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| ***External influences – Economic: business cycle & inflation*** |

**Introduction:**

* *External influences concerning the economy – business cycle and inflation*
* *p110-118*

*Let’s start by reading the introductory topic: ‘Iceland’s economy boils over’*

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| Consider a country’s economy:  ***Rate of economic growth***  ***Rate of price inflation***  ***Unemployment levels***  ***Exchange rate***  They can be both **constraints** of business activity as well as great **newopportunities** |

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| **Government has objectives for the nation’s economy**  In pursuing these objectives, governments take **economicpolicy** decisions that can have a significant impact on businesses  Managers needs to be aware and understand these objectives and policies to protect their organisation from **negative policy changes** and **take advantage** of **positive policy changes** |

**Economic objectives of governments:**

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| *Economic growth* |  |
| *Low target rate of inflation* |  |
| *Low rate of unemployment* |  |
| *Long-term balance between the value of goods bought from other countries (imports)*  *And the value of the goods and services the country sells to other countries (exports)*  *Current account of the balance of payments account* |  |
| *Exchange rate stability* |  |
| *Wealth and income transfers to reduce inequalities* |  |

Unfortunately, several of these objectives may conflict with each other:

* By adjusting one objective, another objective is influenced
* Rate of inflation too high – policies to reduce spending
  + Lead to lower demand and thus result in increased unemployment

***Economic growth – a definition and why it is considered desirable***

Gross Domestic Product (GDP)

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Economic growth

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**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 increases in the physical output of goods and services in an economy*
* Every economy is striving to achieve economic growth

**Economic growth is important to a country because:**

* *Higher* ***real GDP*** *increases the quantity of goods and services available for consumers and this increases living standards*
* *Higher levels of* ***output*** *often lead to* ***increases employment***
* *More* ***resources*** *can be allocated to* ***public sector projects****, such as health and education* ***without*** *reducing resources in other sectors*
* ***Absolute poverty*** *can be reduced or even eliminated if growth is substantial enough and benefits spread*
* *Businesses should experience* ***rising demand*** *for their products (dependant on elasticity of demand)*
* ***Higher GDP*** *– more resources for government - decrease burden of social expenditure (i.e. unemployment benefits) – can reduce the burden of taxation*

As the book illustrates **too rapid growth** is not always beneficial to everyone:

* *it can lead to problems such as pollution and damage to health*
* *…also technological change can lead to some losing their jobs*

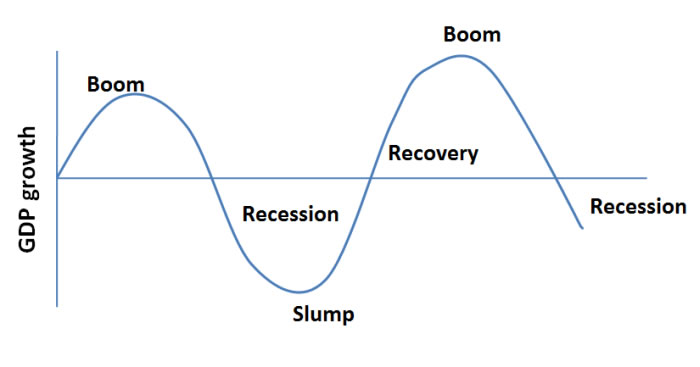
The factors that lead to economic growth

1. Increases in **output** resulting from **technological** changes and expansion of industrial capacity – should not lead to inflation (no demand-pull pressures)
2. Increases in **economic resources**, such as higher working population or discovery of new resources of oil and gas – increase when economic resources are available
3. Increases in productivity – if **existingresources** can produce a **higher level** of output (compared to last year) –i.e. higher labour productivity with higher-skilled and better qualified workforce, acceptance of new technology

**The business cycle:**

Economies tend to grow at very different rates over time – known the business cycle

1. ***Boom***
2. ***Downturn or recession***
3. ***Slump***
4. ***Recovery and growth***



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| ***Boom*** | ***Downturn/recession*** | ***Slump*** | ***Recovery and growth*** |
| Rising **incomes** and **profits**  **Inflation rises** due to high demand for G&S; shortages of high-skilled workers – **higher wage increases**  **High inflation** makes an economy’s goods **uncompetitive** – profits are hit by **higher costs**  Government increases **interest rates** – reduce inflationary pressure  ***Downturn often results from this*** | Effect of falling demand and **higher rates** starts to bite  Real GDP growth **slows** (perhaps falls)  Technically called a **recession**  Incomes and consumer demand fall and **profits** are **much reduced**  Some firms **record losses** and some go out of business | A very serious and prolonged downturn can lead to a **slump** where real GDP falls **substantially** – **house** and **asset prices** fall  Could be tied to a governments corrective economic action such as policies and stimulus (injecting money into the economy like USA and China) | All downturns eventually lead to a **recovery** when real GDP starts to increase again  Could be because: governments takes **corrective** action or country’s products become **competitive** once more and **demand increases** |

Be aware that the above is a simplified version of the economy and reasons/corrective action. It is not always possible for governments to **know** what the right corrective action is or indeed what ‘side effect’ or unintended consequence one policy has on another. Japan has been battling the above for 20 years – the current prime minster is trying to boost the economy but is faced with opposition from those who wish to protect their own interests. It sometimes requires more radical policy change.

***Is recession all bad?***

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| Recession: |

An **economic recession** has serious **consequences** for most business and the whole economy.

* **Output is falling**, **fewer workers** will be needed; **unemployment** will **increase**, so demand for G&S declines faller. There will be **less income tax** and **sales revenue tax** received

However, some **opportunities** for well-managed firms could be:

* *Capital assets many be* ***relatively cheap*** *and firms may* ***invest*** *for the future expected recovery*
* *Demand for* ***inferior goods*** *could actually* ***increase***
* *The risk of* ***retrenchment****(reducing spending) and* ***job losses*** *may improve employer-employee relations and thus increased* ***efficiency***
* *The difficult business climate may prompt firms to be becoming* ***‘leaner and fitter’*** *and therefore potentially more competitive when growth and recovery eventually starts again*

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| ***Type of producer*** | ***Period of economic growth*** | ***Period of recession*** |
| **Luxury goods and services** – e.g. cars | * Increase **range** of G&S * **Raise prices**> increase profit margins * Promote **exclusivity** and **style** * Increase **output** | * May **not reduce** prices for fear of damaging long-term image * **Credit terms** to improve affordability * Offer **promotions** (with caution) * Widen product range with lower priced models |
| **Normal goods and services** – e.g. tinned food | * Add extra value to product – better ingredients/improved packaging * Brand image may attract exclusive tag * Do nothing- sales not much affected anyway | * **Lower** prices * **Promotions** * Do nothing – sales not much affected anyway |
| **Inferior goods and services** – e.g. very cheap clothing | * Attempt to move 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 * Free **consumer** tests * Increase **range** and distribution outlets |

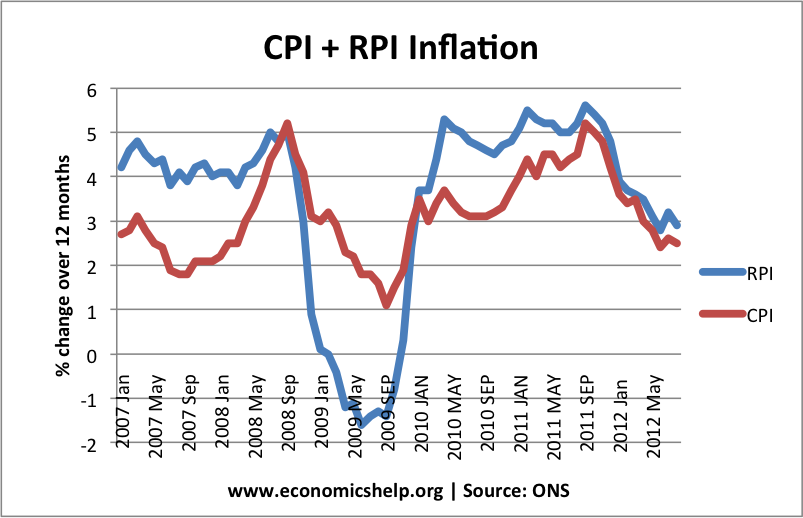
***Inflation*** and ***deflation*** – changing the value of money

* The **spending power** of one dollar is the goods that can be bought for 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** and this must have been caused by **INFLATION**

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| Inflation |

* If one dollar buys more goods *this year* than it did *last year*, then the ***value of money*** has **INCREASED** and this must have been caused by **DEFLATION**

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| Deflation |



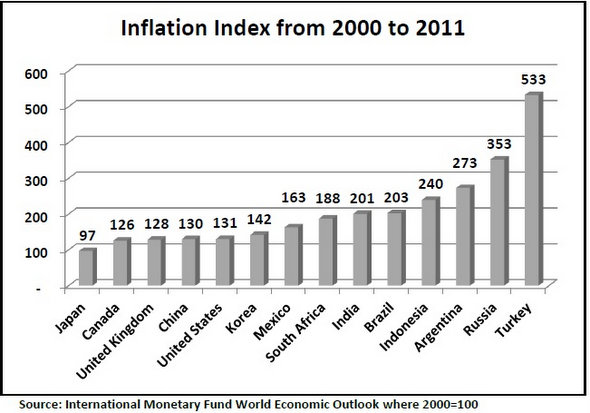
In the book, it illustrates a few examples during the 2008 (I’ve updated them):

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| *Zimbabwe inflation rate (hyper-inflation)* | This lopsided economy is a legacy of the collapse of Zimbabwe’s currency. Inflation reached an absurd **231,000,000%** in the summer of 2008.A ban on foreign-currency trading was lifted **in January 2009**. By then the **American dollar** had become Zimbabwe’s **main currency**, a position it still holds today.  Zimbabwe’s dollar had been too **liberally printed**: a swollen stock of local banknotes was chasing a diminished **supply** of goods. Now the American banknotes the economy relies on have to be begged, borrowed or earned. Even so, the monetary system works surprisingly well. A **scarcity** of greenbacks keeps **inflation** in the low single digits. The economy has made up much lost ground  A problem for all retailers is a shortage of small change. One-dollar bills are filthy from frequent handling. The **South African rand** is the main currency in Bulawayo, Zimbabwe’s second city, and one-rand coins are used in place of dimes ($0.10) all over the country. If coins are short, a **credit note** or **sweets** may be offered instead. Items that are frequent purchases have **rounded** prices. A loaf of bread usually sells for $1. (The Economist - April 27th 2013). |
| *Malaysia inflation* | Malaysia's inflation rate is expected to spike to **2.3%** this year due to the **fuel hike** (increase) effective today, Putrajaya's (the government) economic Czar Datuk Seri Abdul Wahid Omar said today. Putrajaya said it was **cutting subsidies** that would save RM3.3 billion annually by raising fuel prices 20 sen with RON95 petrol at RM2.10 **(4rmb)**a litre while diesel is RM2.00 a litre. The higher quality RON97 is based on market prices.  The Minister in the Prime Minister's Department's forecast was in tandem with several financial research houses that said Malaysia's current 2% inflation rate will trend higher due to **pricier fuel**. (Malaysian Insider – 3rd October 2013) |
| *China inflation* | China's **inflation** remained under control in August despite stubborn increases in the cost of **food**. The **consumer-price index** came in at a modest 2.6% year over year, down from 2.7% in July—and in line with expectations of economists polled by Dow Jones Newswires.  On the **consumer-inflation** front in August, food prices were driven higher by rises in prices for **pork** and **vegetables**. Food prices climbed 4.7% from a year earlier, though that was below the 5% increase in food prices in July.  Data showed better-than-expected August exports, and a strong manufacturing **Purchasing Managers' Index** earlier this month indicated improvement at the factory level:   * The government has used a policy of "mini-stimulus" measures—spending on **subways** and **rail networks** while trimming taxes and cutting red tape to help small businesses—to ensure steady **growth**. Strong **credit** in the first months of the year is also passing through to higher investment, buoying growth. |

***How is inflation measured?***

The ***retail price index* (RPI)** in the UK is used to measure average price changes. This is typical of **price indices** (index) used by all countries to record **inflation**.

* Record **average price changes** in a large number of items
  + **6000commonlybought** items of an ‘average’ household budget
  + Prices are then compared to **previous month** and then **‘weighted’** to reflect importance (bread is more important than a package holiday)
  + **Weighted** price changes are given an index number – which is then compared to **past time periods**. The series of base numbers will have started from a based period (given a value of **100**).
    - If in 2009, the RPI stood at 133.8 and using a base period of the year 2000 (base =100), the weighted average of price inflation since 2000 is 33.8%. (100 to 133.8)
  + *One may see inflation data presented as the* ***consumer price index*** *(CPI). This means that mortgage interest and other housing costs have been excluded from the RPI measure – this is known as* ***underlying inflation***



**What causes inflation?**

**Prices rise** either because business are forced to increase them as

1. *Their costs are rising*
2. *Or businesses take advantage of high consumer demand to make extra profits and raise prices*

***Cost-push*** *causes of inflation*

***Demand–pull*** *causes of inflation*

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| **Cost-push inflation**  *Firms face higher costs of production* - they may then raise prices to maintain profit margins | **Demand-pull**  *Consumer demand in an economy is rising* (boom) |
| *A* ***lower exchange*** *rate pushes up the prices of* ***imported materials***  *World demand for* ***materials raises*** *their prices*  ***Higher wage*** *demands from workers e.g. could be in response of previous inflation – workers usually expect to* ***maintain*** *their real living standards* | *Producers and retailers realise they can raise prices of existing stocks*  *If they do not raise prices,* ***stocks*** *could be sold out*  *Avoids unsatisfied demand: supply shortages led to excess demand in Zimbabwe*  ***Businesses will earn higher profits by raising prices*** |

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| ***Cause of inflation*** | ***Government and central bank policy*** | ***Impact on business strategy of government policy aiming to control inflation*** |
| Cost-push | * **High exchange rate** policy- higher interest rates set by bank * **Discourage** high wage settlements – may use public sector workers as an example | **Exports** less competitive – switch to domestic market  **Higher interest rates** deter borrowing and investment – cancel business projects  **Consumer credit** will be discouraged – reducing demand for expensive goods such as cars  Firms often **ignore** government views on labour – market forces are more important |
| Demand-pull | * Policies designed to reduce demand such as higher tax rates and lower government spending * Central bank is likely to raise **interest rates** | **Higher taxes reduce consumer demand** - progressive taxes are increased, a swing away from luxury goods – change in product mix  **Lower government spending** could hit certain industries very hard – defence equipment suppliers or hospital equipment manufacturers – may enter foreign markets  **Interest rate increases** - same effects as above |

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| ***Impact on business strategy:***  ***Inflation*** *can have the following* ***benefits*** *for business if the rate is* ***quite low****:*   * *Cost increases can be passed onto consumers more easily* * *The real value of* ***debts*** *owed by companies will fall*   + *Because the value of money is* ***falling****, when a debt is* ***repaid****, it is repaid with money of* ***less value*** *than the original loan* * *Rising prices are also likely to affect assets held by firms, so the* ***value*** *of fixed assets such as land and building, could rise*    + ***Increase value*** *of a business (at least on the balance sheet)* * *Since stocks are* ***bought in advance*** *and then* ***sold later****, there is an increased profit margin from the effect of* ***inflation*** *(buying with cheaper money)*   *Therefore, during periods of* ***low inflation****, businesses could decide:*   * *to* ***raise*** *their own prices* * ***borrow more*** *to invest* * *ensure that* ***increased asset value*** *appears on their balance sheet* |

However, **higher rates** of **inflation**, say above **6-7%** per year can have very serious drawbacks for business:

* ***Employees*** *will become much more concerned about the* ***real value*** *of their incomes – increase in industrial disputes and demands*
* ***Consumers*** *are likely to become more* ***price sensitive***
* ***Rapid inflation*** *will often lead to* ***higher rates of interest*** *– highly geared companies may find it* ***difficult*** *to make interest* ***repayments***
* ***Cash-flow problems*** *– firms struggle to find the money to pay the higher costs of materials and other costs*
* *Inflation causes* ***uncertainty*** *–* 
  + *More prices rises?*
  + *Rate of inflation continue to increase?*
  + *Government reaction – effect on the firm*

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| Uncertainty makes **forecasting** more difficult and less reliable   * Sales forecasts and investment appraisals (future cash flows -we’ll do that later) * If inflation is higher in one country than another – business will lose **competitiveness** in **overseas markets** * Business that **sell goods on credit** – reluctant to offer extended credit periods – repayments by creditors in money that is **losing value** rapidly * Consumers may stockpile some items and cut-back on non-essential items of spending |

**Business strategy** during a period of **rapid inflation** might **focus** on:

* ***Cutting back on investment spending***
* ***Cutting profit margins to limit own price rises to stay as competitive as possible***
* ***Reducing borrowing to levels at which interest payments are manageable***
* ***Reducing time period for customers (debtors) to pay***
* ***Reducing labour costs***

***Does this mean deflation is beneficial?***

One would consider the detrimental effect that inflation has so deflation would be seen as a good thing…however:

* *Consumers would delay making important purchase hoping that prices will* ***fall further*** *–* ***reduction*** *in* ***demand*** *– leads to recession*
* *Business with LTL make* ***repayments*** *with money that has gained value since the original loan was taken out –* ***discourage borrowing*** *to invest*
* *As prices fall, future profitability of projects appears doubtful – again, firms are* ***unwilling to invest***
* *Holding of* ***stocks*** *of materials and finished goods* ***fall in value****:* 
  + *businesses hold as few stocks as possible*
  + *reduce order for supplies from other businesses*
  + *could push economy to recession because output will decline*

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| **So can a business win either way?**  *A general consensus is that the* ***optimum position*** *for most economies is LOW INFLATION – an aim to keep it a predetermined target such as the UK and Eurozone CPI of 2% rise p.a.* |

***Worksheet summary quiz and activity:***

1. How are some businesses likely to be **negatively affected** by rapid rates of growth?

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1. Outline **three** macro-economic objectives of China.

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1. Consider **inflation** in China over the last few years. What impact has it had on people and businesses?

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**Summary of the worksheet in your own words (in English and Chinese):**

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*Vocabulary check:*

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| **English** | **Chinese** |
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