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SUBIR GOKARN: Virtues of diversification

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The current crisis highlights the value of diversification in cushioning its impact at various levels, says *SUBIR GOKARN*

When crises are over and done with, which they inevitably are, looking back over their unfolding typically leads us to some rather basic conclusions. Of course, there is the whole paraphernalia of institutional solutions and professional reputations being made or unmade, but all these are complicated manifestations of the simple message at the core of the crisis. In the current context, if I were to be asked to identify that simple message, it would be that old aphorism: "Don't put all your eggs in one basket".

As we analyze the various twists and turns that this crisis has taken so far and speculate on the ones it is likely to take in the coming weeks and months, the distinguishing feature between entities — economies, sectors, companies and households — that have merely hurt and those that have been devastated seems to be that the former were more "diversified" than the latter. This is, of course, an evolving argument and the proposition subject to empirical validation. But, there are a number of rather striking examples of it, which make it worth exploring.

Let's begin at the level of whole economies. Several years ago, the Brazil-Russia-India-China BRIC group was identified as a distinct set amongst emerging economies, because of the relative size and growth of their domestic markets. This, it was argued, would provide a counter-weight to the countries' increasing integration into the global economy, protecting them from shocks that emanated from elsewhere. Of the four, China and India seemed to pull ahead of the pack as both domestic and external drivers of growth fired on all cylinders. Brazil and Russia came into their own in the years immediately preceding the crisis, as oil and other commodity prices surged, playing to the strengths of these two large economies.

But, their persistent dependence on energy and commodity exports has clearly left them quite vulnerable to the downturn in the cycle and their performance is likely to suffer far more than the far more diversified economies of China and India. These two will continue to be the fastest growing economies in the world, showing quite respectable rates of growth even as the rest of the world slows down dramatically from the boom years of 2006 and 2007.

China itself is a great example of diversification. Over the years, different drivers of growth have begun to play more and more prominent roles. Even though exports remain a significant force, they have steadily yielded ground to domestic demand. Within the export basket, the US, while still the most significant market, has become less so as exports to the fast-growing economies of Asia have increased. As far as domestic demand goes, consumer spending is gaining ground relative to investment. These trends both help to shield growth from a US recession and increase the impact that monetary and fiscal policies have by virtue of the fact that they act primarily through domestic demand.

At the sectoral and company level, there are prominent examples of excessive focus on narrow market niches leading to significant damage. The debate surrounding the bailout of the US automobile industry has highlighted the emphasis that the three companies put on the SUV segment — large, relatively fuel-ineffficient vehicles, which were extremely profitable when the going was good, but the demand for which virtually disappeared overnight as fuel prices soared.

The fact that these companies did not have any products in their portfolio that could accommodate such dramatic changes in market conditions is being viewed as a major reason for the situation they find themselves in. While automobile companies the world over are in trouble in current circumstances, it is almost certain that the ones who specialize in relatively small and fuel-efficient vehicles will be the first to benefit from an economic recovery.

Similarly, real estate developers in India took advantage of favourable market conditions to move away from the middle of the price spectrum to its highest reaches. Over-committed to expensive, luxurious projects, they were hit hard by the twin blows of faltering demand and extremely expensive credit. Even if there were potential buyers in the market, they would be deterred by the increasing likelihoods that projects simply would not be completed on schedule in prevailing market and credit conditions. Here again, with monetary and fiscal stimuli essentially targeted at the lower and mid-price segments of the housing market, many prominent developers who have all but vacated these niches will not directly and immediately benefit from the policy measures.

The risks from specialization are visible amongst exporters as well. It is highly cost-efficient from both the buyer's and seller's perspective to develop a very narrow focus. Many exporters sell a narrow range of products to a single buyer as a result, but in the process, leave themselves vulnerable to the buyer's financial state. A large number of export units in China have shut because their sole, or dominant, customer is in trouble. This is true of Indian exporters of manufactured goods as well. More so, the Indian IT and ITES sectors, which have played such a prominent role in the growth story, are heavily dependent on the US financial sector for their revenues, making for some rather bleak quarters as far as financial performance is concerned.

Finally, the way in which individuals manage risk through diversification even at the lowest levels of income is revealing. Workers may migrate from villages to cities, even rather distant ones, to exploit opportunities in industry and services, but in countries like China and India, they rarely sever their ties to rural economy fully. In the absence of reliable formal safety nets, the possibility of returning to the village with some assurance of subsistence requirements being met allows workers to deal with the risks of the urban job market.

From a strategic perspective, the efficiency gains from specialization must be traded off against the risks that it poses. From individuals and households all the way up to giant multinational corporations, there has to be some consideration given to diversifying sources of income, which assures some minimal financial viability in any set of economic circumstances. From a policy perspective, governments and regulators need to make more explicit and strengthen incentives for efficient diversification. Crises may not be avoidable, but we certainly have the knowledge and the means to cushion their impact on economies, sectors, companies and households.

The author is Chief Economist, Standard & Poor's Asia-Pacific. Views are personal