1.3. Business Environment

The nature of the interaction between a business and its environment will be easier to understand if the concept of a system is examined. A system is a group of related parts that work together in an organized way for some specific purpose or purposes. An Individual business firm is a system. It has related parts: management, production workers, machinery and the physical plant. The parts are organized into a system so that they can work together to convert resources into valuable end products.

Just as the production department is a working part of an individual business firm, the individual firm is itself a working part of an industry. **An industry** is viewed as a collection of related businesses that all work together to supply the total demand for a particular kind of good or service. For example, a small shoe manufacturing firm produces particular types of shoes. In turn, all shoe manufacturers work together to supply shoes to the market for shoes using common materials and methods, exploiting new research findings, supporting suppliers and selling to the same

general market. They also influence one another through competition, quality, price setting, etc. Based on our example, a small shoe manufacturer is an individual firm where as all shoe manufacturing firms collectively are called the shoe industry.

A business environment is the collection of factors outside and inside the business system that influence the activities of business. The environment determines what a business can do and as such has a shaping and channeling influence on its development. Business environment also influences business enterprise decisions and ultimately the internal structure and process of business organization**.** Business environments interact with and influence business at every level.

Business environments are classified as **internal** and **external** environment.

The internal business environments

The internal business environments consists the following elements.

i. The market
ii. Suppliers
iii. Marketing intermediaries

The external business environments

The external (macro) business environments are composed of forces outside and beyond the immediate control of the business firm. It includes the following forces.

I. Economic environment
II. Legal environments
III. Socio-cultural environment
IV. Physical environment
V. Technological environment.

The impacts of these environments on business are discussed as follows:

I. The Economic Environment

The economic environment sets the basic rules by which a business operates. The economic environment consists of factors that affect a consumer's purchasing power and spending patterns. The economic environment affects the way firms and the whole economy use resources. The economic environment can and does change rapidly. The effects can be far reaching and require challenges in business activities. Even a well-planned business firm may fail if the country goes through a rapid business decline.

The three aspects of the economic environment of business enterprises deserving special consideration are: The global economy, the business cycle, and the economic system

a. The Global Economy

Though the economic environment varies from one country to another, economies around the world are linked and are very much interdependent. The changes in one country's economy affect the economy of others. One reason for this is that the amount of international trade is increasing.

A change in the exchange rate-the worth of one country’s money in terms of another country’s money- has a great impact on international trade. Business enterprises are not safe from the forces of changes in exchange rate just because their firms are not involved in foreign trade. New competition arises in a domestic market, as foreign products gain a competitive edge with lower prices.

Changes in price and quantity of some products would affect the activities of the entire businesses existing in a given country. For example, the change in price and quantity supply of petroleum products would affect the whole businesses of a country. When the price of petroleum products increases the price that would be charged by business enterprises for their goods and services also increases because they use oil products as a major source of energy. Hence, the global economic environment has a direct impact on the activities of national or local business enterprises.

b. Business Cycle

The term **business cycle** (or **economic cycle**) refers to economy-wide **fluctuations** in production or economic activity over several months or years. These fluctuations occur around a long-term growth trend, and typically involve shifts over time between periods of relatively rapid economic growth, and periods of relative stagnation or decline (contraction). These fluctuations are often measured using the growth rate of **real gross domestic product (RGDP)**. Despite being termed **cycles,** most of these fluctuations in economic activity do not follow a mechanical or predictable periodic pattern.

A business cycle consists of four unique components, each reflecting differing levels of economic activity and the subsequent circumstances occurring during each respective stage. An **expansion** or **recovery** is where the economy is experiencing positive and increasing economic output. Employment tends to increase (unemployment falls) and there is upward pressure placed on prices (inflation rises) as output rises. A **peak** or **boom** is reached when the econ- omy has produced the greatest amount of output. At this point employment is generally at or near its highest level (unemployment is at its lowest level: usually below the full employment rate of approximately 5%) and prices tend to rise more rapidly (inflation accelerates). Following the peak is a **recession,** or **contraction**. During this phase output actually decreases (the rate of growth becomes negative); unemployment begins to rise and the inflationary pressure on prices fades. The low point of the cycle occurs next. This is known as a **trough** or **depressions** and unemployment tends to be at its peak and production at it low point. There is very little upward pressure on prices and in some cases there is downward pressure on prices (deflation).

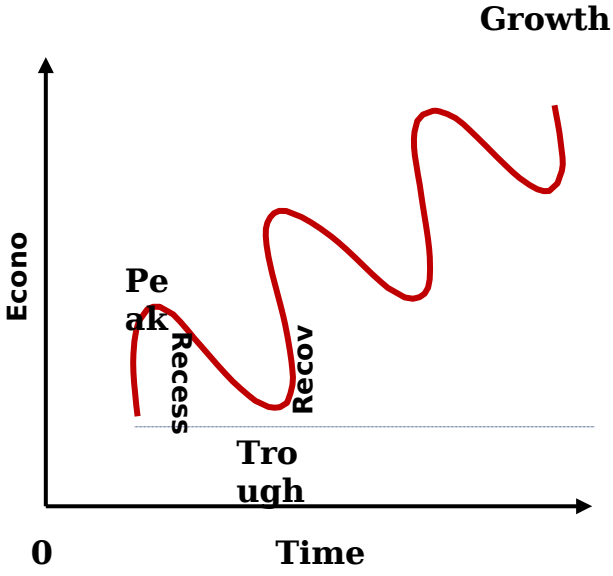


Figure 1.15 Business cycle

c. The Economic System

The economic system includes the basic economic rules that a given country follows in order to operate the business activities. In Ethiopia, the economic setting is guided by free market economic system. Businesses function in an environment where entrepreneurs are free to risk capital with the hope of creating profits and where a free market has the ultimate control over business decisions. One distinguishing mark of a free market economic system is that it permits individuals to own property of almost any kind. Anything owned by an individual is a private property.

When people are free to choose their own lines of business, some business persons make similar choices. This naturally leads to competition. Enterprises producing similar goods or services for their customer compete with one another in some way. One way is to sell at a lower price. This is known as price competition; the producer who charges more than the competitors may be at a disadvantage.

This kind of competition benefits consumers as it holds prices down.

Producers also engage in product competition. That is, each producer tries to make its products better than competing products so that it can get much profit. This kind of rivalry encourages producers to improve their existing products, develop new ones and improve their production system through the use of better technologies. For the consumer, of course, this means not only better goods and services, but also a greater variety as well.

Unlike the prevailing free market system, Ethiopia was governed by command economy system almost for two decades. In this type of economic system, the government controlled the majority of the economic activities. The major production and distribution industries were owned and operated by the government. Government assigned officials directly manage some or all of the extraction of raw materials, manufacturing, communications and transportation. Government also plays a heavy regulative role in all other business activities. Even if limited amount of private profit was available to small businesses, most of the profit centers in government hands through heavy taxation. State planners make decisions centrally about what goods and services will be available rather than by the free play of market forces. Such economic system does not encourage entrepreneurs the desire to risk their capital in order to generate profit. However, the free-market system as is described above encourages entrepreneurs to risk capital to own businesses; who charges more than the competitors may be at a disadvantage.