The Effect of Chaos Theory in the Field of Business: A Review

Tanmoy Kumar Debnath

Lecturer, Department of Business Administration, Shanto-Mariam University of Creative Technology, Dhaka, Bangladesh.

Corresponding Author: tanmoymathdu@gmail.com

Abstract: Chaos theory is a mathematical branch of study and a scientific principle that explains the unpredictability of systems. It has since grown into a thriving and exciting academic topic that has attracted the attention of many prestigious scientists and researchers. Mathematics is not the only source of chaos theory. It is famous for bringing together experts from a wide range of disciplines, including physicists, biologists, computer scientists, and economists. Chaos theory, in addition to science, plays an indispensable role in business and has an impact on a variety of business sectors. In this article, I will describe chaos theory, chaotic systems, and their impact on the business world.

Key Words: — ***Chaos Theory, Chaotic System, Effects of Chaos, Stock Market, Finance, Economics, Marketing, Management.***

I. Introduction

Chaos theory is a mathematical idea that describes how conventional equations can produce random solutions. The key premise of this theory is that minor occurrences have a significant impact on the outcomes of seemingly unrelated events. "Nonlinear dynamics" is another term for chaos theory. Chaos theory is a 'new' discipline of mathematics that deals with systems whose behavior is extremely sensitive to even little changes in their environment. It's the place where minor changes can have major consequences. You may also come across the term "catastrophe theory," which is an area of mathematics dealing with systems that exhibit unexpected discontinuous changes. Chaos is the science of unexpected events, nonlinearity, and unpredictability. It instills in us the ability to anticipate the unexpected. While most traditional science works with allegedly predictable phenomena such as gravity, electricity, or chemical reactions, Chaos Theory deals with nonlinear phenomena such as turbulence, weather, the stock market, our mental states, and so on.

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"Chaos" is derived from the Greek word "Khaos," which means "abyss, that which gapes wide open, that which is huge and empty" [1]. In other words, chaos refers to a condition of complete perplexity or the inherent unpredictability of a complex natural system's behavior.

II. Brief History Of Chaos

The chaos theory emerged during the second half of the 20th century when scientists from different fields of research consistently observed similarities in the behavior of natural systems like weather, chemical reactions, movement of water molecules in containers being gradually heated, etc. The official discoverer of chaos theory is Edward Lorenz of the Massachusetts Institute of Technology (MIT). He first noticed the occurrence in 1961 and, ironically, discovered the chaos theory by chance in 1963 [2]. Lorenz was attempting to better anticipate the weather using computers' newly discovered power. He developed a mathematical model that could predict the weather a few minutes ahead of time when given a collection of numbers indicating the current weather. Lorenz could create long-term forecasts once this computer program was up and running by repeatedly sending the expected weather into the computer, with each run forecasting further into the future. Minute-by-minute forecasts accumulated into days, then weeks. Lorenz decided to rerun one of his projections one day. He decided not to start from the beginning because he wanted to save time, so he utilized the computer's forecast from halfway through the first run as a starting point. After a wellearned coffee break, he returned to discover something unexpected. Although the computer's new forecasts began similarly to the previous ones, the two sets of predictions soon diverged dramatically. What had gone wrong, exactly? Lorenz soon recognized that the computer was crunching the data internally using six decimal places while printing out the forecasts to three decimal places. So while Lorenz had started the second run with the number 0.506, the original run had used the number 0.506127. A difference of one part in a thousand: the same sort of difference that a flap of a butterfly's wing might make to the breeze on your face. The starting weather conditions had been virtually identical. The two predictions were anything but. Lorenz had found the seeds of chaos. In systems that behave nicely - without chaotic effects - small differences only produce small effects. In this case, Lorenz's equations were causing errors to steadily grow over time. This meant that tiny errors in the measurement of the current weather would not stay tiny, but relentlessly increase in size each time they were fed back into the computer until they had completely swamped the predictions. Lorenz famously illustrated this effect with the analogy of a butterfly flapping its wings and thereby causing the formation of a hurricane half a world away [3]. The butterfly effect is known in more technical terms as "sensitive dependence on initial conditions." Lorenz also gave a graphic description of his findings using his computer. The figure that appeared was his second discovery: the attractors. The Belgian physicist David Ruelle studied this figure and he coined the term strange attractors in 1971 [4]. The strange attractor is a representation of a chaotic system in a specific phase space, but attractors are found in many dynamical systems that are non-chaotic. There are four types of attractors. They are fixed point, limit-cycle, limit-torus, and strange attractor. Mandelbrot discovered fractal geometry and found that Lorenz's attractor was a fractal figure, as are the majority of strange attractors. He defined fractal dimension [5]. J.C. Maxwell worked on the sensitivity to the initial conditions. He assumed that it could only happen in systems with a large number of variables whilst H. Poincare worked on the sensitivity to the initial conditions in the systems with a small number of variables and on the unpredictability.

Because its concepts, laws, and conceptualizations are assumed to be universally relevant to the behavior of practically any natural system, the chaos theory has attracted the attention of scientists all around the world. Chaos theory is now used in a wide range of subjects, including "hard sciences" such as mathematics, physics, chemistry, biology, and weather forecasting, as well as "soft sciences" such as psychology, sociology, economics, political science, and management.

III. Chaotic Systems

"Chaos theory is the qualitative study of unstable periodic behavior in a deterministic nonlinear dynamical system," according to the definition. We can draw various inferences regarding the features of chaos using this concept. To begin with, the system is dynamic, meaning it changes over time. Second, the system's behavior is both periodic and unstable, meaning it does not repeat itself. Third, despite its complexity, chaotic behavior might have simple causes. Fourth, the system is nonlinear; it is sensitive to initial conditions, as we have seen. Its aperiodicity and unpredictable nature may give the impression that it is. Chaos, on the other hand, is unpredictable despite being deterministic because to its aperiodicity, instability, and sensitivity to initial conditions. In short, chaos embodies three important principles:

- Extreme sensitivity to initial conditions
- Cause and effect are not proportional
- Nonlinearity

IV. Effects Of Chaos Theory

This section we discuss the effects of chaotic systems in several kinds of business fields.

4.1 CHAOS Theory in Stock Market

Market prices are very unpredictable, according to chaos analysis. The magnitude of the trend varies by market and by time frame. The price movements that take place over the period of several minutes will resemble price movements that take place over the period of several years. In theory big market crashes should never happen. But Mandelbrot forecasts that a market crash should occur about once every ten years. Given the fact that we have had major crashes in 1987,1998 and 2008-roughly once a decade-it's clear that Mandelbrot made a pretty good prediction. The new Fractal Market Hypothesis, which is based on Chaos theory, explains financial phenomena that the Efficient Market Hypothesis couldn't explain. The Hurst exponent specifies the rate of chaos and separates fractal from random time series, according to the theory. The rate of prediction is determined by the Lyapunov exponent. A positive Lyapunov exponent denotes chaos and establishes the time scale that allows for prediction. One can forecast future market behavior by plotting stock market changes and comparing them with chaotic analysis of above exponents [6].

4.2 CHAOS Theory in Economics

Although using chaos theory to economic models may improve their performance, predicting the health of an economy and which factors have the greatest impact is a difficult task [7]. Because economic and financial systems are essentially stochastic in nature, as they originate from human interactions, pure deterministic models are unlikely to produce accurate representations of the data. The empirical research on chaos in economics and finance yields mixed results, partly due to a confusion of specialized chaos tests and more general non-linear connection tests [8]. Recurrence quantification analysis was used to discover chaos in economics. Orlando et al. [9] were able to detect concealed changes in time series using the so-called recurrence quantification correlation index. The same method was then used to identify transitions from laminar (regular) to turbulent (chaotic) phases, as well as disparities between macroeconomic indicators and hidden characteristics of economic dynamics [10]. Finally, chaos may aid in both simulating how economies work and integrating shocks caused by external events such as COVID-19 [11]. For a more recent update on the tools and outcomes of empirically calibrating and testing deterministic chaotic models, see (e.g., Kaldor Kalecki [12], Goodwin [13], Harrod [14]).

4.3 CHAOS Theory in Finance

The goal of Chaos Theory and the Science of Fractals in both physics and finance is to explore the aperiodic non-linear behavior that emerges from systems that are sensitive to the initial circumstances of a deterministic structure. As a result, disordered behavior is a system-wide trait, but there are some recognizable patterns of market behavior. This is the major takeaway from this new paradigm for finance. Markets, like fractal structures in nature, are described as having local unpredictability and global determinism. The transition from a "efficient" to a "fractal" market has implications. A random walk or normal distributions cannot explain financial systems that combine local randomness and global determinism. As a result, in order to examine these systems, a new statistical description of capital markets is required. This will mark the transition from Gaussian to Fractal statistics.

The founder of fractal geometry, Benoit Mandelbrot, addressed the market as a scientist rather than a deductive mathematician, and as a result, he discovered the self-similar quality of financial markets. Indeed, it was in financial time series that he first discovered fractals, when he noticed that the same kind of distributions appeared unmodified without the distinctive scale. It was possible to see distributions with high peaks and "fat" tails that frequently followed a power of law on a weekly, monthly, or annual basis (This implies that graphs will not fall toward zero as sharply as a Gaussian curve). As a result, Mandelbrot came to the conclusion that "the very center of finance is a fractal" [15]. Mandelbrot's discovery is significant because it demonstrates that, despite the seeming disorder of capital markets, there are some "stylized facts" that can be used to describe their behavior. For example, huge and discontinuous price swings, according to Mandelbrot, are significantly more often than the Gaussian hypothesis predicts. As seen in financial markets, transactions occur at different times and are reported in different units; thus, a price series is never continuous mathematically. It is possible to approximate the distribution to a normal if prices shift smoothly from one value to the next. Prices, on the other hand, are only discontinuous for Mandelbrot because they move up or down quite abruptly, and they also tend to group. As a result, discontinuity is a prevalent feature of financial markets, as evidenced by the "fat tails" of distributions [16]. For financial time series, dependence is also a significant characteristic. Long-term memory, in particular, indicates that aleatory impacts in the initial conditions have a significant impact on the future behavior of a dynamical system. As a result, contrary to the independence assumption of a random market, past occurrences cannot be excluded in a fractal market.

4.4 CHAOS Theory and Organizational Strategy

We may apply chaos theory concepts to our everyday management work if we think of organizations, firms, and industries as complex, dynamic nonlinear systems. Whether it's vendors, suppliers, or direct competition, businesses continuously interact with one another. All of the relationships that corporations engage in, according to Levy, are strategic in the sense that decisions made by one organization consider the reactions of others [17]. As a result, macro and micro actions at the company level will be intertwined. Small perturbations in one corporation, according to chaos theory, multiply nonlinearly over time. As a result, the initial action could have impacts for other businesses. Because it is impossible to account for every single variable that affects an organization in chaos theory, forecasting and long-term planning are difficult to achieve. Tiny changes in parameters should lead to small changes in the equilibrium outcome, according to traditional strategy conceptions and paradigms. Chaos theory contradicts this notion and pushes us to consider how little changes can have massive implications.

The depth of understanding that I see as a benefit of chaos theory. Chaos theory forces us to take a step back and analyze whether other variables, large or tiny, are influencing our outcome. Though a butterfly in Brazil flapping its wing and producing a tornado in Texas is a little far-fetched, other sources, such as how is competition in another country affecting our domestic sales, may be available. A further in-depth investigation could reveal that a competitor missed its quarterly production output deadline. As a result of their insufficient supply, their consumers were forced to purchase from us (the competitor). This, in turn, may lead our organization to feel that a rise in sales was due to internal sources when, in fact, it was due to a competitive error. Increased sales in this case should be attributed to external causes, which might be chaotic at times. Because there are millions of factors at play that affect the entire system, chaos theory is particularly useful to organizations. The more variables we can account for, the more control we have, which leads to more accurate forecasting, in my opinion.

According to Ochoa, J. [18], chaos theory is quite complicated. It is one perspective on dynamic, complex, and nonlinear organizations. He used the chaos theory paradigm to uncover causes of results and outcomes both at work and at home. He hoped it would help him see results in a new light, as well as stand back and consider other factors that may be assisting or impeding his ultimate objective. He aimed to limit the number of components and variables inside systems by comprehending chaos theory, resulting in less room for chaotic occurrences, which then affect other components and the system. Patterns were another constructive aspect of chaos that he found useful. Patterns are produced by chaos theory, however they are rarely precise clones or duplicates, making it difficult to identify repeated events and their distinctions. Everyone will need to grasp how teams work as a unit and how each member contributes to the broader team, as well as how a minor occurrence such as a team member suffering a flat tire might affect a project's conclusion. Chaos theory is fascinating, and researchers are still working to better comprehend this notion that accounts for so many unknown variables [18].

4.5 CHAOS Theory in Marketing

As the world becomes more complicated, marketing has to deal with more target customers, more ways to reach them, larger data sets, convoluted marketing funnels, and so on. Every day, the level of difficulty rises. Marketing is no longer as simple as hanging a flier in the local grocery store. Marketing is a complicated system of messages addressed at specific consumers at certain times, in specific ways, on specific devices, with the appropriate message for their stage in the buying cycle.

Consider a complicated product launch marketing strategy. Each media buy has a purpose and is implemented to achieve a specific amount of impressions, clicks, buys, or other key performance indicators (KPI). Summing those KPIs individually, as if each one had been run separately, for each piece of media across each channel (TV, radio, print, paid search, social media, web banners, etc.) will not demonstrate the campaign's potential success. This would turn the problem into a linear one. Other factors, such as the amount of impressions before conversions, messaging changes throughout the funnel, and how the pieces of media work together in general, all contribute to results that differ from what each piece of media might do on its own. A nonlinear problem is marketing. Chaos exists in complex marketing programs. Predicting what will happen once everything officially launches is difficult because there are so many inputs, factors, and possible outcomes [19].

4.6 CHAOS Theory in Management

Chaos theory is a scientific concept that has been used in management. In the 1980s, Tom Peters was the first to use it in this context. Managers, he said, must be ready for changes in the environment and technology. The unpredictability of events and behaviors is the emphasis of chaos theory. Complexity is a natural tendency for systems. As a result, they become more volatile and vulnerable to chaotic events. Additionally, maintaining the processes and stability of an organization necessitates more attention and effort. If not separated or integrated with other systems, these systems will eventually fail. While the unpredictable cannot be predicted, randomness can be measured using mathematical methods. According to Peters, rigid hierarchical structures impede a company's ability to respond to the ever-present randomness. He largely advocated for organizational reform to be more responsive to customers' requirements and wants [20].

V. Conclusion

The application of chaos theory to business opens up a slew of new possibilities for understanding, evaluating, and predicting business growth. It introduces us to a new way of thinking about measurements and scales, as well as encouraging the development of new mathematical tools and approaches that are important in a variety of business disciplines. Various business sectors are extremely complex, and the only thing that can be predicted is that it will be unpredictable. The randomness of many events or circumstances contributes to the unpredictability of many business sectors such as financial markets, stock markets, and economics. One can try to capture the structure of unpredictability using chaos theory and exhibit it in a variety of templates. The chaos theory is a revolutionary technique to comprehending and anticipating the behavior of many business sectors. The implications of chaotic systems on business are examined in this study. Extensive research has recently been conducted in numerous domains of business and science in order to better comprehend these chaotic systems.

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