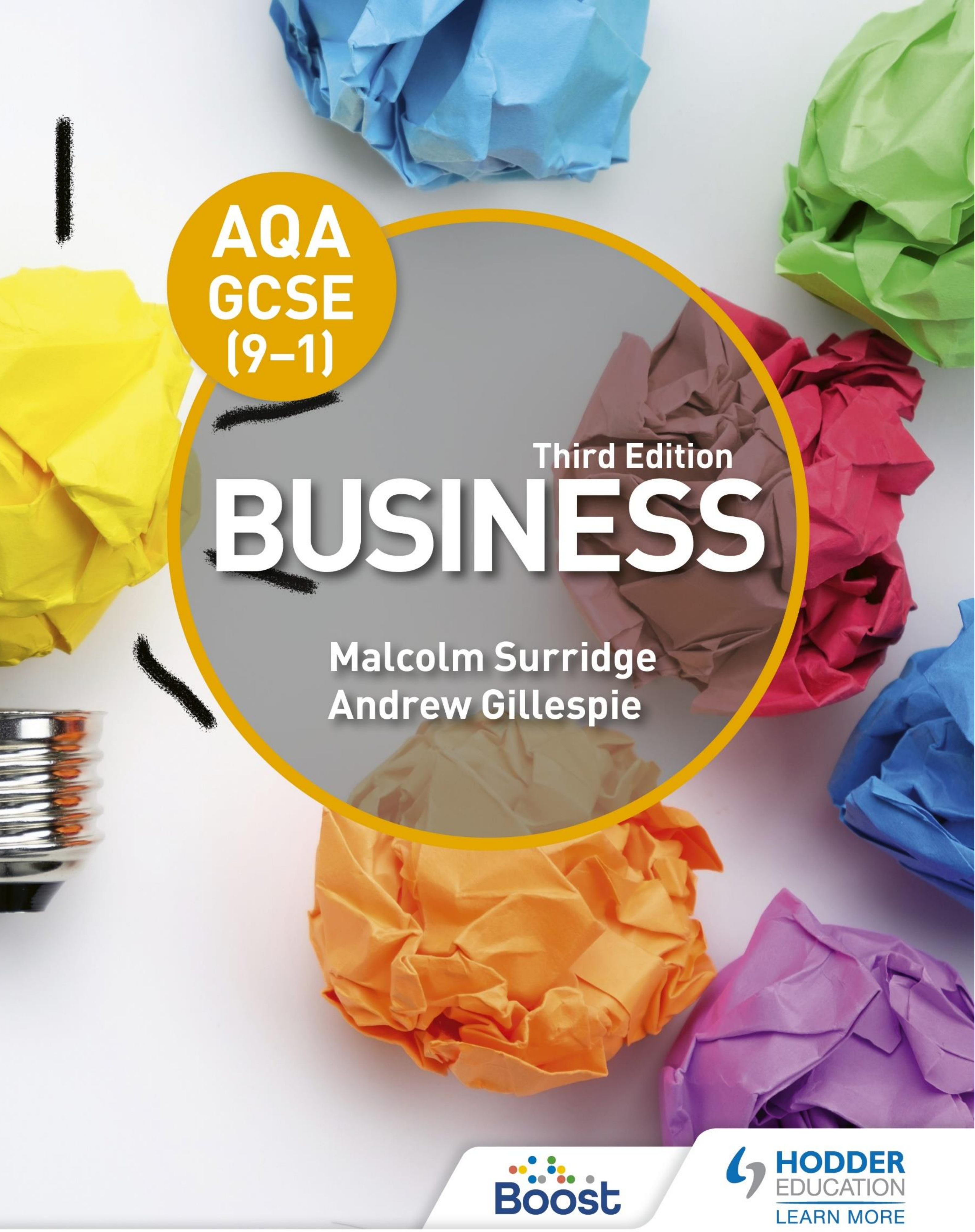

AQA GCSE (9–1)

Third Edition

BUSINESS

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Topic 2.3

The economic climate of business

The economic climate can change relatively quickly from one which provides a good trading environment for businesses to one in which trading is difficult. The economic climate for businesses is a significant external influence on a wide range of decisions taken by managers.

By the end of this topic, you should know:

- what is meant by the economic climate
- how changes in the rate of interest might affect businesses and spending by consumers
- the impact on businesses of changes in the level of employment
- how consumers' incomes and levels of spending can change.

What is the economic climate?

Before describing the economic climate, it is important to understand what is meant by **'the economy'**. The UK and other economies are made up of millions of **consumers** and many thousands of businesses, as well as the national and local governments. All these people and organisations take decisions on what to buy, sell, produce, import from overseas, where to work and many other matters. All together the actions and decisions taken by these individuals and organisations decide what is to be produced, bought and sold. This is 'the economy'.

The **economic climate** is a term that refers to the state of an economy. This term considers whether an economy is:

- producing a greater or a smaller quantity of goods and services
- providing consumers with falling or rising incomes

Key terms

The economy is made up of millions of individual consumers, many thousands of businesses and governments. All take decisions on what to buy and produce.

Consumers are individuals who use goods and services produced by a business.

The **economic climate** describes the state of key factors within a country such as the level of goods and services produced and the number of jobs available.

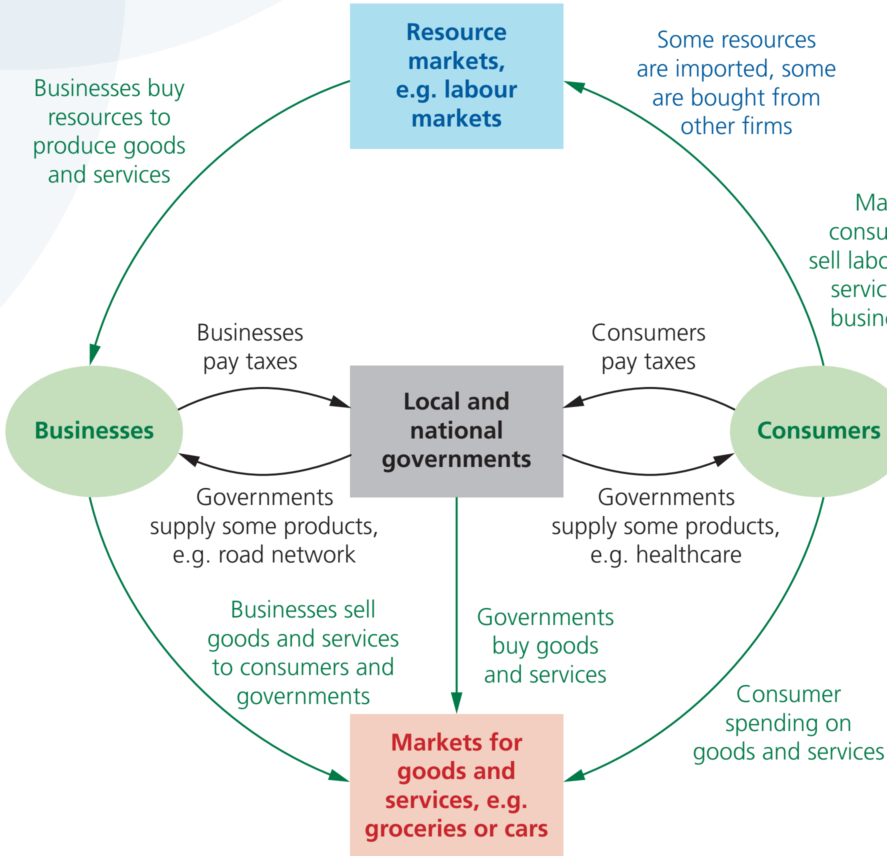


Figure 2.8 A simplified view of an economy

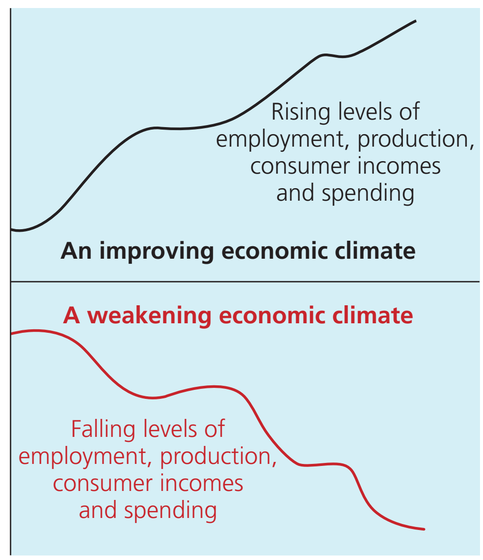


Figure 2.9 Changes in the economic climate

- experiencing a rise or a fall in the amount that consumers can spend on goods and services
- offering more or fewer jobs for people.

As Figure 2.9 shows, it is possible to describe a change in the economic climate as improving or weakening, depending on what is happening to key factors such as production levels and the number of jobs available. Generally speaking, a rise in these key economic factors indicates an improving economic climate.

Business insight

The UK's improving economic climate

The Bank of England has forecast that the economic climate in the UK will improve during 2021. The amount of goods and services produced is expected to be 7.25 per cent higher than it was in 2020. The Bank noted that this was really a 'bounce back' as the economic climate was very weak in 2020 due to the Covid-19 pandemic and the volume of goods and services produced fell by 9.9 per cent.

This growth in output is expected to lower the number of people in the UK who do not have jobs. It may also impact on the level of savings held by people in the UK. In 2020 the proportion of income which was saved in the UK reached record levels due to the uncertainty created by the pandemic.

Approximately 67 per cent of small businesses in the UK expect the economic climate to improve during 2021 and anticipate this having a positive impact on their businesses.

Analyse *one* likely consequence for businesses in the UK if the economic climate does improve. [6 marks]

Interest rates and the economic climate

Interest rates are the cost of borrowing money, expressed as a percentage rate. Thus, if a business or consumer borrows money, they have to repay the amount borrowed plus an additional amount – the interest payment. The additional amount is stated as a percentage to make it easier to understand. A higher percentage rate means a larger 'extra' payment. Equally, if a consumer or business saves money (by putting it into a bank account, for example), they receive an extra amount in the form of an interest payment.

> **Key term**
>
> **Interest rates** refer to the cost of borrowing money or the reward for saving money, expressed as a percentage.

Changes in interest rates can affect the economic climate of a country. They have this impact because they affect decisions taken both by consumers and businesses.

Consumers and changes in interest rates

A change in interest rates will have two broad effects on consumers' decisions. It may affect the amount they decide to save and the amount they choose to spend. The impact can be significant if there are large changes in interest rates.

Let's assume that there is a fall in interest rates – as happened in the UK in March 2020. This will be likely to have the following effects:

- **Saving by consumers.** A fall in interest rates will lead to some consumers deciding not to save, as the interest they receive will have been reduced. They may decide to spend existing savings on goods and services and save less in the future.
- **Spending by consumers.** As well as spending their savings, consumers will be more willing to borrow money to buy more expensive items such as houses and cars. They will do this because lower interest rates reduce the additional amount they have to repay.

A rise in interest rates will have the opposite effects.

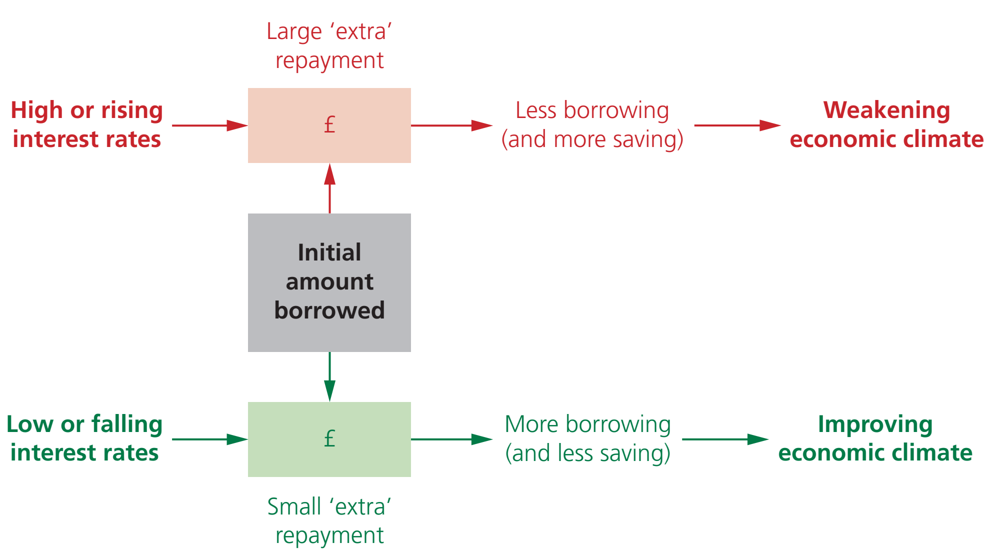


Figure 2.10 Different interest rates and the economic climate

Banks try to persuade customers to save money with them by offering higher interest rates than their competitors.

Businesses and changes in interest rates

Some businesses rely heavily on borrowed money to finance their activities. Sometimes this money is just borrowed for a short period of time, for example, to pay for raw materials. On other occasions, it may be borrowed for a long period of time, for example, to pay for a new factory or offices.

Some businesses rely on borrowing to finance their businesses. For example, some fee-paying schools may rely on short-term borrowing as they only receive fees from parents at the start of each term. However, they have to pay teachers' wages and other costs throughout the term. They may use a short-term **loan**, called an **overdraft**, for this purpose. An overdraft is a flexible loan which businesses can use, whenever necessary, up to an agreed limit.

Borrowing large amounts of money, especially over long periods of time, means that businesses can be affected significantly by changes in interest rates.

- **Rising interest rates.** In this situation, a business may face a large increase in the amount of interest it pays on its existing loans. This could increase its costs, reducing profits. In extreme cases, a large rise in interest rates may result in a business being unable to repay its loans. In this case, it will probably stop trading.
- **Falling interest rates.** This is a more favourable situation for many businesses with borrowings. It may be that borrowing costs will be reduced, helping to improve the business's profits. However, those businesses with large savings may receive reduced returns.

One way in which a business can protect itself against changes in the cost of its borrowing is to negotiate loans with fixed rates of interest. This means the rate of interest is unchanged throughout the period of the loan. However, fixed rate loans may have higher rates of interest from the start.

Key terms

A loan (or a bank loan) is an amount of money provided to a business for a stated purpose in return for regular repayments including interest charges.

An **overdraft** is a flexible loan which businesses can use, whenever necessary, up to an agreed limit.

Businesses, interest rates and consumer spending

Businesses can also be affected following a change in interest rates by consumers' decisions to spend less or more on their goods or services. If interest rates rise, some consumers may decide to save more. Other consumers may choose not to take out loans to buy new cars or technology, such as televisions or computers. These decisions could result in a business selling fewer products and receiving less revenue from its sales. The outcome is likely to be lower profits.

Businesses that sell luxury goods will be affected most when interest rates rise. Similarly, they benefit most from interest rate reductions.

Lower interest rates can prompt reductions in saving and higher levels of borrowing and spending by consumers. This should help to increase a business's profits.

Business insight

New car sales rise

Despite the impact of the Covid-19 pandemic, sales of new cars rose sharply in the UK in March 2020 compared with the previous month. Total car sales in February totalled 79,594. In March they increased to 254,564.

During March 2020 the Bank of England twice announced that it was reducing interest rates. Initially it cut interest rates from 0.75 per cent to 0.25 per cent and then a week later they were reduced to 0.1 per cent. This was the lowest-ever rate in the Bank of England's 326-year history.

Analyse *one* reason why sales of cars might have increased in March 2020 compared with the previous month. [6 marks]

Few consumers can buy houses without loans, often needing to borrow large amounts. Thus, sales of houses can be very sensitive to changes in interest rates.

Study tip

You should focus on the effects of changes in interest rates. You are not expected to know the reasons why interest rates are changed or the methods by which they are changed.

It is important to remember that the effects of any change in interest rates will be greater if it is a large change and results in rates going to very high, or very low, levels.

Rising interest rates	Falling interest rates
Generally result in a weakening of the economic climate for many businesses	Usually result in improvements in the economic climate for businesses
The effects include: • Businesses may suffer falling sales as consumers save more of their incomes. • Sales of goods purchased using borrowed money (such as houses) may fall significantly. • Businesses are likely to reduce production to match sales. • Businesses may postpone expansion plans, such as opening new shops.	The effects include: • Sales may rise, especially of luxury and non-essential products. • Production of goods and services will rise, possibly increasing consumers' incomes. • Businesses may need to employ additional workers, also helping to increase consumer spending.

Table 2.1 A summary of the effects of changing interest rates on consumers and businesses

Levels of employment and consumer spending

Businesses employ workers to produce goods and services for sale. If the economic climate is strong and improving, there is likely to be a rising **level of employment** as more workers are needed. Wages may also rise. On the other hand, during a period in which the economic climate is weakening, employment levels and wages may fall.

Key term

Level of employment is the percentage of the working age population who have a job.

The effects on businesses of changes in the level of employment

The effects on businesses of changes in the level of employment

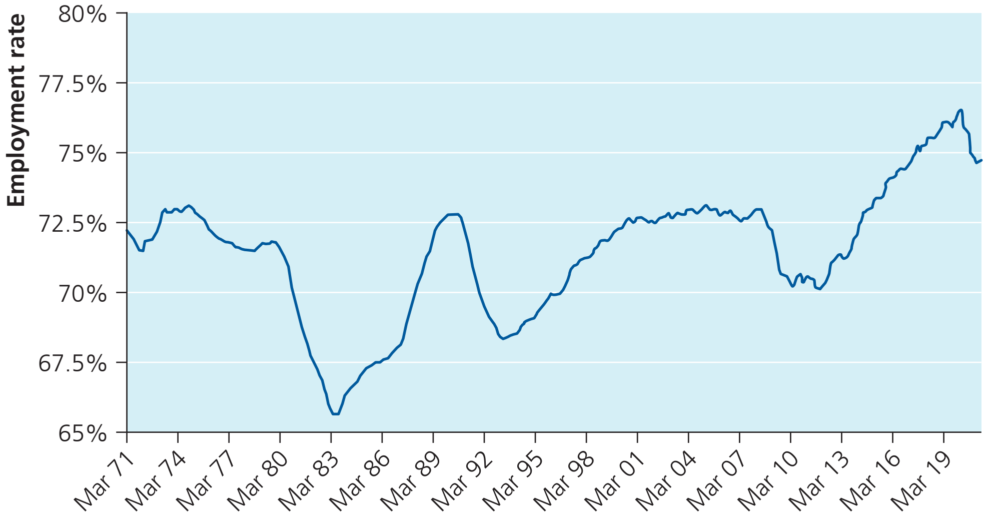
At the time of writing (August 2021) the level of employment in the UK is just starting to show some signs of recovery after significant falls due to the effects of the Covid-19 pandemic. A common way of measuring the level of employment is to calculate the employment rate. This measures the percentage of people aged 16 to 64 who are in employment. It thus allows for changes in the size of the population.

Recent levels of employment in the UK

Figure 2.11 shows that the rate of employment rose fairly steadily in the UK between 2011 and February 2020, just before the first lockdown started. In February 2020 the rate of employment in the UK was 76.6 per cent. This meant that nearly 77 out of every 100 people aged between 16 and 64 in the UK had a job. Some of the remaining 23 may not have wanted employment: they may have been students or have had childcare responsibilities. Nevertheless, some of them would have been unemployed and looking for work.

At this point Covid-19 intervened and many businesses ceased trading. Millions of people were put on furlough, which meant that they were still employed, even though they were not actually working. However, the level of employment declined sharply, as seen in Figure 2.11, as some people lost their jobs rather than being placed on furlough.

In the summer of 2021, the widespread vaccination of the UK population meant that many businesses were able to reopen and the level of employment began to rise once more.



Source: Office for National Statistics (ons.gov.uk)

Figure 2.11 Employment rates in the UK, 1971–2021

Maths moment

Use Figure 2.11 to answer the following questions.

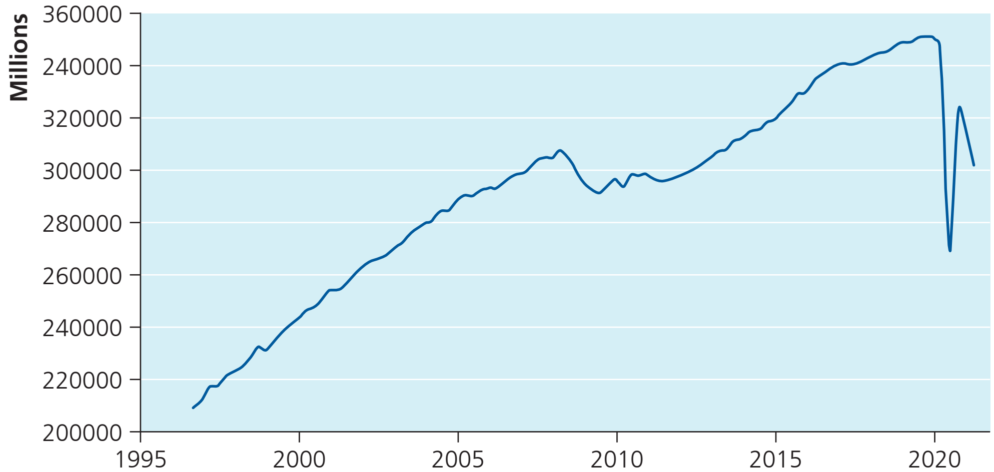
1. **When does the UK experience the lowest rate of employment?**
2. **Calculate the approximate difference between the UK's lowest and highest rates of employment over the period 1971 to 2021.**
3. **Over which period is there the longest continuous fall in the level of employment in the UK?**

Increases in the level of employment, such as that in the UK between 2011 and 2020, can have two significant effects on businesses:

- **The possibility of higher sales.** Because more people have jobs, it is likely that consumer spending will rise. The UK's population increased between 2011 and 2020 and, as Figure 2.11 shows, so did the employment rate. The result of these two factors was that the number of people in employment in the UK rose from 28.4 million in 2011 to 31.7 million in 2020. Therefore, in 2020 approximately an extra 3.3 million people were working in the UK. This represents many extra customers for businesses. In addition, real wages have risen over this period – that is, after allowing for any rises in prices. As a result, consumers have greater spending power and can buy more goods and services. This is good news for many businesses, especially those that sell luxury items such as jewellery and overseas holidays.

- **Increased employment costs.** Even after the impact of the pandemic, the UK's employment rate of 74.6 per cent is a relatively high figure. This means that some types of labour, especially skilled labour, may become scarce. As a result, wage rates can rise as businesses compete to employ the available workers. The outcome is higher employment costs. This can reduce a business's profits as it is unable to increase the prices of its goods and services to compensate.

However, there have been times when the employment rate in the UK has fallen, as in 2008–10 and 2020–21. Such periods can pose problems for businesses as consumers tend to spend less money if they are worried about their jobs. Instead, they save more of their earnings. Businesses may experience falling sales and this can be particularly severe for those that sell luxury goods and services. These are the first products that people tend to give up if they think that the economic climate is weakening.



Source: Trading Economics: tradingeconomics.com

Figure 2.12 UK consumer spending 1996–2021 (£ millions)

Maths moment

In 2020, the level of consumer spending in the UK fell to around £270,000 million. In which year was it last at this level?

The effects on businesses of changes in consumer spending

Consumer spending refers to the value of goods and services bought by consumers over a time period, usually a month or a year. This spending will be on essential products such as food, housing and heating, as well as on non-essential products including restaurant meals, designer clothing and alcohol. Non-essential items are luxury products that consumers want rather than those they need.

It is normal for consumer spending to fall at times when consumers' incomes are lower. Figure 2.12 shows the level of consumer spending in the UK between 1996 and 2021. It is clear that consumer spending fell between 2008 and 2010 due to a financial crisis. However, the impact of the Covid-19 pandemic from spring 2020 onwards is much more severe in terms of consumer spending. Employees lost their jobs or worked fewer hours each week and many were on furlough and receiving lower incomes. There was a great deal of uncertainty about the future. As a result, consumers saved more and spent considerably less on goods and services.

High levels of employment provide consumers in the UK with more money to spend, increasing the sales of most businesses.

We consider the effects of changes in consumer spending on UK businesses more fully below.

The effects on businesses supplying essential and non-essential products

Figure 2.12 shows us that there was a sharp fall in consumer spending during the years 2008–2010, when the financial crisis occurred, and again in 2020–21. It also shows that **consumer spending** rose fairly steadily between these two periods, when the incomes of many consumers were rising. It is apparent, therefore, that there is a direct link between consumers' incomes and the level of their spending. This is not surprising. If consumers receive higher incomes, they are likely to spend more and businesses' sales will rise. If consumers' incomes fall, so will their spending and the sales of businesses.

> **Key term**
>
> **Consumer spending** refers to the value of goods and services bought by consumers over a time period, usually a month or a year.

The effects of lower consumer incomes and falling sales can be felt by all functions within a business. It may affect business operations as they have to cut production levels. Human resources may have to employ fewer people. The marketing department may have to cut the prices of its products and to develop cheaper versions.

However, the levels of sales of all businesses are not affected equally by changes in consumers' incomes. Some businesses, which produce or sell essential products such as basic foods, do not experience large falls in sales when consumers' incomes fall. Equally, they do not enjoy significant increases in sales when consumers' incomes rise.

On the other hand, some businesses do sell goods and services whose sales vary considerably when consumers' incomes change. These products are likely to be luxury and non-essential items. Examples include designer handbags and organic foods. These products are called **income elastic products** as their sales are sensitive to changes in consumers' incomes.

Thus, businesses that produce some products may experience significant fluctuations in their sales as consumers' incomes change. Others may experience fewer changes as their products are not income elastic, or perhaps are less income elastic.

Key term

Income elastic products are those whose sales are sensitive to changes in consumers' incomes.

Products that are income elastic	Products that are *not* income elastic
The sales of income elastic products are sensitive to changes in consumers' incomes. For example, a fall in incomes is likely to result in a substantial fall in sales of these products. Many of these products are luxury products.	The sales of products that are not income elastic are relatively unaffected by changes in consumers' incomes. Many of these products are essential for consumers; some may be addictive.
For example: Luxury travel Fine wines New kitchens and bathrooms Gym memberships Sports cars such as Ferraris	For example: Basic foods, such as bread, milk and eggs Tobacco products Bus travel Petrol and diesel for cars Tap water

Table 2.2 Examples of products that are income elastic and those that are not income elastic

Rising incomes normally lead to higher sales of luxury products, such as sports cars, while demand for other products, such as travelling by bus, can fall.

Business insight

Ryanair's sales unaffected by consumers' income levels

Ryanair is best known for providing cheap flights throughout Europe. Its website advertises flights to European cities such as Aarhus (Denmark) and Warsaw (Poland) for as little as £10 one-way. The company has successfully lowered its prices over time.

By selling flights very cheaply, it has increased its sales enormously. In 1990, it had 745,000 passengers. By 2019, the figure had risen to 139.6 million. Its passenger numbers have grown steadily since 2000, even when consumers' incomes were falling.

Explain *one* reason why Ryanair's sales continued to rise even when consumers' incomes were falling. (2 marks)

Summary

Businesses are influenced by changes in the economic climate. Fluctuations in the level of interest rates or the level of employment are likely to affect most businesses. Changes in consumers' income will affect many. Those selling income elastic products will be affected most.

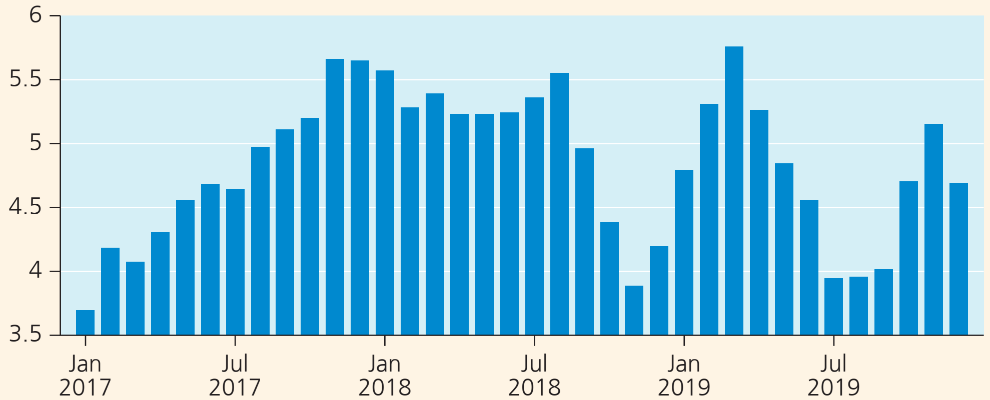
Quick questions

1. Explain the term 'economic climate'. (2 marks)
2. Which of the following is most likely to be a sign of an improving economic climate?
   - **(a)** A rise in the number of people who do not have jobs but are looking for one
   - **(b)** A rise in the number of businesses that are forced to cease trading as they cannot repay loans
   - **(c)** A rise in the number of people in employment
   - **(d)** A rise in the number of people moving overseas for work (1 mark)
3. Explain the term 'interest rates'. (2 marks)
4. State **two** changes that might occur when an economic climate is weakening. (2 marks)
5. Explain **one** possible effect of falling interest rates on a business. (2 marks)
6. Explain **one** reason why house builders might be affected by a rise in interest rates. (2 marks)
7. Explain **one** possible effect of falling levels of employment on UK businesses. (2 marks)
8. Explain the term 'consumer spending'. (2 marks)
9. State **two** luxury goods whose sales might be affected significantly by a fall in consumer spending. (2 marks)
10. Explain **one** reason why a bakery's sales of bread may **not** be affected significantly by a fall in consumers' incomes. (2 marks)

Case study

The USA increases its interest rates

During 2018, interest rates in the USA increased from 1.5 per cent to 2.00 per cent. Interest rates there had risen steadily from 0.5 per cent in late 2016. The higher interest rates have already had a number of effects. Some industries, such as house building, have been affected as consumers normally buy houses using loans. Despite this, the news on wages and salaries is positive, as shown in Figure 2.13.



Source: Trading Economics: www.tradingeconomics.com

Figure 2.13 The percentage increase in wages and salaries in the USA, 2017–19

However, consumers in America do have high levels of debt. In 2019, the average American household owed $147,000 (approximately £108,000).

1 State **two** other examples of products other than houses that consumers often buy using borrowed money. [2 marks]

2 Explain **one** way in which this increase in interest rates might affect the profits of an American company. [3 marks]

3 Analyse **one** likely effect of this rise in interest rates on the level of spending by American consumers. [6 marks]

4 Rising interest rates in America will have an effect on many businesses. Recommend if American businesses should respond by:

- reducing the amount that they have borrowed **or**
- reducing their levels of production.

Analyse the effect of **each** of these options on the profits of American businesses. Evaluate which of these two approaches might be the most effective at maintaining profits. [12 marks]

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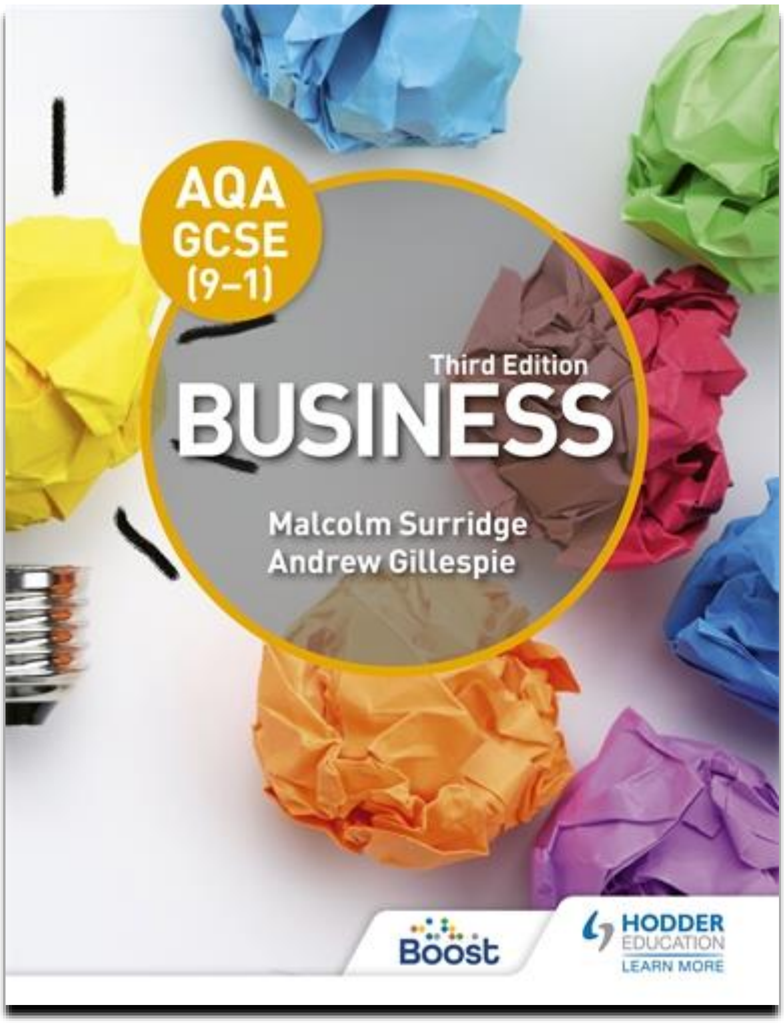

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