HOW DO FIRMS AND GOVERNMENTS RESPOND TO EXTERNAL SHOCKS? A SYSTEMATIC LITERATURE REVIEW

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Abstract

*Firms are generally quite vulnerable to external shocks because they rely heavily on exports. These shocks, which occur unexpectedly, make companies completely unprepared for them, and at the same time, they represent a significant source of business cycle fluctuations. This is why domestic adjustment is needed with an appropriate policy response from both companies and governments. This article aims to provide a systematic literature review of how firms and governments have responded to various external shocks in the latest period, 2018 to 2021. Тhe effects of policy measures used in response to distinct terms-of-trade cycles are also evaluated here. Additionally, this review examines the appropriateness of policy instruments used in the adjustment process. Hence, some of the policy challenges that companies face today are highlighted, along with economic policy responses that would improve the country’s capacity to absorb future shocks.*

Keywords: firms’ response, external shocks, policy response, domestic adjustment.

1. Introduction

When external shock crises occur, the best answers are the bold ones (Lim et al., 2020). External shocks are dangerous, but the greatest danger occurs when society is unprepared to respond to the attack (Oetzel & Oh, 2021). This unpreparedness creates general uncertainty for people, firms, and countries (Oh & Oetzel, 2022). According to Courtney et al. (1997), there are four classifications of uncertainty: First classification (one explicit forecast), Second classification (alternate futures), Third classification (a range of futures), and Fourth classification (a future impossible to predict). However, according to Thungavel et al. (2022), crises are not predictable, and the most uncertainty happens when countries act alone by responding to these shocks. That is why globalization and creating international cooperation are good strategies to avoid uncertainty and better handle the shocks (Thungavel et al., 2022). Another aid to avoid uncertainty and help firms from shocks is restructuring supply chains (OECD, 2020). The restructuring of supply chains is also in the flow of firms' responses to the shock, a topic discussed in more depth below in the study. Firms that have developed more technology are more vulnerable to uncertainty and consequently have more accessible adaptation to the situation created by external shocks (Vo & Le, 2017). Uncertainty also appears in clients, making them save money, especially non-essential things (Winarsih et al., 2020). Enormous distress is when an external shock in one country can cause other subsequent disaster events (Oh & Oetzel, 2022). One of the latest shocks - the one of the Covid-19 pandemic- was followed by a sequence of events damaging the people's social life and severely damaging the country's economy (Oh & Oetzel, 2022). All of these levels of uncertainty require people who, regardless of the circumstances and level of uncertainty, are conscientious, professionally trained, experienced, and give relatively good responses in some instances of external shocks. When a firm or government officials are inexperienced, unprepared, or unqualified, this results in delayed responses or the wrong answer to these shocks (Webb et al., 2000). The Covid-19 pandemic has changed the economic circle of development and the industry frame (Sheng et al., 2020). Many studies assessed how the COVID-19 pandemic has affected the functioning of the firms and economies around the globe. One finding is particular: after these shocks create consequences, firms and economies need a structured and guided revitalization process (Amankwah-Amoah et al., 2021). This process is "far-fetching" for some firms as they suffered tremendously during a pandemic. Since the pandemic Covid-19 is among the latest crises, the firms' and governments' reactions gained research interest, with the view to define the future acts of any other crisis. The present study's central aspect is offering a literature review and providing new insights into how firms and governments responded to the external shocks. The pandemic of Covid-19 was severe to both developed and developing countries, small, medium, and large businesses, and very advanced economies such as the US and UK (Amankwah-Amoah et al., 2020). It has led to the collapse of government-backed and privately owned businesses (Amankwah-Amoah et al., 2020). However, the responses of firms and governments in developed and developing countries differed significantly due to the economy's level of development and preparedness to react (Puig et al ., 2022). That is because the developed countries support and subsidize the countries' business better, whereas, in developing countries, the survival of some small and underperforming companies has become a struggle (Amankwah-Amoah et al., 2021). It is also important to point out that external shocks can affect some industries more than others (Puig et al., 2022). Isolation measures and local bans have affected some industries more than others because different conditions can never be the same for different industries. For example, essentials and medical devices have advantages over other industries. This advantage reflects different responses from governments and firms to external shocks. Among other factors, financial support, size, ownership, and activity explain the difference between the responses of different firms (Puig et al., 2022). Identifying effective strategies for managing the crisis of external shocks is essential through exploring previous experiences from firms and the government. Aiming to summarize the firm's and government's responses that had an impact on the journey of surviving the crises, they become valuable literature for firms and governments to future experiences with cases of external shocks. Another dimension of general economic fragility during Covid-19 was the time durability, the level of uncertainty, and the realm of impact. It is associated with social and economic damages, which cause a weakening of the position of businesses and a high risk of business failure (Amankwah-Amoah et al., 2021). This review contributes to the literature by offering essential insights into firms' and governments' responses to the Covid-19 pandemic shock, which is the topic least studied by international business scholars. The study will mainly focus on the responses of firms and governments to the shock of different industries and their responses impact. The paper proceeds as follows: First, it draws upon the literature on firm's and government's responses to external shocks, specifically to the Covid-19 pandemic as the latest external shock, also, with further deliberation on the practical measures undertaken by firms and governments to fend the economy from external shocks destruction. This study will highlight the different responses to this shock in the context of intense global competition and enhanced digitalization (Brynjolfsson & McAfee, 2017). More specifically, we review the characteristics and the unique challenges of firms and governments' responses to external shocks. The results of this study have strategic, social, and economic results. They show the relationship between crisis and a firm's response by exposing the individual strategy of the firm, the impact of the response on society and the firm's future, and the response's impact on the firm's economic development. In the remainder of this article, a background of factors that have contributed to the firms and governments making the actions and responses is outlined. In the third section, firms' problems and responses are summarized. This review includes the authors' views based on accumulated evidence and arguments on the results of firms and government's responses to external shocks, focusing on responses to the Covid-19 pandemic. The effects of the Covid-19 pandemic were accompanied by a disruption of the national supply chain (Orlando et al., 2022; Khan et al., 2022). To complete our study, we have two research questions:

RQ1: Which types of responses do firms make to better cope with the crisis caused by external shocks?

RQ2: Which types of responses do governments make to better cope with the crisis caused by external shocks?

2. Range of factors of the external shocks that provoke necessary responses

External shocks are not new (Oh & Oetzel, 2022). Nowadays, mainly due to climate change, the expectation of the number and severity of external shocks has increased. Consequently, the need for a new way of thinking to respond to these external shocks has increased (Oh & Oetzel, 2022). Crises created by external shock can differ, but what they have in common is the power to damage social and economic life (Hällgren et al., 2018). This study highlights the fact that due to the different outcomes that external shocks create, consequently, the responses to different situations must be different. This heterogeneous circumstance creates a diversity of cases that causes a lack of literature for each case. This study contributes to the literature on firms and governments responses to external shocks. One of the factors caused by external shocks that provokes a response is the disruption of the supply chain. The effects of the Covid-19 pandemic were accompanied by a disruption of the national supply chain (Orlando et al., 2022; Khan et al., 2022).

3. Firms responses to external shocks

The theoretical aspect revolves around firms' responses and activities to achieve success in a crisis, overcome external shocks, and change crisis path dependence. Careful and accurate responses used in crises enable firms' faster return to a good situation (Williams et al., 2017). Also, knowledge preparedness helps firms respond better to adverse events caused by external shocks (Orlando et al., 2022).

To better elaborate on this aspect, this study will discuss the strategic renewal plan of firms, the dynamic capabilities of firms, financial support, and government support. When external shocks cause economic uncertainty, the firms are reluctant to invest (Gulen & Ion, 2016). Firms respond to economic uncertainty with a delay in investment, which is the opposite of economic growth (Adelino et al., 2017). There is no doubt that firms' actions for strategic renovations and the need for support often commence after experiencing external shocks or turbulence in the business environment (Eggers & Kaplan, 2009). However, thanks to the rise of digitalization, firms' improved renewal processes are accelerated (Amankwah-Amoah et al., 2021). Besides, firms nowadays should renew themselves to remain competitive because of increasing global competition (Osei et al., 2019). A firm's responses to external shocks should be concentrated on the firm's underlying resources and expertise. Also, financial managers, firm resources, skilled employees, and external factors affect a firm's responses (Amankwah-Amoah et al., 2021). The external factors include changing consumer behavior and changes in industrial policy. Thus, the renewal plan consists of the firm's activities to ensure that the firms are ready to respond to the external forces (Knott & Posen, 2009). The search, selection, and deployment capabilities are the dynamic capabilities from which firms may outperform their rivals (Helfat et al., 2007). Still, the main one is the ability to refund resources and capabilities continuously to address environmental threats (Teece et al., 1997). A firm's responses should fit with limited existing resources (Rumelt, 1987); they should be mobilized and integrated with the knowledge and skills of employees to respond to, soften, or decline external threats (Wright & McMahan, 1992). The responses of many firms were without prior experience, thus creating significant uncertainty in the results of the responses (Corsini et al., 2021). Considering the beginnings of the last crisis, the Covid-19 pandemic, which was and still is a major macroeconomic attack on firms in general (Hong et al., 2022), we remember that it all started in China. As China was the first to be attacked by this pandemic, it was also the first to search desperately for responses to combat it. According to Narayandas et al. (2020), China has coped well with this crisis thanks to good strategy developed before. Particular emphasis is on these responses: Transparency in times of challenges; new forms of communication; Digitalization; Collaborations; Elasticity/adaptation to remote work (Narayandas et al., 2020). Narayandas et al. (2020), during their interviews with corporations in China, encountered corporations that have chosen to respond to the pandemic by closing their centers. This response in that corporation was due to the logic that "If a company does not survive three months, there is no future." Also, this study describes cases when the organization responding to the Covid-19 pandemic has chosen different responses, which are written below in the Table 1. (Narayandas et al., 2020).

*Tab. 1.* Strategic responses to external shocks Source: Narayandas et al. (2020).

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Firms/Organization | Function | External Shock | Respond | Conclusion |
| Yili Group | A leading dairy company. | Covid-19 | Re-organize to enhance decision making. | This helped in the good and safe distribution of milk throughout China during the pandemic. |
| Ping An Bank | Chinese joint-stock commercial bank. | Covid-19 | Increase the focus on digitalization. | Great performance achieved in April 2020. |
| New Oriental Group | Leading Education Firm. | Covid-19 | Move to a live-streaming platform. | The firm increased the service even in cities that did not operate before. |
| Huanxi Media Group | Movie Studio | Covid-19 | Live-stream the movie online. | More than 600 million views within two days. |
| Trip.com Group | Travel Agency | Covid-19 | Developed a new “one-click” application. | It helped the firm respond, with its reputation intact. |
| Yum China | Food Chain | Covid-19 | Asked for volunteer workers. | 900 volunteers, far exceeding requirements. |

In addition to the findings of these firms' responses to external shock Covid-19, Narayandas et al. (2020) emphasized that firms that had financial reserves during the crisis did not save but invested as much as possible to create an advantage concerning competition, adaptation to the situation and progress.

*3.1 Small and medium firm’s responses*

As for the small and medium firms, they find it hard to escape from the situation created by the pandemic. Unfortunately, many small and medium firms responded by closing their business (Hu & Kee, 2022). Another response of small and medium firms was a strategy to reduce the number of employees-downsizing (Thorgren & Williams, 2020; Hu & Kee, 2022), some of which resulted positively in their longevity even during the pandemic, others responded by creating a diversity of clientele (Marconatto et al., 2022).

Another response of small and medium enterprises is the temporary innovation of the business model (Clauss et al., 2021). According to a study by Clauss et al. (2021), these business models had positive results with five small and medium enterprises in Germany, Liechtenstein, and Austria. The complete changes in the business models that those firms have made to respond to the Covid-19 pandemic so that they can adapt, survive and emerge victorious from it were as follows: the distillery and beverage producer firm turn into disinfectants producer; creating digital value for conference sponsors; cooking firm turns to sell toilet paper, masks, and delivery service; an organic farmer turns to digital shop; a classic consulting firm turns into the retail firm (Clauss et al., 2021).

*3.2 Textile firms respond to external shocks*

Also significant is the response of textile firms to the situation created by the Covid-19 pandemic. Textile firm's responses are critical because they had new ways to contribute and benefit from the situation. Since they had possibility to supply and assist hospitals with necessary products for doctors and patients and with the masks and other new products adapted to the need of this crisis, textile firms might benefit from the situation with the correct responses. Conversely, textile firms were significantly affected by the Covid-19 pandemic; the lack of raw materials is the biggest challenge for textile firms (McMaster et al., 2020), including the textile giant Inditex (Dowsett, 2020). The adaptation of textile firms to the pandemic situation and the survival of textile firms is significant for the economy as a whole, as there are over 160,000 textile firms in Europe alone (Puig et al ., 2022). Textile firms are also important for the Balkan region. Puig et al. (2022), during an analysis of textile firms in Spain, found a difference between The Valencian Textile Cluster (VTC) and other textile firms. The difference is that VTCs were more effective in adapting their functioning in response to the pandemic. VTC responded to the pandemic Covid-19 situation effectively (El Periodic, 2020). The factor such as the tradition of this company in the production of home textiles, and the responses to the shocks, such as cooperation with social media and institutional support, were the reason why VTC's response was more effective to the Covid-19 situation than other textile firms in Spain (Puig et al ., 2022).

Among other factors, financial support, size, ownership, and activity explain the difference between the responses of different textile frms.

Tab. 2. Strategic responses to crisis. Source: Wezel et al., 2020.



Table 2, shows the model of strategic responses to external shocks by Wezel et al. (2020). In their study of strategic responses to crises caused by external shocks, four strategic segments are analyzed: retrenchment, persevering, innovating, and exit.

Retrenchment refers to all firms' reductions (Pearce & Robbins, 1993). This effect narrows the firm's potential, and its effects are mixed as a response. Perace and Robbins (1994) state that the retrenchment gives positive results since it stabilizes performance declines. Nevertheless, Barker and Mone (1994) see the retrenchment as an underperformance contributor. The retrenchment may be the firm's correct response only for fixed-term (Chadwick et al., 2004). In crises like the Covid-19 pandemic, in the inability to recognize its longevity, the continued retrenchment is not the correct answer because it may lead to an erosion of a firm's resources (Ndofor, Vanevenhoven, & Barker, 2013). Like retrenchment, the persevering strategic response is brutal to be productive for an extended period. It can contribute to firm survival in the medium run, but it is almost impossible to contribute if a crisis lasts longer (Wezel et al., 2020).

Persevering, in contrast to retrenchment, aims at preserving the firm's status (Wenzel, 2015). Persevering is an essential and influential strategy in crisis (Stieglitz et al., 2016' Carolic et al., 2009); bringing enormous contributions to survive a firm in times of crisis is better than changing and renewing one's business in times of crisis, which is not always the best response (Wezel et al., 2020).

Innovation is always an opportunity and inevitable response in times of crisis (Takeuchi & Nonaka, 1986). The uncertainties caused by the crises, which we have mentioned and discussed above, push businesses towards innovation and new ideas (Wezel et al., 2020). According to Brinckmann et al. (2019), innovating may be an excellent response to the crisis. In contrast to persevering and retrenchment, innovating is an essential response to long-term crises (Wezel et al., 2020).

There are firms that deliberately create crises, to drive innovation (Kim, 1998). Such strategies for creating crises and fostering innovation were also used by Steve Jobs at Apple (Isaacson, 2011). But according to Lichtenthaler (2021) and Guderian et al., (2020), there are firms that respond to external shock by choosing to reduce innovation costs. Also, in the study of Hong et al., (2022), firms in the research have responded to the Covid-19 crisis by cutting down the cost by frugal innovations; by using innovation to bring new products or services; creating value potential through human development and focusing on core values. In a similar vein, the retail investors, in response to the crises that engulf the economy after the external shock, respond by reducing the intensity of trade (Pagano et al., 2021). These cost savings have been shown to be unproductive during the external shock of the 2008 financial crisis (Lichtenthaler, 2021). Exit refers to closing a firm's business activities as a response to a crisis (Argyres et al., 2015). The 'exit' response comes when other attempts to respond to crises fail or when beliefs that the crisis can be overcome fail (Wenzel et al., 2020). According to Dai et al. (2017), sometimes the 'exit' response to a crisis is good. The exit responses may be essential for strategic renewal (Ren et al., 2019). According to Carnahan (2017), exit responses may contribute to creating new firms.

Tab.3. Strategic responses to crisis. Source: Puthusserry et al., 2022.



Puthusserry et al. (2022), categorize responses to external shock crises into four categories: reactive, proactive, conforming, and innovative. Their findings suggest that start-up firms use reactive responses. These cases are characterized by a network of general lack of heterogeneity in the firm - staff, decision making, and organization (Puthusserry et al., 2022). Proactive responses are proactive responses of firms to market development (Lahiri et al., 2019). Proactive responses were mainly from young-growth firms that benefit from diversity but poorly formulated organizational contexts (Massis et al., 2020). With more significant development than young growing firms, medium-sized firms followed the conforming category's responses. In this category more complex and complete organizational networks are characteristic. Finally, firms categorized as mature growth firms use innovative strategic responses to the situation caused by Covid-19.

To better cope with the crisis caused by the Covid-19 pandemic, firms must respond by creating open communication and crisis management strategy, which according to Haryono & Wijaya (2022), has several steps as presented in the Table 4 below.

Table.4 Strategic responses to crisis. Source: Haryono and Wijaya, 2022.



The first step, crisis research, means a firm's research on what has happened from the crisis and what is expected to happen. So this step means gathering information on the force of the external crisis and causes. Then, the second step, which is establishing a crisis team, means organizing a team of employees who will take full responsibility for dealing with the crisis threatening the firm. This part is significant as that team will have no other work, and the responsibility of stabilizing the crisis is on them. Depending on the type of crisis and the type of business, the crisis team should come up with a concrete plan for crisis management steps, with ideas and plans to respond to the crisis created by external shock. The fourth step, or step of the new work system, means that the work system will change due to the firm's response to external shock. A nation's culture determines how firms respond to crises caused by external shock (Fernandez et al., 2021). With the new work comes the new system culture, and employees have to adapt to this new work culture.

In their study, Weber & Huynh (2021) analyzed the responses of 16,300 firms in Vietnam to crises caused by an external shock, the Covid-19 pandemic.

Tab. 5. Strategic responses to crisis. Source: Weber & Huynh, 2021.

Strategic responses to external shocks

Change product

E-commerce

New product markets

New imput markets

Training labor

Weber & Huynh (2021) defined several responses. Namely, some firms had changed the products to exploit changing market requirements and necessities in the new product. Other firms made e-commerce more functional to grow the electronic market resulting in overall market growth. Some of the firms responded that they had chosen new product markets as domestic demand had fallen due to the pandemic. Then, some firms responded to the crisis by seeking new input markets, as the pandemic broke supply chains. And the final response of some other firms was training labor, by some companies that in these crises also know how to face labor shortages.

Salunke & Rajan (2021) have analyzed the responses by the firms according to the main operations and processes. Their classification is given in the Table 6 below.

Tab. 6. Strategic responses to crisis. Source: Salunke & Rajan, 2021.



When faced with external shock, a firm needs to make transformations in marketing must-have skills. That is, it needs to develop a strong sense of the opportunities to respond to the market by creating a new approach to a new problematic situation for the firm. According to Gartner (2020), the firm's skills and flexibility positively impact marketing and quickly overcome crises. Transformations in technology have a bearing on the survival of firms in times of crisis. Technology plays a crucial role in the development of the economy during external shocks. Few of its components, such as electronic remittances, digital currencies, work from home, the online school-education system, and the online dating system are just some of the technological innovations developed of late. The financial processes that cost the company must be re-evaluated in times of crisis. This form creates an economic transformation adapted to the situation to have fewer adverse effects on the firm. One of the economic transformations that some retail firms have made is the extension of days to make original payments. The production process has been especially attacked by the recent crisis caused by Covid-19.

The transformations of production enter the industrial term "Industry 4.0," which includes innovative and intelligent products (Kumar, 2021). Medical device production is also considered a transformation of production (Longhitano et al., 2021). Transformations are more visible in the operations part. The pressure from the crisis to find new ways and forms to survive pushed firms to make transformations in the operating system.

4. Government responses to external shocks

This section has explored the responses of governments to external shocks. Overall, governments have responded to the latest external shock - the pandemic Covid-19, by facilitating payments, increasing the debt repayment period, and supporting firms financially (Khoury et al., 2022). The firms' and the governments' responses were challenging, hoping for good results but without any convincing certainty. During the Covid-19 pandemic crisis, government responses must be life-saving and economically responsible. This situation puts governments under pressure (Itani et al., 2020). Economic crises caused by external shocks make firms reluctant to respond in such times. Hence, governments take care to respond by securing economic welfare because solid responses from the government to the COVID-19 crisis play an essential role for firms and the country's economy (Hoang et al., 2022).

Government-reconfirmed wider responses to the Covid-19 pandemic were: border restrictions; border restriction policy; school closures (Salunkhe & Rajan, 2021; Torsello & Winkler, 2021). These measures created difficulties for the firms of a country.

Indeed, government responses impact the future of firms during external shocks. This review examines what those responses were, how they were implemented, and finally, what impact they had on the socio-economic sphere. In the US, despite the decrease in investment during the latest external shock- the pandemic Covid-19- the government response has positively affected the US economy (Hoang et al., 2022). According to Hoang et al. (2022), the economic support packages from the government are vital for economic recovery after an external shock. Government responses do not have the same impact on all firms alike, firms that are not politically dependent tend not to affect the development of their business by government responses to external shock (Xu, 2020). According to Hoang et al. (2022), US government safeguards and economic support have had a positive impact by increasing investment by firms.

2. Conclusion

This article aimed to examine how firms and governments respond to external shocks. Using multiple sources, we could deduce a straightforward narrative of how the firms and government responses have manifested during and afterward the external shocks crisis, specifically during the Covid-19 pandemic. The two particular points of analysis were synthesized and integrated into one broad overview identifying the similarities and differences between the two.

The answers to the first and second research questions in this study, RQ1, and RQ2, are solved from the sources we have gathered. RQ1: Firms have different responses to better cope with the crisis caused by external shocks. Financial managers, firm resources, skilled employees, and external factors affect a firm's responses. Some of the responses are: Reorganizing decision making, digitalization, new technology, developing new applications, reducing employees, changing product line, closing the firm, innovating, new work system, new work culture, and transforming these systems: financial, marketing, production.

As for the second research question, the government responds to better cope with the crises caused by an external shock; we have: by facilitating payments, increasing the debt repayment period, and supporting firms financially, border restrictions, border restriction policy. Drawing critical insights from the two subjects completed the review. This comprehensive literature review offers valuable insight for organizational renewal in light of future external shocks.

In this article, the light is shed on which firms and governments respond to external shocks, what the circumstances affected the responses and the difference in responses in different countries. It can be deduced that firms respond to external shocks with differing results. Similarly did the governments, with different measures and different outcomes. Developed countries had more significant support for economic support packages from the government. While for developing countries, the measures and bans were rather penalizing for firms. Responses found by firms and governments in this study help future strategic decisions regarding organizational design during and after external shocks and crises.

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