

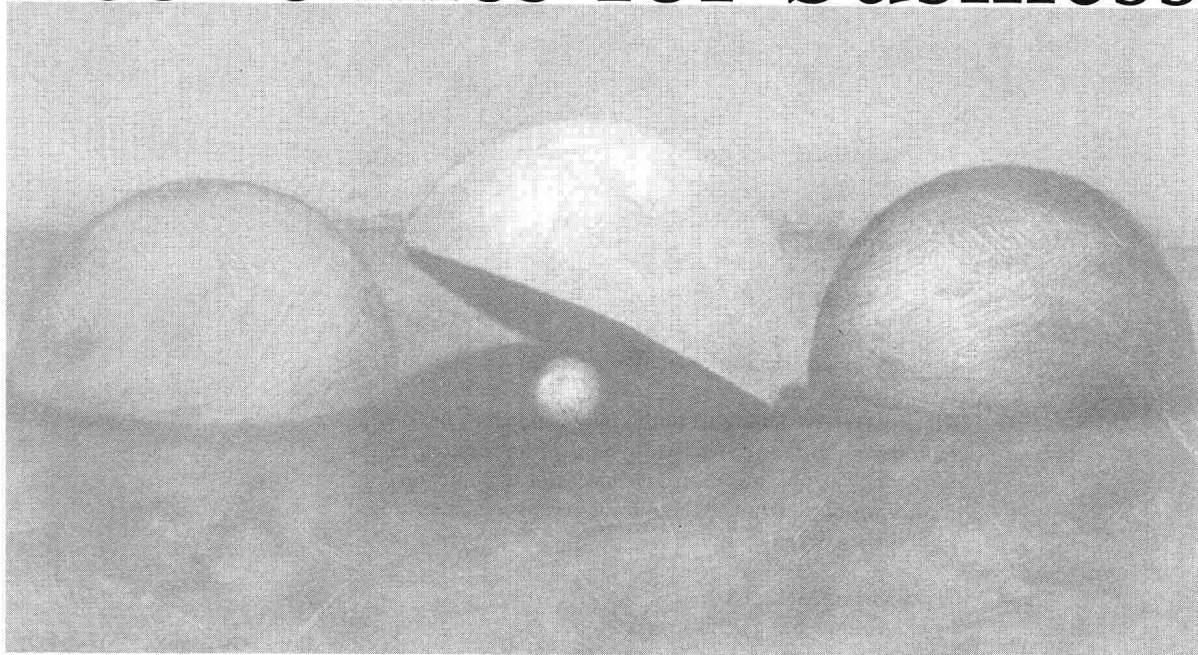
# Economics for Business



John Sloman

Mark Sutcliffe

# Economics for business



**John Sloman** and **Mark Sutcliffe**

University of the West of England

**PRENTICE HALL**

LONDON NEW YORK TORONTO SYDNEY TOKYO  
SINGAPORE MADRID MEXICO CITY MUNICH PARIS

First published 1998 by  
Prentice Hall  
A Pearson Education Company  
Edinburgh Gate  
Harlow  
Essex CM20 2JE

© John Sloman and Mark Sutcliffe 1998

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form, or by any means, electronic, mechanical, photocopying, recording or otherwise, without prior permission, in writing, from the publisher.

Typeset in 10.25/12pt Sabon  
by Goodfellow & Egan, Cambridge

Printed and bound in Great Britain  
by Martins the Printers, Berwick upon Tweed

Library of Congress Cataloguing-in-Publication Data  
Available from the publisher

British Library Cataloguing in Publication Data

A catalogue record for this book is available from  
the British Library

ISBN: 0-13-356254-9

2 3 4 5 02 01 00 99

# Preface

## **To the student**

If you are studying economics on a business studies degree or diploma, then this book is written for you. Although we cover all the major principles of economics, the focus throughout is on the world of business. For this reason we also cover several topics that do not appear in traditional economics textbooks.

As well as making considerable use of business examples throughout the text, we have included many case studies (in boxes). These illustrate how economics can be used to understand particular business problems or aspects of the business environment. Many of these case studies cover issues that you are likely to read about in the newspapers. Some cover general business issues; others look at specific companies.

We hope that, in using this book, you will share some of our fascination for economics. It is a subject that is highly relevant to the world in which we live. And it is a world where many of our needs are served by business – whether as employers or as producers of the goods and services we buy. After graduating, you will probably take up employment in business. A thorough grounding in economic principles should prove invaluable in the business decisions you may well have to make.

Our aim throughout the book is to make this intriguing subject clear for you to understand and as relevant as possible to you as a student of business.

The written style is direct and straightforward, with short paragraphs to aid rapid comprehension. Definitions of all key terms are given in the margin, with defined terms appearing in red. Summaries are given at the end of each chapter, with points numbered according to the section in which they appeared. These summaries should help you in reviewing the material you have covered and in revising for exams. Each chapter finishes with a series of questions. These can be used to check your understanding of the chapter and help you to see how its material can be applied to various business problems.

We hope you enjoy the book and come to appreciate the crucial role that economics plays in all our lives, and in particular in the practice of business.

Good luck and *bon appetit*.

## **To the tutor**

The aim of this book is to provide a course in economic principles as they apply to the business environment. It is designed to be used by first-year undergraduates on business studies degrees and diplomas where economics is taught from the business perspective. It is also suitable for students studying economics on MBA, DMS and various professional courses.

Being essentially a book on economics, we cover all the major topics found in standard economics texts – indeed, much of the material in the principles sections is drawn directly from *Economics* (third edition). But in addition there are several specialist business chapters and sections to build upon and enliven the subject for business studies students. The following are some examples of these additional topics:

- The business environment
- Business organisations
- Marketing the product
- Alternative aims of firms
- Growth strategy
- The small-firm sector
- Pricing in practice
- Government and the firm, including policies towards research and technology development (R&TD) and policies towards training
- Government and the market, including environmental policy and transport policy
- The multinational corporation
- Trading blocs
- Monetary union.

The text is split into 31 chapters. Each chapter is kept relatively short to enable the material to be covered in a single lecture or class. Each chapter finishes with review questions, which can be used for seminars or discussion sessions.

The chapters are grouped into 10 parts:

- Part A *Business and economics* (Chapters 1–5) establishes the place of business within the economy, the relevance of economics to business decision making and the operation and functioning of the market economy.
- Part B *Background to demand* (Chapters 6 and 7) considers the consumer, how consumer behaviour can be predicted and how, via advertising and marketing, consumer demand can be influenced.
- Part C *Background to supply* (Chapters 8–10) focuses on business costs, revenue and profits.
- Part D *Supply: short-run profit maximisation* (Chapters 11 and 12) presents the traditional analysis of market structures and the implications that such structures have for business conduct and performance.
- Part E *Supply: alternative strategies* (Chapters 13–16) considers various alternative theories of the firm. It also examines how business size can influence business actions, and how pricing strategies differ from one firm to another and how these strategies are influenced by the market conditions in which firms operate.
- Part F *The firm in the factor market* (Chapters 17 and 18) focuses upon the market for labour and the market for capital. It examines what determines the factor proportions that firms use.
- Part G *The relationship between government and business* (Chapters 19–21) establishes the theoretical rationale behind government intervention in the economy, and then assesses the relationship between the government and the individual firm and the government and the market.
- Part H *Business in the international environment* (Chapters 22–4): after establishing the basis of international trade and the benefits that accrue from it, the emphasis of the remaining chapters is to consider how the world trading system has changed with the development and proliferation of the

multinational corporation, and the expansion of regional trading agreements.

- Part I *The macroeconomic environment* (Chapters 25–8) considers the macroeconomic framework in which firms operate. We focus upon the principal economic variables, investigate the role of money in the economy, and briefly outline the theoretical models underpinning the relationships between these variables.
- Part J *Macroeconomic policy* (Chapters 29–31) examines the mechanics of government intervention at a macro level as well as its potential benefits and drawbacks. Demand-side and supply-side policy and economic policy co-ordination between countries are all considered.

## **Special features**

The book contains the following special features:

- All technical terms are highlighted and clearly defined in the margin on the page they appear. This feature has proved very popular in the three editions of *Economics* and is especially useful for students when revising.
- Additional applied material to that found in the text can be found in the boxes within each chapter. All boxes include questions so as to relate the material back to the chapter in which the box is located. The extensive use of applied material makes learning much more interesting for students and helps to bring the subject alive. This is particularly important for business students, who need to relate economic theory to their other subjects and to the world of business generally.
- Detailed summaries appear at the end of each chapter with the points numbered by the chapter section in which they are made. These allow the students not only to check their comprehension of the chapter's contents, but also to get a clear overview of the material they have been studying.
- Each chapter concludes with a series of review questions to test students' understanding of the chapter's salient points. These questions can be used for seminars or as set work to be completed in students' own time.
- A careful and consistent use of colour and shading. The tint used for the second colour allows several different shades to be achieved. The object is to make the text more attractive to students and easier to use by giving clear signals as to the book's structure.

## **Supplements**

The following supplements are available free to tutors adopting the book. They can be obtained from your Prentice Hall representative or directly from the Prentice Hall office.

### **Case studies**

A booklet of case studies has been prepared by Mark. These can be photocopied for class use or for assignments. They are also available on the CD (see below), and could thus be loaded onto your network for direct student access.

**Answer pack**

Answers are available in both hardcopy and on the CD to all questions in the book. Again these can be distributed to students or made available on your network as appropriate.

**CD**

The above are available in both Word and WordPerfect formats on a CD. This CD also contains a set of full-colour Powerpoint® slide shows of key diagrams, each one consisting of a sequence of diagrams showing how a model is built up and the effects of shifts in curves. (The CD also contains supplementary material for John's *Economics* (third edition) and *Essentials of Economics*.)

**WinEcon**

Most UK higher education institutions now have WinEcon on their network. This is a comprehensive computer-based learning programme for introductory economics, developed by the Economics Consortium of the Teaching and Learning Technology Programme (TLTP). Included in this software package is an Economics for Business pathway, which makes the software ideal as a supplement to this book. Further details on the WinEcon software are available from Blackwells publishers. There is also a web site for information on the software: <http://sosig.ac.uk/winecon>.

**Acknowledgements**

Writing a book like this is very much a joint effort of many people. We'd like to thank the whole of the team at Prentice Hall, without whose continuing and enthusiastic support and encouragement the project would not have been possible. In particular, Tony Johnston, the editor of the book, has been a constant source of ideas, and many conversations between the three of us have helped to fashion the book into the version you're now reading. We'd also like to give a special thanks to Alison Stanford in production who has meticulously steered the project from manuscript to finished book. Thanks too to Derek Moseley, the assistant editor; Clare Grist Taylor, Simon Allen, Bridget Hall, Jane Mackarell and all of the sales teams. Finally, thanks to the many reviewers, many of whose good ideas we have incorporated.

*John and Mark*

Writing books is only possible with the wholehearted support of your family. Alison has been fantastic and has never complained about my long hours spent tapping away at the computer. But now it's time to take a break from writing. Mind you, our house needs a lot of decorating. Out with the paintbrushes!

*John*

At the end of yet another very long project, my long-suffering family can have me back. Without their tolerance and encouragement, what you see here would never have been possible. Yes kids, daddy's almost finished. Sheila, put the kettle on.

*Mark*

# Contents

## **Preface** *xiii*

## **PART A**

### **Business and economics**

#### **Chapter 1 The business environment and business economics** 2

- 1.1 The business environment 3
- 1.2 The structure of industry 6
- 1.3 The determinants of business performance 13
- Box 1.1 The UK defence industry 4

#### **Chapter 2 Economics and the world of business** 16

- 2.1 What do economists study? 16
- 2.2 Business economics: the macroeconomic environment 18
- 2.3 Business economics: microeconomic choices 22
- Appendix: Some techniques of economic analysis 26
- Box 2.1 Looking at macroeconomic data 20
- Box 2.2 The opportunity costs of studying economics 23
- Box 2.3 Representation of data 29

#### **Chapter 3 Business organisations** 38

- 3.1 The nature of firms 38
- 3.2 The firm as a legal entity 43
- 3.3 The internal organisation of the firm 45
- Box 3.1 Managers and owners 42
- Box 3.2 Downsizing and business reorganisation 47

#### **Chapter 4 The working of competitive markets** 51

- 4.1 Business in a competitive market 51
- 4.2 Demand 54
- 4.3 Supply 58
- 4.4 Price and output determination 62
- Box 4.1 Too many chips 62
- Box 4.2 Adjusting to oil price shocks 64

#### **Chapter 5 Business in a market environment** 69

- 5.1 Price elasticity of demand 69
- 5.2 The importance of price elasticity of demand to business decision making 73
- 5.3 Other elasticities 76
- 5.4 The time dimension of market adjustment 81



## **VI CONTENTS**

- 5.5 Dealing with uncertainty 86
- Box 5.1 The market for leather 80
- Box 5.2 The role of the speculator 87

### **PART B**

#### **Background to demand**

- Chapter 6 Demand and the consumer 94**
  - 6.1 Marginal utility theory 94
  - 6.2 Estimating demand functions 100
  - 6.3 Forecasting demand 106
  - Box 6.1 The marginal utility revolution: Jevons, Menger, Walras 99
  - Box 6.2 The demand for butter 103
- Chapter 7 Products, markets and advertising 113**
  - 7.1 Product differentiation 113
  - 7.2 Marketing the product 116
  - 7.3 Advertising 120
  - Box 7.1 Brands and own-brands 116
  - Box 7.2 BT and its pricing structure 126

### **PART C**

#### **Background to supply**

- Chapter 8 Costs of production: short run 132**
  - 8.1 The meaning of costs 132
  - 8.2 Production in the short run 133
  - 8.3 Costs in the short run 140
  - Box 8.1 The fallacy of using historic costs 133
  - Box 8.2 Followers of fashion 136
- Chapter 9 Costs of production: long run 146**
  - 9.1 Production in the long run 146
  - 9.2 Costs in the long run 152
  - Box 9.1 Industrial clusters and the location of business 149
  - Box 9.2 Minimum efficient scale 156
- Chapter 10 Revenue and profit 160**
  - 10.1 Revenue 160
  - 10.2 Profit maximisation 165

### **PART D**

#### **Supply: short-run profit maximisation**

- Chapter 11 Profit maximisation under perfect competition and monopoly 174**
  - 11.1 Alternative market structures 174
  - 11.2 Perfect competition 175

- 11.3 Monopoly 180
- 11.4 Potential competition or potential monopoly? The theory of contestable markets 184
- Box 11.1 Concentration ratios 176
- Box 11.2 Hypermarkets, suppliers and consumers 185

## **Chapter 12 Profit maximisation under imperfect competition 190**

- 12.1 Monopolistic competition 190
- 12.2 Oligopoly 195
- Box 12.1 Curry wars 194
- Box 12.2 Loyalty cards and petrol price wars 204

## **PART E**

### **Supply: alternative strategies**

## **Chapter 13 Alternative theories of the firm 208**

- 13.1 Problems with traditional theory 208
- 13.2 Alternative maximising theories 210
- 13.3 Multiple aims 215
- Box 13.1 In search of long-run profits 211
- Box 13.2 Heinz means restructuring 215

## **Chapter 14 Growth strategy 220**

- 14.1 Growth and profitability 220
- 14.2 Constraints on growth 221
- 14.3 Alternative growth strategies 224
- 14.4 Growth through vertical integration 225
- 14.5 Growth through diversification 228
- 14.6 Growth through merger 229
- Box 14.1 From checkouts to cheques 229
- Box 14.2 Merger activity 232

## **Chapter 15 The small-firm sector 236**

- 15.1 Defining the small-firm sector 236
- 15.2 The survival, growth and failure of small businesses 241
- 15.3 Government assistance and the small firm 246
- Box 15.1 The Dyson Dual Cyclone vacuum cleaner 242
- Box 15.2 Hypergrowth companies 246

## **Chapter 16 Pricing strategy 253**

- 16.1 Pricing and market structure 254
- 16.2 Alternative pricing strategies 256
- 16.3 Price discrimination 261
- 16.4 Multiple product pricing 265
- 16.5 Transfer pricing 267
- 16.6 Pricing and the product life cycle 268
- Box 16.1 Predatory pricing in the airline industry 255
- Box 16.2 How do UK companies set prices? 260

PART F

**The firm in the factor market**

**Chapter 17 Labour markets, wages and industrial relations 272**

- 17.1 The UK labour market 272
- 17.2 Market-determined wage rates and employment 273
- 17.3 Firms with power in the labour market 282
- 17.4 The role of trade unions 283
- 17.5 The efficiency wage hypothesis 288
- 17.6 Low pay and discrimination 289
- 17.7 The flexible firm and the market for labour 296
- Box 17.1 'Telecommuters' 274
- Box 17.2 Labour market legislation since 1979 288
- Box 17.3 The cost of labour 298

**Chapter 18 Investment and the employment of capital 302**

- 18.1 The pricing of capital and capital services 302
- 18.2 The demand for and supply of capital services 304
- 18.3 Investment appraisal 306
- 18.4 Financing investment 313
- Box 18.1 Investing in roads 308
- Box 18.2 Financing innovation 315

PART G

**The relationship between government and business**

**Chapter 19 Reason for government intervention in the market 322**

- 19.1 Markets and the role of government 322
- 19.2 Types of market failure 323
- 19.3 Government intervention in the market 329
- 19.4 The case for *laissez-faire* 334
- 19.5 Firms and social responsibility 337
- Box 19.1 Can the market provide adequate protection for the environment? 326
- Box 19.2 Public support to industry 336
- Box 19.3 The Body Shop 341

**Chapter 20 Government and the firm 344**

- 20.1 Policies towards monopolies and oligopolies 344
- 20.2 Policies towards research and technology development (R & TD) 352
- 20.3 Policies towards training 358
- Box 20.1 Cartels set in concrete, steel and cardboard 350
- Box 20.2 The R & D scoreboard 356
- Box 20.3 Training and Enterprise Councils (TECs) 360

**Chapter 21 Government and the market 363**

- 21.1 Environmental policy 363
- 21.2 Transport policy 369
- 21.3 The privatisation debate 377
- Box 21.1 Environmental auditing 365

- Box 21.2 Road pricing in Singapore 376
- Box 21.3 Reorganising the railways in the UK 382

## PART H

### **Business in the international environment**

#### **Chapter 22 International trade 388**

- 22.1 Trading patterns 388
- 22.2 The advantages of trade 390
- 22.3 Arguments for restricting trade 394
- 22.4 World attitudes towards trade and protection 397
- Box 22.1 Strategic trade theory 398
- Box 22.2 The World Trade Organisation and its future 400

#### **Chapter 23 Multinational corporations 406**

- 23.1 What is a multinational corporation? 406
- 23.2 Multinational corporations and the UK economy 408
- 23.3 Why do businesses go multinational? 410
- 23.4 The advantages of MNC investment for the host state 414
- 23.5 The disadvantages of MNC investment for the host state 416
- 23.6 Multinational corporations and developing economies 418
- Box 23.1 Investing in Wales 416
- Box 23.2 McDonald's in India 421

#### **Chapter 24 Trading blocs 424**

- 24.1 Preferential trading 424
- 24.2 Preferential trading in practice 427
- 24.3 The European Union 429
- 24.4 The development of the single European market 433
- Box 24.1 The arrival of the 'Pacific Century'? 430
- Box 24.2 Banana split 433

## PART I

### **The macroeconomic environment**

#### **Chapter 25 The macroeconomic environment of business 440**

- 25.1 Macroeconomic objectives 440
- 25.2 Economic growth 441
- 25.3 Unemployment 446
- 25.4 Inflation 451
- 25.5 The business cycle and macroeconomic objectives 458
- 25.6 The circular flow of income 459
- Appendix: Measuring national income and output 465
- Box 25.1 Reducing unemployment in the European Union 452
- Box 25.2 Disinflation in Europe and Japan 457

|                   |  |            |
|-------------------|--|------------|
| <b>Chapter 26</b> | <b>The balance of payments and exchange rates</b>                                  | <b>472</b> |
| 26.1              | The balance of payments account  | 472        |
| 26.2              | The exchange rate  | 475        |
| 26.3              | Exchange rates and the balance of payments   | 479        |
| 26.4              | Fixed versus floating exchange rates   | 481        |
| 26.5              | The European Exchange Rate Mechanism   | 485        |
| Box 26.1          | Dealing in foreign exchange  | 478        |
| Box 26.2          | The effects on business of exchange rate movements                                 | 479        |
| <br>              |  |            |
| <b>Chapter 27</b> | <b>Money and interest rates</b>  | <b>493</b> |
| 27.1              | The meaning and functions of money   | 493        |
| 27.2              | The financial system in the UK   | 496        |
| 27.3              | The supply of money  | 504        |
| 27.4              | The demand for money   | 509        |
| 27.5              | Equilibrium  | 512        |
| Box 27.1          | From building society to bank  | 495        |
| Box 27.2          | Are the days of cash numbered?   | 499        |
| Box 27.3          | UK monetary aggregates   | 506        |
| <br>              |  |            |
| <b>Chapter 28</b> | <b>Economic ideas – Keynesian and monetarist explanations of business activity</b> | <b>516</b> |
| 28.1              | Background to the debate   | 516        |
| 28.2              | The Keynesian theory of national income determination                              | 520        |
| 28.3              | Keynesian analysis of cyclical fluctuations in unemployment and inflation          | 526        |
| 28.4              | The role of money in Keynesian and monetarist models                               | 530        |
| 28.5              | Expectations and the Phillips curve  | 536        |
| Box 28.1          | Business expectations and their effect on investment                               | 528        |
| Box 28.2          | Monetarists and the control of inflation   | 534        |
| Box 28.3          | The political business cycle   | 538        |

## PART J

### Macroeconomic policy

|                   |   |            |
|-------------------|---|------------|
| <b>Chapter 29</b> | <b>Demand-side policy</b>                                   | <b>548</b> |
| 29.1              | Fiscal policy   | 548        |
| 29.2              | The effectiveness of fiscal policy                          | 550        |
| 29.3              | Monetary policy   | 554        |
| 29.4              | The effectiveness of monetary policy                        | 557        |
| 29.5              | Trends in public expenditure and the crowding-out debate    | 562        |
| 29.6              | The management of aggregate demand in practice              | 565        |
| Box 29.1          | The credit boom of the 1980s and decline of the early 1990s | 558        |
| Box 29.2          | Should central banks be independent of government?          | 560        |
| <br>              |   |            |
| <b>Chapter 30</b> | <b>Supply-side policy</b>                                   | <b>573</b> |
| 30.1              | The supply-side problem                                     | 573        |
| 30.2              | Market-orientated supply-side policies                      | 574        |
| 30.3              | Regional and urban policy in the UK and Europe              | 580        |
| 30.4              | Industrial policy in the UK and Europe                      | 585        |
| Box 30.1          | Deregulating the bus industry                               | 578        |
| Box 30.2          | A new approach to industrial policy                         | 589        |

|                   |   |            |
|-------------------|---|------------|
| <b>Chapter 31</b> | <b>International economic policy</b>                  | <b>593</b> |
| 31.1              | International business cycles                         | 593        |
| 31.2              | International harmonisation of economic policies      | 594        |
| 31.3              | European economic and monetary union                  | 599        |
| 31.4              | Alternative policies for achieving currency stability | 604        |
| Box 31.1          | Monitoring the world economy                          | 598        |
| Box 31.2          | Meeting the Maastricht criteria                       | 600        |

|              |            |
|--------------|------------|
| <b>Index</b> | <b>I-1</b> |
|--------------|------------|

# Business and economics

# A

**B**usinesses play a key role in all our lives. Whatever their size, and whatever the goods or services they provide, they depend on us as consumers to buy their products.

But just as businesses rely on us for their income, so equally many of us rely on firms for our income. The wages we earn depend on our employer's success, and that success in turn depends on us as suppliers of labour.

And it is not just as customers and workers that we are affected by business. The success of business in general affects the health of the whole economy and thus the lives of us all. In addition, the activities of firms have effects well beyond that of their immediate customers and employees. If a factory pollutes a river, then everyone living along its banks, or using it for recreation, will be affected. Business then touches all of us virtually every day of our lives.

In Part A of this book we will consider the relationship between business and economics. Chapters 1 to 3 look at the types of environment in which businesses operate, the different ways in which they are organised and the role of economists in analysing business behaviour. Then in Chapters 4 and 5 we will examine the operation of markets. As consumers, we buy from firms and they sell to us. This process of buying and selling involves *demand* and *supply*. As we shall see, the interaction of demand and supply then determines the market price of the product and the profit the firm makes.

**The 'theory of business' leads to a life of obstruction, because theorists do not see the business, and the men of business will not reason out the theories.**

Walter Bagehot (1826–77),  
*Economics Studies*, ed. W. Hutton,  
vol. I, pp. 9–10

## key terms

The business environment  
Production  
Firms  
Industries  
Scarcity  
Macroeconomics  
Microeconomics  
Circular flow of income  
Principal and agent  
Business organisation  
Price taker  
Perfectly competitive market  
Price mechanism  
Demand  
Supply  
Equilibrium price and quantity  
Shifts in demand and supply  
Price elasticity of demand and supply  
Income and cross elasticities of demand  
Speculation  
Risk and uncertainty

# 1

# The business environment and business economics

*What is business economics?*

What is the role of *business economics*? What will you be studying in this book?

Clearly we will be studying *firms*: the environment in which they operate, the decisions they make, and the effects of these decisions – on themselves, on their customers, on their employees, on their rivals and on the public at large.

But what particular aspects of business does the *economist* study? Firms are essentially concerned with using inputs to make output. Inputs cost money and output earns money. The difference between the revenue earned and the costs incurred constitutes the firm's profit. Firms will normally want to make as much profit as possible, or at the very least to avoid a decline in profits. In order to meet these and other objectives, managers will need to make choices: choices of what types of output to produce, how much to produce and at what price; choices of what techniques of production to use, how many workers to employ and of what type, what suppliers to use for raw materials, equipment, etc. In each case, when weighing up alternatives, managers will want to make the best choices. Business economists study these choices. They study economic decision making by firms.

The study of decision making can be broken down into three stages.

*The external influences on the firm (the 'business environment')*. Here we are referring to the various factors that affect the firm that are largely outside its direct control. Examples are the competition it faces, the prices it pays for raw materials, the state of the economy (e.g. whether growing or in recession) and the level of interest rates. Businesses will need to obtain a clear understanding of their environment before they can set about making the right decisions.

*Internal decisions of the firm*. Given a knowledge of these external factors, how do firms then decide on prices, output, inputs, marketing, investment, etc? Here the business economist can play a major role in helping firms achieve their business objectives.

*The external effects of business decision making*. When the firm has made its decisions and acted on them, how do the results affect the firm's rivals, its customers and the wider public? In other words, what is the impact of a firm's decision making on people *outside* the firm? Are firms' actions in the public interest, or is there a case for government intervention?

*What do business economists do?*

Our study of business will involve three types of activity:

- *Description*. For example, we will be describing the objectives of businesses (e.g. making profit or increasing market share), the types of market in which firms operate (e.g. competitive or non-competitive) and the constraints on



decision making (e.g. the costs of production, the level of consumer demand and the state of the economy).

- *Analysis.* For example, we will analyse how a firm's costs and profits are likely to vary with the amount of output it produces and what would be the consequences of a change in consumer demand or a change in the price charged by rivals. We will also analyse the upswings and downswings in the economy: something that will have a crucial bearing on the profitability of many companies.
- *Recommendations.* Given the objectives of a firm, the business economist can help to show how those objectives can best be met. For example, if a firm wants to maximise its profits, the business economist can advise on what prices to charge, how much to invest, how much to advertise, etc. Of course, any such recommendations will only be as good as the data on which they are based. In an uncertain environment, recommendations will necessarily be more tentative.

In this chapter, as an introduction to the subject of business economics, we shall consider the place of the firm within its business environment, and assess how these external influences are likely to shape and determine its actions. In order to discuss the relationship between a business's actions and its environment, we first need to define what the business environment is.

## **1.1 The business environment**

It is normal to identify four dimensions to the business environment: political/legal, economic, social/cultural and technological.

*Political/legal factors.* Firms will be directly affected by the actions of government and other political events. These might be major events affecting the whole of the business community, such as the collapse of communism, the Gulf War or a change of government. Alternatively, they may be actions affecting just one part of the economy. For example, an anti-smoking campaign by the government will affect the tobacco industry. Similarly, businesses will be affected by the legal framework in which they operate. Examples include industrial relations legislation, product safety standards, regulations governing pricing in the privatised industries and laws preventing collusion between firms to keep prices up.

*Economic factors.* Economic factors can range from big to small, from local to national to international, from current to future; from the rising costs of raw materials to the market entry of a new rival, from the forthcoming Budget to the instability of international exchange rates, from the current availability of investment funds to the likely future cash flow from a new product. Business must constantly take such factors into account when devising and acting upon its business strategy.

It is normal to divide the economic environment in which the firm operates into two levels:

- *The microeconomic environment.* This includes all the economic factors that are *specific* to a particular firm operating in its own particular market. Thus one firm may be operating in a highly competitive market, whereas another