supermarkets switch to cheaper suppliers. McDonald Mushrooms in Tipperary reportedly lost an average of €11,000 a week from adverse currency movements, and sterling's depreciation has forced many Irish mushroom producers out of business.

By contrast, importers with a strong currency have to give up fewer euros to buy the same amount of goods. They can then lower the price of goods and maintain profit margins, or maintain price levels and enjoy greater profitability. Extract J shows that Irish importers have enjoyed a Brexit boom, as spending on bargain imports from Britain has soared in construction and automotive industries. However, if imports are cheaper because of a strong currency, domestic firms may face increased competition and lose sales.

A relatively weak or depreciating currency, such as the pound against the euro, means that UK firms that export find their products more price competitive and may see



increased sales. UK importers, however, have to give up more pounds to buy the same amount of goods. They can increase prices to maintain profit margins but may lose sales, or maintain prices and face reduced profitability. UK firms also face rising costs for commodities such as oil, which is priced in dollars, and food and drink manufacturers report increased energy and ingredient costs, which Extract 1 links to exchange rate volatility. This can lead to cost-push inflation, which creates further uncertainty for firms. Consumers may experience falling real incomes, as in the UK real wages have lagged behind inflation, reducing demand for firms' products.

Volatility itself is a problem even if the average rate does not change. Uncertainty makes it hard for firms to set prices, forecast revenue and costs, and plan investment, so firms may delay investment decisions, which reduces their long-run competitiveness. Firms may need to pay for hedging, such as forward exchange contracts, which adds to costs.

However, the extent to which firms are affected depends on the PED of their products. If demand is price inelastic, exporters can keep sales even when their prices rise, so consumers in the UK may continue to buy BMW cars and Samsung televisions despite higher prices. This, though, may mean less disposable income is available for spending on UK produced goods. Firms selling highly price-sensitive products, such as mushrooms, are hit much harder.

Firms can also take action to reduce their exposure. Codd Mushrooms Ltd plans to expand operations into the UK to take advantage of lower production costs, and the Kepak Group has acquired four production sites in Britain. These operational moves offset sterling costs against sterling revenues, mitigating currency exposure. Large multinationals can do this more easily than small firms, which may lack the resources to relocate or hedge, so small firms are most at risk.

Much of the impact also depends on the size of the exchange rate movements and how



long they last before moving back. A short-term fluctuation may be absorbed through hedging or profit margins, but the fall in sterling has persisted since 2016, close to post-2008 crisis lows, which explains why it has forced firms out of business. Firms that both import inputs and export output may find that the effects partly cancel out. In conclusion, exchange rate volatility has significant implications for firms: it creates winners, such as Irish importers, and losers, such as Irish mushroom exporters, and the uncertainty it causes discourages investment. The overall impact depends on the direction, size and duration of the movement, the PED of the products and how far firms can hedge or relocate production. Small, specialised exporters to a single market are the most vulnerable, while large firms that match costs and revenues in the same currency can largely protect themselves.

(Total for Question 2 = 50 marks)

TOTAL FOR SECTION B = 50 MARKS
TOTAL FOR PAPER = 100 MARKS



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