

THE ROLE OF BUSINESS ECONOMICS IN STRATEGIC BUSINESS PLANNING

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WHAT ARE THE potential contributions of business economics to the strategic business planning process? Traditionally, business economics provided the baseline macroeconomic forecasts that drive divisional sales estimates and annual budget and earnings projections. A long-term trend forecast of GNP growth covering the planning horizon and an annual cyclical forecast for the first year of the business plan were the main inputs into the planning process from the business economist. However, the potential contributions of business economics to the planning process are expanding far beyond this traditional role, as strategic planners develop more sophisticated planning systems in response to a more complex and more global competitive environment.

CONTRIBUTIONS TO THE STRATEGIC PLANNING PROCESS

The strategic planner uses these inputs to identify opportunities and threats in the external environment, and to assess and account for the company's internal competitive strengths and weaknesses in formulating the business plans. The planner also uses these inputs to establish cost, productivity and other business plan goals; to provide internal consistency checks on the plans and projections of individual SBUs; and to test the sensitivity of alternative plans to critical assumptions and uncertainties. Other inputs from business economics are used to help create the organizational structures and incentive systems appropriate for the strategies of each SBU.

BUSINESS ECONOMICS AND THE DEVELOPMENT OF STRATEGIC BUSINESS PLANS

A comprehensive analysis of the external business environment is required to support the development of strategic plans in a Phase 4 planning system. This analysis of the external environment must include the macroeconomic forecast, and analyses of the industry, competitors and relevant regulatory and trade issues.

MACROECONOMIC FORECAST

The macroeconomic forecast that drives industry demand and overall cost levels is critical at every phase of planning, but even more so in Phase 4 where the forecast is an integral part of an analytical effort to understand and plan for an uncertain future rather than a discreet set of data points for cranking out budget and earnings projections. Long-term, trend forecasts spanning the planning horizon (typically five years) of growth in GNP, disposable income, personal consumption expenditures, employment, inflation, interest and exchange rates and energy and other raw materials prices are all essential inputs into the strategic planning process. In a Phase 4 planning process, they are essential not only as basic drivers of demand and cost, but also as determinants of competitive advantage and changing business opportunities and threats.

For many companies today, these macroeconomic forecasts must take on a global dimension, which does not mean simply generating forecasts for the various regions of the world in which the company operates. Companies in global industries need integrated, worldwide design, research, production and marketing strategies to compete successfully. The strategic business planner therefore needs to understand the implications of developments in one region of the world for interdependent operations in others, and how the economies of the different regions of the world are linked together through global financial and product markets. For example, forecasts of slowing U.S. consumption and growing exports to reduce the huge U.S. trade deficit must be accompanied by the implications for demand, imports and growth in large trade-surplus nations such as Germany and Japan, the NICs and the debt-ridden countries of South America.

INDUSTRY ANALYSIS

Macroeconomic forecasting in Phase 2 planning systems sometimes includes limited industry forecasting and analysis. However, in a Phase 4 planning system, industry analysis takes on a decidedly different, micro analytic character. In this advanced planning system, the role of the business economist changes dramatically with the added responsibility for the analysis of the competitive structure of the industry (ies) in which the company (SBUs) competes. Analyses of the number and size distribution of

sellers and buyers in the industry, potential new entrants, capacity utilization and expansion, economies of scale, entry barriers, vertical integration, diversification, distribution channels and downstream component suppliers all are undertaken to provide strategic business planners with the information they need to plan effectively. These analyses help planners understand the nature of competition in the industry; identify current and future business opportunities and risks; and assess the long-term profit potential of alternate strategies.

As an illustration of such industry analysis, the projected increase in North American automobile production capacity by over two million units by the early 1990s as a result of new entry of foreign producers and expansion by existing producers will add to worldwide excess capacity, increase competitive pressure and produce declining real automobile prices for at least the next several years. This industry environment will result in limited profit opportunities for manufacturers that cannot reduce their costs substantially or successfully differentiate their products.

COMPETITIVE ANALYSIS

The in-depth analysis of competitors is the most distinguishing characteristic of a Phase 4 planning system. This analysis yields critical insights into the company's strengths and weaknesses relative to its leading competitors. When coupled with the identification of opportunities and threats in the external environment, the analytical foundation for the development of the company's strategic plans is in place.

Competitive analysis is typically conducted at the SBU, division and corporate levels within the firm. The business economist contributes to competitive analysis primarily at the corporate level. This analysis is directed at providing a broad strategic perspective on the company's competitors, which is needed to supplement the more product or functional-specific analysis conducted at the SBU and divisional levels. The business economist also helps avoid costly duplication by conducting competitive analyses needed by several SBUs competing against common rivals. Finally, the competitive analyses conducted by the business economist, who has no line responsibilities, often provide a more objective assessment of competitors' strengths, and the probable success of their strategic initiatives.

The business economist is well equipped to conduct analyses of competitors' production and distribution systems, sourcing strategies, R&D programs, incentive systems, capital structures and financial position. But the most important contribution of the business economist to competitive analysis is the analysis of cost differences among companies in the industry, and the reasons for those differences. The tools of the business economist are particularly useful for analyzing differences in labor, materials and capital cost, and differences in productivity. For global industries, the tools of the business economist are absolutely essential because these comparative cost analyses must include the important effects of exchange rates on costs, and country-specific cost advantages arising from differences in relative factor endowments, culture and the institutional relationships among business, government and labor.

The recent appreciation of the Japanese yen from 250 yen to the dollar to 130 demonstrates the role of business economics in the analyses of cost differences in global industries such as the automobile industry. This tremendous appreciation of the yen has substantially reduced the \$2,500 cost advantage of Japanese motor vehicles sold in the U.S. at the weaker yen. However, the increase in Japanese cost was far less than most expected, because nearly half of the value of a Japanese vehicle sold in the U.S. is denominated in dollars and because the Japanese redoubled their efforts to improve productivity and quickly moved additional operations offshore as the yen strengthened. The move to offshore operations required additional cost analyses to determine the extent to which the Japanese could maintain their cost and quality advantages outside of Japan. If the advantages enjoyed by Japanese manufacturers were country-specific, owing, for example, to unique labor-management relations in Japan, their operations in the U.S. and Europe would be much less of a competitive threat than the vehicles imported from Japan. Comparative analyses of U.S., European and Japanese assembly plants, however, reveal that competitive cost advantages in the automobile industry are as much company-specific as they are country-specific. Companies that have low-cost plants in one country tend to have low-cost plants in others as well, reflecting the transportable superiority of their management and planning as much as any unique advantages of location.

PUBLIC POLICY ANALYSIS

In a Phase 4 planning system, the responsibilities of the business economist for public policy analysis extend far beyond the traditional analyses of monetary and fiscal policies that are an integral part of the macroeconomic forecast. In a Phase 4 planning system, the business economist must analyze the impact on the company of a broad array of safety, health, environmental, energy and industrial policies (e.g., plant closing legislation). These regulations can have an important impact on the demand for the company's product, its cost and performance and on the company's relative competitive position. The tools of the business economist are especially helpful in analyzing the impact of regulation on product cost and performance as viewed by the consumer, who may well discount any social benefits in his purchase decision. Even more importantly, the business economist must analyze the differential competitive effects these regulations can have on individual competitors, or between current and potential competitors or domestic and foreign competitors.

Environmental regulations that limit plant or product emissions illustrate the full range of public policy analysis required of the business economist. These regulations add to the cost of the product and often reduce its performance, while the social benefits in terms of cleaner air are not adequately valued by the individual consumer because of a classic free-rider problem. These regulations also often benefit existing firms, which may be "grandfathered-in" under the regulations, over new entrants that are required to install the best available (and most expensive) technology. They also often disadvantage domestic firms relative to foreign producers who face less stringent or perhaps no regulation. If economies of scale are significant in reducing emissions, large manufacturers also may be advantaged over smaller producers.

TRADE POLICY

Trade policy has become a critical element in strategic planning for international companies. Trade policy also can have an important impact on the competitive position of domestic companies. A company cannot avoid international competition by restricting its operations to its home market. Indeed, such a strategy may only increase the company's exposure to global competitive risks by limiting its access to international product and financial hedging strategies.

Trade restraints, local content and export requirements, exchange rate policies and nontariff barriers to trade all can have significant effects on a company's competitive position and on its efforts to implement an integrated, global strategy.

The business economist in a Phase 4 planning system is responsible for monitoring such developments and for assessing their impact on the company's strategic business plans. Like domestic regulations, they can have an important impact on the company's competitive position. Not surprisingly, the differential impact on domestic and foreign competitors can be very dramatic, which, more often than not, is the intent.

The strategic opportunities and risks created by international trade policies are illustrated by the current effort to improve the integration of the European Common Market by harmonizing regulations, standardizing border taxes and lowering trade barriers among the Common Market nations. This development will create important strategic opportunities and risks for different companies. This integration should lower costs and increase overall economic growth and consumer demand. It also will change relative prices, and thus the demand for the goods and services of particular companies. For countries outside the Common Market, there is the risk of heightened trade barriers as the internal barriers within the Common Market are dismantled.

BUSINESS ECONOMICS AND THE IMPLEMENTATION OF THE STRATEGIC PLANS

In a Phase 4 planning system, the business economist has an important role to play in the implementation as well as in the development of the company's strategic plans. The business economist can assist in the implementation of the business plans by helping ensure that a good strategic fit exist among the company's strategy and its organizational structure and internal management systems.

The internal organizational structure of the firm is critical to the successful implementation of the business plan because it effects the basic flow of information to decision makers (including the information provided by

business economists); the decision makers' collective capacity for processing that information; and the incentives facing those decision makers. An ill-conceived organizational structure will result in decision makers receiving inadequate or biased information; being unable to process that information in a timely manner; or facing incentives for decisions inconsistent with the company's long-term strategic goals.

Business economists can provide substantial assistance to strategic planners attempting to design internal organizational structures that will ensure the effective implementation of their strategic plans. A rich tradition of organizational efficiency analysis in business economics traces its origins to the fundamental insights of Ronald Coase, who first noted that "a firm will tend to expand until the costs of organizing an extra transaction within the firm become equal to the cost of carrying out the same transaction by means of exchange on the open market or the cost of organizing in another firm."⁽¹⁾ Subsequent work has added to the richness of this analysis in especially relevant ways. This work now provides both a theoretical and empirical foundation for assessing the impact of different organizational structures (e.g., functional and multi-divisional structures) on the firm's ability to process complex information, eliminate sub-goal pursuit and monitor SBU performance.

Following the dictum that "structure follows strategy," General Motors, after extensive analysis, undertook a massive reorganization in 1984. General Motors had developed strategies to shorten product lead times, to increase the differentiation of its vehicles and to improve quality and lower cost through better coordination among product design, engineering and manufacturing. Implementing this strategy, however, required a new, less centralized organizational structure to improve the coordination and speed of decision making. Thus, the company created two new car groups (C-P-C and B-O-C) that were given total responsibility for engineering, manufacturing and marketing their products and that were held accountable for the quality and performance of their vehicles and for the profitability of their operations.

Business economists also have an important role to play in the design of the all-important incentive systems. The incentive systems must be congruent with the strategic business plan to ensure the successful implementation of that plan. The rewards of key decision makers must be tied to accomplishment of the long-term goals of the business plan to ensure an identity of corporate and self interests. In advanced planning systems, this typically requires incentives to be tied to external benchmarks of long-term financial or stock performance. Establishing and measuring progress against such external benchmarks is vastly more difficult than basing rewards on annual performance relative to historical norms for the company. The business economist, utilizing his knowledge of competitors and competitive conditions, can play an important role in helping to establish appropriate external benchmarks that account for differences in financial and business risks.

SUMMARY AND CONCLUSIONS

The basic point of this article is that the role of the business economist in strategic planning depends upon the needs of the planning community within the firm, and that those needs grow exponentially as the firm progresses through more advanced phases of strategic planning. The role of the business economist in a Phase 4 planning system goes well beyond the traditional macroeconomic forecasting role appropriate for less advanced planning systems. To support a Phase 4 planning system, the business economist needs to provide a broad array of macroeconomic, industry, competitive, regulatory and trade policy analysis. In a Phase 4 system, the business economist also has a major role to play in helping to devise the organizational structures and management systems needed to implement the plans successfully.

To improve the usefulness of business economics to strategic planners in more advanced planning systems, business economists must help planners deal more effectively with uncertainty; must develop more integrated global outlooks that link the regions of the world together economically; and must incorporate public policy issues in the planning process in operationally useful ways.

The basic challenge to business economists, however, is to keep pace with the advances in the company's planning system to ensure that the planners have and fully understand the information they need to respond effectively to a more complex, less stable and increasingly global business environment.