**1.5 The External Environment: PEST Analysis**

* <http://www.youtube.com/watch?v=eGLFVjs1Zak>
* The framework used to analyze the external environment is called a **PEST** analysis.
* A PEST includes an examination of:
	+ **(P) Political/Legal factors** - this considers changes in government policy that may affect the firm. This may include employment law, health and safety legislation, competition law and a range of other areas.
	+ **(E) Economic factors** - this area includes looking at changes in the overall economic situation that the firm faces. This may include the stage of the business cycle the economy is at, the level of interest rates, changes in taxation, inflation or perhaps unemployment levels.
	+ **(S) Social / cultural factors** - firms need to watch carefully social changes that are taking place. This may mean looking at population changes (demographic factors) and changes in the age structure of the population, changes in people's attitudes and opinions and perhaps lifestyle changes.
	+ **(T) Technological change** - technology affects firms. This comes about partly because methods of production change, but also because technology changes the pattern of demand. Firms may be able to break into new markets if the technological opportunities exist.

**1. The Political & Legal Environment**

* Governments want to encourage business activity, but they also need to pass laws and put in place rules and regulations to control business activity and avoid undesirable outcomes.
* These may be regulations concerning employment of people, environmental impact or perhaps constraints to ensure that all advertising is legal, decent and truthful.
* Governments use Fiscal and Monetary policies to influence the country/economy.
	+ Fiscal Policy:
		- Government can use taxation and subsidies (expenditure) to bring about changes in the economy.
		- *Expansionary Fiscal Policy* is used to increase consumer spending and encourage production. This can be done via lowering taxes and/or increasing government spending/subsides.
		- *Deflationary Fiscal Policy* is used to decrease consumer spending and discourage production.
	+ Monetary Policy:
		- Government can change interest rates to influence spending and investment as well to tackle inflation.
		- Increasing interest rates discourages spending and investment, while at the same time encouraging saving.
		- Decreasing interest rates encourages spending and investment, while at the same time discouraging saving.

**The Legal Environment**

* All business is subject to laws.
* When looking at this area of the external environment you should be aware of:
	+ The reasons why certain laws have been passed
	+ What a business has to do to comply with certain laws and what impact the laws are likely to have on its operations.

Employee Protection Legislation (Health & Safety)

* Business is generally responsible for providing a safe working environment, a written safety policy and a recognized training program for health and safety.
* The EU, for instance, now issues directives on working hours (minimum), the lifting of heavy weights, the use of computer screens and the rights of pregnant women.
* Like all laws imposed by any government, they involve costs for those applying them.
* Also, employees respond to better and safer working conditions and this might improve efficiency and productivity.

Employment Legislation

* The law relating to employment can be either applicable to the individual or collectively to the company.
* Laws relating to individual rights may cover areas like:
	+ **Equal pay** - the right to equal pay for equal work.
	+ **Sex discrimination** - the right to a working environment free from sex discrimination
	+ **Race discrimination** - the right to a working environment free from race discrimination.
	+ **Disability discrimination** - the right to a working environment free from discrimination on the grounds of disability.
	+ **Dismissal procedure** - and the formality of written and oral warnings prior to dismissal which staff are generally entitled to.
	+ **Notice of dismissal** - this refers to the length of notice an individual has to be given. After 4 weeks continual employment an employee is often entitled to 1 week's notice and this will increase by perhaps 1 week for every year employed to a maximum of 12 weeks.
	+ **Contracts of employment** - all employees are entitled to receive, within a certain time of commencing employment, an official contract of employment.
	+ **Trade union recognition and involvement**. It is a right in most countries of any employee to seek membership of a trades union but they do not have to belong if they do not wish to.
* Consumer Protection Legislation:
	+ This area of the law aims to protect consumers from unfair practices relating to product quality and especially financial terms.
	+ This will differ significantly between countries but may include:
	+ Laws dictating how goods should perform in relation to the quality and functions described by the producer.
	+ Laws, which prescribe how quantities should be accurate (weights and measures etc.)
	+ Laws, which cover accurate and truthful description of goods and services offered for sale.
* Laws relating to the amount of credit that can be given by recognized credit agents.
* Laws that make companies responsible for reasonable damage caused by one of their products.
* Laws that control food display and safety.
* Competition Legislation:
* The government keeps a watchful eye on corporate behavior.
* It is looking for abuses of power by firms (e.g. monopoly behavior, control of markets via mergers and takeovers and restrictive practices).
* Most now agree that competition leads to greater choice, quality and lower prices and so government is charged with monitoring business to make certain it lives up to these expectations.
* It is also argued that modern, global capitalism helps control business and makes them act in the interest of consumers.
* They are open to greater competition and so must be able to attract custom by offering quality at affordable prices.
* Environmental legislation**:**
	+ Laws, rules and regulations concerning the environmental impact that firms have.
* Information /reporting law:
	+ Governments often legislate to ensure that the information that firms provide is accurate and reflects the true state of the business.
	+ These types of rules and regulations may include accounting regulations/standards to ensure firms represent their financial position accurately.

**Political Stability & Instability**

* Political change can have a significant impact on business.
* Government changes the legal framework, which as seen above, is wide-ranging,
* It could also be that a change of government changes the political attitudes towards business.
* Governments can also change the social agenda and this may impact on firms.
* Changes of this nature will affect firms significantly and may raise their costs.
* However, additional rights could also result in improved motivation and this may help compensate for higher costs.
* Businesses will look carefully at all political changes to assess the impact that they will have on them and their competitors.

Political Instability

* Political instability can have an even greater impact on business and it may even make them reluctant to enter a particular market or relocate their activity to a more stable and predictable area.
* Political instability in an area where a firm operates will mean that the firm has to be very flexible and adaptable - ready to change their operations at very short notice to reflect changes in the political environment.

**Assign:**

* Read text pages 74 to 75 and 86 to 89
* Answer Q.1.5.5

**1.5 The External Environment: PEST Analysis (continued)**

**2. The Social & Cultural Environment**

This category of the PEST Analysis includes changing lifestyle and buying habits or preferences, as well as changing demographics.

Social change may affect businesses through many aspects of their activity. These may include:

* **Human Resources:**
	+ Expectations within society about patterns of employment and working conditions will affect the way the firm operates.
	+ Current trends towards teleworking and a more flexible employment patterns are affecting firms and the way they operate.
* **Marketing:**
	+ Firms need to ensure that their product portfolios reflect the pattern of demand in society.
	+ Market research will be an important element of this.
* **Production:**
	+ With the growth of MNCs, production has become increasingly globalized and ready to shift anywhere.
	+ Firms are also under increasing pressure to ensure that their production does not impact negatively on the countries and societies where they operate.

**Demographic Trends:**

Demographics refer to the aspects or characteristics of a country’s population such as race, sex, age, household size, household income, literacy rate, life expectancy, population growth, population density, and many more.

Population

* Businesses need to think on a global scale. They need to look carefully at population changes in the various countries they operate in:
* The **Market** as your customer base continues to widen
* The **workforce** available to you
* The **availability of the resources** needed for production

An Ageing Population

* A more mature consumer will be predominant and this will be reflected in the product ranges being offered.
* Example: retirement homes will become more popular and the pool of labor available may have to consider working longer in order to finance their pensions.

The Dependency Rate

* This reflects how many non-working individuals those in work have to support.
* This is also scheduled to grow and so those in work will face an increasing burden to support those not directly contributing to the economy. The older members of society will want to see their living standards maintained and that will be a consider able challenge for those in work

Life Expectancy

* People can work and consume for many more years.

Lifestyles

Some of the trends being put forward are:

* The need for greater flexibility in the labor market - part-time, flexi-time and working from home will all form a larger part of how people work.
* People will have both more income to spend and more time in which to spend it - holiday time is increasing for a growing number of workers; so is life expectancy and the desire to travel and experience different forms of leisure.
* The advent of lower cost transport and fast communication also influence how people see their lives evolving.
* Social changes are also taking place and these include later marriages, later first-born children and more divorces. All of these will impact on how people consume and what they will want to buy at certain times of their lives

**Pressure Groups**

* Pressure groups are without political power, but who aim to influence businesses, people and government to help achieve their objectives.

Pressure groups can be split into:

* **Local community groups**
* **Environmental groups**
* **Employee groups** - may include trade unions
* **Consumer groups**
* **Social groups**

Pressure groups will try to influence in a variety of ways:

* **Lobbying politicians**
* **Lobbying Boards of Directors**
* **Organize direct campaigns** - pressure groups may try to influence consumers to boycott particular firms or products.
* **Lobby investors** - there has been a significant growth in recent years in 'ethical investment'.
* **Media campaigns**

The extent to which pressure groups are able to influence issues will depend on various factors, including:

* **Their size** - this can be financial size as well as their organizational ability.
* The **popularity of their cause** and their ability to mobilize the public.
* Their **access to politicians** - this will be a key determinant of their ability to influence the political process.
* The **reputation of the pressure group** and the respect they have from the general public.

<http://www.stuff.co.nz/business/world/7756350/Ikea-removes-women-from-Saudi-ads>

**1.5 The External Environment: PEST Analysis (continued)**

**3. The Technological Environment**

* Advantages of technological change include:
	+ Reduced costs, waste and increased efficiencies.
	+ Higher quality products at competitive prices.
	+ Innovation and development.
	+ Advances of applied science and improved communications.
	+ Better working conditions and greater opportunity for personal development.
* Disadvantages of technological change include:
	+ The real costs of remaining ahead of the pack.
	+ The increased risk of thinking you know what consumers really want.
	+ A decline in industrial relations and working conditions.
	+ Less job security.
	+ The pace of constant change
	+ The increased risk of interconnected systems failing and causing chaos
	+ Resistance to change may lead to conflict between employers and employees.
* Change tends to affect business in terms of:
	+ Products
	+ Materials
	+ Processes
	+ Systems

Products

* The application of science and technology means that new products and services are forever entering the market.
* The possibility of '**first mover advantage**' is a strong motivator for many businesses.
* Much time is also spent on developing new ways of reducing the period that passes between the first idea and the actual appearance of the product and advantages that correct technical applications can make to product life cycles.

Materials

* Adapting new or what were not previously used materials can reduce costs, improve quality and boost productivity.
* Much is now made of genetically modified (GM) foods and at present they are not popular with many consumers, but this might change.
* We are also developing new ways of using well-known materials such as silicon and technology is constantly being applied to packaging and presenting the goods and services we buy.

Processes

* The application of ICT to ways in which products are produced has changed the ways in which we make and trade goods and services.
* Firms are becoming increasingly aware of such terms as CAD (Computer Assisted Design, or CAM, which stands for Computer Aided Manufacture).
* Other relatively new terms include: MRPH, which is Manufacturing Resource Planning and EDI or Electronic Data Interchange.

Systems

* These have been radically transformed by technology.
* In marketing, the Internet is now a major way of reaching both current and potential customers.
* Communications can now be virtually instantaneous to anywhere on the globe.
* Stock control, financial records, and human resource records are now kept electronically allowing for easier access and faster response to changes etc.

Failure by a business to utilize technology could result in it:

* Not developing new and exciting products
* Failing to note changes in consumer tastes
* Failing to notify and educate staff to the new technical devices appearing in their work place
* Failing to train staff in the use of such technology

**Assign:**

* Read text pages 76 to 79
* Answer Q.1.5.1 and Q.1.5.2

**4. The Ecological Environment**

* Increasing attention is now being paid to the environment and the impact that business activity has on it.
* This impact is usually negative, but business can often have a positive impact on the local environment and perhaps even national environment.
* *Negative Externalities* may include:
	+ **Congestion** caused on the use of local services - roads etc.
	+ **Noise** - noise is also a form of pollution and many forms of business activity are noisy
	+ **Air and water pollution** - a side effect of many production processes is pollution of some form, though there are often options to minimize these side effects.
	+ **Use of non-renewable resources** - many processes use fossil fuels or other non-renewable resources. These are by their very nature un-replaceable and so will have a serious impact on future economic activity.
* The impact that a firm has on the environment is a key area of corporate social responsibility.

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**1.5 The External Environment: PEST Analysis (continued)**

**5. The Economic Environment**

* The Business Cycle: <http://www.youtube.com/watch?v=jGP-vPEHRRE>
* *Economic growth* is when the general level of economic activity increases and it is measure via **GNP** (Gross National Product) or **GDP** (Gross Domestic Product).
* The determinants of economic growth in an economy are:
	+ Access to factors of production
	+ Use of technology.
	+ Developing a competitive advantage.
	+ A better skilled workforce.
	+ More investment.
	+ Positive government policies that support business and aid growth.

* Business normally benefits from economic growth because:
	+ It delivers new opportunities.
	+ There is greater certainty in markets.
	+ Incomes are increasing
	+ Demand is increasing
	+ The size of all markets is increasing
* Problems with Economic Growth include:
	+ Externalities - social costs
	+ Damage to the environment
	+ Depletion of resources
	+ Rising prices
	+ Dealing with increased size and perhaps degree of power of firms

**Business Cycle:**

* The business cycle (trade cycle) shows the changes that take place in the rate of economic growth.

 

* Possible causes of Business Cycle Changes are:
	+ Changes in business confidence.
		- When business is confident they invest in fixed assets and other important parts of their enterprise.
	+ Fear of a fall in consumer demand business will de-stock and sell what they have without replacing it. This means a fall in output.
	+ Changes in government policies.
	+ Changes in consumer behaviour.
* 4 Phases of the Business Cycle:
	+ Boom – a period of sustained and rapid economic growth
	+ Downturn – when growth falls
	+ Recession – two or more consecutive quarters of zero or negative economic growth
	+ Recovery (upturn) – when the economy begins to pick up again.

 

* During a BOOM demand will outstrip supply and prices will rise. Costs might also increase as shortages in resources occur. With capacity running at or near full levels, new investment is needed. Normally, businesses make high profits in boom times.
* During a DOWNTURN the economy will experience an excess of stocks as sales fall. Prices may have to fall to encourage consumers to keep spending. Also, profit margins will be trimmed and investment funds may start to dry up.
* During a RECESSION the economy will experience a fall in output and profits. Some firms may go out of business and bankruptcies and liquidations will increase. We would expect to see an increase in bad debts as firms struggle to pay their bills. With confidence low, investment will fall and unemployment will rise.
* During a RECOVERY the economy shows an upward movement in demand and a pick up in profits. This would tease out more money for investment.

**Inflation**

* Defined: a persistent increase in the general level of prices.
* *Deflation* – the general level of prices are persistently decreasing.
* We measure the changes in inflation via a Consumer Price Index (CPI).
* Causes of inflation:
	+ Demand-pull – when demand within an economy is greater than the ability of the economy to supply.
	+ Cost Push inflation – when costs of such items as raw materials or wages rise and making companies increase prices.
	+ Changes in money supply the supply of money increasing faster than output.
	+ Expectations – if consumers think that prices will rise in the near future they buy now and so actually cause some inflationary pressure.
* Problems associated with inflation:
	+ Cause sales to fall as prices increase.
	+ Exported goods become more expensive and demand falls.
	+ The increase in prices will put pressure on employees to seek compensatory wage claims.
	+ Business will feel less secure regarding future planning (cut investment).
	+ Government action such as increases in interest rates or increases in taxation can damage business performance.

**Exchange Rates**

* Defined: the price of one currency in terms of another.
	+ They are mainly determined by the supply and demand for the currency.
* Currency is needed to engage in foreign trade or you want to invest in a country.
	+ You sell your own currency and buy that which you want to use.
* Determinants of Exchange Rates:
	+ Interest rates
	+ The desire to invest in that country
	+ The desire of others to buy goods made in your country.
* Money supply is determined by government policy.
* When the exchange rate changes = export and import prices change.
	+ *Appreciation in exchange rate* - export prices rise, import prices fall
	+ *Depreciation in exchange rate* - export prices fall, import prices rise.
* Movements in exchange rates mean:
	+ Uncertainty and difficulty in planning
	+ Problems in overseas markets
	+ The need to buy on spot or future markets
	+ Costs of changing catalogues etc.

**Assign:** Read pages 79 to 86 and answer Q.1.5.3 and Q.1.5.4

**Unemployment**

* Types of Unemployment: <http://www.youtube.com/watch?v=ZckAN1KYB5I>
* Defined: the number of people out of work and seeking ways to move back into a job.
* Types of Unemployment:
	+ Seasonal
		- Unemployment that changes during the year
	+ Frictional
		- Workers who are between jobs
	+ Structural
		- When the conditions of demand or supply relating to one industry change.
	+ Cyclical
		- Arises when demand within the economy falls during the downturn and recession phases of the cycle.
* Impact of Unemployment
	+ Unemployed lose part of their income = consumption down
	+ Raw materials and resources fall in price as their own demand falls.
	+ Workers see their 'power' reduced and this means that their representatives cannot bargain for such high wage increases.
	+ Producers will seek to cut costs and labor is normally one of those they cut.
	+ Investment will also fall and this might be in people and training just as much as machinery.

**Interest Rates:**

* Defined: the percentage received on an investment at the bank or the percentage charged on loans.
* A fall in interest rates may:
	+ Making saving less attractive = increased spending
	+ The cost of credit falling = increased borrowing.
	+ Mortgages becoming cheaper = more disposable income for spending.
	+ Business short-term debt charges falling
	+ Investment becoming more attractive - projects that were not viable at higher interest rates may become viable now.
	+ The value of the national currency falling - cheaper exports, more expensive imports.

**Regional Economic Groups / Blocs**

1. Free Trade Area
	* Member countries trade freely amongst themselves, but have individual trade barriers with countries outside the free trade area (e.g. NAFTA)
2. Customs Union
	* Standardization of trade policies. They will have a common external tariff (CET), which is applied to all countries outside the customs union.

3. Common Market

* + Allows the free movement of factors of production such as labor and capital between the member countries without restriction.

4. Economic Union

* + This is a common market where the level of integration is more developed.
	+ Member states may adopt common economic policies (e.g. the Common Agricultural Policy (CAP) of the EU).
	+ They may have a common currency like the Euro.

Protectionism:

* Tariffs - a tax on imports. Tariffs reduce supply and raise the price of imports.
* Quotas - restricting the maximum amount of imports allowed into an economy. Once again they reduce the amount of imports entering an economy and increase the equilibrium price within the market.
* Export Subsidies – government provides funds to firms that export in order for them to compete for effectively.
* Reasons for Protectionism:
	+ To safeguard domestic employment.
	+ To prevent labour exploitation in developing economies.
	+ To prevent dumping.