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Subir Gokarn: Differentiated recovery

A modest recovery is not a rising tide. Its impact will vary across businesses, based on their strategies

Subir Gokarn | New Delhi August 10, 2009 Last Updated at 00:26 IST

A modest recovery is not a rising tide. Its impact will vary across businesses, based on their strategies, says *Subir Gokarn*

Indications that the global economy is turning around are increasing by the day. Nobody is seriously arguing that the tough times have gone away. But, it is clear that many things are visibly improving while very few things are actually worsening, at least as a direct consequence of the economic turmoil. This should come as welcome relief to policymakers and investors around the world. In many countries, the policy debate is beginning to turn from crisis management to the potentially adverse consequences of the response to the crisis and how these can be contained. Investors are taking advantage of the high levels of liquidity to re-diversify their portfolios, both geographically and across asset classes.

This is a rather reassuring macroeconomic assessment. However, as so often happens, what is true of the aggregate is not necessarily true of each component of it. Even as the recovery consolidates, there is little doubt that it will be a relatively modest one. Even the most optimistic forecasters do not expect that growth rates around the world by 2011 or 2012 will replicate the boom of 2005-07.

It is in this context that the issue of differentiation becomes important. A boom is essentially a seller's market. In these conditions, most businesses will succeed, regardless of what strategy they use. Every entrepreneur and manager thinks he has the Midas touch, allowing whatever he pursues to turn into gold. However, many, if not most, strategies that succeeded during the boom were obviously not tested during tougher times.

All businesses were undoubtedly hit very hard by the recession but not all businesses will have the same capacity to ride with the macroeconomic recovery. Businesses that over-leveraged themselves when funds were plentiful and cheap or those whose systems and processes were opportunistic, for example, will find it difficult to compete with firms that are more balanced and robust on these parameters.

A recession and even a modest recovery are much more buyers' than sellers' markets. In such circumstances, the more resilient business models — on financial, managerial and other parameters — will have an advantage in attracting customers, luring them away from the more fragile companies. As the recovery progresses, the differentiation between resilience and fragility will widen, allowing some businesses to recover quite successfully while pushing others deeper and deeper into crisis.

One direct implication of this pattern is that defaults, bankruptcies — in general, symptoms of financial distress — will remain at relatively high levels even as the recovery is taking hold. We should, therefore, not be surprised by what may appear to be somewhat disconcerting numbers for these indicators. These will not, in any way, be inconsistent with the view that a recovery is, indeed, taking place at the macroeconomic level. Banks and other lenders will have to anticipate this and perhaps begin to scrutinise the strategies and organisational capabilities of the businesses they lend to more closely.

Investors in equities, similarly, will have to go beyond country- and sector-based approaches and look for robust and resilient business models in every sector. In every bad sector, there will be good companies and vice-versa. For managers of good companies, the time is right for acquisition and consolidation of market positions. Even if overall financial flows are somewhat constrained, more credible borrowers will benefit from differentiation being practised by financial institutions.

This overall argument is analogous to the explanation of why the unemployment rate is a lagging indicator in economies like the US. When recession strikes, every employer lays off workers but when the recovery begins, many employers are too badly hurt to be able to re-hire. In fact, as they go into bankruptcy, they lose even their remaining workers. Meanwhile, the surviving companies have used the slowdown as an opportunity to re-engineer their organisation, making some positions redundant. As a result, they will not re-hire all the workers they laid off even as business returns to pre-recession levels.

Together, the financial distress and unemployment consequences of a recession have provided the underpinnings of institutional safeguards against the full impact of recessions in the developed economies. These are, as yet, generally quite primitive or non-existent in emerging economies. As global integration increases, the exposure and vulnerability of emerging economies to business cycles escalate. They, therefore, have to begin implementing or expanding the coverage of safeguards that are suited to their specific domestic conditions.

To deal with the unemployment problem, a safety net in the form of unemployment insurance has to be available, at least initially, to workers in sectors that are most at risk. More importantly, given the lagging nature of unemployment, this protection must be available for at least a few months, if not longer, than the duration of the downturn itself. Further, given that these sectors are unlikely to return to their earlier levels of employment at the end of the full cycle, processes that help unemployed workers find work in other sectors need to be established.

The financial distress problem is a little more complex. Clearly, providing financial lifelines to fundamentally unviable businesses is an untenable proposition. At the same time, these owners and managers of such businesses must have the freedom to shut shop and quickly re-deploy whatever is left of their capital elsewhere. Also, successful businesses must be able to acquire and assimilate such (or any) companies in as short a timeframe as possible. Essentially, the faster the processes that govern the disposal and acquisition of assets, the more effectively will the impact of financial distress be contained.

To sum up, while a boom phase, particularly one as strong as the global economy experienced during the 2005-07 period, is a rising tide which makes all strategies look like winners, a recession and a subsequent modest recovery are huge differentiators between business models and, very importantly, individual workers. The consequence of this differentiation is that a macroeconomic recovery does not translate into equal opportunities or relief to all businesses and workers. Some will continue to face distress even as others successfully exploit the opportunities provided by a recovery.

There are, of course, ways for the more successful businesses to take advantage of the effects of differentiation as well as for policymakers to insulate the economy from them. But, generally speaking, these are not particularly well-developed in emerging economies. The recent recession will, hopefully, compel policymakers to pay greater attention to this issue.

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