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# Economic Environment

# TABLE OF CONTENTS

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1. Learning outcomes
2. Meaning and nature
3. Significance of Economic Environment
4. Elements of Economic Environment
5. Relationship between business and Economy
6. Economic Crisis effect on Business
7. Importance of small businesses for the economy
8. The Indian economy environment and world
9. Case study: EURO zone crisis
10. Summary

# Learning Outcomes

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After studying the present chapter, you will be able

* + To explain the concept and nature of economic environment
	+ To explain the significance of economic environment
	+ To identify the elements of economic environment and their impact on business

# Meaning and Nature

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Economic environment is a main component of external business environment. It can be explained as an aggregate of various economic factors such as inflation, interest rate, GDP, monetary and fiscal policies, etc. The economic environment factors affect the manufacturing and trade decisions of a business firm. The understanding of economic environment helps business managers to predict how trends and events in economy might affect the performance of their business. In the present chapter, we will discuss the factors which constitute economic environment and their impact on business.

# Significance of Economic Environment

The main objective of every business firm, profit maximization is supplemented by other objectives such as sales maximization, market leadership, cost reduction, etc. To achieve all these objectives, a business manager has to deal with economic environment at different levels of operations. Therefore, it becomes very important for managers to study the each and every element of economic environment and their impact on business very carefully.

The main reasons for exploring economic environment are as follows:

* + To provide inputs for planning and decision making.
	+ To understand prevailing market conditions in the economy.
	+ To keep business dynamic and innovative.
	+ To understand government policies and their impact on business.
	+ To understand international events and their impact on business.
	+ To identify opportunities and threats exists in economic environment.

# Elements of Economic Environment

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As stated earlier, economic environment connotes external economic factors or forces that are beyond the control of a business and affect the functioning of a business. These factors mainly include:



## Figure 1 . ELEMENTS OF BUSINESS ENVIRONMENT

* + Economic policies
	+ Economic System
	+ Economic conditions
	+ International economic environment
	1. **Economic Policies**

All the business operation and activities are directly influenced by the economic policies of the government. These policies are changed from time to time in view of changing requirements of present economic scenario and political expediency.

Broadly economic policies include industrial policies, trade policies, monetary policies and fiscal policies.

## Industrial policy

The ‘Industrial policy’ covers the rules, regulations, plans and procedures which direct and control the establishment, development, growth and management of industrial sector in the country. It also states the government’s policies towards labour, foreign investment, export-import and other related aspects of an industry. Generally, industrial policy defines the role of government in business which determines the pattern of industrialization in the country.

The industrial policies are announced by the government with the following objectives:

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* + - * To balance the growth and development of various sectors of the economy.
			* To bring desirable change in particular sector.
			* To divert the scarce resources towards the most desirable activities in accordance of national priorities.
			* To regulate the expansion of private sector in accordance with overall economic objectives.
			* To make the balance among public, private and joint sector of economy.

## Monetary policy

The monetary policy is announced by the central bank of a country to control the money supply and bank credit in the economy. In India, monetary policy is announced periodically by the RBI and implemented through the large network of commercial banks. The monetary policy has profound impact on business firms. Change in money supply affects the general price level in the economy that leads to change in aggregate demand. It also affects rate of interest that influence the investment and capital structure decisions of the firms.

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The monetary policy changes influence the business in both negative and positive manner. A liberal monetary policy facilitates expansion of business because the funds are available at cheaper rates.

Therefore, business managers take these changes carefully and adjust their plans accordingly.

## Current monetary policy of RBI

In February 2015, RBI has announced the sixth bi-monthly monetary policy. Monetary and Liquidity Measures

On the basis of an assessment of the current and evolving macroeconomic situation, it has been decided to:

* + - * keep the policy repo rate under the liquidity adjustment facility (LAF) unchanged at 7.75 per cent;
			* keep the cash reserve ratio (CRR) of scheduled banks at 4.0 per cent of net demand and time liabilities (NDTL);
			* reduce the statutory liquidity ratio (SLR) of scheduled commercial banks by 50 basis points from 22.0 per cent to 21.5 per cent;
			* replace the export credit refinance (ECR) facility with the provision of system level liquidity with effect from February 7, 2015;
			* continue to provide liquidity under overnight repos of 0.25 per cent of bank-wise NDTL at the LAF repo rate and liquidity under 7-day and 14-day term repos of up to 0.75 per cent of NDTL of the banking system through auctions; and
			* Continue with daily variable rate term repo and reverse repo auctions to smooth liquidity.

Consequently, the reverse repo rate under the LAF will remain unchanged at 6.75 per cent, and the marginal standing facility (MSF) rate and the Bank Rate at 8.75 per cent.

## 4.1.3 Fiscal Policy

Fiscal policies are announced by the government under the annual budget of the country which states the planned expenditure and estimates of income for current period. Fiscal policy includes investment in particular sector, taxation policies, subsidies, etc. Fiscal policy may provide opportunities or posed threats for businesses. If government levies taxes and increase duties for a particular sector than it increase the cost of production and negatively affect the demand of their product in the market.

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In the budget 2015, government has reduced the corporate tax to 25% for next four years. It is an opportunity for corporate sector that will increase the profits available for distribution to shareholders.

* 1. **Economic System**

The scope of private and public sector and extent of government intervention in business depends on the nature of economic system, which is a crucial element of economic environment. Mainly, there are three types of economic systems:

* + - Capitalism
		- Socialism
		- Mixed Economy

Figure 2 Classification of Economic System

**Capitalism**: Under the capitalism, all the factor of productions are controlled and used by the private hands for profit motive. It is characterized by economic liberty, i.e. freedom to choose any economic activity and employment. Capitalism system involves minimum government intervention in economic decisions. All the economic decisions i.e. what to produce, how to produce and for whom to produce are taken by the market forces of the economy.

**Socialism**: socialism means economic system where all the economic factors are owned and controlled by the state. These factors are used for the benefits of society. Under socialism system, government plays very active role in every economic activities. Government makes all efforts to provide equal opportunities to all by ensuring the optimum distribution of scarce resources.

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**Mixed Economy**: Mixed economic system is a combination of capitalist and socialist system of economy. The main feature of mixed economy is the co existence of both public and private sector. In this system, government role is limited only to regulate and control private sector. Government frames economic policies and tries to minimise inequality in distribution of resources.

At present, many countries of the world such as India have mixed economic system of economy.

## Figure 3 Comparison of different Economic Systems

|  |  |  |  |
| --- | --- | --- | --- |
| **Idea** | **Capitalism** | **Socialism** | **Mixed Economy** |
| **Resources** | Own by privatesector | Own byGovernment | Own by both |
| **Market** | Free andcompetitive | Regulated | Partially regulated |
| **Motive** | Profit maximization | Social Welfare | Both profit andwelfare |
| **Government** | No intervention | Total intervention | Partial intervention |
| **Labour market** | Competitive wages | Regulated wages | Regulated wages |

* 1. **Economic conditions**

There are different economic factors which determine the nature and structure of an economy. These factors also have significant impact on functioning and decision making of a firm. These factors act as an opportunity or threat for a business. Some of these factors are as follows:

* + 1. Gross Domestic Product (GDP)

GDP is a very important indicator of health of an economy. GDP can be explained as gross value of goods and service produced in a economy during a particular accounting year. GDP can be estimated by multiplying the quantity of goods and services produced with the market price.

## Impact

The GDP growth rate has significant impact on business. The level of GDP in the economy determines the size of aggregate demand and employment level in the economy. The high growth of GDP indicates green signal for investment in the economy. If the GDP growth rate is high then it is an opportunity for a business to produce more and more to satisfy increasing demand in the economy.

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## Per capita Income

Per capita income means the average annual income per person. It can be calculated by dividing the national income by total population of the country. On the basis of per capita income, we can divide the economies in three different categories:

* + - * Low income economies or underdeveloped countries
			* Middle income economies or developing countries
			* High income economies or developed countries.

## Impact

The purchasing power and consumption pattern of people in a country depends on their per capita income. If the per capita income of the people will be high then there will be huge demand for goods and services in the economy.

## Inflation

Inflation refers to the increment in general price level or fall in the purchasing power. Higher inflation rate adversely affects the aggregate demand in the economy.

## Impact

High inflation rate increases the cost of production and makes the business uncompetitive. High inflation rate also reduces the purchasing power of people in the economy.

## Prevailing interest rates

Prevailing interest in the economy influences both corporate borrowings and household borrowings. The capital structure decision of a business firm completely depends on the market interest rates. The expansion plans and decision of firm also depends on availability of funds at lower interest rates.

## Impact

The high interest rates in the economy increase the cost of using funds. It also affects the capital structure of the company. If the interest will be high, then firm will raise the funds through equity.

## Exchange Rate

If a business is involved in international trade (i.e. export and import of raw material or finished goods) then it is also influenced by the exchange rate of currency. The exchange rate can be defined as a price of one currency in terms of another currency. The high exchange rates will make the domestic goods cheaper in foreign country and encourage the export. The exchange rates fluctuations also influence the price of raw material and machinery which are imported from foreign countries.

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## International Economic Environment

With the increase in foreign trade, foreign investment and increase in scope of international organisation such as WTO, IMF, SAARC, ASEAN in the international economic environment has increased. If any organisation is involved in international business then it is not governed only by local economic environment but also by the international economic environment. There are different international organisations which issue various rules, regulations and guidelines for international trade. The firms engages in international trade has to follow the rules and regulations set up by these international organisations. Nowadays, various countries enter in trade agreements to facilitate foreign trade in the economy. These trade agreements are also affect trade between member countries of agreement.

# 5. Relationship between business and economic environment

Business is an economic activity which is performed with the objective of maximising profits. These activities involve transformation of inputs into outputs with the help of economic factors- land, labour and capital. It takes inputs such as capital, labour, material etc from the economy, converts these inputs in finished goods and returns these goods to the economy in the form of goods and services, profits etc.



**Figure 4 Relationship between economy and business**

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**6. Economic crisis effect on business**

A bad economy affects both large and small businesses. Since it takes longer time for an economy to recover, businesses that were affected at the start of the downturn will likely face the negative effects of the bad economy for a longer period of time. The slow recovery time is also a problem especially for the companies that have already affected by bad economic situation. As economic recession occurs, many businesses will have to make sacrifices and alter their business operations to survive.

As the revenues and profits of businesses fall, some of these companies will lay off many of their employees or freeze their hiring process entirely. Because of the financial crisis, many businesses will cut cost by limiting research and development, ceasing purchase of new equipment, and terminating new expansion plans. They will also reduce their marketing and advertising expenditure. All the cost-cutting measures can definitely affect businesses both at large-scale and small-scale.

 **Importance of small business sector for the economy**

While small businesses may not generate as much money as large corporations, they are a critical component of and major contributor to the strength of local economies. Small businesses generate new employment opportunities and serve as the base for large manufacturing sector of economies. Sometimes, the small business sector works as a complementary unit for large scale industries.

1. **Role in Economic Growth**

Small businesses contribute to local economies by bringing growth and innovation. Small businesses also help stimulate economic growth by providing employment opportunities to people who may not be employable by larger corporations. Small businesses also attract the new entrepreneurs and talent who invent new products. Larger businesses also get benefitted by small businesses, as many large corporations depend on small businesses for the completion of various business functions through outsourcing.

* 1. **b. Adaptability to Changing Climates**

Many small businesses also possess the ability to respond and adapt quickly to economic environment changes. This is due to that the small businesses are very customer-oriented. Many local customers will remain loyal to their favourite small businesses during economic crisis. This loyalty means that small businesses can survive easily during tough times, which further strengthen local economies. Small businesses also hold lesser market share than larger corporations which mean they have less to lose during economic crisis.

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 **The Indian Economic Environment and world**

When we discuss about Indian economic environment we see a sub-continent endowed with a huge natural resources, 7th largest country in geographical area, 2nd largest in population and 2nd fastest growing economy in the world, ranks 10th in GDP in nominal terms and 3rd in PPP. However at the same point of time Indian economic environment face huge problem of extreme poverty (more than 300 million people below poverty line), high unemployment, high public debt, corruption, black money locked in foreign banks etc.

As we know economic environment of any country is largely influenced by their economic system and central policies, same is true with India. In today’s world there is no pure form of capitalism and Socialism. All economies are mixed economies and so with India. Central economic planning in India is viewed as an instrument of social transformation and rapid economic development. Planning in India induces coordinated efforts for a steady and balanced growth in all sectors and all regions.

## Impact of Indian Economy on World

In recent time period no one can neglect the role of Indian economy in global front.

Firstly, Focusing of Indian government on areas like strategic dialogue and reinforcing joint efforts to create a business climate conducive to increasing private sector participation in India's infrastructure needs. With increasing FDI many MNC’s are playing a leading role in bringing cutting-edge technologies, equipment, capital, services and know-how to India.

Secondly, India is sharing best practices and skills in manufacturing, training and education. It is also sharing its talent with global world. India is already a centre of entrepreneurship with budding innovators. But we can expand practical programmes like vocational training, community colleges and healthcare industry skills. Some 1, 00,000 Indian students are pursuing higher education degrees at American universities. Thirdly, creating a business climate that is open to global business and investment is key to unleashing India's

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economic potential. Attracting investment, technology and know-how is essential to growth and requires all of us to have world-class, transparent and clear regulations that encourage innovation by ensuring protection of intellectual property rights.

Case Study : EURO Zone Crisis

Greece followed market economy after World War II. A crisis knocked at the doors of Greek economy in 2009. The government of Greece had followed expansionary fiscal policies, which led the economy into fiscal deficits. Moreover, shortage of financial liquidity to the banking system becomes a major reason. Public debt in the country become out of control as a result of rising public expenditure. In 2010, the Greek government revised its deficit at 13.6% of GDP. Total public debt was estimated to be at 120% of GDP in 2010, while as per OECD, it was over 140%. The trend of government debt rose up to 140% in the country in the comparison to the other economies.

This compelled the Greek government to follow economic reforms. The government initially targeted bailout plans. However, this program was not successfully implemented. In November 2011, Greece passed the conditional reforms measures for Labour Market and Midterm fiscal plan 2015-16. European Union also provided the rescue package to Greece. The government also started to adopt policies to keep public expenditure under control. It improved its monitoring and budget control system. Tax evasion was also kept under the scanner of the government. The country also started fiscal adjustment programmes. Thus, a free market economy resorted to government interventions under the circumstances of a crisis. Therefore, today’s economy has multiple characteristics, which business executives and professionals ought to understand through the lens of economic systems.

 **Summary**

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* Economic environment is a combination of various economic factors such as economic policies, economic conditions, economic system, etc.
* Economic environment helps in understand different economic variables like current market scenario, government policies, international events and their impact on business.
* There are four main elements: economic policies, economic system, economic conditions and international economic environment which shape the economic environment of a country.
* Small scale businesses also play important role in economy by generating employment opportunities and providing outsources services to large organisations.