Impact of economic environments on banking industry

Finance, Banks

1. 0 Introduction The main purpose of this assignment is to identify the impacts of economic environments on banking industry. Economics environment is the collection of numerous markets interacts with government to deal with exhaustive individuals, businesses, and consumers sell and buy products and services at national and international stages. R. Glenn Hubbard, Anthony Patrick O’Brien (2008) suggests that economic environments basically separated into two different entities such as Microeconomic and Macroeconomic. Economic models are used to analyze and clarify decision making in many domestic and international areas.

Microeconomic is the study of how households and firms make their decisions, how they interact with markets, and how government influences their choices. On the other hand, Macroeconomic includes the topics such as inflation, unemployment rates, and economic growth and also comprehends that policy issues made government interventions to regulate economy. There are five major Elements of Economic Environments which are EconomicLegislations, Economic Policies, Economic Conditions, Economic System and International Economic Environment (TR Jain, MukeshTrehan, RanjuTrehan, 2008).

Those Economic factors which effect on the working of the business are known as economic environments. Besides, Macroeconomic has the crucial impacts on banking industry during the period of economic cycles. Banking industry apparently business provides financial services and serves as accumulator of deposits from public tomake loansto others. It strengthen the efficient allocation of capital stock, provides essential transaction and intermediation services and funds the development of new businesses (K. P. V. O'Sullivan, 2010). This process keeps recycling until the end to ensure that liquidity in the markets.

Meanwhile, any changes of economic environments prone to influence on financial institutions policies such as banks and federal bank to regulate economic varying conditions. 2. 0 Economic Conditions (Recession) Basically, economy experiences various economic cycles. Sampat Mukherjee (2007) suggests that there is four phases of the economic cycle which are prosperity, recession, depression, and recovery. Most economists believe that society is capable of preventing future depressions (recession) and inflations (booming) through integrative Federal bank and banking industry's fforts. When recession strikes the markets, the living standards keep decreasing, unemployment rates intensively heighten and trading businesses stop expanding. Meanwhile, economic recession shows a sign of significant decline in all industry sectors across the nation and gross domestic product (GDP) at least two consecutive quarters for long lasting more than few months. What cause the recessions? N. Gregory Mankiw(2008)is a researcher of the US economyduring the recession in 2001.

In his statements strongly recommends that -Low demand: Aggregate demand curve shift to left due to household reduces their spending on major products and services while the economic uncertainty. -Plantation Closures: Many companies need to amputate some of their plants in order to cut cost due to decrease of profits. -Job layoffs: Because of bankruptcy and plant closures, the employment rates raise more higher. Performance per employee may increase, but morale may suffer as hours become longer and wages remain constant although works become harder.

Workers more concern the job layoffs than job conditions or welfares. -Stock market decline: The ambiguous anxieties of stock investors sell their stocks at once, tremendously destroy stocks' value. During recession, KennethMolbjergJorgensen (2007)mentions that banking industry mostly suffers losses of doubtful debts because of trading businesses and also individual bankruptcy. Therefore, most commercial banks initiate liquidity crunch which result in a tight situation where it has become extremely difficult for individual loans even for top companies to take loans for their needs.

A sense of disbelief and extreme prevention is prioritizing in the banking industry to curb doubtful debts. Crackdowns of liquidity in the money markets drive the recession to great depression while investment community has become extremely risk-averse substantially affect the social welfares. (Gamble, Richard H. , 2001) In reality, government interventions are the pivotal engine to regulate market conditions in conjunction with banking industry's participations. In general, monetary policy aims to encouraging consumer spending and investments to shift aggregate demand to right and eases recessions or reduces its impacts.

In order to do so, Federal bank and commercial banks must ensure that efficient allocation of money supply in market. Thus, Federal bank increase the excess reserve fund of commercial banks. GEckhard Hein, AchimTruger, (2007) suggests that government usually exercises its Economic policies and Economic legislations' influence initiate expansionary monetary policy and fiscal policy as simulative economic packages. There are three main components of expansionary monetary policy as stated as below. -Lower the reserve ratio: Federal bank changes the essential required reserves into excess reserves and increase the size of the monetary multiplier. Purchase securities: By purchasing securities in the open market especially banking industry, in order to increase commercial bank reserve fund. -Lower the interest rate: By lowering the discount rate, commercial banks especially enjoy the priority to borrow more reserves from Federal bank. (William J. Baumol, Alan S. Blinder. 2008) Expansionary monetary policy directly impactson banking industry. Borrowers especially enjoy the short-term interest rates offered by commercial banks, to stimulate domestic investments and consumption demand.

Besides, because of the low discount rates and reserve ratio issued by Federal bank, commercial banks tend to acquire quicker ratio to issue more individual loans even for organizational loans to keep robust market liquidity, although the economic condition is hostile. The aims of this policy are to maintain high levels of employment, price stability, and substantial economic growth. (William J. Baumol, Alan S. Blinder. 2008) However, expansionary monetary policy may be in vain to recover economy from recession. Thus, fiscal policy will be the second choice.

Fiscal policy is concerned with the consumption/spending and tax initiative of government to increase nationwide Gross Domestic Product (GDP) by fostering aggregate spending and demand . An increase in government spending stimulate the demand of good and services whereas has to bear gigantic deficit debts . Hereby, a decrease on tax rates is encouraged to increase individual disposable income spur the aggregate demand of goods and services from public. As a small conclusion, Fiscal policy has the most direct impacts on the economy, but indirect influence on banking industry. . 1 U. S. economy United Nations, Economic Commission for Africa (2002) suggests that 9/11, 2001 terrorist attack on Twins Tower of World Trade Centre had crashed the U. S. economy to greater recession , dispersed foreign /domestic investors and households ’confidence over market security issue/uncertainties for few decades. Besides, U. S . economic environments are the one contemporary recession’s models to support all theories from above such as aggregate demand, unemployment rates, liquidity crunch, Expansionary monetary policy, Fiscalpolicy, banking industry and so on.

Subprime mortgage crisis, business and individual bankruptcy has threatened domestic and worldwide financial institutions and market growth. Banking industry especially undergoes the hardship to collect loans from creditors and initiates credit crunch which subdues the money supply and market liquidity. Meanwhile, under Former President George Bush leaderships assigns major funds on war consumptions which collapses The financial instability induce the Federal bank to intervene the Reserve Fund rate on January 22, 2008announce the 75 basis point decline spur all banking liquidity.

Meanwhile, Expansionary monetary policy has significant impact on banking industry but less influencing on economic environments (Keith Bradsher and David Jolly . 2008). Thus, government debates fiscal stimulus packages initiate $300 to $1200 tax for each family within income limits, and interim tax reduction for businesses and investments in 2008. However, stimulus packages is deemed to be superficial encouragements on bargaining powers and fails to push the domestic aggregate demand.

Meanwhile, international economic environment such as China‘ s economic power in 21st century directly shake on financial institutions . The huge cash and credit turnovers from foreign and local investors are inevitable veer to China and oversee markets . Local consumers and investors especially still turmoil over unclear economic conditions and unwilling to spend more on daily consumptions and investments. Theshift of interest on imports from China due to price differentiations tremendously weakens the U. S production and plantation business growth.

Because of plantation closures and high unemployment rate induce the banking industry issue unsecure and doubtful debts to public, although indecent applicants in order to obey government’s agenda to provide market liquidity. In other word, banking industry are stuck with dilemma on bank‘ s interest and government polices to maintain efficient allocation of money supply. (Anon. 2005) 3. 0 Economic Conditions (inflation) General speaking, inflation is the other economic cycle while the upward price movement of goods and services higher than base year. Consumer and he Producer Price Index are the main factors. Over time, as the cost of goods and services increase, the value of real income is going to fall. (Anon, 2009) What is Consumer Price Index? Consumer Price Index (CPI) is used as an economic indicator to measure the inflation rate and cost of living typical consume to the base year . Besides, CPI is used to find the real value (real GDP and real income) of an economic valuable and adjusted certain nominal income and calculate the deflation income. (Beatrice Du Boys, JulienDupont, , 2002) In this case, stock market is booming and increasing household wealth.

Thus, aggregate demand is shrift to right . Meanwhile, scarcity of resource and cost –push inflation are inevitable due to (The supply of goods goes down) . On the other, demand for goods goes up may also causes Demand-Pull Inflation . In general, all types of inflation is harmful especially for those middle and working classes. Therefore, Federal bank’s intervention is essential . Contractionary fiscal policy usually applied by government to regulate economic conditions to deal with inflation and aggregate demand.

By cutting government spending and raise the tax impose on public. Federal bank able to regulate the economic crisis to pull the Y = C+ G + (X-IM) schedule down to achieve healthy GDP growth and aggregate demand/supply. However, those Economic Legislations, Economic Policies have the indirect impact on banking industry so far However, monetarily policy is perceived has significant impacts on commercial banks to deal with Federal bank policies. (Partha Ray, 2008) -Interest rates: Federal bank normally raise commercial banks loan interest rates to slow down leading abilities. Bonds/securities: By selling its bond and securities to banking industry, weaken commercial quicker ration liquidity. -Raising the reserve ratio: Increasing the reserve ratio to tighten loans issued publicly, so that money supply under control. Commercial bank normally is a profit organization and seemed to be unwelcome such monetary policies which destroy the golden opportunities during economic booming (inflation) in order to generate more profitability by leading more loans to public, but they may enjoy the lucrative profit brought by high interest rates refined by Federal bank imposes on creditors .

Tight allocation money supply in market is necessary to ease the rampant aggregate demand of products and services. Since, housing loans, car, mortgages, capital investment and so on are perceived more expensive to borrow from commercial banks . Thus , economic growth is slowed because of low demand , the inflation rate decelerates as well. (Sangeeta Bishop, Christine Parrott, Chuck Martie, Raymond Miller, 2009) 4. 0 Economic System There are hundreds of countries but only two major economic systems so far such as Socialism and Capitalism .

However, most countries have chosen elements from both economic systems. What is Economic system? An economic system is characterized by largely private ownerships of productions, market allocations of resource such as raw materials and financial allocations, and also market decision making. Meanwhile, government plays a substantial and regulatory role. Capitalism: The market decides market allocations and what goods will be produced. Therefore, private sector has much crucial role in economic activities . It also called open market such as United State and U.

K. Socialist: The Government decides market allocations and role in determining what will be produced. Mix economy: Such economic systems consist of both private and public sector co –exist . Nowadays, a shift of interest from socialism to capitalism to enhance the market allocation of resources has gained the attention from government such as Malaysia. (Brian P. Simpson. 2005) The concept is simple to justify the banking industry directions while operating under two economic systems. First, if commercial bank operates under Socialist system .

Thus, government has the general impact of bank control to assess the effectiveness of bank control over ownerships of productions, market allocations of resource and also market decision making. Eui-Gak Hwang (2010) says that most decision-makings are focused government policies and commercial banks are said that lack of power on interests such as North Korea and China adopt the Socialism ideology control over banking industry, but China is seemed to be decentralized decision makings and sharing power with banking industry. The Capitalist ideology has a small influence on banking industry.

Each commercial has the powers to make decisions within certain rules and regulations made by governments mostly in western countries. Many researches and analysts argue government intervention by initiating Fiscal policy and monetary policy . In their opinions, Economic conditions whether recessions and inflations have its self-healing abilities in the end (Ambe J. Njoh (2003). However, United State eventually adopts the Mixed Capitalist Economies to deal with uncertain economy and keeps pumping fund aids to market place by increasing government expenditures (Robert J. Carbaugh. 2006) 5. International Economic Environment The international economic environment refers to worldwide economic trends and situation outside the country. Besides, those international business environments prone to get the influences by the trend or conditions in social economic variable such as GDP, exchange rate, economic system /conditions and policies. (David L. Kurtz, H. F. MacKenzie, Kim Snow. 2009) 5. 1 Malaysia financial crisis Referring to international financial crisis of 1997/98, the collapse of world financial market eventually influences the financial structures and banking industry in many countries.

These included Malaysia, Thailand, Philippines, Indonesia and also Korea show a sign significant impact. (Teofilo C. Daquila, 2005) The impacts of the Asia Financial crisis (AFC) strike the Malaysia's financial institutions profoundly deep. Besides, stock market and stock currency are roughly to collapse during that crisis because of US financial crisis , the main issues distracts from major electronic exports and foreign investor confidence over Asian economic performances. (Anon, 2010) As a result, commercial banks sustain hefty repercussions pertaining to business/commercial and individual bankruptcy.

The late responses and ambiguity policies issued by Federal bank and finance ministry weaken local banking industry abilities during 1997/98 year.

Meanwhile, turbulent free float and interest rate (cost of borrowing) puzzle the commercial banks to deal with foreign investments and local allocation of money supply. Rina Bhattacharya, International Monetary Fund. Middle Eastern Dept (2000) mentions that Local commercial banks especially experience the credit environment and collapse of currency, the additional supply sparks huge market bankruptcy ratio. Fix rate at 3. 8 ringgit Malaysia to one dollar U.

S issued by Former Prime Minister Tun Dr. Mahathir Mohammad eventually ease those impacts, and restructure commercial banks interest rate (cost of borrowing) consequently restore economic conditions back to recovery stage. Government actually learns from lessons, too depending on electronic industry is harmful for nation. Thence, the shift interest on agriculture industry has gained attention to balance economic shortcoming. At the same time, collaboration between local banking industry and International Islamic Financial Centre (MFC); strengthen internal fundamental money supply and commercial banks interest. Anon, 2009)risk premium attached to loans is inevitable issued to publicity. Thus, risk of non-performing loans (NPLs), threatens commercial banks adopt credit crunch to save itself from peril. Meanwhile, failure of efficient allocation of money 6. 0 Environmental factors Could an industry survives and mitigate the impacts during bad economic environments? The answer is yes. PEST analysis and Porter Five Forces have been established by most industries to assess the environmental influences and industry survival. (Neil Botten. 2009) 6. 1 The Far Environment

Far environment means that external forces or Macro environments that are out of control for most organizations influence those factors. PEST analysis *Political environment Legislation/regulation, nationalization/ privatization, government, fiscal and monetary policy, contact law, trade union and so on *Economic environment Business cycles, economic growth, interest rates, supply and demand, unemployment, disposable income, interest rate and so on *Social environment Demographic trend, income distribution, social mobility, spending pattern, educational standards and so on *Technologies environment

New inventions, types of products, research and development, speed of change and technology transfer and so on 6. 2 The Near Environment Near environment means that internal forces or Micro environments that are under control of most organization to influence those factors Porter Five Forces *Threat of Entry Differentiation, government policies, capital requirement, access to distribution channels, economics of scale, etc *Power of Supplier Supplier of raw material, components, labor, power, plant, equipment, finance, etc *Power of Buyer Manufacturer, retailer, wholesalers, distributors, etc Threat of Substitutes It can be anything such as pen, pencil, new car, holiday, etc *Rivalry among Existing Competitors Price competition, product, advertisements, etc Nowadays, most commercial banks have the great trouble to deal with PEST analysis and Porter Five Forces to evaluate their strategic positions brought by economic environments. Because of far environment, government intervention and market social have the main impacts on few factors such as *Political environment,*Economic environment,*Social environment and Technology environment.

Thus, there is nothing, commercial banks to fix and regulate those four environmental factors. On the other hand, Porter Five Forces are seemed to be indecent assessment for banking industry. This analysis tool is mostly used by producers and suppliers to value its competitive intensity and attractiveness of a market such as *Threat of Entry,*Power of Supplier,*Power of Buyer,*Threat of Substitutes, and *Rivalry among Existing Competitors. Although, banking industry is not encouraged to apply PEST analysis and Porter Five Force because of difficulty to adopt industry requirements and environments .

However, PEST analysis and Porter Five Forces slightly herald clues that commercial banks are inspired to refine the its business strategic with integrative both analysis whether good or bad time. 7. 0 Business strategic Jeremy Kourdi (2009), comments that business strategic is the directions, plans, choice and plans used to guide the company to greater success and also environmental matching strategic . A clear view is deemed to be important for an organizational objectives to assign all resources (workforce , finance, and effort) concentration. . 1 Differentiation *Differentiation: A differentiation strategies original ideal taken from Porter Five Force, Threat of entry (differentiation focuses on brand identification and customer loyalty). Commercial banks seek to be more unique in its banking industry with some dimensions that are valuable assessed by investors, depositors, and debtors. Moreover, differentiation normally bases on product itself, banking system, reliability, and also a broad of other factors.

Product here refers to package or financial policies offered to publicity by commercial bank such as Special Return Package, Interest Rate, Student Packages and so no. It is very crucial for commercial banks secure those promises and healthy banking system. Investors, depositors and creditors normally look at commercial bank which has premium status and reliable banking . Meanwhile, commercial bank particularly eases the risk of high cash flow turnover and market stock by depositor and investor during unstable economic conditions. Alexander von Pock. 2007) 7. 2 Merging Merging: Merging strategic basically stands for two or more business entities merge together into one new business entity. A business entity B business entity AB business entity (combination of capital, technologies, market share, workforce, management level, consumers) Suk H. Kim, SeungHee Kim (2006), suggests that East Asian countries especially facing the mess politic and economic conflicts weaken the banking industry.

Many ailing commercial bank forcedly close down its business to settle the nonperforming loans ((NPLs). Meanwhile, merging strategic has be more popular for existing banks survival. Combination of capital meets the quick adequacy ratio set by Bank for International Settlements to secure themselves from bankruptcy and opportunity to penetrate foreign clients and investments because of reliable status. Meanwhile, it also enables local commercial banks to avoid the heated rivalry among existing competitors and benefits threat of entry (Porter Five Forces).

Management /organizational restructuring which comprehends the capital reforms improvement via debt deductions, human power (expertise), technologies improvement, strong market share and also escalate the corporate governance performances has substantial mutually benefit for both parties(A and B bank entity). Departmental merging and labor slimming are inevitable to decrease average costs. At the same time, leaders and manager from both parties must wisely revise experience curve from the pass events to determine decent objective and leadership shall be adopted to meet current environments change. . 3 Bargaining power of supplier and buyer * Dispensation of concentration of clients and consumers: These original ideals actually come from bargaining power of supplier and buyer (Porter Five Forces). Commercial bank hereby assumes concentration of depositors (client) and investors as their main concentration of major suppliers fund cash liquidity. Huge bargaining powers of suppliers basically threaten the banking industry strategic position. Depositors and investors (shareholders) especially may withdraw huge liquid cash at once trigger the quick ratio crisis.

Therefore, commercial bank is induced to disperse the bargaining powers of depositors and investors' influences by expanding fund venture and branches penetrating oversea markets. An allocation fund system of all oversea market is much better than over depend on domestic market. Tan Sri Teh Hong Piow the co-founder of Malaysia, Public Bank group in his interview with Anon, January, 2009, the Star online tells that successful bank particularly required to maintain healty deposits and loans ratio The expanding to oversee market is essential to increase the allocation fund system and never ever “ Put all Yours into One Basket” . . 0 Conclusion According to case study, economic environment apparently bears upon banking industry which serves as watershed of economy. Strictly speaking, governments in many countries are advocating their effort to strengthen local banking industry as well as foreign banking industry benefits the society.