

Macro and micro economic drivers



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Management in a Complex World

A View on Macro and Micro Economic Drivers

At a macro level, the complexity of global corporate management can be better understood by studying the Business Cycle Fluctuations. However, the complexity is further intensified with the existence of micro economic forces, which we will be studying using Michael Porter's Five Forces model.

MACRO-ECONOMIC FORCES

Business cycle fluctuations are a key driver of multinationals' profits. An accurate understanding of the length and depth of business-cycle fluctuations is therefore an important element in successful planning of firms' investments as well as in forming the appropriate strategies. During the last fifty years there have been a decline in frequency and depth of recessions in a large majority of countries in what is known as the Great Moderation. However, the Great Recession that began at the end of 2007 brought this pattern to an end. Understanding the causes of the Great Moderation is critical as it helps in understanding the future patterns of the macroeconomic environment.

Two important aspects of recessions are tightening of credit conditions and increased unemployment. However, these conditions significantly differed across countries. While in Germany or Denmark the unemployment rate did not increase much, in Spain it has increased from 8% to over 20%.

The Great Recession should be seen as a wakeup call for the risks of globalisation. Increased trade volumes that have come with globalisation is

the international amplification of downturns in large developed economies such as the U. S., Japan and the EU. Increased financial integration paralysed developing countries from counteracting the global effects of these shocks. As a result, domestic recessions in developed economies contribute with a significant destabilizing force towards developing countries.

This new reality was hard to anticipate 10 years ago when the consensus was that openness to international capital was the main destabilizing factor of developing economies. However, China did not experience any currency crisis in the 1990s and became the largest holder of foreign exchange reserves, together with effective capital controls, China maintained an artificially low RMB that helped it grow its export markets. Despite China's productivity miracle had many factors, one of the most important was the acceleration at which Chinese companies mastered increasingly sophisticated technologies.

A large academic literature tried to understand the causes of business cycle fluctuations and their effects on the economy. Some of the literature propositions include shocks to government spending, taxes, money supply and demand, input prices such as energy or capital, news about future technology, wage and price mark-ups, volatility and frictions in credit markets.

2. UNEMPLOYMENT

A key aspect of business cycles is the fluctuations in the unemployment rate. The academic literature has studied this in the context of the search and matching models (Mortensen and Pissarides, 1994). These models recognise

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that it is costly for workers to search for jobs and for companies to post vacancies. In equilibrium, these search and matching frictions generate both unemployed workers and unfilled vacancies. The search and matching models have been used to study how different regulations such as firing costs, hiring cost, minimum wages, and collective bargaining agreements affect the unemployment rate and the average duration of unemployment phases.

2. 2BUSINESS CYCLES IN DEVELOPING COUNTRIES

In addition to analysing the time variation of fluctuations, the literature also studied the geographical variation in business cycles. In particular, a body of research tried to understand how and why business cycles are different in developed and developing countries. Comin et al. (2009) explore the effect that shocks to developed economies have on developing countries. They found that disturbances that originate in developed economies are a key driver of business cycles in developing countries. This is not only the case because they contract the demand for exports to the developed economies but also because they affect the flow on new technologies to developing countries.

2. 3GLOBAL IMBALANCES

Though the literature on global imbalances has taken a U. S. theme, global imbalances are as much about Chinese trade surpluses as U. S. trade deficits. Some of the proposed explanations of the global imbalances are:

Lack of investment opportunities in developing countries.

Savings glut (Rajan, 2006).

Increased in U. S. wealth (Backus et al., 2009).

Excess consumption by the U. S.

Decline (increase) in relative competitiveness of U. S. (Asian countries).

Undervaluation of the RMB (Dooley et al., 2003).

More efficient financial intermediation by the U. S (Eichengreen, 2004).

Asian reserves are a collateral for U. S. FDI in Asia (Dooley et al., 2004).

2. 4INFLATION

Empirical evidence suggests that high inflation is damaging to an economy because of its distortionary effects on investment and savings decisions.

High inflation encourages people to spend and discourages saving, thereby reducing the funds available for deployment to the most efficient uses in the economy. So, in the long run, overspending and reduced savings could result in an underperforming economy and ultimately lead to slower economic growth.

Perhaps more condemning is that high inflation is often highly variable.

Because investment decisions are based on forward-looking expectations of real (inflation-adjusted) interest rates, inflation that is highly variable is damaging as it amplifies uncertainty and ambiguity.

2. 5EXCHANGE RATES

Businesses that trade internationally, are under the mercy of global exchange rate fluxes. Changes in currency conversion rates can increase or wipe out profit gains. When a firm has profits in millions, this can make a significant impact on profits and losses. For instance, McDonald's saw sales increase in Europe during 2011, but the annual profits went down as a result of a weakness in euro.

The rapidly changing exchange rates can have the potential to make businesses reluctant to set firm figures in contracts early before a deal takes place. Therefore, organisations need to embrace and understand the risks of doing business internationally.

MICRO-ECONOMIC FORCES

The micro economic forces are best understood by considering Porter's Five Force model, which consists of: Suppliers Bargaining Power, Buyer Bargaining Power, Threats from New Entrants, Threats from Substitutes, and Degree of Rivalry. For better understanding the author will use the automotive industry in the UK as a base for discussion.

2. 1BUYER POWER

Main buyers within the automotive manufacturing industry are dealerships. They are highly dependent on manufacturers which undermines their buyer power.

There is a large number of buyers within the automotive manufacturing industry which, along a relatively high level of product differentiation, weakening the buyer power. Dealers are forced to sell car models of

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preference to customers, which also tends to reduce their buyer power further. Overall, buyer power is relatively weak in this industry.

2. 2SUPPLIER POWER

Key raw materials needed by automotive manufacturers are commodity items, such as metals. Which are usually manufactured by other firms. With the fairly low differentiation in raw materials, causing less differentiation on the supplied side, subsequently reducing supplier power. However, the critical importance of quality raw materials and components to automotive manufacturers (especially safety-wise) can enhance supplier power.

Taking a macro perspective, there has been fluctuation in the prices of primary raw materials, which places pressure on manufacturers' margins.

Typical suppliers are more likely to sell to a variety of different sectors, with the automotive industry being forming a small part of their customer base.

Which strengthens the position of suppliers.

Overall, supplier power is moderate

2. 3NEW ENTRANTS

In markets where there is little protection or barriers to entry from government regulations, customers having little brand loyalty, start-up costs are low, products in the existing market are not unique, production process is simple and access to inputs are relatively easy, risks of new entrants are significantly higher.

Putting this into context, the automotive manufacturing industry in the UK has a low new entrants threat level. For new entrants, setting up a production facility is an endeavour that involves the need of large start-up capital thus forming a strong entry barrier enhanced with the high fixed cost too. Which is further amplified with the existing car manufacturers who command strong brand equity and the tighter emission regulations.

Taking a macro perspective, the global economic downturn has had a negative impact on car sales as consumers have avoided making expensive purchases. This has resulted in a fall in demand, which reduces the likelihood of new entrants. This shows the importance of considering the macro as well as the micro factors in the approach to corporate management.

Overall, the threat of new entrants is assessed as weak.

2. 4THREAT OF SUBSTITUTES

Numerous other forms of transportation are available, but none provide the convenience and independence of automobiles. However, the main substitute threatening players in this industry is used vehicles.

Taking a macro perspective, during the global economic downturn as consumers avoid making big purchases, this amplifies the threat of cheaper substitutes such as used cars or public transport.

The threat of substitutes is fairly moderate.

2. 5DEGREE OF RIVALRY

Highly competitive industries generally yield low returns because the competition costs are high. The automotive industry for instance, is considered to be an oligopoly globally, which helps minimising the effects of price based competition. Automakers understand that price based competition does not necessarily increase the size of the marketplace but will rather put pressure on their profit margins.

There is some degree of diversification amongst manufacturers. Honda, for example, uses diversification to reduce dependence upon the automotive industry to an extent, and consequently eases rivalry

The presence of strong, multinational incumbents such as Honda and Nissan intensifies rivalry and makes it difficult for smaller players to compete. The degree of rivalry in the automotive industry is further increased by high fixed costs related with manufacturing and the low switching costs for customer when buying.

Both macro and micro forces play indicative role for global corporate management. A detailed analysis of both macro and micro is essential in order for businesses to consider entering a foreign or local market.