Ninth Edition

THE BUSINESS ENVIRONMENT

A Global Perspective

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The Business Environment

Its replacement by the WTO can be said to mark an attempt to put the question of liberalising world trade higher up on the international political agenda.

web link The WTO can be accessed at *www.wto.org*

With a membership of more than 150 states (plus other observers), the WTO is a permanent international organisation charged with the task of liberalising world trade within an agreed legal and institutional framework. In addition it administers and implements a number of multilateral agreements in fields such as agriculture, textiles and services and is responsible for dealing with disputes arising from the Uruguay Round Final Act. It also provides a forum for the debate, negotiation and adjudication of trade problems and in the latter context is said to have a much stronger and quicker trade compliance and enforcement mechanism than existed under the GATT. See also Chapter 17.

The World Bank

Established in 1945, the World Bank (more formally known as the International Bank for Reconstruction and Development, or IBRD) is a specialised agency of the United Nations, set up to encourage economic growth in developing countries through the provision of loans and technical assistance. The IBRD currently has over 180 members.

web link The IBRD can be accessed at *www.worldbank.org*

Synopsis

Business and economics are inextricably linked. Economics is concerned with the problem of allocating scarce productive resources to alternative uses – a fundamental aspect of business activity. In market-based economies, this problem of resource allocation is largely solved through the operation of free markets, in which price is a vital ingredient. The existence of such markets tends to be associated primarily, though not exclusively, with democratic political regimes.

In all democratic states, the government is a key component of the market economy and exercises considerable influence over the level and pattern of business activity – a point illustrated by the use of elementary circular flow analysis. A government's aims for the economy help to shape the policies it uses and these policies have both direct and indirect consequences for business organisations of all kinds.

In examining the economic context in which firms exist, due attention needs to be paid to the influence of a wide range of institutions and organisations, some of which operate at the international level. Equally, as markets become more open and business becomes more global, the fortunes of firms in trading economies become increasingly connected and hence subject to fluctuations that go beyond the boundaries of any individual state.

Summary of key points

- Business activity exists in and is affected by the broader macroeconomic environment; it also helps to shape that environment.
- Economics is concerned with how societies allocate scarce economic resources to alternative uses and the 'real costs' of the choices that are made.
- Broadly speaking, two main approaches to the problem of resource allocation exist: state planning and the market.
- Most economies in the world are market-based economies which operate through a price mechanism. Within such economies the state also plays a key role in some allocative decisions.
- In market economies, economic activity essentially involves 'real flows' and corresponding flows of income and expenditure between producers and consumers.
- Combining these flows into a simple model of the macroeconomy illustrates that income basically flows round the economy in a circular motion.
- Levels of income in the economy are related to levels of output, expenditure and employment.
- Changes in the level of economic activity can be explained by examining changes in one or more of the key economic variables such as consumer spending, saving, government decisions on state spending/taxation and external trade.
- Within the macroeconomy, governments often play a key role in influencing both the levels and patterns of demand in pursuit of their macroeconomic objectives.
- Key government objectives usually include controlling inflation, promoting economic growth, reducing unemployment and creating a stable macroeconomic environment.
- To pursue these objectives governments use a range of policies, most notably fiscal and monetary policies.
- Government policy decisions take place within a broader economic and financial framework, which includes the influence of financial institutions and markets and the requirements that accrue from membership of different supranational and international organisations.

case study Austerity

As the UK economy contracted in 2008 and took a long time to recover, people lost jobs and bought fewer goods, so corporate, income and sales tax (VAT) revenue fell. The government was getting less money in as demands on social support systems, such as unemployment benefits, increased. As a result the UK was getting further in debt.

Between 2010 and 2020 Coalition and Conservative governments implemented policies designed to cut government spending across most areas. Central government administration (Whitehall) and local governments were asked to find some of the highest proportions of the cuts. Some of the most visible cuts were to social welfare or 'benefit' systems and local services such as youth centres, libraries and smaller hospitals. In this time the amount of extra money that the government is borrowing each year has reduced from around £150 billion to around £60 billion, but the total is still going up. Since 2010 the UK debt has risen from around 71 per cent of UK GDP to more than 100 per cent. One of the reasons for this is slower than expected growth over a longer period, as well as the sudden impact of the pandemic and increased spending to support the population.

Case study questions

1. What is the fiscal effect of austerity policies?
2. Why did the government choose to spend more during the pandemic?
3. Now that the pandemic is coming to an end, what might the government do in terms of spending?

case study Quantitative easing (QE)

As indicated by the analysis presented in this chapter, governments have a variety of options available when tackling a problem such as recession in the economy. Where monetary policy is concerned, a traditional approach has been to lower interest rates in the hope of boosting demand by making money cheap to borrow. This option has become increasingly difficult in recent years as interest rates in many countries have fallen to historically low levels in the wake of the global financial crisis that occurred after 2008.

An alternative approach that has become widely used in recent years (e.g. in Japan, the UK, the United States) is the policy known as **quantitative easing (QE)** or credit easing. In simple terms this involves a country's central bank 'creating' money electronically by crediting the accounts of financial institutions (e.g. banks, pension funds, insurance companies) in return for the purchase of assets, particularly government bonds held by these investors. In Japan the supply of money has almost been doubled by this method. By buying bonds, the central bank reduces their supply in the market, resulting in an increase in the price of these assets. Since bond prices move inversely to the yield they generate (i.e. the rate of interest on the asset), an increase in prices reduces long-term interest rates, thus making borrowing cheaper for businesses and mortgage holders. This, it is hoped, will help to stimulate demand, boost the housing and stock markets, and generally increase confidence among both firms and consumers.

The additional cash held by the financial institutions as a result of QE can also be used to purchase other assets, including equities and corporate bonds, and this could encourage firms to issue new stock to fund investment. In the case of the banks, this additional money can be lent on directly to consumers and businesses, thereby cascading through the economy and generally increasing economic activity. Coupled with low interest rates and a rising stock market, the conditions for a return to growth appear to be an inevitable consequence of this form of monetary stimulus to the economy.

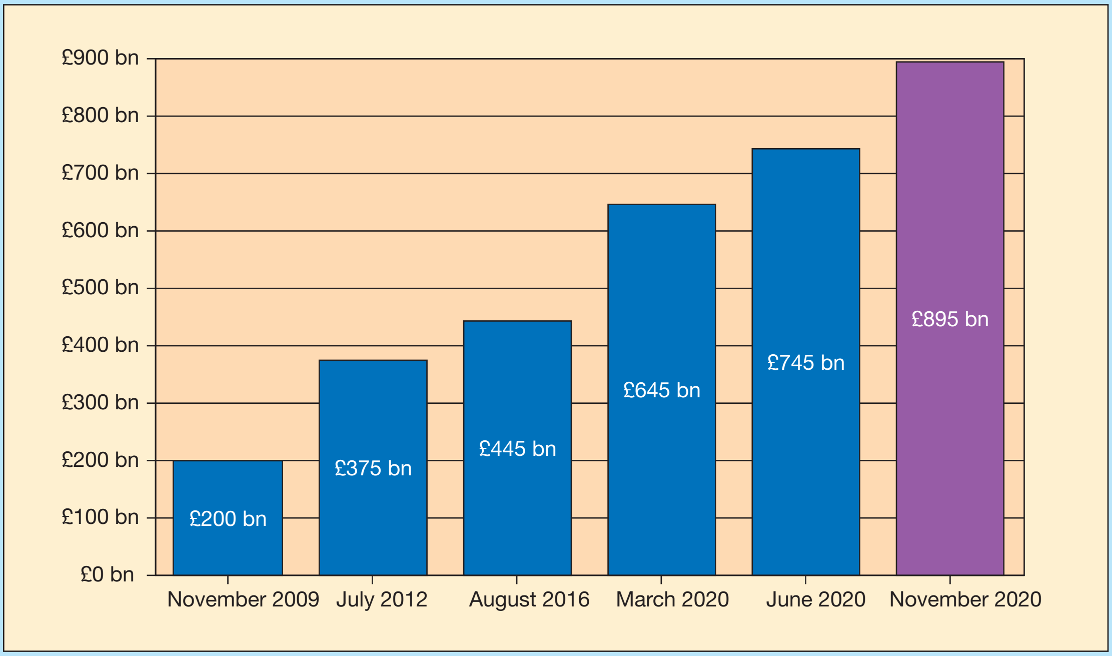
Critics of QE tend to be less sanguine about its ability to achieve its objectives of boosting economic growth and reducing unemployment associated with a recession. One criticism is that there is no guarantee that the banks will pass on the additional cash to consumers and businesses. Instead, they may use it to speculate in, say, commodities (e.g. oil), thus pushing up commodity prices and making conditions even tougher for consumers, some of whom (e.g. pensioners about to invest in an annuity and savers generally) are already being adversely affected by low interest rates. In the UK, as QE was being implemented banks were being told to maintain higher levels of cash reserves, acting as a strong incentive to hold onto the funds that the Bank of England was readily handing over. Others have suggested that QE might be being used by a country surreptitiously to depress the value of its currency in the hope of making its exports more attractive on international markets. Given the tough global trading conditions that are affecting many countries at the moment, this development could prove highly controversial and could spark off an exchange rate and trading war.

There was a further concern that some of the global tidal wave of cheap money has found its way into emerging markets, such as India, and has helped to mask some underlying economic problems. With the Federal Reserve's announcement that it intends to taper off QE in the future – eventually reversing the huge investment flows – there are fears that any phasing out of QE, if handled badly, could have adverse consequences for global bond markets and interest rates.

In Japan QE policy has continued long past the financial crisis. Even before the global recession Japan had been facing a downturn: since 1997 interest rates and wages had been declining and the Japanese government had been increasing taxes to pay for public services. By 2013, Japan's economy had shrunk back to the size it was in 1991. In 2013, Japan's Prime Minister, Shinzō Abe, implemented 'three arrows' of negative interest rates, QE and structural reforms (austerity); the QE component was to be ongoing. Since 2013 the Bank of Japan has been buying ¥ trillions worth of bonds per year, putting the same amount of money into the economy.

Quantitative easing was used again during 2020 to offset the slowdown in the economy, but this created a massive surge in the supply of money in the economy, which in turn has caused a spike in inflation (combined with increased prices related to Brexit). Figure 6.11 shows the rounds of QE which the Bank

Figure 6.11 **Bank of England purchases of bonds (quantitative easing) 2009–2020**



Source: Bank of England, *www.bankofengland.co.uk/monetary-policy/quantitative-easing* of England has used to stimulate the economy. The Federal Reserve in the United States conducted a similar programme, stating that it would initially purchase $300 billion USD of bonds and mortgage backed securities, in March 2020 expanding the purchase scheme to $800 billion USD. In June 2020 it made the purchases ongoing, with up to $120 billion USD per month, eventually tapering the purchase down to $30 billion USD in December 2021. This will contribute to inflation in the USA, but it is proportionately less than the interventions which have been made in the UK.

Case study questions

1 QE is seen as one way in which a government can stimulate the economy. What other approaches could it use?

2 What might happen when central banks start to reverse QE, and when might be the right time to do it?

Review and discussion questions

1 To what extent do you agree with the proposition that the market economy is the 'best' form of economic system? Do you have any reservations?

2 Explain how interest rates could be used to boost the economy. Why, then, do governments frequently hesitate to take such steps?

3 Using circular flow analysis, suggest why a large programme of capital expenditure by government (e.g. on new motorways, roads, railways) will benefit businesses. How could such a programme be financed?

4 Which businesses are likely to benefit from a recovery in a country's housing market?

Assignments

1 Imagine you work in the economic development unit of a local authority (council). Produce a draft report outlining the benefits to the local economy of encouraging direct inward investment. Indicate any disadvantages.

2 You are a contributor to a new news website. As part of your first big assignment, you have been asked to provide information on the 'privatisation' of Eastern European economies. Using journals and newspapers, blog post about the different ways in which western companies have sought to exploit business opportunities in Eastern Europe.

Further reading

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