



Planning Resource

Theme 4

This document provides an example of a plan for one topic within Theme 4. This resource goes into much more detail than is required in the specification but it provides some background to the topic and suggested approaches for planning content.

The approach to planning taken in this document was to:

- Identify the specification content and possible links to other topics in the specification
- Identify resources to support delivery – these might include:
 - Support resources including sample assessment materials and Getting Started guide
 - Published resources including textbooks
 - Websites and news stories
- Identify the **knowledge**, **application**, **analysis** and **evaluation** relevant to that content
- Develop activities and resources – these might include:
 - Multiple choice questions from past papers
 - Worksheets
 - Past and new case studies
 - Practice questions for explain, calculate, assess and evaluate (where appropriate)



Risk and uncertainty

This resource sheet is designed to support the A level Economics B specification
Topic 4.5.1 Risk and uncertainty.

Specification content	4.5.1 Risk and uncertainty a) The difference between risk and uncertainty b) The impact of shocks c) Exchange rate risk and forward markets d) The role of insurance in business
Possible specification links	1.2.5 Implications for firms of changes in: <ul style="list-style-type: none"> Exchange rates
	1.3.2 Supply d) The factors that may cause a shift in the supply curve: <ul style="list-style-type: none"> external shocks
	2.4.4 Exchange rates a) Changes in exchange rates b) Impact of changing exchange rates on firms c) Interpretation of exchange rate data d) Interpretation of effective exchange rates
	3.1.5 Exchange rate changes a) Impact of changes in exchange rates and the possible effects on: <ul style="list-style-type: none"> the current account and the balance of payments economic growth; firms employment/unemployment the rate of inflation FDI flows b) The Eurozone

Resources

- www.tutor2u.net, www.economicsonline.co.uk and <http://www.learneconomicsonline.com> have some useful info
- <http://www.bbc.co.uk/> remains an invaluable resource
- <https://www.youtube.com/> has many excellent clips



Knowledge, application, analysis and evaluation

The difference between risk and uncertainty

Risk involves situations where the outcomes are known and can be calculated or quantifiable. When you buy an insurance policy so that you can drive, the insurer has carefully calculated the probability of your having an accident, based on the information you give about age, gender, experience and so on. This reduces the risks that the insurance company is taking very considerably. The insurer knows that the outcome of people driving will involve accidents and they can usually work out how many for any given number of drivers. Similarly, accountants can assess the financial risks that a business is taking. Risks can be greatly reduced when businesses make sure that they are as well informed as possible about the kinds of things that might go wrong.

Uncertainty is different because it is caused by factors outside the businesses' control and possible outcomes cannot be calculated with any degree of accuracy. It is unpredictable; there are too many unknown variables which make it impossible to estimate what is going to happen. The business may be well aware of these factors but this does not reduce uncertainty. We know that oil prices vary all the time but we cannot calculate what they might be in a year's time. Bad weather can lead to poor harvests and increased food prices but we cannot predict how many bad harvests there might be in the next 10 years. For farmers and consumers this is uncertainty.

The impact of shocks

An economic shock is any unexpected event that has a marked effect on an economy. They are unpredictable and can be either positive or negative in nature and will affect the equilibrium position of national income.

Shocks can occur for any number of reasons and can be dramatic in nature such as a terrorist attack or natural disaster, or more commonly in the form of factors that will affect Aggregate Demand (AD) or Aggregate Supply (AS).

The table below gives some examples of potential shocks. Supply-side shocks affect AS and demand shocks affect AD.

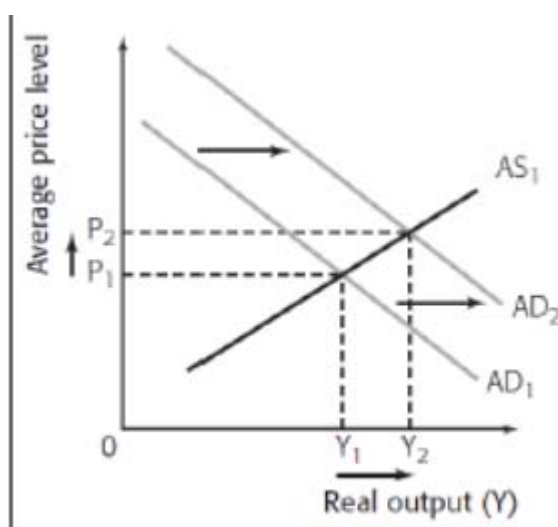


Supply-side shocks	Demand shocks
Costs of production – particularly oil prices	Anything that will affect the levels of consumption or investment e.g. a change in interest rates
Wage levels and labour costs	Changes in unemployment
Taxes and subsidies	Availability of credit
Changes in technology	Business confidence
Productivity levels	Changes to fiscal policy
Labour migration	Anything that affects levels of exports and imports

Demand shocks are sometimes divided into *exogenous* shocks meaning that they originate from outside of the AD model or *endogenous* shocks that come from within. For example a change in consumption would be an endogenous shock but change in exchange rates would be an exogenous shock.

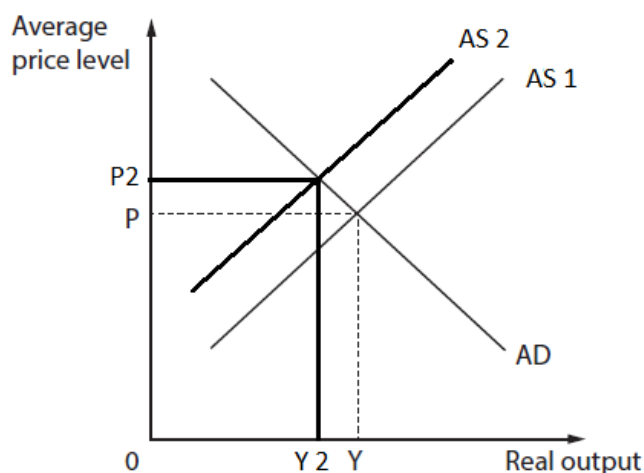
Because the shocks affect either AD or AS, the equilibrium level of national income is affected.

For example, a positive demand shock such as a fall in unemployment will increase AD as more people have disposable income and consumption (a component of AD) will increase. The AD curve will shift to the right and there will be an increase in the equilibrium level of national income. The impact on the price level will depend on the ability of AS to respond.





For example, a negative supply-side shock such as an increase in the oil price will increase costs throughout the economy leading to a reduction in supply and AS which will cause a decrease in the equilibrium level of national income.



Exchange rate risk and forward markets

Firms involved in overseas trade need to exchange currencies. The problem is that exchange rates vary all the time and there is a risk that rates will change between a business agreeing a deal and the time when it actually takes place.

For example a firm agrees to buy a consignment of machine parts from America at a price of \$160 000 to be delivered in two months' time. If the exchange rate is currently at $\text{£}1 = \$1.60$ the firm will expect to have to pay $\text{£}100\,000$ on delivery. **BUT** if the pound depreciates and the exchange rate drops to $\text{£}1 = \$1.51$ the firm will have to pay $\text{£}105\,960.26$ which makes a big difference to the profitability of the deal. Of course the pound may appreciate against the dollar and the firm would gain but that is risky. Firms are not currency speculators and they want certainty which is where a forward market can help.

Firms that need to buy and sell in foreign currencies can insure against exchange rate changes using forward markets. These allow them to buy a certain quantity of a currency at a price/exchange rate that is agreed now, and they will receive the money on a particular date in the future. There is of course a cost to using a forward market but this is offset by the added security and certainty.

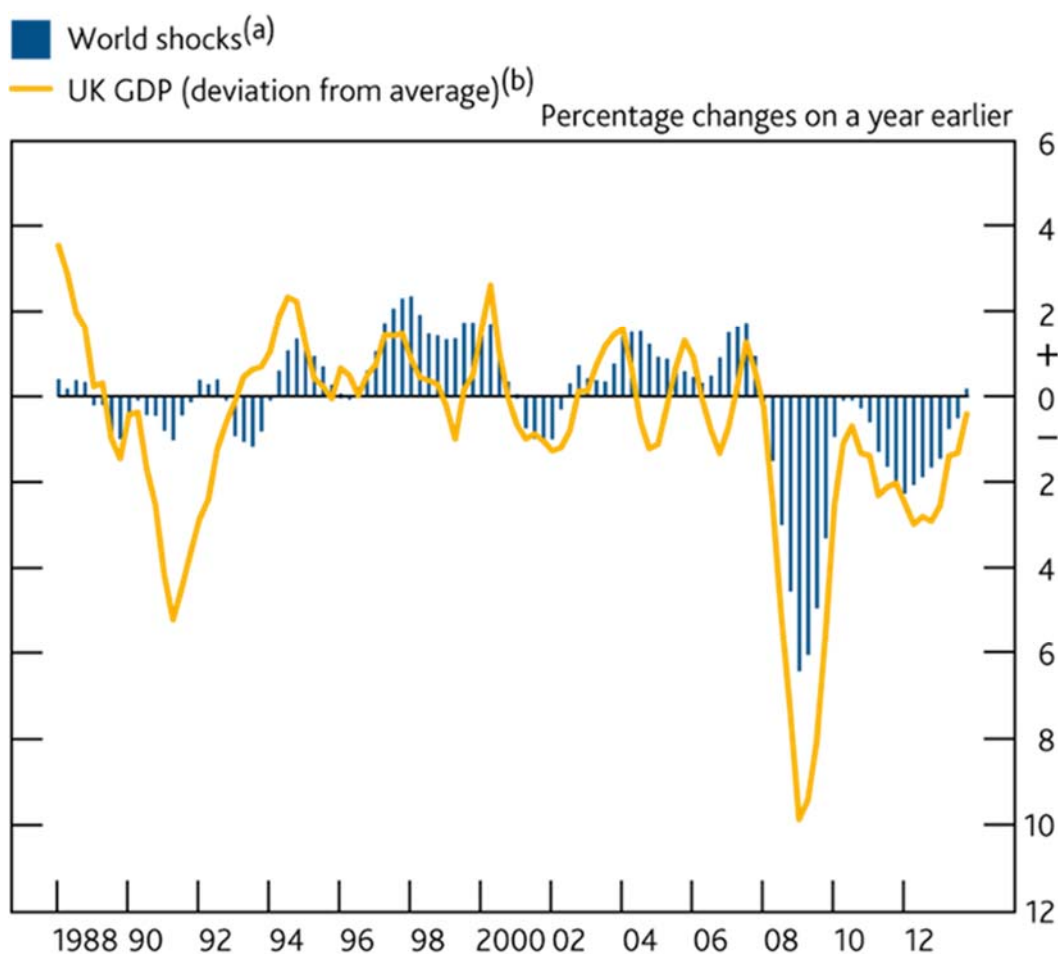


The role of insurance in business

In general, insurance reduces risks. By paying a premium now, we avoid an unpleasant surprise in the future. Businesses can include the premium in their accounts, treating it as a cost of production and using it to help set the prices they are charging. The risk of making a loss is reduced.

Activity 1

Figure 1



With reference to Figure 1 assess the extent to which a correlation exists between shocks and GDP.



Activity 2

Explain the impact on the UK economy of:

- a) A demand side shock such as the recent credit crunch
- b) A supply side shock such as an increase in the minimum wage

Activity 3

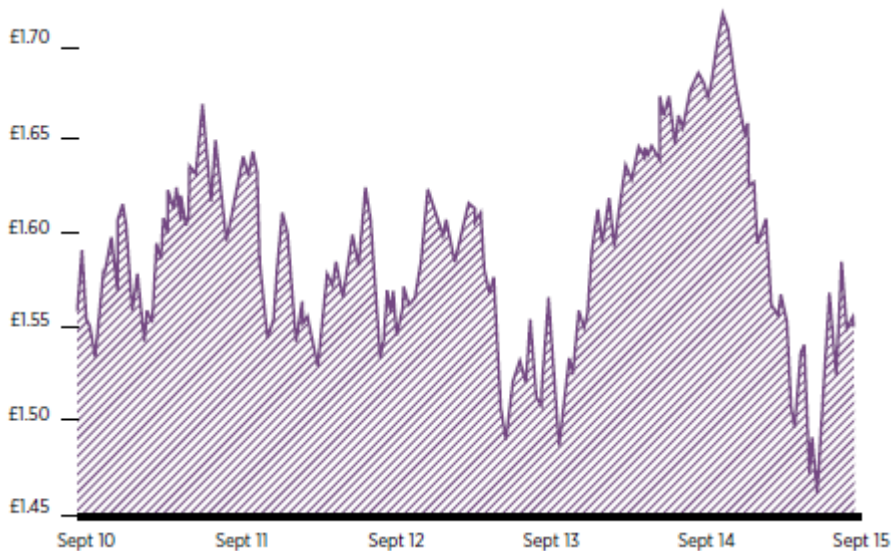
Predicted impact on the Indian economy of oil price changes - 2012			
Oil price	\$110	\$125	\$135
GDP % (change)	7.1	6.6	6.2
CPI %	7.2	7.7	8.2
Current account deficit % (of GDP)	-2.8	-3.4	-4.0
Fiscal deficit % (of GDP)	-5.0	-5.5	-5.9

1. Explain why a rise in oil prices would change each of the four economic indicators in the table.
2. Assess the impact of shocks in the form of oil price rises on the Indian economy.



Activity 4

Figure 3 - £ exchange rate against the US dollar 2010 to 2015



1. With reference to figure 3 assess the risks for a UK company trading with the US.
2. Explain how a forward market might reduce those risks.

Activity 5 Extended writing

Evaluate the extent to which a firm can eradicate risk and uncertainty.