

Economic Environment and Business Strategy

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Week- 01

Lecture- 01

Introduction to Business Environment

Hello everyone, welcome to the course "Economic Environment and Business Strategy."

I am Sukumar Vellakkal, a faculty member in the Department of Economic Sciences at IIT Kanpur. Today is our first session, an introductory overview of this course. Let me start with the course description and its main objectives. One goal is to understand the business environment and macroeconomic dynamics within businesses and the economy. Another goal is to understand how business decisions are made and how a business can succeed in a dynamic environment with competitive strategies.

This course module covers eight weeks. Here's a brief overview of what we'll discuss each week. In week one, we'll begin with an introduction to the economic and business environment. This session will include various concepts related to the economic and business landscape, such as internal and external environmental factors, along with numerous economic, political, legal, environmental, technological, and reputational risk factors.

All these aspects will be thoroughly covered in this session; then, in week two, we will talk about government intervention in a competitive market. So, what are the rationales behind government intervention in a competitive market, what are the costs associated with it, and what are the benefits associated with such government interventions? Then, moving to week three, to understand the economic and business environment, we need to have a thorough understanding, at the very least, of various macroeconomic and environmental concepts. To understand this, we first need to discuss key macroeconomic variables that have been widely discussed in an economic context. It includes GDP, inflation, and their relevance to business. Then, in the fourth week, we will discuss the financial environment.

In this context, we will discuss direct and indirect finance, as well as various financial institutions, including banking, insurance, mutual funds, and pension funds, their structures, and operational mechanisms. We will then discuss financial instruments and markets, which include bond markets. Additionally, we'll examine why the regulation of financial markets is important, as the financial market is one of the most heavily regulated markets globally. We also touch upon the credit ratings of firms and

governments. Moving on to week five, we'll discuss the economic policy environment in more detail.

Here we will cover the basics of monetary and fiscal policy. Additionally, we'll examine India's economic environment, with special regard to how these policies are designed and implemented in the Indian context. And accordingly, how does India's economic environment respond? In week 6, we will discuss the external sectors of the economy. we can say that this is the understanding of an economy. Here, the various concepts such as the balance of payments, capital and current accounts, and exchange rate determination will be thoroughly discussed in week 6.

In week 7, we will examine the global business environment, including topics such as the business cycle, its definition, and different business cycles that have occurred over time. We will then connect this to international trade, discussing the CBAM, free trade, and WTO negotiations. All these topics will be covered in Week Seven. In the final week, we will focus on strategic management. In this part, we'll explore various concepts, including environmental scanning, industry analysis, internal scanning, corporate strategy, competitive tactics and strategies, and basic types of strategic alliances.

Regarding the basic textbook I use to cover the business environment, I have used Paul Weatherly and Deron Otter. I also incorporate the textbook Concepts in Strategic Management and Business Policy by Thomas Whelan and his team. Additionally, I discuss key macroeconomic variables, primarily drawing from the book Macroeconomics by Mankiw and Taylor. Now, turning to the broad topic, it mainly covers an introduction to business environments. Here, the topics we will focus on mainly include an introduction to the business environment.

As I mentioned earlier, we'll cover concepts of internal and external environmental variables, and subsequently, we will discuss various risks in the business environment, including economic, technological, environmental, political, and legal risks. So, we will cover these topics one by one. So let me move on now. So, the term 'name' refers to the concept I mentioned here, which is the business environment. First, what is meant by the term 'business environment'? Let's ensure our conceptual clarity and share it with others.

The business environment refers to the total sum of environmental factors that provide an atmosphere for the business. It encompasses the aggregate of all conditions, events, and influences that surround and affect a business. Primarily, when we discuss the business environment, it comes to mind that these are external factors. Numerous external factors, including political, economic, socio-cultural, technological, legal, and global factors, directly impact the business environment. Most of them affect it directly, and some also impact the business environment indirectly.

When discussing the business environment, let us also consider what is meant by the term 'business'. Business is the activity of a firm related to trade and services, be it private, public, or non-commercial. All these are businesses. So, when we talk about a firm, that is a business; when we talk about government, that is also part of business. So, business is an economic activity—that's the core definition here.

A business organization is an economic unit. Therefore, business decision-making is fundamentally an economic process. Business involves human activities such as production, extraction, or the buying and selling of goods, all aimed at earning a profit or maximizing societal welfare. When we talk about earning profits, it mainly relates to private entities whose goal is to maximize profit. When addressing societal welfare, the primary goal of government businesses is to enhance societal well-being.

Coming to the second component—that is, the environment—it refers to aspects of the surroundings. A business firm exists within a broader social, economic, political, and cultural context. Any changes in this context influence the operations of a business. So, talking about the business environment, since we started with a very basic definition—a business firm is a dynamic entity because it operates within a context. One of the contexts is the internal environment.

The internal environment refers to the conditions within the firm, encompassing people, materials, money, and machinery. Management is typically within the business's control, allowing it to adjust these factors in response to changes in the enterprise's operations, including its infrastructure, physical assets, human resources, organizational structures, technology, and work systems. In short, the internal environment is within the control of that particular entity, that firm. That means it has the freedom and flexibility to change or alter any of these. The firm can change its managerial expertise, maintain its technical expertise, and decide everything, including how much capital it wants to invest in its firm. This is about the internal environment.

As I mentioned, it is mainly under the firm's own control. However, the external environment encompasses factors beyond the business enterprise's control. It encompasses the broad economic environment—the environment in which we all live. Technological, natural, physical, environmental, political, and legal factors—all these constitute the external business environment. Regarding this business environment, particularly for this session, I relied primarily on the textbook by Weatherly and Otter for input. To discuss the external environment, we are primarily focusing on the external factors that influence it.

When we discuss the environment—specifically, the external environment—we also consider external risk simultaneously. That means the emerging risks. These include external macro-environmental factors that can impact operations and decision-making. To

understand this, a framework commonly known as the PEST framework is used. PEST stands for Political, Economic, Social, and Technological, and it helps organizations identify and understand various forces and trends, including Political factors, such as political risk.

The political landscape and government actions have a significant impact on businesses. For example, emerging regulations, changes in political leadership, geopolitical tensions, and other political developments could all pose risks or opportunities for the firms. All these political factors are key components of external environmental risk. Then come economic factors. The broad economic conditions encompass emerging economic trends—for example, countries imposing tariffs on each other or implementing trade restrictions—and changes in inflation and overall economic conditions, such as recessions or economic booms.

That means the slowdown of the economy, currency fluctuations, economic and trade policies, and other factors—all of which could affect an industry or market. So, these are the economic factors and associated risks. Then come social factors. Social factors primarily include societal and demographic changes, which can all influence your business. Emerging consumer preferences, cultural shifts, social trends, health, education, lifestyle issues, etc.

For example, if I mention demographic changes—such as an aging society—when the proportion of the elderly in society increases, what are the likely implications of these for the business? As people live longer, they tend to save more. then, it may have an implication on the present consumption. In this way, we need to try to relate these factors to the business conditions. One of the things I want to mention in the case of social factors—unlike political and economic factors—is that social factors are slow to change and slow to take effect. Unlike political factors—where a sudden change in political leadership can occur, and accordingly, its policies will change— And similarly, with economic factors, there can be sudden economic downturns or slowdowns, which can occur unexpectedly.

However, social factors—societal and demographic changes, as well as cultural factors—all take time. However, firms must be aware that these changes will occur gradually over time. So, then come technological factors. Technological advancements and innovations are impacting virtually every industry. Focus on emerging technologies, automation, data security threats, and other tech-related risks and opportunities that are emerging, and firms need to take all these factors into account.

In short, a firm should be aware of technological changes and actively participate in technological development and adaptation to new technologies. Then it will gain an edge in the market; otherwise, it will lag. In addition to this PES framework, there are also

legal factors to consider. To some extent, this issue will sometimes be addressed in the political arena. However, these legal factors can be considered separately.

This is in addition to the PES Framework. So, the legal and regulatory environment will likely impact your business. Emerging laws, regulations, complaints, requirements, and legal challenges could all affect business operations. Additionally, there are several other factors, collectively referred to as environmental factors. For example, environmental factors and sustainability issues—nationally and globally.

You are aware that climate change is a pressing issue these days. As a result, there will be environmental regulations, climate change impacts, resource scarcity, and other environmental risks. And, when it comes to climate change, you know that there are carbon regulations, and firms must adhere to various carbon regulation policies. All of these have implications for our businesses. Now, let me illustrate the points we discussed using a figure.

See this figure. I can show it layer by layer. The first is the external layer, also known as the super external layer—for example, the natural and physical environment, physical resources, climate, and wildlife. So, these are all very broad environments. These are not within our control. Not within the control of even the firms or under the control of governments.

These are the very broad external environment. Then, the external environment comes. These are the external environment. You can see that societal environment. Economic forces, technological forces, political forces, legal forces, and socio-cultural forces.

All of these come from the external environment. Then the next layer is the environment, but it is not the innermost environment. It falls somewhere between the external and internal environments. To some extent, we can say that these are part of the external environment, but they are mostly related to the environment of a particular industry, rather than a specific firm. Suppose when we talk about a firm—a firm means one production unit or one production entity—and an industry means all the homogeneous production units working together as an industry.

For example, the mobile phone industry. One mobile firm, maybe Sony or Samsung. You can see that these are the firms. When you talk about the industry, that smartphone, and all these firms together constitute an industry. That one comes here. In this industry, various factors influence it, including the government's role, special interest groups, customers, creditors, communities, trade associations, competitors, employees, suppliers, and shareholders.

These are all related to that industry. Then comes the internal part. This one is the inner layer. This primarily belongs to each individual firm.

This is the internal environment. It is within the control of that business, that firm. It depends on its own structure, culture, resources, and other factors. As I mentioned earlier, firms have almost full control over their internal environment, but they don't have control over the task environment or the broader external environment. In short, what we are saying is that, within their internal environment, firms have more control, allowing them to assess risks. Even for external risks, they can assess them and make strategic changes within the firm accordingly to manage these risks.

When we proceed, we will discuss various types of risks and the environment. Some of the key themes to consider are whether you can relate them to the business and the environment in which it operates. So, there are different themes.

Let me go one by one. One is called diversity. Diversity means that business is a diverse category. There is the private sector, the public sector, the voluntary sector, and non-governmental organizations. Therefore, we need to determine the type of business we are discussing. Diversity is one of the components.

Then there is internal and external. By now, you are likely familiar with the fact that the business environment encompasses both internal and external aspects of the organization. You are aware that the external environment is more uncertain and riskier, and these factors are more dominant. In our discussions in this course, our primary focus will be on the external environment as it pertains to business environments. We will primarily discuss the external business environment. Ultimately, at the conclusion of the course, we will analyze how firms devise strategies to address the various external factors.

So, the environment—most of it is very uncertain, as I have already mentioned—is uncertain and risky, and firms develop strategies to predict and respond accordingly to this external environment. Then, complexity arises: the external environment is multidimensional, more complex, and interrelated. For example, the economic environment and political environment are highly correlated. So, you need to see that these are not standalone; each environmental factor is not independent. They all depend on one another; they are multi-dimensional, more complex, and highly interrelated. Then, local to global: the business environment can be analyzed at various spatial levels or scales.

Perhaps we can start by examining a small local area, then move on to the state level, the national level, and finally some regional areas, such as Asia, Europe, and the Americas. This way, we can develop an understanding and observe the global perspective. Globally, some of the issues that will impact your business can also be discussed. Additionally, the business environment is dynamic and uncertain, changing over time, even within relatively short periods. There is also a two-way interaction between business organizations and their environments.

The primary point here is that businesses have an impact on the environment, and the environment, in turn, influences businesses. This means there is a two-way interaction. Thus, the earlier discussion about environmental factors—external environments—and how businesses operate within them is not entirely one-sided; it is, in fact, a two-way interaction. Businesses impact the environment—perhaps affecting the economic, political, or legal environment.

Similarly, all these environments influence businesses, creating two-way interactions. There are also several stakeholders to consider—individuals and groups affected by business decisions and vice versa. This includes values as well. Business decisions involve ethical questions, competing perspectives, and values related to the nature and purpose of business in society, encompassing aspects such as power, responsibilities, performance, and ethics, including climate implications and the private costs of producing goods and services. What are the social costs linked to this production? For instance, when firms produce goods and services, they account for their private costs—what costs are included—but we must also consider societal costs, such as pollution introduced into society.

The pollution that they generate also needs to be considered. So far, in our discussion about the business environment, we have categorized it into the external environment and the internal environment. Within the external environment, the most dominant component is the economic environment. Whenever we discuss the business environment, we spend considerable time discussing and understanding the economic environment because it is dynamic, and every firm is subject to economic environment risks. Now, let us delve deeper into the discussion of the economic environment.

The economic environment mainly includes the nature and direction of an economy in which a firm must operate and compete. Generally, firms aim to compete in a relatively stable economy with strong growth potential. The major components of the economic environment include, first, the economic system. An economic system refers to whether we are living in a capitalist economic system, such as those found in the US, Canada, the UK, or Germany. A socialist economic system, like that of Russia, some Latin American countries, or Cuba, or a mixed economic system, like that of India.

Then we need to understand various economic policies, including fiscal policies, monetary policies, industrial policies, and foreign trade policies. Next comes the economic status—the general trend of macroeconomic variables, such as Gross Domestic Product, the business cycle, investment, savings, consumption, inflation, employment, the balance of payments, and income distribution—along with regional and international economic integration. Regarding the economic environment, one of the fundamental principles is scarcity. Scarcity is at the heart of the economic environment. You know that resources are limited—be it land, capital, or other resources.

You may see that there are plenty of resources, but all these are relative, and there is scarcity. These resources—natural resources, land, labor, capital, and others—are not only scarce, but they can also be used for multiple purposes. There are alternative uses. So, when you are using a resource for one particular purpose, you are foregoing another use of the same resource.

This is what we refer to as foregone production. Suppose that when you are using resources to produce one good or service, then in that process you are foregoing something else—some other goods or services. For example, the resources we allocate to defense—when we prioritize defense—involve an opportunity cost, as we forgo the production of education, health, and other social sector goods and services. This is called opportunity cost—the next best alternative foregone due to the use of resources for one production. When discussing the economic environment, there are broadly two types: one is the free market economy, and the other is the regulated economy under government control.

For example, wage determination and the minimum wage law. Wage determination is usually set by the free market, but when the government intervenes to regulate, it creates laws like the minimum wage. So, what creates an efficient economic environment? In a free market economy, the economic problems—the three main questions: what to produce, for whom to produce, and how to produce—are all decided by the market, as in a capitalist economy. However, in a socialist economy, these questions—these problems—are all answered by the government. What to produce, for whom to produce, and how to produce.

All of these are decided by the government there. Economists broadly classify economic systems into four main schools of thought. One is the neoclassical or neoliberal view, which primarily relies on the free market. Most Western economies are based on a neoclassical, neoliberal approach. Then we have the institutionalist or structuralist perspective.

They argue for government intervention in market capitalism. Then we have the socialist or Marxist perspective—that means they believe in full government control, complete state ownership of all means of production, and public ownership. Next, there is a more recent entry, known as the green or environmentalist view. They argue that economic growth should be green economic growth—that means in the production of goods and services, we should cause minimal harm; we shouldn't harm the environment; and we should minimize the harm to the environment as much as possible. Regarding the neoclassical or neoliberal view, which I already mentioned, most Western economists adhere to this perspective. In their case, most of these economies transitioned from a primitive communist system.

Primitive communism refers to a time when there was no private ownership of resources, including land and capital. There was no private ownership. Back then, people used all these resources collectively. Over time, these economies gradually transitioned to feudalism.

Feudalism means that land is the primary means of production and the main resource, owned by the feudal lords. Over time, feudalism transitioned to capitalism. Today, most Western economies operate under a capitalist system, which emphasizes private ownership of the means of production. Their goals are profit and efficient production of goods and services. Then, regarding the free-market economy that we will discuss in the next session, we will explore how this market system functions.

In that context, I will discuss various market mechanisms. We will examine demand and supply—what they mean and how they work. Using this framework, we will explore how prices are determined. Then, with the same framework, we will analyze how government intervention occurs and evaluate the pros and cons of government involvement in this free-market economy using demand and supply analysis. See you in the next session. Thank you.