

Introduction to Small Business

Revision Notes

Topic 1.5

Understanding the economic context



Question....

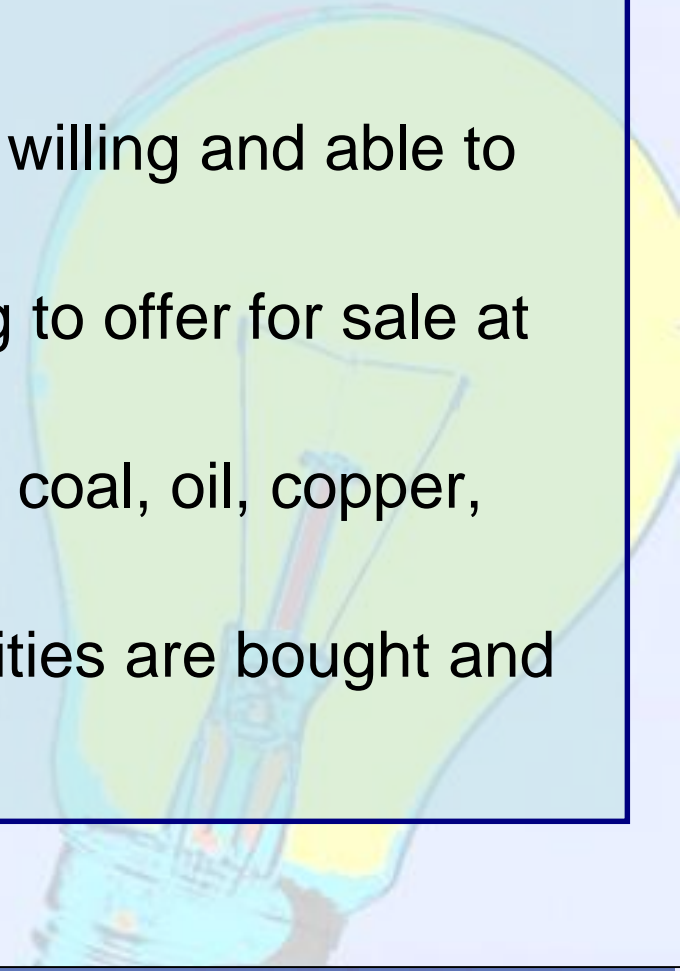
- **If something is popular (High demand) do you pay a high price or low?**
- **Can you think of an example?**



Market demand and supply

Terms you need to know:

- **Demand** – the amount consumers are willing and able to buy at any given price.
- **Supply** – the amount sellers are willing to offer for sale at any given price.
- **Commodities** – raw materials such as coal, oil, copper, iron ore, wheat and cocoa beans.
- **Commodity market** – where commodities are bought and sold.



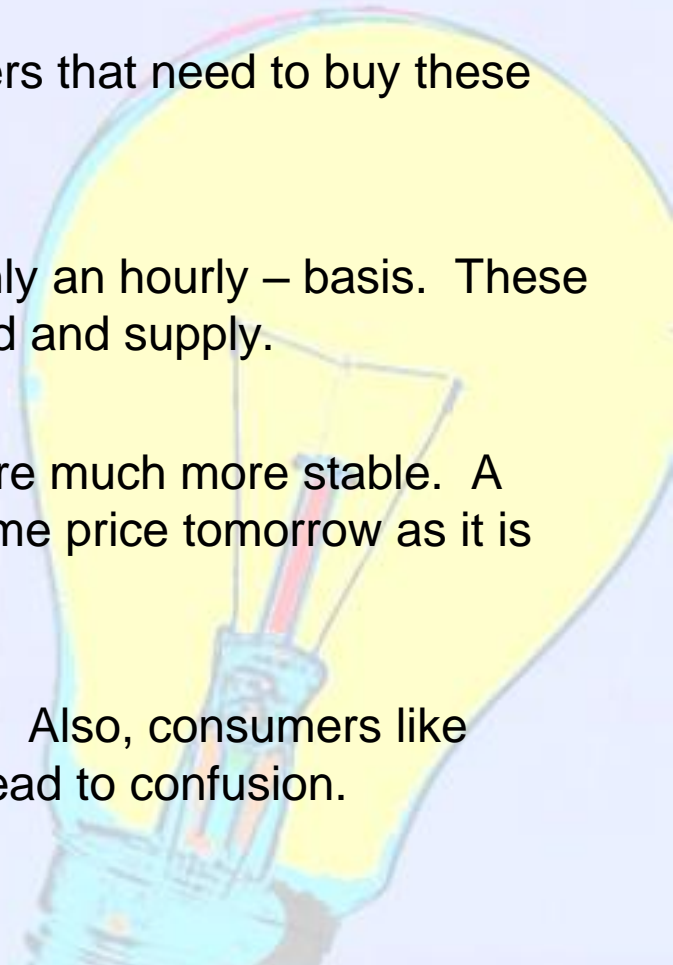
Commodity markets

Commodity markets are used by businesses and traders that need to buy these products for use in other businesses.

Prices in commodity markets change on a daily – even hourly – basis. These changes occur due to changes in conditions of demand and supply.

In markets that we use on a day-to-day basis, prices are much more stable. A packet of crisps in a local shop will probably be the same price tomorrow as it is today. But why?

Changing prices in shops can be costly for a business. Also, consumers like prices to remain constant; regular price changes can lead to confusion.



Questions...

- You have borrowed some money from the bank to pay for a machine.
- Interest rates have **gone up**, is that **good** or **bad** for you and your business? **WHY?**
- You have some **RETAINED PROFIT** from previous years trading. You put it in a savings account.
- Interest rates have **gone up**, is that **good** or **bad** for you and your business? **WHY?**



Changing interest rates

Interest rates are the percentage reward or payment over a period of time that is given to savers or paid to borrowers on savings or loans. Changes in interest rates affect businesses in two ways:

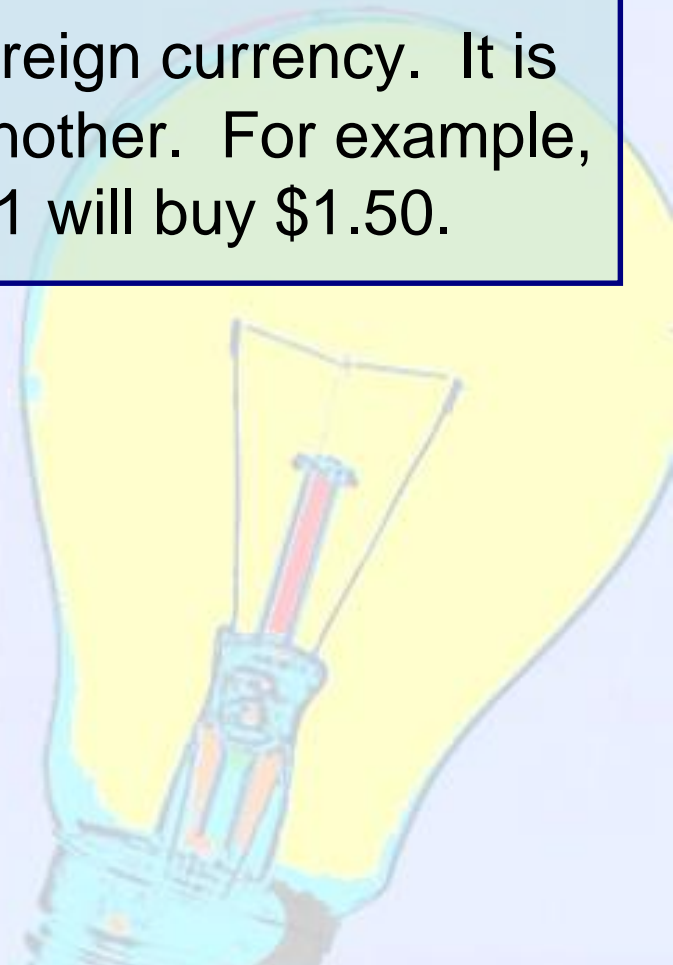
	Falling interest rates	Rising interest rates
Small businesses	<ul style="list-style-type: none">• <i>Lower fixed costs due to lower loan repayments</i>• <i>Greater incentive to invest</i>	<ul style="list-style-type: none">• <i>Higher fixed costs due to higher loan repayments</i>• <i>Borrowing becomes more expensive</i>
Consumer spending	<ul style="list-style-type: none">• <i>Higher spending due to lower mortgage payments</i>• <i>Less incentive to save due to lower returns</i>	<ul style="list-style-type: none">• <i>Higher mortgage payments = less spending (especially on luxury items?)</i>• <i>Greater incentive to save</i>



Changing exchange rates

Exchange rate – the price of buying foreign currency. It is the value of one currency in terms of another. For example, an exchange rate of £1/\$1.50 means £1 will buy \$1.50.

You need to understand how changes in the value of the pound (£) to the dollar (\$) and the euro (€) affect small businesses.



What Determines Exchange Rates?

- Since money is a **commodity**, a currency's value depends upon:
 - The number of people who want to buy it (**DEMAND**)
 - The number of people who want to sell it (**SUPPLY**)

- Changes in the exchange rate can have very big effects upon businesses:



New Exchange Rate

£1 = \$2

British car sold in USA for:
\$40,000 ($£20,000 \times 2$)

American car sold in UK for:
£15,000 ($\$30,000 \div 2$)

Original Exchange Rate

£1 = \$1.50

British car sold in USA for:
\$30,000 ($£20,000 \times 1.5$)

American car sold in UK for:
£20,000 ($\$30,000 \div 1.5$)

Changing exchange rates

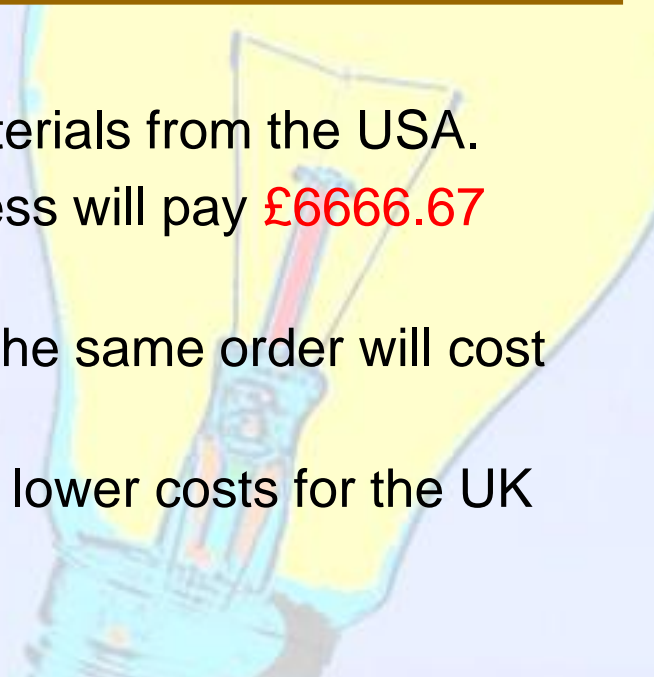
Revision tip

A good way to remember the impact of changing exchange rates on business is by the mnemonic, **SPICED**.

Strong, **P**ound, **I**mports, **C**heaper, **E**xports, **D**earer

Example

- A UK business wants to import \$10 000 of materials from the USA.
- At an exchange rate of $\text{£}1/\text{\$}1.50$ the UK business will pay $\text{£}6666.67$ ($\text{\$}10\ 000/\text{\$}1.50$).
- If the UK exchange rate strengthens to $\text{£}1/\text{\$}2$, the same order will cost the UK business $\text{£}5\ 000$ ($\text{\$}10\ 000/\text{\$}2$).
- In other words, the stronger pound has caused lower costs for the UK business.



Calculating exchange rates

Worked example:

To convert pounds to a foreign currency, multiply the amount of pounds by the rate. Example:

Exchange rate = £1/\$1.50

To find the value of £500 in dollars, the following calculation should be performed: $500 \times 1.5 = 750$

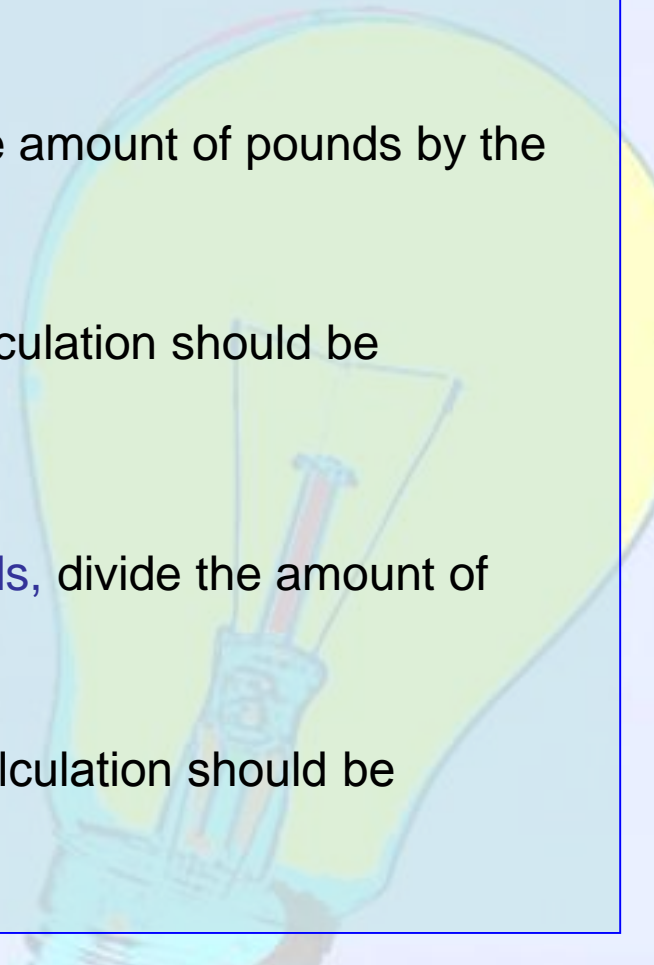
£500 will buy \$750

To convert an amount in a foreign currency to pounds, divide the amount of pounds by the rate. Example:

Exchange rate = £1 / €1.10

To find the value of €300 in pounds, the following calculation should be performed: $300 / 1.10 = £272.73$

€300 is worth £272.73



How do business cycles affect small businesses?

Business cycle – fluctuations in the level of economic activity over a period of time. Most economies experience times when economic activity is rising and others when economic activity is slowing.

Small businesses can be affected by the business cycle. In a recession – when economic activity is slowing – consumer spending falls. This might affect the business negatively. It depends on the type of product it provides. A luxury cafe might see lower sales when incomes fall.



Question....

- In 2009 we entered a **recession**. Do consumers have much money to spend?
- How will this affect businesses?

- In a **BOOM (economic growth)** what might businesses do to **prices**? Their **business**?



Impact of the business cycle on business

Businesses need to be aware of the phase of the business cycle that the economy is in. They also need to be able to respond to the changes that might occur in different phases.

Phase of the business cycle	Possible impacts on business	Possible business response
<i>Downturn/ Recession</i>	<ul style="list-style-type: none">• Rising unemployment• Falling consumer incomes• Less consumer spending on luxury and non-essential items	<ul style="list-style-type: none">• Reduce prices• Cut costs – reduce number of workers; cheaper suppliers• Change type of product
<i>Recovery/ Boom</i>	<ul style="list-style-type: none">• Rising employment• Rising income levels• Increased consumer confidence – more likely to take out loans to buy expensive items.• Rising consumer spending• Inflation – higher costs from suppliers	<ul style="list-style-type: none">• Possible need to employ more workers.• Pricing to reflect the fact that consumers have higher incomes.• Increased advertising



How does business affect stakeholders?

Stakeholders are individuals or groups which have an interest in and are affected by the activities of a business. Stakeholders include:



Stakeholders: conflict of interest

Conflict of interest – businesses need to be aware that decisions that are intended for one stakeholder group might affect other groups. For example:

1. A decision to increase wages of **employees** is likely to reduce profits for **shareholders** (at least in the short term).
2. Changing **suppliers** to reduce costs will be negative of the old supplier, but may result in lower prices for customers.

