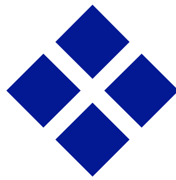

Chapter 8.
Your Economic Radar

Business is what, if you don't have, you go out of.

- Jewish merchant's proverb

The purpose of the economic radar is to understand the economic factors that can create or destroy opportunities to grow your business.

The economic radar, in particular, is one whose signals cross over the imaginary boundaries of the other radars. Many issues are not solely economic, solely political, or solely legal, for example. As with each of the radars, we must be careful to avoid getting caught up in categorical thinking, and to trace the issues freely across all boundaries.

The Big Shift: Intangible Economies

Virtually all of the major economies of the world have been undergoing a profound shift since the 1950s and 60s, and in fact reaching as far back as the 1900s. This has been most noticeable in the US economy, but the others are all moving in the same direction. The sustained growth in consumer economies, despite occasional recessions, has made possible a standard of living in which people can enjoy a range of services not previously available, or even possible.

As economies pass from through their "agricultural period" into their "industrial period," they become more and more efficient at producing "things," i.e. durable goods and various tangible products. This increases overall productivity and liberates human energy and talent (formerly called "labor") for the creation of additional value. This additional value often takes the form of personal and professional services, as well as public services. Education gets better, more widely available, and more cost-effective. Sectors like health care, publishing, entertainment, education, travel and hospitality, financial services, insurance, law enforcement, and many others can grow

© Karl Albrecht. All rights reserved.

and flourish as the “Thing Economy” delivers its value at ever-lower costs.

This “productivity engine” is really quite astonishing in its effect. Consider that, in 1900, about 70 per cent of the US workforce engaged in farming. By the early 1990s, fewer than 3 percent of the workforce was producing enough to feed a population that had grown to more than three times its size in 1900, as well as exporting food to much of the rest of the world. This has led to a profound shift in the American economy, and a similar trend in all of the other developed economies of the world, as shown in Figure 8-1.

For example, while many people like to think of the American economy as an industrial economy, and many Americans take pride in their country’s historical leadership in manufacturing, as of the mid-1990s fewer than 15 percent of the jobs in the US workforce directly involved manufacturing.

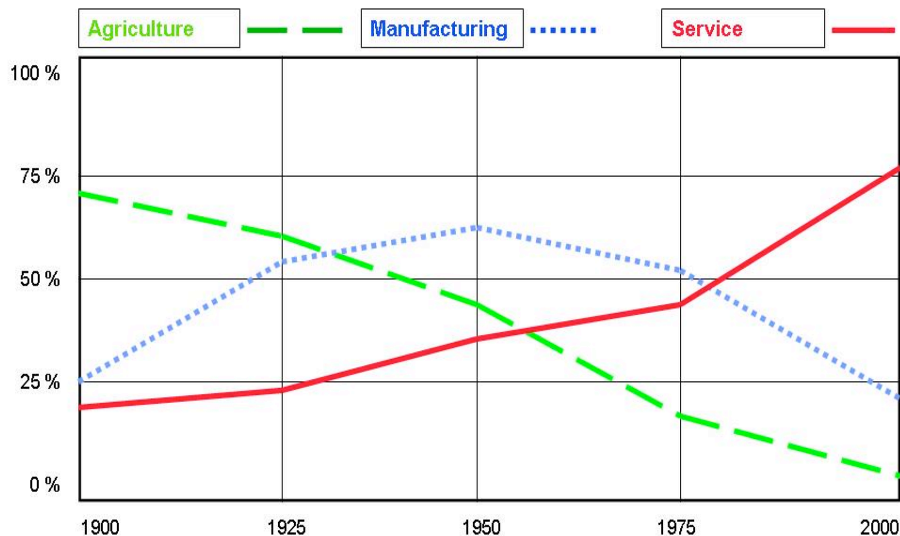

Figure 8-1. The Big Shift

The profound structural shift in the American and other developed economies toward a service structure, i.e. a “non-thing economy,” has presented economists and government statisticians with a difficult problem: how to measure and classify economic activity that has no physical output? Increasingly, the old boundary lines that have separated economic sectors seem to be dissolving, or making less sense, especially the stereotypical categories of “manufacturing” and “service.”

For example, economists can’t decide whether to classify the printing business as a manufacturing industry or a service industry. On one hand, it involves machinery, raw

material, and finished products. On the other, it involves an added value operation defined by applying information to the raw material. A catalog marketing firm may never see the raw materials involved in its operation. It provides the computer files that define the graphic layout of the catalog, and the mailing firm handles the setup, prepress operation, prints the catalogs, applies mailing labels created by its computer equipment, and delivers the catalogs to the government postal center.

Traditional measures of output seem to make little sense for many business operations. For example, economists can estimate the value of inventories held by manufacturing firms, but what is the “inventory” of a hospital? A bank? An airline? How should we measure the productivity of a university? A police force? An on-line news service? Does the concept of return on capital make sense when the primary asset is merely information?

Another peculiar aspect of the shift toward intangible economies is the difficulty in measuring imports and exports, and indeed even defining them. Can a service be exported? If it is consumed in one country by people visiting temporarily from another country, does it count as domestic commerce or an exported service?

For example, suppose a business person in Canada subscribes to a magazine such as *The Economist*, which is published in England. Should the statisticians count the value of the copies mailed to Canada under exports, deducting it from the figures for the domestic market? Suppose the same customer downloads information, for a fee, from the publisher’s Web site? Should the publisher report the revenue from foreign customers as exports? With a larger and larger fraction of commerce involving the movement of information, government measures of economic activity become progressively less precise.

As another example, consider that the US has over 1,000,000 foreign students residing there at any given time. Each one spends thousands of dollars for lodging, food, clothing, books, entertainment, and all the other expenses of studenthood. Although the products and services each student buys are consumed locally, they are sold to a foreign person. What defines a transaction as an export, the place where it is consumed or the person who consumes it? Do government economists count the university tuition fees paid by foreign students as exports or as domestic purchases? The same question obviously applies to purchases made by tourists in any particular country, which amount to many billions of dollars annually.

More and more, business people have to think beyond the old artificial boundaries — boundaries between “industries,” commercial sectors, governments, nations, and economic regions. Commerce always outruns the ability of governments to describe, measure, influence, and regulate it.

As the developed economies become increasingly knowledge-based, the educational status of their workforces becomes ever more critical. As information technology develops, it works both for and against the economic opportunity of workers. On the one hand, it enables lower-skilled workers to fill jobs they could not otherwise handle,

by down-skilling the required knowledge and cognitive skills involved.

For example, a person with limited schooling, or indeed even a mildly retarded person, can learn to operate a cash register in a fast-food restaurant just by pushing the keys that have pictures or symbols representing the various products. If the job required them to add up prices and total the customer's order with a pen and paper, as was the case a few decades ago, many of them would not qualify. This opens opportunities to those with minimal education and cognitive skills.

On the other hand, the information technology that drives the down-skilling of labor demands a higher level of skill on the part of other workers, the ones who develop it. People who write software, set up accounting systems, maintain and repair computers, operate corporate networks, and interpret data are more and more in demand. Technology will create opportunities for both high-skill and low-skill workers, but the gap between the two will become ever wider. This means that those at the upper end of the bell curve of information skills will benefit proportionately more than those at the lower end. Economic growth in all of the developed countries will be increasingly paced by the capacity of their educational systems to produce people with strong information skills.

Economics as a Behavioral Science

It has always seemed to me that economics, as a science or an attempt at science, has been put together all wrong. This may be one reason why so few people feel they understand it, and why so many economic pronouncements create confusion rather than relieve it.

Economics should be a behavioral science, not a mathematical science. It should deal directly with the attitudes, feelings, and actions of people, not the indirect consequences of their actions. Probably because most university professors and academic researchers prefer to express theories in abstract, mechanistic terms, with support from statistics and calculations whenever possible, the study of economics has been constructed as if people and their behavior were not part of the discussion.

This mechanistic tradition has completely infected the business press as well as the popular press. It appears most clearly and tellingly in the vocabulary newswriters and newsreaders use to explain things. There is a nearly universal tendency to describe economic activity using a vocabulary normally used for objects, machines, things, or figurative creatures. For example, a news report may describe a nation's economy as "overheating," its currency as being "battered by international turmoil," and its stock market as "needing a breather One description evokes an image of something like a steam boiler, another the idea of a bruised prizefighter. The last metaphor evokes the image of a stock market as an animal, perhaps a racehorse.

American newswriters are fond of referring to "Wall Street" in terms that might suggest an emotionally unstable human being, or at least a creature with humanoid

tendencies. They may say “Wall Street turned gloomy today...,” or “Wall Street was bursting with confidence...,” meaning presumably that the people buying and selling stocks on Wall Street felt that way. They describe “the market” — whatever that is — as being “nervous,” or “gripped with fear,” or “in a wait and see mode,” or “searching for direction,” as if referring to some excitable creature.

This tendency to objectify complex forms of human behavior, and to displace the discussion of it to the vocabulary of things, is not wrong in the purely semantic sense. However, it does tend to discourage a more precise manner of describing and explaining what people do, which could help us make more sense out of what’s happening.

For example, the phrase “Wall Street staged a rally today...” completely obscures the otherwise obvious fact that people were *selling* stocks as well as buying them. Why were the sellers parting with shares at exactly the same prices buyers were willing to pay to acquire them? Presumably the expression means that the buyers paid the sellers higher prices on average than other buyers paid other sellers the day before.

Using a machine or a metaphorical creature as a surrogate for people’s actions leads to another important type of fuzzy thinking. It blurs an important distinction between two different kinds of people who are doing the buying and selling. News reports often refer to “investors” as if they were all basically the same. In truth, all stock market activity involves two very different kinds of actors: investors and traders. Investors are individuals who occasionally buy and sell securities as investments, using their own money and taking their own risks. Traders are paid professionals who use large amounts of other people’s money to buy and sell securities on a daily basis.

Sudden large swings in share prices are almost always caused by traders, not individual investors. These are mutual fund managers and managers of other large portfolios who trade billions of dollars worth of stock each day. They respond to hourly news events, earnings reports, government announcements, and momentary price changes.

Yet many newswriters imply with their vocabulary that “mom and pop” are the ones who are causing the instability, because of their supposed naiveté and emotional reactiveness. In truth, mom and pop don’t sit at a computer screen watching financial news reports all day and reacting to the latest release of government unemployment figures. Most of them are busy making a living, and they may check the prices of their holdings every few days, not every few minutes. They are much less likely to sell on bad news or buy on rumor than the so-called professional managers are. In most cases the swings are over before they discover they’ve happened.

Financial newswriters also tend to refer to currencies with mechanical metaphors, for example, “the Thai baht fell sharply against the dollar today...,” which actually means that many more people placed orders to convert baht to dollars than orders to convert dollars to baht. Or, it could mean that currency speculators, a peculiar breed of

investors, sold large quantities of baht in anticipation of actions by other actors that would lead to unbalances in supply and demand.

They may further confuse their readers when they speak of the risk that "the Thai baht could pull other Asian currencies down with it." Can you picture these currencies as nasty little creatures like crabs in a barrel, clawing at one another and pulling one another down? What does a currency look like when it's been "battered"? Is it ready to be deep-fried?

Even expert economists who should know better can fall into this sloppy and potentially misleading style of description. In a recent issue of a well-known investment newsletter published in America, a columnist chided the Federal Reserve's chairman, Alan Greenspan, for taking certain actions that he felt resulted in a too-rapid growth in the US money supply. The writer noted that Greenspan had gone on a binge of "printing money." In another part of the article he reported that "the Fed has been running the printing presses night and day." An intelligent reader, unfamiliar with the Fed's activities, could easily get the impression that the organization was literally printing paper money and sending it out into the world. The Fed does no such thing.

The Federal Reserve, and typically most other central banks, have only two ways to increase the supply of money. One way is to cut the interest rate it charges to member banks (and the rates banks charge one another) for the money they borrow from it, enabling them to borrow more money and lend it out. This puts more money in circulation. The other way it can increase the money supply is to buy government bonds on the open market, thereby putting some of the money it holds into circulation.

To reduce the money supply, or slow its growth, it can increase those same interest rates, or sell some of the government bonds it holds, thereby taking money out of circulation. Aside from certain other methods too technical to explain here, these are the primary ways a central bank can affect the money supply of its parent country. It does not literally print money, and the economist who wrote the article in question is guilty of incompetent use of metaphors.

If you'd like to try a curious exercise, read a typical article from the business news and underline every word or expression that uses a mechanical or animistic metaphor to describe some economic activity. For each one, try to restate the underlying information in terms of human behavior. What did certain people do to cause the result? If a stock "rose" or "fell," try to explain who did what. If a currency "showed strength" or "lost ground," try to explain the actual behavior that led to the price changes. In some cases, you might find that the clever metaphorical description fails the test of common sense. Something that seems to make sense in metaphorical language may make less sense when translated into the simple language of behavior and cause and effect.

I'm not suggesting that we outlaw all mechanical figures of speech from economic discussion. However, I do assert that the careless use of metaphor and slang instead

of more specific descriptions of human economic behavior leads to a sense of fuzziness and imprecision in explaining cause and effect. And when we are tempted to use one set of metaphors as logical inputs to a thinking process that is expressed in other metaphors, we run the risk of being not only inaccurate, but in some cases actually wrong.

You may find it worthwhile to train yourself to use operational and behavioral language more carefully and consciously in describing the economic factors that affect your business. It might very well keep the discussion focused more clearly on the primary drivers you need to track and understand.

Domino Economics: the Knee Bone's Connected to...

The more you study the business environment, the more it becomes obvious and intuitively plausible that "everything affects everything else." Everybody does business with somebody, and whatever affects anybody will have a domino effect on somebody else. Having a clear sense of this interconnectedness can help you interpret the picture on your economic radar screen, and trace the chains of cause-and-effect that eventually reach your enterprise.

For example, how do falling oil prices increase the profits of United Parcel Service? Well, when you consider that UPS is actually one of the largest airlines in the world, i.e. it operates a fleet of more than 250 planes, and that aviation fuel is one of its biggest operating costs, the domino connection becomes obvious.

A drop in customer orders and revenues experienced by a major manufacturer, such as Boeing Aircraft Corporation, affects not only the firm itself, but virtually all of the suppliers who do business with the firm. When customers buy fewer airplanes, the firm buys less paint, fewer tires, less electrical wire, fewer radars, less fabric for seats, fewer communication systems, less plastic, fewer autopilots, less aluminum, fewer windshields, and on *ad infinitum*. Firms like Boeing, General Motors, and 3M Corporation have tens of thousands of suppliers of various sizes. All of them feel the effects of any major change in the sales of these mega-customers.

The world's second biggest exporter of poultry, the Asian conglomerate C.P. Pokphand, experienced a sudden drop in sales because Brazil's government allowed the price of its currency, the *real*, to decline in value against other currencies. That action gave Brazil's poultry industry, the world's largest, an advantage by repricing its products lower, as measured in other currencies, than before.

A major strike by the employees of one firm can create immediate undeserved benefits for its competitors. When United Parcel Service had its first strike in many years, early in 1998, one of the biggest beneficiaries was the US Postal Service. In recent years, USPS has been actively competing with private-sector firms for rapid-mail and parcel services. It went from a stodgy, unresponsive model for poor public service to a quasi-commercial operation that even advertises on TV. When news of

the impending UPS strike first began to circulate, thousands of firms of various sizes whose businesses depended on shipping packages to their customers began to turn to USPS, Federal Express, DHL, Rodeway Express, and others.

Even more important, some of those customers who abandoned UPS during the strike never came back. A major dislocation such as a strike or a materials shortage can sometimes cause a permanent or long-lasting shift in market share or market structure.

Of course, changes in society can cause domino effects that create new industries or business opportunities. The increasing atomization of society, coupled with public fear about crime, is driving unprecedented growth in lines of business such as home security. Industrial theft, sabotage, and espionage are driving demand for plant security, asset safeguarding, executive protection, and data security. Workplace violence drives increasing demand for assistance in dealing with employee problems. Increasing concern about ecological issues drives growth in waste disposal services and special methods for handling toxic waste.

If your firm is one of the major players in its sector, it is wise to keep your radar tuned for special opportunities that might arise as a result of your competitors' misjudgments or misfortunes. Conversely, it makes sense to pay close attention to the kinds of events that might befall your organization and create undeserved advantages for your competitors. A labor strike is not just a conflict between your firm and a union; it also involves your competitors, as UPS learned the hard way.

If you are one of the smaller or mid-sized firms in a particular sector, your competitor radar should be tuned for events or trends that could change the competitive dynamics of the major players. In some cases a shift in the power structure among the alpha players might threaten your firm's opportunities; in other cases it might work to your advantage.

Death-Row Economics: Industries Slated for Destruction

The demand for typewriters just isn't what it used to be. Plastic LP records only sell well in antique shops and collectors' stores. The encyclopedia salesman was put out of business by the CD-ROM. The Boy Scouts, Girl Scouts, and a wide range of service clubs have experienced steadily declining membership; some have gone extinct. Church attendance in the US and many other industrialized countries has been declining for many years. Over time, structural changes in societies, economies, and industries cause the basic appeal of certain value propositions to go into permanent and irreversible decline.

If your firm operates in such a business sector, you are probably well aware of it. However, what about the possibility that changes that are now barely visible may eventually cause such a decline in a business sector that seems healthy, or at least not in jeopardy? Suppose your line of business, or the line of business of your most

important customers, is headed for decline? How do you detect the early-warning signals — at the point of inflection, as Intel's chairman Andy Grove calls it — and how do you interpret them?

A whole industry, or a category, goes into decline either because the value proposition on which it operates loses its appeal, or because the value can be delivered by other means in a way that is more attractive to the majority of customers. The macro-trends described in Chapter 3, "The New Realities of Business," i.e. globalism, cheap information, and deconstruction, can all create impacts that can destroy businesses and whole industries.

Cheap information is the business killer most often mentioned in the press recently, and possibly one of the most devastating. As discussed further in Chapter 9, the availability of cheap and abundant information will destroy some businesses and create others. While many observers dwell on the marvels of "digital technology," the technology itself is relatively unimportant. Cheaper, faster, and ubiquitous computers are simply the means for making information cheap and abundant. The Internet and the Web page concept for structuring information, although fascinating developments in their own right, are simply schemes for deploying information more cheaply and abundantly. It is the cheap and abundant information that is destroying and creating opportunities, not the digital technology that manipulates it.

Any business sector or category that has traditionally depended for revenue on the control of information is probably in serious jeopardy. Whenever the relationship between customer and provider is based on privileged access to information on the part of the supplier and a dependent need for that information on the part of the customer, the tendency for information costs to fall steadily can radically change the customer's options.

Specifically, almost any business or person operating under the label of "agent" or "broker" has serious cause for concern. The traditional full-service stock brokerage, for example, has always charged substantial fees for executing stock transactions, but has represented them as an inseparable part of a presumed added-value relationship between the investor-customer and the professional broker. Supposedly the customer or client received advice, assistance, and valuable information not otherwise available, as part of the relationship.

However, with the advent of discount trading offered by firms such as Charles Schwab and various Internet brokers, clients have been "unbundling" the service product and buying it in separate pieces. By calling a discount brokerage, an investor can place a trade for a fraction of the cost previously charged by the so-called full-service brokerage. The client gets no advice or special information as part of the transaction, but many clients say they got little support of that type from the broker in the past.

Further, by signing on to a Web site, the client can not only place trades at ever-lower discount prices, but can also pull down huge amounts of useful financial information for free. The sharp rise in on-line investing, and investing activity in general among

computer-using adults, has been triggered largely by the ready availability of free stock market information. Instead of having to wade through pages of microscopic newsprint to pull out daily stock prices of the firms they are following, investors can now get a complete list of prices and associated performance factors quickly and at no cost. An investor can now easily follow stock market performance, literally on an hourly basis.

Stockbrokers now have to face the daunting prospect of persuading clients that they do indeed add value by what they do, and that paying them high fees for something — whether it's executing trades, giving advice, or providing special information — is in the best interests of the clients. It has become a tough sell, and it's getting tougher all the time.

Unfortunately, many on-line investors will only succeed in shrinking their assets faster and more efficiently by trying to outguess the markets with their newfound trading power. The value issue is not how cheaply one can trade securities, but how effectively one can choose what to buy and when, and what to sell and when. Many on-line investors will learn the hard way that low trading costs are an invitation to destroy capital. Those who do may well turn back to consultative relationships with financial advisors who can support their self-reliant style of investing with valuable advice, education, and counseling.

Travel agents are another endangered species. As information technology has enabled airlines to reduce their "distribution" costs, i.e. the costs associated with taking reservations, collecting the customers' money, and issuing tickets, they have less and less use for travel agents. With the trend toward electronic tickets, they hope to eliminate completely the costs associated with printing tickets and physically distributing them to the customers. They have also been promoting on-line sales of tickets, i.e. direct sales through the Internet, although these sales represent a very small fraction of total revenues so far.

With each new application of information technology, the potential economic added value supplied by travel agents diminishes. It seems clear that all major airlines intend to bypass or eliminate travel agencies from the distribution system eventually, as soon as they can reduce their costs to a level lower than the costs of using the agencies to sell and distribute tickets.

But perhaps the greatest appeal to the airline companies of bypassing travel agencies is in changing the triangular relationship between the airline, the customer, and the agency, and making it a simple two-party direct relationship. The greatest impediment to airline pricing freedom has always been the huge number of agencies — 30,000 in the US alone — who are constantly shopping all airlines for the lowest possible fares for their clients, the people who want to fly. Travel agencies use sophisticated "fare shopper" software programs and little-known scheduling tricks that allow them to keep working the fares down, even after the ticket is sold. Without this constant pressure on prices, airlines are likely to gain much greater pricing power, since relatively few customers will be sufficiently tenacious to call many

carriers for price quotes, or visit a great number of Web sites looking for the best fares.

Another distinctly American sector at risk for demolition by information technology is the real estate finance industry. This is a cartel of service businesses that has long antagonized its customers with high fees and miscellaneous charges, as well as mountains of red tape and condescending treatment of both buyer and seller. In order for a residence to change hands in America, the buyer and seller will typically spend a total of $7000 to $10,000 in loan fees and "closing costs A typical uncomplicated deal will involve as many as 100 pages or more of documents, and various fees with mysterious names such as "loan origination fee," "administrative fee," "documentation fee," "recording fee," "appraisal fee," "title search fee," and "escrow fee Frequently the bank making the loan receives a commission on these fees from the specialty firms it chooses to do the work.

Further, most banks play psychological games with prospective borrowers, dragging them through detailed and time-consuming documentation and credit investigation processes. Inasmuch as most buy-sell transactions take place against a deadline — at the instigation of helpful real estate brokers who want to push the sale through as quickly as possible — the prospective borrower usually receives the terms offered by the bank so late in the process that he or she has no time to seek competing offers. It simply isn't feasible for the customer to go through the application process with more than one lender. Very few buyers or sellers get through a real estate deal without feeling exploited and resentful. Most of the firms in the real estate cartel fully deserve the collective image they have as manipulators and exploiters.

With the popularity of the Internet, lenders are now being forced to compete against one another more transparently, by disclosing rates terms on the Web sites where they advertise. The first casualty of on-line lending will probably be the mortgage brokers, who collect thousands of dollars in commissions — paid by the borrower — and do little more than make a few telephone calls and help with the documentation.

The second casualty of on-line lending will probably be the administrative service firms who run the red-tape mill. Banks will be forced by competition to disclose itemized estimates of all closing costs. It will probably only be a matter of time before they find themselves offering packages with guaranteed or fixed closing costs, and using suppliers who can provide the services for less.

And, of course, the venerable real estate agent may become an endangered species. It is highly likely that bulletin-board type real estate listings will proliferate within cities or communities, in which buyers and sellers can find one another without paying big commissions to brokers. The new term of art in real estate may well be "FISBO," which is agent slang for "For Sale By Owner To the extent that the firms in the real estate business fail to offer a significant economic added value in return for the fees they charge, newly liberated customers will feel free to seek value and reduce their costs by making their own connections.

Information technology is not the only macro-trend that will destroy or eclipse whole industries or lines of business. And, of course, it will create new ones as well. Actually, the world of cheap information will require more middlemen, not fewer. With an unmanageable glut of information and no easy way to separate it by usefulness or validity, we will probably see a new generation of information organizers and advisers.

Librarians may enjoy a newfound role as information consultants, leaving behind their traditional image as custodians of books. Stockbrokers, travel agents, and real estate brokers who can show their customers real value as a result of their superior knowledge, judgment, and ability to marshall information may be able to re-invent their businesses and possibly succeed even better than before. For those who can't, however, the business prospects seem ever more uncertain.

Economic "Weather" Factors: How they Affect Your Business

As you review the macro-economic environment to see how it affects your business, you typically have to consider at least five overall "weather" factors, i.e. the vital signs of overall economic strength of the national economy in which your business makes its home. To the extent that you do business in a number of economies, you of course have to make the same analysis for each of them. And to the extent that your major customers are businesses, you also need to understand how the economic weather factors are affecting their operations.

As with certain other topics, I will apologize in advance to expert readers who are intimately familiar with economic analysis, who may find this discussion a bit elementary for their needs. However, it seems fair to provide a brief summary for those who are not.

Five key economic weather variables you have to consider are:

***GDP, or gross domestic product, growth*.** The overall rate of growth, or contraction, of the host economy signals the general level of economic energy, buying power, and typically consumer activity. As the proverb has it, a rising tide lifts all boats. And conversely, a falling tide typically makes it more difficult to sail any one boat. Clearly, a growing GDP tends to favor starting a new business, growing an existing one, or doing business with other firms in the same environment. A declining GDP not only tends to dry up demand for most firms' offerings, but often a kind of recession mentality can depress demand, especially for highly discretionary purchases.

***Employment levels*.** At or near the so-called level of full employment, i.e. the level at which almost all qualified and motivated people have jobs, barring a statistical number who are in transition, most firms do not experience intolerable economic effects. However, when employment is very high and economic growth continues to create additional jobs, some firms may have more and more difficulty filling their best jobs. In the late stages of an economic expansion the last-hired workers tend to be the marginal ones, lacking in education, skills, and work attitudes. In the past few

decades, labor shortages tend to be most acute among the higher-skilled jobs, including professionals. Healthcare and information technology are two areas in which firms find it increasingly difficult to find qualified people. A number of firms have had to curtail growth plans or revise their competitive strategies to some extent because they haven't been able to locate the needed talent. In recent years, the US Congress has increased quotas for immigrant workers who have special qualifications such as computer and software design. Conversely, as unemployment levels increase, firms tend to worry because fewer gainfully employed people means fewer customers for the goods and services being produced. This is why many economists make as strong case for a full-employment policy.

Interest rates. Here, too, we have a two-edged sword. High interest rates make it difficult for consumers to finance major purchases such as houses and the things that go into them, making it difficult for firms selling these kinds of goods — and the firms that do business with them — to grow through demand. Higher rates also make it more costly for companies to find capital for investment or expansion. And, of course, some firms benefit or suffer directly from changes in interest rates because of the very nature of their business activity; this includes banks, insurance companies, and various kinds of financial service firms. Conversely, lower interest rates free up capital for investment and growth.

Inflation. Inflation is a widely misunderstood concept, and many newswriters contribute to the misunderstanding. Broad-scale inflation, i.e. a generalized rise in prices throughout a country, is caused by money corruption. As governments and central banks send money into circulation, banks create even more money by recirculating it. More money offered for the available goods and services causes prices to rise. Because a price is basically a signal in a complex communication system, rising prices confuse the signal system and cause confusion and distortions. Businesses that are not free to increase their prices, and people whose compensation is not price-flexible are the ones who suffer. Those who have fixed-income securities such as bonds, annuities, retirement payments, bank deposits, and the like see the buying power of their assets decline as other prices rise. Another myth is that full employment causes inflation. Without an increase in the money supply, as just explained, inflation can only be local and selective. That is, if unions can force higher labor costs on the host companies, these increased costs will be paid at the expense of other purchases or investments that will not be made. It is not possible, as many journalists believe or imply, for rising labor costs to trigger generalized inflation. Nor does a rising stock market cause inflation; it simply attracts capital from other sectors of the economy. Some sectors, such as information technology and more recently oil, have experienced deflation, allowing capital to move to other sectors. As with many environmental drivers, inflation tends to be selective in its effects.

Currency exchange rates. Imbalances in trade amongst various countries contribute to variations in the exchange rates between their respective currencies. These variations can significantly influence prices and costs of doing business. This

particular topic deserves a special mini-lesson, which is provided in the next section.

There are, of course, many other economic parameters that influence the growth prospects of a particular firm, such as tax laws, costs of patent rights, licensing costs, franchising costs, regulatory costs, and the like. Some of them are generalized and others are quite specific to the type of business. In addition to the five key factors described here, the executive team has to consider the full range of variables that can drive its own environment. Taking all of these together, they can then develop a profit model that can help them think about strategic options and priorities.

How Currency Exchange Rates Affect Business Performance

Many business people are baffled by the subject of currency exchange rates, and have difficulty understanding the connections between exchange rates, international trade, and profits. They hear the newsreader tell about how the Italian lira "strengthened" against the German mark, or how the Japanese yen "lost ground" to the US dollar. They hear that a country's "weaker" currency favors its exports to other countries, but many don't clearly grasp what's being said. Very few news reports or articles in business magazines explain the logic of exchange rates, possibly because the writers assume everyone understands the subject, or maybe they feel it's just too hard to explain. Possibly, some of them don't understand it themselves.

Actually, it's fairly simple. Here again, I appeal to the expert reader for patience if he or she finds the following discussion a bit elementary. However, I believe it is appropriate for many business people who don't have that level of expertise.

If you want to buy a product from a producer in a foreign country, you first have to buy the currency of that country, and then use the foreign currency to buy the product. Conversely, if a business in another country wants to buy your product, you want to receive payment in your home currency. The simple reason is that native businesses operating within any particular country buy and sell in their own national currency. This obvious reality may be obscured in the chain of events that's visible to you, but it can have a big impact on the economics of your business.

For example, suppose you operate a luxury hotel in Tokyo, and you want to provide your guests with a special wine made only in South Africa. If you didn't have access to wine brokers and importers who could take care of the logistical arrangements for you, then you might travel to Cape Town, exchange your Japanese yen for South African *rand*, pay the wine producer for the wine, and bring it or have it shipped home with you. This seems obvious once you study it in its simplest form; the company producing the wine must pay its expenses in rand. Its employees don't want to receive Japanese yen, Mexican pesos, US dollars, or Korean won in their pay envelopes. They can only pay their rent and buy food with rand.

The simple procedure just described is basically what happens when you order the South African wine through your local wine broker, although various intermediary firms

handle the arrangements. The broker places an order with a foreign distributor, or directly with the foreign producer, and instructs its Japanese bank to wire funds to pay for the order. The broker's bank deducts enough yen from the broker's account to buy the rand at the exchange rate that prevails at the instant of the electronic transfer, buys the rand, and wires it to the foreign distributor's bank. Either of the two banks, or intermediate banks in between might have an inventory of rand to make the exchange. The bank making the exchange charges a fee for the service of converting the currencies. The distributor in South Africa receives the rand and uses it to pay the producer, while the Japanese broker bills your company in yen.

Every purchase transaction between people or businesses in two different countries involves an exchange of currency, except for unusual cases where both parties agree to use one country's currency. Even as a tourist, you typically have to buy the currency of the country you are visiting before you can pay for food, hotel rooms, or transportation. In some countries, shopkeepers will accept strong currencies such as the US dollar, but they are still basically acting as currency exchangers, and they typically charge you more than the bank's exchange rate for accepting your currency. Then they deposit your currency in their bank accounts, at the exchange rate charged by their banks. When you use a credit card to buy something in a foreign country, the merchant charges you the price in the local currency, and your bank sells you the foreign funds when it converts the charge to your home currency and calculates your monthly bill.

The obvious question arises: why do the exchange rates fluctuate, and why are governments always so concerned about them? The answers to those question are also fairly simple.

The buying and selling of currencies, i.e. exchanging one for another, exactly mirrors the buying and selling of goods and services between countries. The same principles of supply and demand apply to currency as to all other products. If beef is scarce, the price goes up. If oil is plentiful, the price goes down. If German marks are scarce, the price — expressed in units of some other currency — goes up.

For example, if a huge imbalance in trading activity causes more dollars to be exchanged for yen than yen for dollars, then dollars become more plentiful in the banks' treasuries and yen become more scarce. The banks have to buy more yen from other banks to keep their supplies up. If more people need to buy yen than dollars, the sellers of yen can raise their prices. This is what economists mean when they say "the yen gained strength against the dollar."

Economists sometimes confuse people when they say things like "the British pound *rose* against the dollar" when they actually mean that a dollar will now buy *fewer* pounds than before. An easy way to eliminate this confusion factor and quickly understand which currency is being more heavily bought, is to visualize a pattern of the foreign currency as *increasing* its exchange rate as it *weakens*, or "falls" down the chart, compared to the primary currency, as shown in this hypothetical example:

US Dollar	Japanese Yen
$1.00	110
$1.00	111
$1.00	112
$1.00	113
$1.00	114
$1.00	115
$1.00	116
$1.00	...

When the report says “the Japanese yen *fell* (or weakened) against the dollar,” you just have to visualize it falling down the list of increasing exchange rates, as shown above. At a rate of 115 yen to the dollar the yen is weaker against the dollar than at a rate of 110. In other words, if the yen is stronger, i.e. rising up the list as shown above, then a person buying yen with dollars will receive fewer yen than before. If it is weaker, i.e. falling down the list, a person buying yen with dollars will receive more yen.

You can apply this same simple chart to all exchanges between currencies. Put the primary currency in one column, and put the various levels of the other currency in the other column, ranging from smaller values to larger values on the way down.

The next question you are likely to ask is “So what?” “How do these exchange rates affect my business?” Returning to the example of your hotel in Tokyo, you will find that your local wine broker charges you more or less for the South African wine you want, depending on whether international buying and selling of all goods and services has strengthened the rand against the yen or vice versa. The winery’s price for the wine in rand might not have changed at all, but if your yen buy fewer rand, then you’ll have to give your broker more yen for the same amount of wine.

Clearly, a weaker currency favors the foreign buyer, who gets more goods for the money spent. The seller is not directly affected, unless the buyer finds the price in the original currency too high and decides not to buy, or buys less of the product. Or, the buyer may begin to look for cheaper substitutes for the product in other countries with more favorable exchange rates. This is one of the causes of trade politics among nations.

For example, Japan has long enjoyed a trade surplus with most of the other developed countries, especially America. Because more and more American importers have to buy yen in order to pay for the Japanese products, the demand for

yen increases and the demand for dollars falls. Dollars become more plentiful in the international banking system and yen become more scarce. This allows the exchange banks to raise the price of yen, as measured in dollars. This trade imbalance, and the higher exchange rate it caused, also allowed Japanese companies to buy imported raw materials and various other ingredients more cheaply than their competitors, and to minimize their manufacturing costs.

However, if a country's currency continues to appreciate against most others, then the prices foreign buyers have to pay for its products, as measured in their own currencies, continue to rise. At some point, the country's products become too pricey for foreign consumers and more difficult to sell. This has the effect of weakening demand for its currency and slowing the rise in its exchange rate.

Conversely, if a country's currency is weak against most others, particularly those of countries to which it can export its goods, then foreign buyers pay lower prices for its products, as measured in their own currencies. This increases demand for its products and can have a powerful effect on the growth of its economy, provided its currency does not become too expensive as a result of the increased trade.

Obviously, some businesses are much more affected by currency exchange rates than others. Companies that routinely do business across national borders may have to do business in several currencies at once. Airlines, for example, pay for landing fees, on-board supplies, certain maintenance procedures, and sometimes crew salaries, in the currency of the country they visit, while their revenues usually come in the currency of the country whose people they transport. Oil companies may buy oil in various countries and import it to their home countries, where they refine it and sell it in the home currencies.

If the government of a country, such as Japan, sees its currency as becoming too expensive, its central bank may start selling some of its currency reserves to make it more plentiful and reduce the exchange rate. This is generally a limited strategy, which few banks can maintain for more than a short period of time. Conversely, a government such as that of Brazil, seeing its currency becoming too cheap, gets concerned that foreign investors may sell it for more desirable currencies, so it may buy its currency on the markets to reduce the supply and drive up the exchange rate.

Governments can also adjust interest rates to create favorable conditions for their own companies. And, of course tariffs and trade regulations are part of the political interactions that make international trade more complex than simply selling goods and services.

Exchange rates can also affect profits coming back from foreign operations. If a firm has a division operating in a foreign country, and it transfers the profits back to the home country, then the actual profit as measured in its home currency will depend on the exchange rate. A weakening foreign currency means the foreign profits will buy less of the home currency and consequently decrease the final profit figure. A strengthening foreign currency will buy more of the home currency, increasing the final

profit figure.

Some large firms use *hedging* techniques to reduce the effects of currency fluctuations on their profits. While these techniques are beyond the scope of this discussion, they involve buying and selling the foreign currency, or trading in financial instruments called options. If the foreign currency gets weaker, the currency trading can produce profits that offset some of the conversion losses. If it becomes stronger, then the profits are greater and the cost of the trading activity is treated as an "insurance" investment.

To understand how currency exchange rates can affect your business, you have to sketch out the picture of your customers' business activities and your own, and identify the points at which currencies change form. This picture can help you make decisions about whether to make certain products yourself or purchase them from others, how to finance your operations in other countries, and whether to operate your own business activities abroad or simply work through agents and foreign partners. The more susceptible your revenues, costs, and profit margins are to currency influences, the more carefully you must plan for growth and the more flexibility you need in arranging the financial structure of your business.

The Euro: the Great Equalizer?

A key part of the economic struggle for modernization that's going on in Europe is the concept of a transnational monetary unit, the *euro*. To some, it promises nothing short of a profound transformation of the European economic system. Others prefer to view it as merely one of a number of tools for enhancing trade and promoting economic efficiency across national boundaries. Surely, the euro will play a key role in reshaping commerce on the continent, but much needs to be done to truly rationalize and coordinate the disparate commercial systems among the eleven primary countries that are leading the modernization.

A key argument in favor of a universal currency, at least in Europe, is that it will promote the freer movement of goods and services throughout the continent by eliminating economic frictions involved in cross-border financial transactions. Eliminating the huge costs of currency exchange operations would be just a start. Price disparities between countries for the same goods and services would become obvious, and this would give rise to competitive forces that would presumably reallocate demand and drive down prices overall. A single currency would, of course, encourage suppliers of goods and services to market more widely outside their own countries, and would simplify the financing and payment for imports and exports. Coupled with reduced administrative procedures and controls on the transfer of goods across borders, it could reduce the overall costs of trade significantly.

The agenda for a single monetary unit goes almost as far back as the origin of the European Union itself. But just as the EU has faced a turbulent history, so will the euro face difficulty in becoming the standard European currency.

The plan for the Economic and Monetary Union, as the currency project was called, began with 11 of the 15 EU member countries participating. Notably, England did not choose to join the euro project in its first phase. According to the plan that emerged from the 1991 treaty of Maastricht, the euro was to be phased in over a period of three years, beginning on January 4, 1999. The treaty also created a European Central Bank, whose powers would ultimately supersede those of the member countries' central banks.

The architects of the new "United States of Europe," as some called it, realized that formidable political barriers stood in the way of full acceptance of a superordinate monetary system, not the least of which was public attitude in the various member countries. So, they decided to phase in the new currency over a three-year period. In January 1999 the euro became, symbolically, at least, the official currency of Europe, with each member country's currency pegged to it at a predefined exchange rate. All prices on the European stock and bond markets were to be quoted in euros. However, the individual national currencies remained in full force and effect.

The euro plan called for the progressive introduction of the new currency, in various stages. The objective was for all of the national currencies of the member states to disappear from circulation by about the end of 2001, and for the euro to be the single, universal unit of money.

Clearly, the success — or failure — of the euro poses huge potential impacts, politically and socially as well as economically. The transition to a single super-currency places severe restrictions on the governments and central banks of the member states, and the Maastricht treaty dictated stringent standards for government budget deficits, interest rates, and expansion of the money supply. Trade politics remain difficult and complex across the continent. Popular support for the euro, and for its implications for national identity, have been relatively thin from the start. Government actions to combat recessions in individual countries could severely strain the fabric of the economic union, and could test the willingness of member states to subordinate the selfish interests of their citizens to the presumed common good of the economic fraternity.

Non-European firms doing business on the continent will probably find the single monetary system helpful to their operations, as will European firms. However, the euro will probably be a decidedly mixed blessing for some time to come. For example, some analysts predict that the euro will threaten the US dollar for its role as the world's primary reserve currency and standard of commerce. Oil prices, now typically quoted in dollars, might shift to euros. Depending on the euro-dollar exchange rate, this could help or handicap American firms. It could be like lining up all of the individual European currencies against the dollar, and trading at the level of the strongest one.

If the unprecedented conversion to the euro succeeds, it could lead to other regional attempts at currency consolidation. Some Asian and South American countries have already "dollarized" their economies to some extent, by maintaining a fixed exchange

rate to the US dollar.

Actually, the much-publicized economic integration of Europe has stolen the spotlight from an equally impressive integration of the “Americas,” i.e. the range of trading partners all the way from Canada and the US, through Mexico and the Central American countries, to South America. The North American Free Trade Agreement and a variety of other trade treaties have radically reduced the barriers among those countries. By the time Europe reaches a significant level of integration, the “United States of America” might refer to the whole of the Western hemisphere as a kind of mega-free trade zone.

The Organization of American States, or at least individual countries, might even adopt the US dollar as a common currency, for their own individual motives. The idea of a world currency, however appealing in its abstract form, is probably many decades away, however.

As you study your economic radar screen, it makes sense to learn as much as possible about the economic integration taking place in Europe, whether your home market is there or elsewhere. Depending on your type of business, an integrated Europe could be easier or harder for your firm to cope with. The commercial benefits of the euro and the other aspects of European integration will be mixed, slow in coming to pass in some cases, and selective in their effects. For most firms, it will take some careful thinking and planning to make the most of them.