Q (A) there are two reasons, which have caused the pound to appreciate in value in 1997.

First, economic growth. Countries experiencing a positive economic growth cycles often find that their exchange rate is strengthening. Traders in the currency markets may take the fast growth to be a sign of general economic growth and "mark up" the value of the currency as a result.

Also, economies with strong "export-led" growth may see their currency's rise in value. Japan is a good example of this in recent years. The Euro was weak during the first six months of its existence in part because the financial markets were worried about the slow growth of the European economy and the persistently high level of unemployment.

Second, interest rates. Interest rates have a large effect in a world where financial capital can move freely between countries.

When a country's interest rates are high relative to elsewhere this attracts inflows of money into a country seeking to take advantage of the high interest rates. This "interest differential" boosts the demand for the currency and can cause its value to rise.

(B) (i) Price elasticity of demand is the responsiveness of quantity demanded of exports/imports to a change in prices of exports/imports.

The passage indicates that British exports are becoming less price elastic and more price inelastic. I.e. a change in price has a lesser effect on the quantity demanded.

(ii) This transformation from price elastic to price inelastic of British exports can be explained by firms stressing the importance of quality not price. Exporters that have competed on price have gone out of the game. The successful ones have been the ones that have made their products price inelastic by specialising in quality and other unique selling points that are desired by foreigners.

(C) Changes in the exchange rate can have a powerful effect on the economy - but these effects take time to show through. There are time lags between a rise or a fall in the exchange rate, and changes in variables such as inflation, GDP and exports & imports.

Much depends on

The scale/size of any change in the exchange rate

Whether the change in the currency is short term or long term

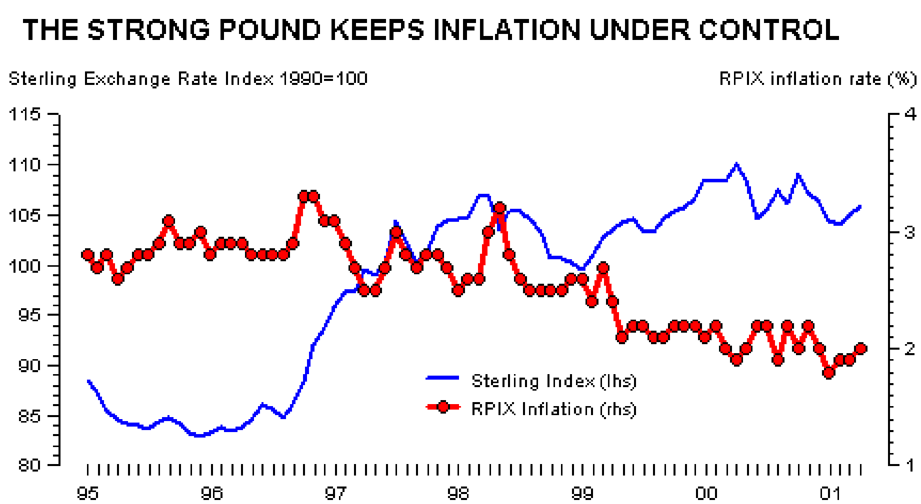
How businesses and consumers respond to exchange rate fluctuations

WINNERS AND LOSERS FROM EXCHANGE RATE FLUCTUATIONS

In recent years the sterling exchange rate has risen appreciably against a range of other leading currencies - not least the Euro since its inception in January 1999. Who are the main gainers and losers from a rising exchange rate?

An appreciation of the exchange rate has economic consequences both in the short and long term. As the economy adjusts to a higher exchange rate, some of the main beneficiaries and losers start to emerge. But textbook economics does not always provide clear cut answers to this question:

Advantages of a strong pound

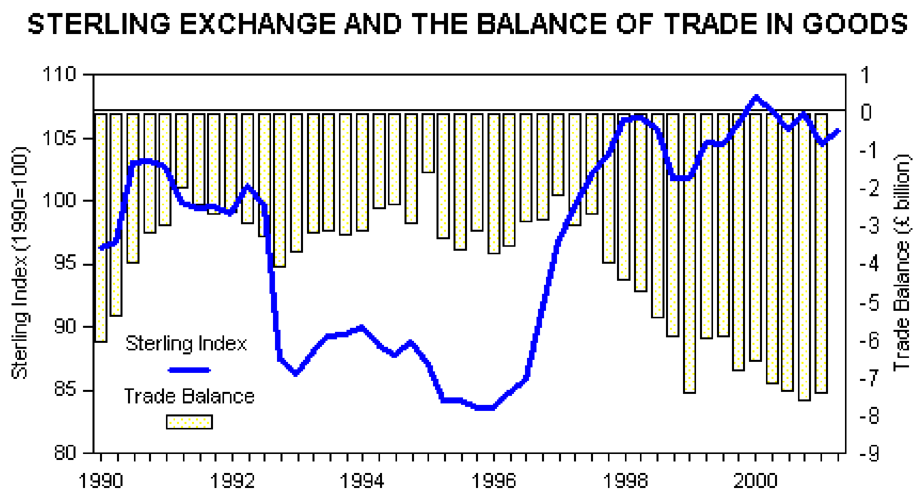


A high pounds leads to lower import prices - this boosts the real living standards of consumers at least in the short run - for example an increase in the real purchasing power of UK residents when travelling overseas

When sterling is strong, it is cheaper to import raw materials, components and capital inputs - good news for businesses that rely on imported components or who are wishing to increase their investment of new technology from overseas countries.

A strong exchange rate helps to control inflation - domestic producers face stiff international competition from cheaper imports and will look to cut their costs accordingly. Cheaper prices of imported foodstuffs etc. will also have a negative effect on the rate of consumer price inflation.

Disadvantages of a strong pound



Cheaper imports leads to rising import penetration and larger trade deficit e.g. the £28bn trade deficit in goods in 2000

Exporters lose price competitiveness and market share - this damages profits and employment in some sectors - notably manufacturing industry in the last three years

If exports fall, this has a negative impact on economic growth. Some regions are affected more than others. The strength of sterling in the last five years is one of the factors highlighted when economists analyse the north-south economic divide in the UK

Many business organisations have identified the strength of the exchange rate as a major economic problem over recent times.

Economists working for the ITEM club argued in the summer of 2001 that the pound should be lower by at least 10% in order to prevent manufacturing industry falling into an economic slump.

However it should be noted that business can adapt to a high exchange rate. There are ways in which industries can adjust to the competitive pressures that a strong pound imposes. Some of the options include:

- Cutting export prices (lower profit margins) to maintain competitiveness and market share
- Out-sourcing components and raw materials from overseas
- Seeking productivity / efficiency gains to keep unit labour costs under control
- Investing resources in new product lines where both domestic and overseas demand is more price inelastic and less sensitive to exchange rate fluctuations. This involves producing products with a higher income elasticity of demand, where non-price factors are more important in securing orders.
- Moving production overseas

(D) One of the supply-side policy used in the hope of increasing competitiveness of British exports is the reforms of the labour market. Labour is a key factor of production.

Improvements in labour and capital productivity allow businesses to produce output at a lower average cost (i.e. exploit economies of scale) These cost savings might be passed onto foreign consumers in the form of lower prices, encouraging an expansion of demand, higher output and possibly an increase in employment.

Productivity growth and lower unit costs are key determinants of the international competitiveness of British firms in domestic and overseas markets. From improved productivity, businesses can develop (or protect) a competitive advantage in markets where there is intense price and non-price competition from overseas suppliers.

However it is clear that the capacity of the economy to produce goods and services depends on the stock of factor resources available (i.e. the active labour supply, the stock of capital inputs and natural resources) plus the productivity of those factors.

The Treasury recently published a study of the determinants of long-run growth for the UK. The trend growth for real GDP of 2.5% per year is based on an assumption of 2% year on year improvements in productivity. (The remainder of the growth comes from increasing levels of employment)

If the British economy can raise the rate of growth of productivity then the sustainable growth of national output can also pick up. This has implications for living standards, unemployment and tax revenues and government spending