BUS.AL24 Economic Influences on Business: Interest Rates and Exchange Rates

Total Marks

AQA 7132 · Calculators not allowed · about 65 minutes

Name: ______________________________ Date: ____ / ____ / ______

Answer ALL questions in the spaces provided. Show your working for every calculation. Use UK examples where asked.

1 Which one of the following best describes the 'interest rate' set by the Bank of England and used as the base for many commercial loan rates?

- [ ] A) The tax rate applied to business profits
- [ ] B) The percentage charged on borrowing by commercial banks influenced by the Bank of England base rate
- [ ] C) The annual inflation rate measured by the Consumer Prices Index
- [ ] D) The exchange rate between sterling and the US dollar

(Total for Question 1 is 1 mark)

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2 Which one of the following best describes an 'exchange rate' as relevant to a UK firm buying inputs from abroad?

- [ ] A) The price in sterling for one unit of a foreign currency
- [ ] B) The tariff charged on imported goods
- [ ] C) The domestic VAT rate charged on imported inputs
- [ ] D) The profit margin a firm earns on exports

(Total for Question 2 is 1 mark)

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3 Define the term 'interest rate' in the context of business borrowing, and give one immediate effect on a firm when interest rates rise.

(Total for Question 3 is 2 marks)

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4 Define the term 'exchange rate' and state one immediate consequence for a UK importer if the pound weakens against the euro.

(Total for Question 4 is 2 marks)

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5 Define 'appreciation' of a currency and give one effect on UK exporters if the pound appreciates.

(Total for Question 5 is 2 marks)

6 Define 'depreciation' of a currency and state one effect on a UK importer if the pound depreciates.

(Total for Question 6 is 2 marks)

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7 State two ways a rise in UK interest rates can affect consumer spending by households in the UK, referring to mortgage borrowers and savers.

(Total for Question 7 is 2 marks)

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8 Scenario: London Leisure Ltd is a medium sized UK gym chain that finances new gym fit-outs with variable-rate bank loans and relies on monthly membership fees. Explain the impact of a rise in UK interest rates on London Leisure Ltd, showing effects on borrowing costs, consumer demand for memberships and the firm's investment decisions. Use the scenario in your answer.

(Total for Question 8 is 6 marks)

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9 The exchange rate used in the next three questions is EUR per GBP. A UK exporter previously received 1.30 EUR for each 1.00 GBP. The pound weakens so the rate changes to 1.15 EUR per GBP. Calculate the percentage change in the value of the pound against the euro. Show your working and state whether this is appreciation or depreciation of the pound.

(Total for Question 9 is 3 marks)

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10 Analyse the likely effects of a weakening pound from 1.30 to 1.15 EUR per GBP on a UK firm that exports handmade furniture priced in sterling at 1,000 GBP per unit and sells mainly to the eurozone. Consider price competitiveness, demand, revenue in sterling and possible firm responses. Use figures where appropriate.

(Total for Question 10 is 8 marks)

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11 Using the rate change in question 9, the UK furniture exporter previously priced items at 1,000 GBP and billed eurozone customers in euros at the equivalent price of 1,300 EUR. If the exporter wants to keep the same euro price for customers after the pound weakens to 1.15 EUR per GBP, calculate the new sterling price the firm must charge. Show your working.

(Total for Question 11 is 3 marks)

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12 State two ways a period of rising inflation could affect a firm's costs and pricing decisions. Give concise answers.

(Total for Question 12 is 2 marks)

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13 Scenario: Bright Brew Ltd, a UK coffee roaster, has a 250,000 GBP variable-rate loan priced at Bank base rate plus 2 percentage points. If the Bank base rate rises by 1 percentage point from 1.5% to 2.5%, calculate the increase in annual interest payments for Bright Brew in pounds. Show your working.

(Total for Question 13 is 3 marks)

14 Recommend how a UK mid sized manufacturer that both imports components and exports finished goods should respond to a period of rising interest rates and a weakening pound. Justify your recommendation using the economic effects discussed in this pack and considering costs, pricing, investment and risk management options. Use the specific figures given earlier where helpful.

(Total for Question 14 is 9 marks)

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15 Identify one financial tool a firm can use to reduce uncertainty from exchange rate movements when it expects to receive euros in six months time.

- ☐ A) Forward contract
- ☐ B) Variable rate loan
- ☐ C) Short term overdraft
- ☐ D) Raising the dividend payout

(Total for Question 15 is 1 mark)

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16 Explain one advantage to a firm of using a natural hedge, where possible, to manage currency risk. Apply your explanation briefly to a firm that both invoices customers in euros and pays suppliers in euros.

(Total for Question 16 is 3 marks)

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Question 1

- **B1** B cao
- **Answer: B**

Question 2

- **B1** A cao
- **Answer: A**

Question 3

- **B1** definition: the percentage cost of borrowing or return on saving per year
- **B1** effect: firms face higher interest payments on variable-rate debt or new loans, increasing costs
- **Answer: Interest rate is the percentage cost of borrowing or the return on saving per year; if interest rates rise firms face higher interest payments on variable-rate debt, increasing their costs.**

Question 4

- **B1** definition: the price of one currency expressed in units of another currency
- **B1** consequence: imports priced in euro become more expensive in pounds, raising import costs
- **Answer: Exchange rate is the price of one currency expressed in units of another; if the pound weakens against the euro, imports priced in euro become more expensive in pounds, raising import costs.**

Question 5

- **B1** definition: appreciation is when a currency gains value relative to other currencies
- **B1** effect: UK exports become more expensive for foreign buyers, likely reducing export demand
- **Answer: Appreciation is when a currency gains value relative to others; if the pound appreciates, UK exports become more expensive for foreign buyers, likely reducing export demand.**

Question 6

- **B1** definition: depreciation is when a currency loses value relative to other currencies
- **B1** effect: imports become more expensive in domestic currency, increasing costs for importers
- **Answer: Depreciation is when a currency loses value relative to others; if the pound depreciates, imports become more expensive in pounds, increasing costs for importers.**

Question 7

- **B1** higher mortgage or loan payments reduce disposable income for borrower households
- **B1** higher interest on savings makes saving more attractive, so households may cut spending
- **Answer: Higher mortgage payments reduce disposable income for borrowers; higher returns on savings make saving more attractive so households may cut current spending.**

Question 8

- **B1** identifies that borrowing costs rise for London Leisure because its variable-rate loans will increase
- **B1** explains consequence: higher interest payments increase the firm's fixed financial costs and reduce profit unless offset
- **B1** identifies that higher interest rates reduce disposable income for consumers, reducing demand for non-essential services like gym memberships
- **B1** develops consequence: lower membership demand reduces revenue and may increase churn, hitting cash flow
- **B1** explains effect on investment decisions: the firm may delay or cancel further fit-outs because the higher cost of finance raises the required return threshold
- **B1** links these points to an overall impact on London Leisure's viability or growth plans, for example lower expansion and tighter cash management

Question 9

- **M1** method: percentage change = (new - old) / old x 100 or equivalent seen
- **M1** substitution: (1.15 - 1.30) / 1.30 x 100 seen
- **A1** final: -11.54% approximately, showing a 11.54% depreciation of the pound cao
- **Answer: Percentage change = (1.15 - 1.30) / 1.30 x 100 = -0.15 / 1.30 x 100 = -11.538...% approximately. The negative sign shows the exchange rate fell from 1.30 to 1.15 EUR per GBP, so one pound now buys fewer euros: the pound has depreciated by about 11.54% against the euro.**

Question 10

- **B1** identifies direct price effect: at old rate 1,000 GBP = 1,300 EUR, at new rate 1,000 GBP = 1,150 EUR, so the product is 150 EUR cheaper for euro buyers
- **B1** explains that the firm's price competitiveness improves if it keeps its sterling price unchanged, because foreign buyers now pay fewer euros for the same item, which could help protect or grow sales in the eurozone
- **B1** explains demand effect: cheaper price in euros could increase quantity demanded in the eurozone, adding to revenue
- **B1** analyses revenue in sterling: if the firm quoted prices in euros, converting receipts means each euro now converts into more pounds, potentially increasing sterling revenue
- **B1** considers firm responses: the firm could keep the euro price unchanged to boost sterling revenue and margins, or cut the euro price to gain market share while keeping sterling revenue roughly the same, with implied volume and margin trade offs
- **B1** considers hedging and contractual responses: use of forward contracts, invoicing in euros, or targeting non-euro markets as ways to manage future exchange rate risk
- **B1** evaluates net effect by weighing increased volume against lower unit revenue, noting outcome depends on price elasticity of demand and cost structure
- **B1** applies figures to give a quantitative sense, for example unit euro price falls from 1,300 EUR to 1,150 EUR, a 11.54% change, and suggests scenarios where volume rises by less or more than 11.54% to indicate likely revenue impact

Question 11

- **M1** method: sterling price = euro price / new exchange rate seen
- **M1** substitution: 1,300 EUR / 1.15 EUR per GBP seen
- **A1** 1,130.4348 GBP approximately cao
- **Answer: Sterling price = 1,300 EUR / 1.15 EUR per GBP = 1,130.4348... GBP, approximately 1,130.43 GBP. This is the sterling price required to keep the customer-facing euro price at 1,300 EUR after the pound weakens.**

Question 12

- **B1** higher input costs as suppliers raise prices, increasing the firm's variable and possibly fixed costs
- **B1** need to raise selling prices to maintain margins, risking lower sales if demand is price sensitive
- **Answer: Rising inflation pushes up input costs as suppliers raise prices; the firm may need to raise its selling prices to maintain margins, which could reduce demand if customers are price sensitive.**

Question 13

- **M1** identify new rate: (base 2.5% + 2%) = 4.5% and old rate: (base 1.5% + 2%) = 3.5% or show change of 1% on the loan
- **M1** method: additional annual interest = loan x change in rate seen
- **A1** 2,500 pounds cao
- **Answer: Change in interest rate on loan = 1 percentage point = 0.01. Additional annual interest = 250,000 x 0.01 = 2,500 pounds. Bright Brew will pay an extra 2,500 pounds per year.**

Question 14

- **Level 1** (1-3): Simple statements about possible responses with little application to the firm or the figures, and no clear justification.
- **Level 2** (4-6): Developed recommendations that apply some of the pack's economic points and figures, but do not fully weigh alternatives or provide a clear, justified final choice.
- **Level 3** (7-9): A coherent recommendation that weighs costs and benefits, applies relevant figures from the pack, considers alternative actions and risk management, and justifies the chosen strategy clearly.
- **Indicative content:**
  - Recognise the combined challenge: rising interest rates increase borrowing costs and reduce consumer demand; a weakening pound makes exports more price competitive abroad but raises the sterling cost of imports.
  - Short term responses: hedge foreign exchange exposure with forward contracts or invoice major customers in euros to stabilise euro revenue, and negotiate longer supplier contracts to lock in current sterling costs for imports
  - Pricing and market responses: consider selective price adjustments, targeting cost increases to less price sensitive markets, or absorb some exchange gains to keep euro prices stable where volume is elastic
  - Investment decisions: postpone non essential capital investment while borrowing costs are higher, but consider investment that reduces variable costs if it offers a short payback and is not debt financed
  - Cost management: improve operational efficiency, switch some sourcing to sterling priced suppliers where possible, pass on unavoidable cost increases to customers in a phased manner
  - Risk management: use a mix of hedging, natural hedges (matching currency revenues and costs), and fixed rate borrowing where appropriate to reduce exposure to further rate rises
  - Judgement: recommend a balanced approach combining active FX hedging to protect export revenue, efficiency and targeted price strategies to preserve margins, and cautious investment financed from internal funds or fixed rate borrowing; justify by referring to earlier figures such as the 11.54% pound depreciation example and the 2,500 pounds annual interest increase for a 250,000 GBP loan per 1 percentage point rise

Question 15

- **B1** A cao
- **Answer: A**

Question 16

- **B1** identifies advantage: offsets currency inflows and outflows so net exposure is reduced
- **B1** develops the point: reduced need for financial hedging lowers direct hedging costs and administrative complexity
- **B1** applies to the firm: if euro receipts from customers roughly match euro payments to suppliers, exchange rate moves have smaller net impact on sterling profits
- **Answer: A natural hedge offsets currency inflows and outflows reducing net exposure; this lowers the need for costly financial hedging and administrative work, and for a firm that both invoices and pays in euros, exchange rate movements affect net cash flows less if receipts and payments broadly match.**