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Economics and Business environment



Fourth edition

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Noordhoff Uitgevers Groningen/Houten

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Preface

The economic business environment has a considerable influence on company turnover and returns. An increase in the degree of competition, a period of economic decline or a strong increase in the exchange rate of the euro involve risks for European companies. These risks are discussed and analysed at length in the annual reports of many European companies.

What should students who will be taking up future managerial positions within European companies know about the business environment of these companies?

This book offers a twofold answer to this question.

In the first place, in their future careers, students will need to be able to independently follow and analyse economic developments. They will need to be able to do such things as interpret the economic and financial pages of newspapers, as well as relevant economic publications by banks, national governments, the European Union and global international organisations. To do this requires a basic knowledge of the terminology generally employed in these publications. For this reason this book avoids complicated economic jargon and mathematical analyses as much as possible. The theoretical perspectives contained in this book are concerned with the analysis of industries as well as macroeconomic and international economic developments. The theory is well illustrated by means of tables, figures and case studies that give an impression of recent developments within the European economy.

In the second place, students will need to have an insight into the way in which the business environment influences the company returns. Companies run risks that may be associated with developments within the industry (industry risks), or be the result of developments within the national or the global economy (such as business cycle risks, interest rate and exchange rate risks and country risk). In order to analyse these risks, the managers of companies will firstly need to determine the extent to which companies results are exposed to economic developments, and secondly they will need to be able to make a prognosis of future developments in the industry and in the national and global economy. The material in this book will provide the student with both these skills.

Educational material for a tertiary institution has to conform to a number of criteria. Firstly, it must allow independent processing of the subject matter. Secondly, the material must be practical and directly applicable to professional practice. Tertiary institutions often take thematic approaches to education, where the emphasis is not on the individual disciplines but on themes or practical problems. This book fits in with that approach, because

it takes the business environment as its basis and only to a lesser degree economic theories. Nevertheless, the emphasis is still on the economic elements of the business environment. This is in keeping with the philosophy of Adam Smith, the founder of economics, who saw a certain amount of specialisation increases productivity within society (which includes the field of education).

In the fourth edition, text, tables and figures have been updated.

We thank all those colleagues and students that have given their opinions on the study material, whether invited or not. Their remarks have been an incentive to improve on the educational material.

Zwolle, Hattem, Autumn 2014

A.J. Marijs

W. Hulleman

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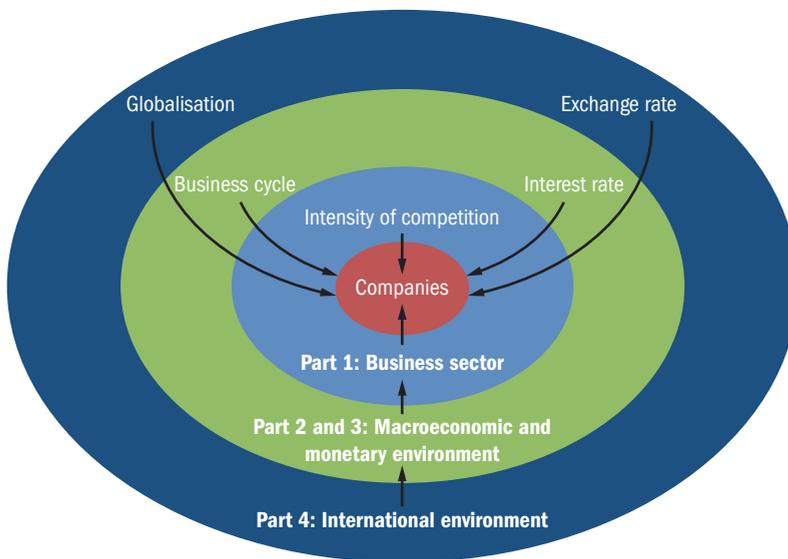
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Study guide

Central to this book is the issue of what influence the business environment has on company results. Chapter 1 discusses the concept of the business environment and the role that economics as a science can play in analysing the business environment.

The rest of the book is made up of four parts. Each of these deals with a particular aspect of the business environment (see figure).



Part 1: The company in the business sector

Part 1 deals with the immediate environment within which companies operate; that is, the particular industry. Chapter 2 deals with price formation within markets. Market price is a function of supply and demand. The factors that determine supply and demand will also be treated. Any change in supply or demand will have an effect on the degree of competition between businesses. However, even in industries with a high intensity of competition, there will always be businesses which will succeed in making good profits. They will have succeeded in doing so because of their competitiveness. Those factors which determine the competitiveness of companies within an industry will also be treated in Chapter 3.

Part 2: The macroenvironment of companies

Central to Part 2 is the macroenvironment. Chapter 4 deals with the supply side of the European economy. Some of the issues that will be dealt with include how production within the economy is organised, how production is gauged and over what sectors of the economy production is carried out.

Chapter 5 discusses the demand side of the economy. To what destinations do the products of an economy go? What relative amounts are purchased by private consumers, businesses, government authorities and foreign consumers? Developments within macroeconomic demand have a repercussion on the business cycle. Those factors that affect the business cycle are dealt with in Chapter 6. The business cycle has a considerable effect on the both government income and expenditure and on business results. As such, Chapter 6 also deals with the government and business policies in relation to business cycles.

Part 3: The monetary environment of companies

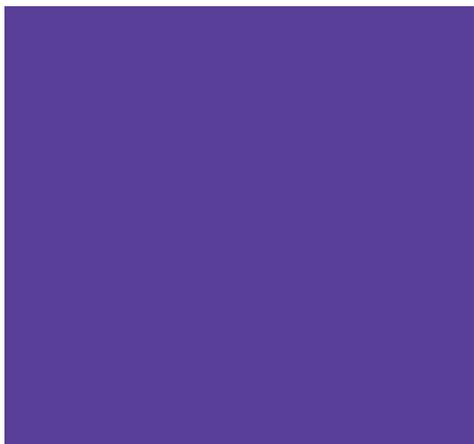
Part 3 deals with the monetary environment of companies. Chapter 7 deals with money supply and demand. Too rapid monetary growth can have the effect that private consumers and companies start spending too much, with inflation as the result. The monetary policy of the European Central Bank is directed towards preventing inflation. The means at its disposal are also dealt with in Chapter 7.

Interest is the price one has to pay in order to borrow money. Chapter 8 deals with the factors that determine the money market and long-term interest rate within the Euro zone. Interest rate fluctuations can have a considerable effect on company profits. As such, Chapter 8 also deals with interest rate risk.

Part 4: The international environment of companies

Liberalisation of international trade and capital flows and improvements in transportation and telecommunication technology are meaning that the distances and borders between countries are increasing less important than they used to be. Chapter 9 deals with the main trends in global economy as well as the background against which international trade has arisen and what effects it is having. This chapter also deals with how trade and capital flows are reflected within the balance of payments.

International trade and investment involve currency market transactions. The exchange rate is set by the currency market. Chapter 10 deals with the factors that determine the exchange rate. Exchange rate fluctuations have a considerable effect on business profits and turnover. As such Chapter 10 also deals with exchange rate risk. Companies that intend to internationalise their operations face the problem of finding a suitable sales market. Central to Chapter 11 are country selection procedures according to the so-called filter method. These procedures allow a suitable target market to be selected from a large number of potential sales markets. Chapter 11 also deals with one of the main risks of doing business outside Europe, namely, country risk. This is the risk that business partners of European companies will not be able to fulfil their international obligations in hard currency as a consequence of government measures.



1

Economics and the business environment

- 1.1 Economic activity and economics
- 1.2 Business environment
- 1.3 Absolute and relative data

What is economic activity and what academic discipline studies it? What is the relationship between the business environment and economics? Economic phenomena are regarded as belonging to the so-called business environment.

This chapter will address the following key question: what role does economics play in the business environment?

On the next page a situational sketch as a way of introducing these issues.

People always have needs of one kind or another, and they fulfil these needs with the available resources. This is termed economic activity. Economic activity is the subject of many branches of economic research, and is dealt with in Section 1.1.

Section 1.2 deals with the objectives of economics within the framework of the business environment. It delineates that business environment with these objectives in mind. The main issue is what external factors determine business results. Political developments in market areas, technical innovations, major shifts in customer demand and changes in work ethics all have a major effect on companies. The contribution that economics could make to analysing these aspects is illustrated in a diagram.

Section 1.3 treats the relationship between absolute and relative changes in variables. The importance of the absolute change in economic variables will always be manifestly evident (for example, the employment figures over a number of years). However, the relative changes to these variables are often just as significant (for instance, the percentage of employment growth during a specific year).

CASE

The economic conditions under which the management of an airline have to operate are crucially important. Knowing these conditions can be the key to success. The top management level may have to find answers to the following questions: if there is an economic slump, what is the effect on tourist spending likely to be? What will happen to the oil prices? Will the prices of American competitors' tickets drop dramatically if the exchange rate of the dollar drops? Can we still afford our pilots' wages, or will we have to buy bigger planes instead? Should we invest in new machines if the interest rate rises and lending becomes more expensive? The top management needs to make sure there is sufficient expertise in these fields to understand those symptoms and developments that have a direct bearing on the company's achievements. They will need to ask themselves whether there are ways and means of avoiding negative effects.

1.1 Economic activity and economics

Human beings need things like food, warmth, shelter, safety and self development. These needs can be partly fulfilled by the supply of goods and services. The ready availability of goods and services to fulfil needs is termed prosperity. Human needs are virtually unlimited, while production is limited by the availability of resources like land labour, and capital. The excess of human needs over what can be produced is termed scarcity.

Prosperity
Resources
Scarcity

Resources such as raw materials, machines and labour, which are used in the production of goods and services can be used for a variety of purposes. Labour can, for example, be used for the production of food, consumer electronics, education or safety (the judiciary and police). Raw materials and machines can also be put to a variety of uses. Since they can be put to a variety of purposes, they can be described as scarce or in short supply.

Economic activity

Economic activity occurs when people (consumers, managers) make choices to maximise their prosperity using scarce resources. Economic activity occurs everywhere in society: consumers obtain an income by going out to work; a company buys products, uses them to make other products and sells them; a bank employee buys shares on behalf of a customer; a town planner makes plans for a new city suburb for the city council; a sales employee of a company obtains a big international order.

Economic activity takes place within and between various organisations. In the examples mentioned, there is an interaction between consumers and companies, government institutions and companies and companies interacting with companies in other countries.

Science of economics

The science of economics is concerned with the study of economic activity. The field is so complex that it has had to be divided up into several subdisciplines. These can be roughly divided into two groups: those that study the internal process within companies (such as financial accounting, management accounting) and those that study the relationship with the environment or the environment itself (such as marketing and macroeconomics).

Company employees are rarely able to resolve the problems they encounter merely by having a knowledge of one of these fields alone. A problem often has both internal and external causes. This is illustrated in Example 1.1.

EXAMPLE 1.1

A sales employee has noticed that the sales of a product are increasing at a lesser rate than was anticipated. There may be a number of reasons for this. Perhaps competitors have brought a similar product but with a better price-quality ratio onto the market. Maybe the costs have become too high because of inefficient production methods (which may then constitute an economic, a business management or even a technical problem). Perhaps competitors have increased their advertising or improved their distributing organisation (aspects that are investigated in marketing). Perhaps the product is sensitive to cyclical trends and the economic growth in the sales area is suffering a setback. Sometimes customers abruptly change their spending pattern, which will affect sales. A product may have suddenly become too expensive for buyers in certain countries because of changes in the exchange rate. These are all aspects of the problems that fall under economics.

All these factors could play a role and may even exert a simultaneous influence on sales.

The sales employee would like to take measures to turn the tide.

To do that he will first have to find out what the causes of declining sales are.

TEST 1.1

What measures could the company in Example 1.1 take to reduce costs that are the result of a wage rise?

T 1.1

Economic activity in a country can be studied on various levels. One way of doing it is to study the options open to all the companies and households within a country. Another is to analyse the economic activities of a group of companies or households who make or buy a similar type of product. The relationship with other countries is also important for the economic processes within a country.

All these topics belong to the field of economics. A distinction needs to be made between the following:

- Industry analysis
- Macroeconomics
- Monetary economics
- International economic relations.

Economics

Industry analysis is the study of the characteristics of markets and business sectors that companies come into contact with, the supply and demand of goods and the changes that occur in supply and demand when prices change. These subjects are dealt with in chapters 2 and 3.

Industry analysis

Macroeconomics deals with economic activities at a national level, such as the total consumption, all company investments, company imports and exports and the government of that country. These subjects are dealt with in chapters 4, 5 and 6.

Macroeconomics

Monetary economics is concerned with the phenomenon of money and the role that banks play in the economy. The extent of lending and the interest rate are variables that monetary economics tries to explain. The tasks of monetary authorities are also part of the field. These subjects are dealt with in chapters 7 and 8.

Monetary economics

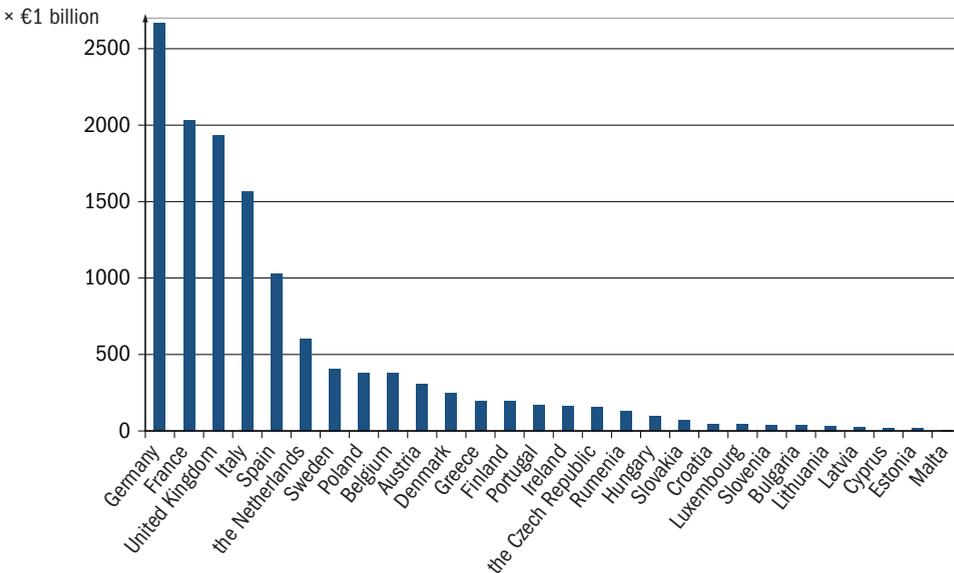
International economics

International economics is the study of the international trade between countries, international capital flows and monetary relations between countries. These subjects are dealt with in chapters 9, 10 and 11.

European Union

Much of the data in this book, concerns the 28 countries that form the European Union (EU) or the 18 countries that use the euro as mutual currency. These countries are usually identified as the euro zone. In figure 1.1 the EU countries are shown. The EU-15 consist of, in order of economic size: Germany, United Kingdom, France, Italy, Spain, the Netherlands, Belgium, Sweden, Austria, Denmark, Finland, Greece, Portugal, Ireland and Luxembourg. The countries of the euro zone comprise the EU-15 except the United Kingdom, Sweden and Denmark, but include Cyprus, Malta, Slovenia, Estonia and Slovakia. In 2004, the following countries joined the EU-15: Poland, Cyprus, the Czech Republic, Hungary, Slovakia, Slovenia, Lithuania, Latvia, Estonia and Malta. In 2007, Bulgaria and Rumania also found their way to the EU. Although the entry of these countries has had severe political consequences, their joint production only contributes 6% to the EU. In 2013 Croatia became also a member of the EU. In 2014 the total amount is 28 countries. In Figure 1.1, the EU countries are shown, based on their share of the total production in the EU in 2012. The total production of the EU amounted in 2012, to approximately 13,000 billion euros, whereas over 9,500 billion was produced in the euro zone. By comparison: the production of the US amounts to nearly €12,500 billion and in Japan €4,500 billion. The four largest countries in the EU are responsible for approximately 63% of the total EU production. (see Figure 1.1).

FIGURE 1.1 Gross domestic product in the EU, 2012



Source: Eurostat

1.2 Business environment

Having a general overview of the business environment is essential to understanding how economic variables affect companies. Section 1.2.1 deals with this issue. Section 1.2.2 gives an overall view of the connections between the economic environment and the business economic variables.

1.2.1 The business environment

The term 'business environment' covers all the changes in the environment of a business that can have an effect on the company results. These effects can relate to buying, selling, market developments, competition, staff management and the like.

The factors relating to the business environment that can have an effect on the results of a company are usually presented in a standard way, based on the extent to which the company can influence the environment. A distinction can be made between factors relating to the direct environment, indirect factors and macroenvironmental factors (*see* Figure 1.2).

TEST 1.2

List the factors that are likely to affect a large company in the food retail sector under direct, indirect and macroenvironmental factors.

T 1.2

The direct environment is made up of the buying or selling markets on which the company operates. Entrepreneurs are in ongoing contact with market players (suppliers, distributors and final customers), collecting information to effect as advantageous a quality-price ratio for their raw materials and products as they can. They continually collect information to improve the reliability of their delivery of the products. One of the ongoing tasks of the sales department is to try to obtain as much information about the sales market as it can in order to improve on the effectiveness of advertising campaigns. A lot of different departments are involved, all of which have to put a lot of energy into detecting any tendencies within the direct environment. It is the only way a company can exert a favourable influence on it.

Direct environment

**Ongoing contact
Market players**

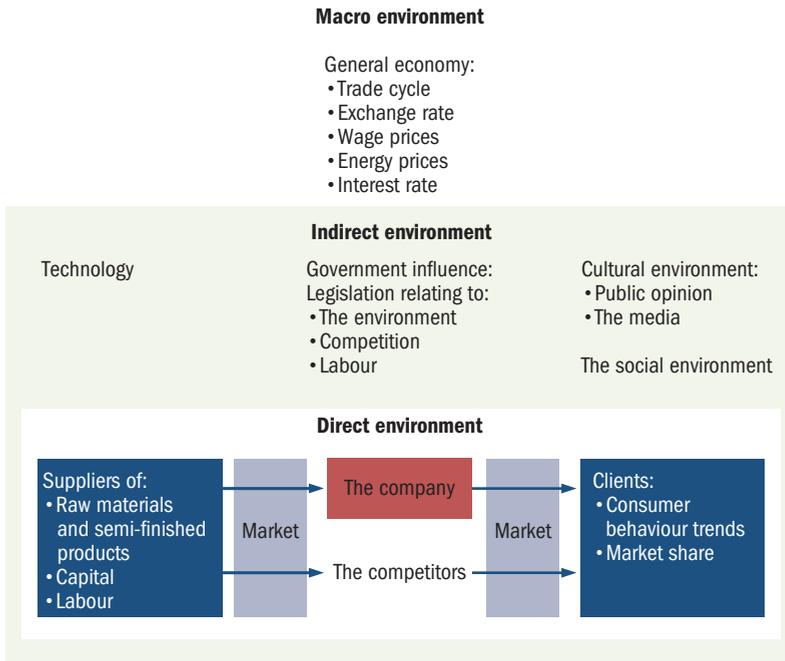
Every company has an incoming flow of goods and services: raw materials, labour and capital, each with their own buying market. Every company also has an outgoing flow: the products or services that are supplied to the various sales markets. Depending on the company, these markets will have different characteristics in terms of the nature of the competitors and the type of clients. This also means that the company itself has to constantly adapt its approach. If there are many companies operating within the same business sector and competition is stiff, there will be less margin for stipulating the price than in a situation where there is little competition. If the clients are consumers, a different promotional approach is required than if the clients are other companies. The indirect environment consists of employer and employee organisations, the government and cultural elements such as public opinion and the media. There is usually no need for company departments to keep a daily check on its indirect business environment. The company will be represented by one or more of the employer organisations, who in turn lobby with the government on behalf of the employer organisations. The company can exert little influence on the indirect environment, but the influence of the indirect environment on the company can be very great indeed.

The nature of competition

Indirect environment

Little influence

FIGURE 1.2 The business environment

**Public opinion**

Companies are increasingly having to take public opinion into account. This is a task for the public relations department or the public relations manager. The media can easily sway public opinion one way or another and as such, the task should be approached warily. Many companies have issued directions on how to handle situations where public opinion might play a role, such as environmental calamities or product safety. Public opinion may have an immense influence on a company, whereas the effect that a company can have on public opinion is usually very small.

Social environment

As one would expect, the social environment exerts a considerable influence on a company, as the following illustrates. Many companies have difficulty finding staff. For a long time a poor coordination between supply and demand on the labour market was held responsible for this. It was thought that the education and mentality of the working population was insufficiently geared to the requirements of employers. It has now been shown that the company's working conditions can play an important role in how successful a company is on the labour market. Improvement of working conditions and the company's image can help to improve the situation.

T 1.3**TEST 1.3**

When applying for a job, would you take note of the working conditions in a company? Would you also want to find out about the rate of turnover of the company's products?

Technology

Technology exerts a powerful influence on competition. Products are replaced at a rapid rate. A product lifecycle of a few months is no longer

unusual in industrial markets. Technological advancement is accelerating, as are the associated risks.

For those companies that provide their own technological advancements through research and development, this factor is one that belongs to the direct business environment. For those companies that rely on other firms for new technological developments, technological advancement is an indirect business environment factor.

The macroenvironment belongs to the wider company environment. This environment takes in economic trends, variations in exchange rates and the price of raw materials and demographic developments. While these factors can have a major bearing on a company, individual companies cannot exert any influence on them: they are virtually uncontrollable. Because of the disastrous effects they can have on company results, an economic slump or lowering of the exchange rate of an important export country are the entrepreneur's nightmare. There is however no way in which an entrepreneur can influence these variables.

Consequently, it is important that managers have an idea of the influence macroeconomic variables can exert on returns, costs and profits. They can then more easily assess the competitive position of their own company.

1.2.2 The influence of economic variables on a company's results

Those aspects of the business environment that fall within the field of economics exercise a considerable influence on the results of companies.

This is shown in Figure 1.3.

Many of the variables that are shown in Figure 1.3 are dealt with at length in this book. The illustration aims to show how varied the influence of economic variables is on businesses.

In Figure 1.3 the different parts of a profit and loss account have been related to economic variables. Some of these variables, such as the national and international economic situation, the wage and salary bill, government influence, the amount of capital investment and labour productivity are dealt with in the section dealing with the macroeconomy.

Exchange rates, exchange rate systems, interest theory, capital market, central bank monetary policy and the like usually fall under monetary economics or international economics. Managers operating in an increasingly internationally focussed environment should possess some knowledge of these matters.

Apart from macroeconomic, monetary and international variables there are variables in Figure 1.3 that belong to the fields of business economics or industry analysis. Amongst these are various market structures and circumstances, the competitive position of companies and technical developments. The relationship between suppliers and customers and especially the question of whether these relationships can be described as networks or clusters is a business economics issue. The competitive strength and the profitability of companies depend on this kind of variable.

Managers should not try to solve business economic problems in isolation from other changes in the business environment. However, if environmental variables are seen as unchangeable, this sometimes happens. Costs, sales and interest are sometimes viewed as being constant for long periods (for instance, when an internal returns account is drawn up). Such an approach

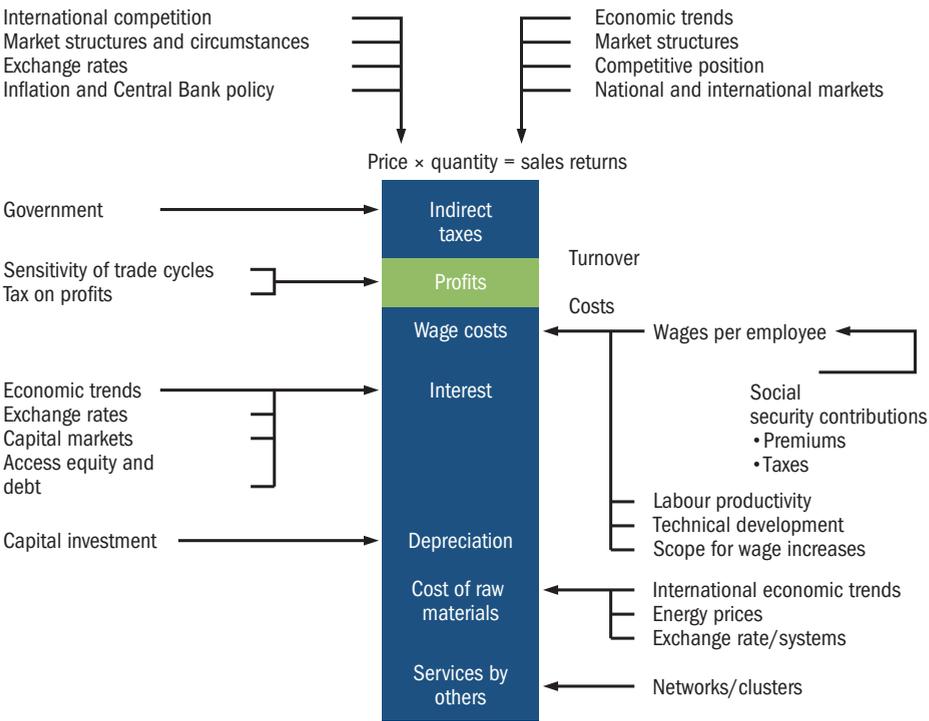
Macro-
environment

Profit and loss
account

Changes in the
business
environment

obviously simplifies the reality far too much. In reality, there may be major fluctuations in these variables. Managers would be far better off working with predictions relating to environment variables and taking their risk to the company seriously. A policy of reducing the effects of changes in economic trends, currency, prices of raw materials, wages and interest is essential for many companies. Companies are often able to determine their relationship to their suppliers and clients, the currency in which they lend their capital, where they are based, how they can make their range of products less susceptible to trade cycles, and so on.

FIGURE 1.3 The influence of general economic variables on business results



1.3 Absolute and relative data

The concepts of volume, price and value are interrelated. The turnover of a company over a certain period consists of the sales multiplied by the price. Turnover is a variable that denotes a value and sales is a variable that denotes either volume or quantity.

It is not only the absolute amounts of quantity (volume), price and value that are interrelated, the changes within each of the variables are also related in a certain way. This can be illustrated as follows.

We will assume that the data in Table 1.1 applies to a certain company.

TABLE 1.1 Quantity, price and value

	Quantity (in tons)	Price (in euros per ton)	Value (in euros)
Period 0	1,000	20	20,000
Period 1	1,050	22	23,100
Changes in % compared to period 0	5	10	15.5

Both the quantity and the price have increased in period 1 as compared with period 0. Multiplying price and quantity gives the value per period. The percentage change to each variable is calculated by dividing the increase by the amount in period 0 and multiplying that by 100. This produces a percentage of change between period 0 and period 1 of 15.5%. There is also another (but less accurate) way of determining the value increase, namely by adding the percentage change in quantity and price together.

It is a rule of thumb that the relative change in a variable that is a product of two other variables is approximately the same as the sum of the changes to the component variables. If a variable is the quotient of two other variables, the relative change is the difference between the relative change to the component variables. The reader can check this in Table 1.1, where price can, for example, be expressed as a quotient of value and quantity.

The change in value obtained in Table 1.1 by adding the percentages of the changes in quantity and price together is 15%, a discrepancy of 0.5% compared to the calculated change in value of 15.5%. The smaller the percentages of change in quantity and price, the smaller the degree of inaccuracy, also known as the discount factor. If the degree of inaccuracy is very small, it can be disregarded.

The increase in value of a variable is known as a nominal increase. The nominal increase in the example is 15%. The change in quantity is known as the real increase and is 5% in the example. The nominal increase is therefore equal to the real increase plus the price increase.

Nominal increase

Real increase

With economic variables, it is equally important to make a distinction between nominal and real changes. The total wages can be defined as the number of employees multiplied by the wages per employee. A change in the total wages can be broken up into a change in the number of employees and in the wages per employee. If an increase in the total wages is the result of a rise in wages, a quite different economic picture emerges than if the increase is due to an increase in employment.

We will assume that Table 1.2 gives an estimate of the total wages for a certain year.

TABLE 1.2 Volume and price changes to the total wages (example)

	2014 in 2014 prices	Volume increase	2015 in 2014 prices	Price increase	2015 in 2015 prices
	(1)	(2)	(3)	(4)	(5)
Total wages	200	2%	204	5%	214.5

The first column gives the value of the total wages in 2014. From column 2 it can be deduced that there is an increase in employment of 2%. The total wages would have been 204 if the wages per employee had remained constant. In that case the price increase would have been zero: the total wages in 2015 would have been the same as in 2014. This is why column 3 is headed '2015 in 2014 prices'. If the volume increase is added to the price increase (column 4) the result is the value of the total wages in 2015 (column 5). The wage per employee has risen by 5%.

In this case the rise in the total wages is approximately the same as the volume increase plus the price increase: $2\% + 5\% = 7\%$; 7% of 200 = 14. If the percentage increases in volume and prices are small they may be added up to determine the increase in value. Here, the discrepancy is 0.2, which is 0.1% of 200, a negligible difference.

The relationship between total wages, wages per employee and number of employees

The relationship between total wages, wages per employee and number of employees can be expressed in an equation:

$$W = W_{\text{emp}} \times N$$

in which:

- W = the total wages
- W_{emp} = the wage per employee
- N = the number of employees

The relationship between the changes can be expressed as follows:

$$g_W = g_{W_{\text{emp}}} + g_N$$

in which:

- g_W = the relative increase in the total wages
- $g_{W_{\text{emp}}}$ = the relative increase in the wage per employee
- g_N = the relative increase in number of employees

Glossary

Business environment	The company environment that exerts an influence on the results of a company. Three types of environment can be identified: 1 Direct environment 2 Indirect environment 3 Macroenvironment.
Economic activity	The quest for maximum prosperity using limited resources.
EMU	The Economic and Monetary Union, consisting of those countries that have the euro as their currency.
Macroeconomics	Sub-discipline of economics, mainly concerned with the study of the connection between economic factors such as national income, employment, consumption, investments, inflation and the like.
Scarcity	The excess of human needs over what can be produced given the limited availability of resources.
