CHAPTER 3

THE DYNAMICS OF BUSINESS ENVIRONMENT AND CORPORATE ADJUSTMENT

Chapter Outline :

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  - Changes in Consumer Attitudes, Tastes and Preferences
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  - External Economic Shocks
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- Corporate Response and Adjustment
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INTRODUCTION: THE INHERENT DYNAMISM OF BUSINESS ENVIRONMENT

Business environment of a country is never constant or static. It is always in a dynamic state and is affected by a number of factors as discussed in the following sections. The various factors that affect or constitute business environment keep interacting with one another. Except in the case of emergency or crisis, changes in business environment are not sudden but gradual. Many business organisations are able to predict or forecast the changes on the basis of their wisdom and experience with which they can analyse the existing configuration of variables affecting the environment. Such organisations are able to reposition themselves and exploit the opportunities unfolded by changing environment. Those who are not able to understand the present environment and anticipate future changes face the danger of being marginalised in competition.

Understanding a changing business environment and predicting it atleast in near future is not an easy task. The task requires a cadre of professional business economists and managers who have thorough knowledge of the behaviour of macroeconomic variables and can estimate the impact of their changes on business environment conditions. Not only that, an appropriate understanding of the interaction between the different layers of business environment (as discussed in Chapter 1) is also essential. There is a deep relationship between economic and non-economic environment, local, regional, national and international environment and past, present and future environment. The various facts, data and trends have to be carefully studied and analysed and researched to scan and assess business environment over a particular period of time. Unfortunately, most of the firms don't have adequate resources and the expertise in this regard and depend upon the reports of the rating agencies, consultants, newspapers and journals, economic research institutions or even on the intuitive understanding of a few top-level managers in their organisation.

FACTORS PRODUCING CHANGES IN BUSINESS ENVIRONMENT

The dynamics of business environment can be understood in terms of the following important factors that trigger changes in business environment. At a particular time, some or all of the factors could be at work but their impact on the environment would depend on the extent of change and intensity of impact.

CHANGES IN GOVERNMENT POLICIES

Government affects business environment in various roles as regulator, promoter, entrepreneur, planner and consumer. Changes in government policy in each of these roles have a profound impact on the macroeconomic as well as sectoral business environment. Changes in fiscal policy affect expenditure levels and the structure of taxation, which affects costs and prices. Monetary policy changes impact the cost (rate of interest) and availability of credit (liquidity), which influence the cost of capital of business firms. Monetary policy changes influence the financial environment in general which impacts economic growth. Public debt policy affects the supply of savings and the aggregate level of demand for the private sector. Often, government has a coordinated approach in designing monetary, fiscal and public debt policy in terms of a set of pre-determined objectives like spurting growth, controlling inflation, promoting employment or correcting regional disparities. Similarly changes in policy towards foreign investment and export-import policy affect competitiveness, foreign exchange position and balance of payments. These variables, in turn, affect the demand for and supply of foreign exchange, which, within the parameters of exchange rate policy, affect the rate of exchange. Changes in rate of exchange themselves affect imports, exports and prices.

Government policies are also designed to impact specific sectors. Government undertakes investment and disinvestment programmes in specific industrial segments affecting their growth and competitive conditions. For example, under the present policy of the Indian government towards public sector undertakings, it has been decided to reduce government equity to 26 per cent in all non-strategic undertakings and in a number of sectors including telecommunications, transport, metallurgy, petroleums automobiles, tourism and hotels, privatisation is in progress. Government also adopt policies for specific sectors like infrastructure, agriculture, small-scale industries, core-industries, exports, textiles and the like. Reserve Bank of India, in consultation with the government, decides qualitative credit controls under which it changes the flow of credit to specific industrial sectors according to national priorities or their specific financial problems and requirements. In agriculture, government policies affect agricultural costs and prices as well as infrastructure and the operation of agricultural markets. These, in turn, affect food prices and prices of agro-industrial inputs. The effectiveness of government policies depends greatly on the clarity and consistency of objectives, implementation design and sufficiency of funds.

VARIATIONS IN GROWTH PERFORMANCE

Performance of the various sectors determines the growth environment. A growth rate of about 7 per cent or more causes appreciable increase in national income and aggregate demand, assuming saving behaviour to be constant. Variations in growth rate from year to year bring about corresponding change in the business environment and business firms adjust to the changing scenario. Along with the overall growth rate, the sectoral contributions from different segments of agriculture, industry, infrastructure and services also change depending upon sectoral environment conditions. The different sectors of the economy are, however, not segmented or independent. Each sector has both forward and backward linkages **(Box 3.1)**. Changing economic conditions in one sector tend to affect conditions in related sectors. For example, a slump in the automobile industry will reduce demand for steel. The excess of demand over the supply of electricity will increase the demand for power generators and batteries. These interrelations are complex and widely networked. Where forward and backward linkages are weak or non-existent, different business situations can persist in different sectors. Inter-sectoral variations in performance are caused both by supply-side and demand-side factors.

BOX 3.1

What are Forward and Backward Linkages? How do these Linkages Guide Public Policy?

The concept of forward and backward linkages was originally introduced by noted development economist E.O. Hirschman. If a business project encourages investment in subsequent stages of production, it is said to have forward linkage. For example, steel industry has great forward linkage as its output is used as input in a large number of industries. Similarly, if a project encourages investment in earlier stages of production, it is said to have backward linkage. For example, a cotton textile mill encourages investment in dyestuffs and related chemicals. At the level of public policy, it is desirable that the government should provide incentives for the growth for those sectors and industries which have maximum forward and backward linkages (called '**total linkage effect**')

CORRECTIVE POLICY ACTIONS

Corrective actions are taken when actual performance deviates from intended or planned performance. Governments as well as individual business firms take corrective action when progress or performance does not proceed according to the objectives and the time and expenditure schedules. Government often makes fiscal correction to keep revenue and expenditure growth on budgeted lines. Central banking authorities undertake monetary correction under which they readjust money supply and credit growth rates according to the output performance and liquidity conditions in the market as well as in terms of the objectives of macroeconomic policy. Countries like India, which have a formal system of planning, undertake mid-plan reviews and appraisals and make necessary corrections. Corrective actions are relatively less smooth and sometimes are one-time decisions as compared to policy actions, though these can be taken on a number of occasions. Corrective actions are based on performance feedback and are an important part of the overall control system. An untimely, irrelevant or ill-found corrective action can frustrate policy objectives.

CHANGES IN MARKET STRUCTURE AND COMPETITION

In an economy, different product and industry groups face different market structures depending upon the state of competition. The market structure basically depends upon such factors as the number of buyers and sellers in the market, freedom of entry and exit, independence between firms, mobility of the factors of production and availability of market information to the various participants. At one end, the market for gold or for wheat at the time of harvest is highly competitive whereas the government has monopoly in rail transport. Markets for such products as detergents and readymade garments are monopolistically competitive. Oligopolistic conditions prevail in markets for automobiles, refrigerators, air conditioners and automatic washing machines. The determinants of market structure are constantly changing and so is the state of competition. For example, the number of firms in aerated (soft) drinks in India has considerably gone down after the entry of multinationals. Trade liberalisation and import competition are further impacting the market structures. Similarly, policy of the government towards foreign direct investment and multinational corporations, public sector disinvestments and privatisation are making the economy more competitive forcing the firms to become more efficient or pack up.

FUTURE EXPECTATIONS AND BUSINESS SPECULATION

Constantly changing variables of business environment generate future expectations and speculation. Both individuals and business firms, on the basis of past trends and current scenario anticipate future changes in a number of variables such as rate of interest, rate of inflation, exchange rate, taxes, government borrowings, advertisement expenditure, production in the various sectors and market demand and these changes guide their current economic behaviour which produces changes in the present business environment. When there are future expectations about inflation, economic units tend to prepone their purchases to save money. This tends bring inflation from future to the present. Similarly an expected increase in the rate of interest will weaken the current demand for fixed-interest bearing financial assets or investments. Firms that are able to foresee substantial increase in government borrowings can anticipate liquidity shortages and a rise in the rate of interest in future. This can spur them to borrow ahead of their requirements so that additional cost and scarcity of capital could be avoided. Current changes and future expectations lead to the establishment of markets for futures and forwards in respect of commodities and financial investments. Now, the markets for derivatives are emerging fast in a number of developing countries like India adding new dimensions to business environment.

BOX 3.2

What are derivatives? What is their basic function?

Derivatives is a generic term used for such instruments as futures, options and swaps. These are the instruments which are derived from direct dealings in currencies, securities and commodities and according have been given a variety of names. Trading in derivative securities rose at a significant pace in 1990s and the fund managers of various business organisations found them convenient and useful as hedging devices against price, exchange rate and interest rate changes. There has been widespread proliferation of derivative markets all over the world, particularly in developed countries and the nature of daily trading in these markets has grown at a tremendous pace in recent years. These markets operate both in formal (official or regulated) segments and informal or unorganised segments. There are no reliable statistical systems to measure the value of derivatives trading. In these markets, the instruments used are complex and not universally understood. The elements of speculation are large and there is great potential for under-capitalisation and unfair dealings.

CHANGES IN CONSUMER ATTITUDES, TASTES AND PREFERENCES

Consumer attitudes and tastes play a major role in product designing, delivery and accompanying services. In competitive markets, professionally managed firms are customer focused and closely monitor any changes that take place in consumer perception attitude towards their products. Such consumer related factors are subject to slow change over time. The main factors that bring about changes are education, geographical mobility, fashion trends and compulsions of seasonal factors. Consumer tastes also change as his age advances but among younger age groups even major changes over relatively shorter period of time may be expected. Among these groups, tastes and preferences quickly change over to jeans, entertainment parks, sunglasses, horse races, sleek mobiles and exercising equipments. A large number of persons quickly get initiated into smoking and drinking. Consumer perceptions, attitude and lifestyle are greatly influenced by advertising and result in changing tastes and preferences. The changes on the side of consumer induce changes in product content and presentation (including packaging and delivery) making the environment more competitive.

IMPORTS AND FOREIGN INVESTMENT CHANGES

Exposure to foreign products and foreign business firms can cause a sea change in the nature of business environment. Present age is the age of globalisation and interdependence between countries. Within the framework of the World Trade Organisation, most economies of the world are opening their borders for imports and paying special attention to export development. As explained earlier, imports not only add to competition but also create an environment in which domestic firms learn about new products and the technologies on which they are based. Differences in the prices of imported and domestically produced goods pose challenges to the domestic firms to become lean and efficient so that they can stay in competition. With the progress of import liberalisation, the environment gets more vibrant and dynamic. Similar effect is produced when multinational firms enter with their own range of products and brand names. Foreign firms only bring in investment, but also new management philosophies, cultures, work ethos and performance standards.

Multinational companies compete with domestic enterprises both in home and foreign markets and establish new benchmarks. Domestic enterprises which are fat and lazy, are either taken over or driven out of the market.

EXTERNAL ECONOMIC SHOCKS

Between economies with high degree of global linkages, international economic changes get transmitted easily. Conditions of recession in industrial market economies mean reduced markets to a large number of countries, which export to them. Globally inter-dependent economies freely transmit, like infectious diseases, such problems like inflation, stagnation, unemployment and slump. The greater the degree of international economic linkage of a country, the greater is its vulnerability to external economic shocks. The cases like collapse of a number of East-Asian economies in the late nineties and the September 11, 2001 terrorist attacks on the US caused economic disruption in a number of countries. Similarly, international wars, civil strife, international economic sanctions affect international trade, tourism, foreign investment and international remittances of the countries which have good international economic relations. The countries whose trade and investment are concentrated in a few narrow geographic locations are more likely to be adversely and severely affected.

NON-ECONOMIC FACTORS

There is a wide variety of non-economic factors, which can destabilise the business environment. Business firms can do very little with these factors. The best they can do is to adjust to such changes. Social and cultural environment of business by itself is slow changing but social tensions, communal violence and religious fanaticism can trigger disturbances in internal law and order situation and can disrupt smooth flow of business. Similarly, political changes, existing or anticipated, have the potential to disturb the business environment. Major industrial accidents and natural calamities like earthquakes and floods, outbreak of epidemics or a spurt in crime rate over a wide region can have a destabilising effect on the business environment, which can be felt over a considerable period of time. An earthquake in an urban location, for example, can halt infrastructure projects and can make a number of insurance companies go bankrupt. Recent earthquake and communal violence in Gujarat have caused tremendous damage to the economy of the state. Such factors are least predictable and prudent business firms seek insurance against the most likely factors in this group.

CORPORATE RESPONSE AND ADJUSTMENT

The above factors are capable of bringing changes in the macroeconomic as well as sectoral environment for business firms, depending upon the magnitude, direction and duration of impact. These factors impact the different macroeconomic variables ands the interrelationship between them making the business environment volatile, less comprehensible and unpredictable. A large number of firms, unable to understand the current state and dynamics of business environment, consider it as black box and attempt to wriggle out of a particular set of circumstances through strategic or tactical postures. Rational and professional firms always seek to build projections, at least in the short run, basing their predictions on past experience and current trends. Determining the right quantum and direction of adjustment is not an easy task. Over-reaction and under-reaction both can be expensive and painful and deviate the firms from their planned goals. Before deciding a particular response action, it is necessary to find out which causative factors will affect which component of business environment. **Table 3.1** gives an illustrative list of areas of corporate adjustment corresponding to specific changes in business environment.

Table 3.1: An illustrate List of Areas of Corporate Adjustment Corresponding to Specific Changes in Business Environment

Areas of environmental change	Areas of corporate response
Technological environment	R&D, foreign technical collaborations, choice of technology, labour-capital ratio.
Labour environment	Employee motivation, productivity, employees' turnover rate, working conditions, labour relations, compensation, capital-labour ratio, nature of employment, job description and specification.
Competitive environment	Pricing, merger, acquisition or amalgamation, sub-contracting, horizontal, vertical, backward or forward integration, marketing strategy, new product development, cost cutting, measures for realisation of economies of scale and scope.
Monetary environment	Working capital financing, liquidity restructuring.
Fiscal environment	Dividend policy, sub-contracting, transfer pricing, product mix, industrial location, sourcing.
Trading environment	Foreign collaboration, input mix, export orientation, import intensity, product mix.
Financial environment	Project development, overhead financing, financing mix, capital structure, rate of return, external financing, risk management.
Legal environment	Procedures and documentation, credibility, conformity and ethical practices, intellectual property protection.
Social environment	Social responsibility, local and regional relationships, welfare expenditure.

Firms that are able to make appropriate adjustment to business environment changes reduce risk and uncertainty and gain competitive edge over the rivals. Failure to make timely adjustment may seriously erode profitability, competitiveness and market share or may even trigger industrial sickness putting the clock of corporate development several years in the back. Therefore, it is necessary to monitor the environment closely and visualise the future at least in the short run.

Environment monitoring and forecasting require appropriate database, market intelligence and analytical skills for corporate managers. Environment-savvy firms are often able to perceive the foreshadows of environment changes and listen to early warning signals. Such firms have sufficient leeway and lead-time to readjust and re-orient their operations well in advance and are able to exploit the new opportunities and meet the challenges that a change in business environment may toss up. The foreshadows or early warning signals are contained in the movements of the business environment indicates discussed in **Chapter 2.** The corporate policies must have sufficient flexibility to enable the firm to adjust to the changing environment. Business environment changes are sometimes like stormy currents. Firms that bend and give way survive those that stand erect and are razed to the ground.

Unfortunately, a large number of firms are either unwilling or unable to make adjustments to business environment changes. There are a number of reasons. First, the momentum and flow of business along a pre-set business plan and within a particular strategic perspective does not permit interruption by way of adjustment. Secondly, the current state of business environment and the anticipated changes are subject to varying and even conflicting interpretations and no conclusive response action is possible to arrive at. Thirdly, a possible wrong adjustment can be fatal and generally no individual or group of individuals in the top management is willing to volunteer for a risky initiative. The adjustment could mean alteration in the debt-equity ratio, readjustment of inventory size, and introduction of a new or redesigned product, staff rationalisation or changes in compensation structure. There are financial, physical or even psychological costs associated with adjustment. Finally, many business environment changes are considered to be minor or temporary and reversible so that no response is required.

Nevertheless, firms prefer to restrategise or restructure when changes in business environment are clear, dominant and durable. They may have to readjust their goals, business plans and policies and implementation designs. One of the basic decisions is whether to diversify or stick to core competency in the new business environment. They may have to plan changes in their liquidity, use of assets, capital and investment-return ratios. A change in their planned return may be required as business environment changes cause variations in the competitive environment and vary the relative strengths of market entry and exit barriers. When the environment changes take place at the sectoral level, the changes in relative market growth rate and market shares may affect the profitability and cash generation potential of products. These factors require to be scanned carefully so that the adjustment and response of the firms is appropriate.

ROLE OF THE BUSINESS ECONOMIST

Large and professionally managed companies maintain a distinct cadre of business economists who provide valuable support to the top management. The primary job of a business economist is to provide the economic logic and perspective for managerial decision-making. The ability of a business economist lies in integrating economic theory with practical business situations so that economically sound and logical solutions could be provided to the issues related to business planning, strategy and policy. Monitoring and scanning the different components and layers of business environment requires careful analysis and interpretations and a business economist performs this task and advises the top management on the kind of adjustment and market response to be made. Large and diversified organisations maintain separate economic research divisions to provide inputs for managerial decision-making. At the micro level, business economists study the industry level trends and advise the managements about the specific actions to be taken. These professionals also perform the predictive function. On the basis of past and current trends, they are involved in exercises of making short, medium and long run projections to guide future planning and strategy of business. These professionals generally have good level of skills in the applications of managerial economics, business econometrics and forecasting. The firms, which are unable or unwilling to employ such cadres, have to depend upon outside economic consultancy and research services or on the economic wisdom of their own top managers.

Key Terms

Backward linkage	Forward linkage	Options
Balance of payments	Forwards	Privatisation
Cost of capital	Futures	Public debt
Derivatives	Hedging	Qualitative credit controls
Disinvestment	Inflation	Recession
Economics of scale	Job description	Swaps
Economics of scope	Job specification	Total linkage effect
Employee turnover	Liquidity	Trade liberalisation
Fiscal policy	Monetary policy	Transfer pricing
Foreign direct investment	Multinational corporations	

Supplementary Readings

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Long Questions

1. What do you understand by dynamism of business environment? What are the corporate challenges posed by the dynamism?
2. What are the factors or variables reflecting the dynamism of business environment? What should be design of corporate response to the business environment changes?
3. Can business environment be predicted? How do future expectations and business speculation affect environment projections for the future?
4. What are the major factors that bring about changes in consumer attitudes, tastes and preferences? How do these changes affect production decisions of business firms?
5. How do changes in government policies trigger changes in business environment? Can policy changes be anticipated?

6. How does globalisation affect business environment of a country? Does globalisation stabilise business environment? What are the critical factors in this regard?
7. How can a business firm monitor business environment? What are the critical requirements for this work? What is the importance of a business economist in this regard?

Short Questions

1. What accounts for inherent dynamism of business environment?
2. What is the role of the government in dynamising business environment?
3. Why should a business manager be concerned with the dynamism of business environment?
4. How do GDP variations affect business environment?
5. How are market structure and competition related?
6. Account for the changes in consumer tastes and preferences.
7. What are the variables that reflect dynamism of business environment?
8. How does foreign investment affect competition?
9. What is business environment forecasting? What are its limitations?
10. What is the role of a business economist in a corporate organisation?

Practical Assignments

1. Scan a leading business daily over a period of last three months and list major changes in government policies that you think have impacted or will impact current business environment in a significant manner. Discuss these findings in the class.
2. From the newspapers and business magazines of the last few months search a case in which the business of an organisation ran into rough weather because it could not anticipate and adjust to changes in business environment. Discuss it as a case study in a class.
3. Hold a group discussion on 'the recent dynamic changes in business environment for companies in the telecommunication sector'.
4. Organise a brainstorming session on 'the impact of entry of private and foreign companies in insurance on 'Life Insurance Corporation of India'.
5. Hold a panel discussion on 'the impact of falling interest rates on banking business in India'.