Collateral Damage

*In the Eye of the Storm: Ignore Short-Term Indicators, Focus on the Long Haul*

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May 2010
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In the Eye of the Storm: Ignore Short-Term Indicators, Focus on the Long Haul

It has been a while since we published the last paper in our Collateral Damage series, in which we foresaw depressed global growth for some time to come. Recently, many of the short-term economic indicators have begun offering more encouraging messages. The G-20 finance ministers clearly believe so. They are now saying that government efforts to jump-start the recovery are paying off: “The global recovery has progressed better than previously anticipated largely due to the G-20’s unprecedented and concerted policy effort”—although they acknowledge that progress is occurring “at different speeds within and across regions.” At the same time, however, the G-20 is urging members to develop credible strategies for reducing stimulus spending and allowing ultra-low interest rates to rise to more normal levels. These exit plans pose considerable risk to the nascent recovery. And the sovereign debt crisis has taken the gloss off some of the G-20’s optimism.

We continue to find the policymaker and media focus on short-term changes in economic indicators to be unhelpful. Governments and management teams need to take a longer-term perspective, planning for their economies and their businesses in a prudent and more farsighted way. We do not argue against the likelihood of some sort of recovery. Our point has always been that for the West, at least, the recovery after the stimulus effect wears off will be anemic—the sort of slow-growth environment that will change the rules of the game for companies as they seek to grow amid increased competitive intensity. Indeed, our most recent survey of 440 executives in seven major economies shows that managers are less optimistic than their political leaders. We see no reason to change our prediction of the emergence of a two-speed economic world.

Harry Truman famously asked for “a one-armed economist so that the guy could never make a statement and then say ‘on the other hand…’” In this paper, we look behind the two-armed economist that Truman tried to wish away: we seek to interpret the conflicting economic signals; we describe the findings of our survey of senior executives across a broad range of issues relating to how they view the recovery and the implications for their companies; we revisit some of the new economic realities that we described about a year ago; and we explore the potential implications of trying to rebalance the books in some highly indebted countries.

1. Two-Armed Economists Are Back in Fashion

Why have so many companies been so willing to take a knife to costs and then demonstrated reluctance to go on the offensive in pursuit of growth? In previous papers, we have looked at companies that prospered in tough economic times. They, too, cut costs. But they also acted decisively to exploit market opportunities, recognizing that many initiatives can take months or years to reach fruition. History also shows that in the aftermath of turbulent times, the pecking orders of entire industries are changed for years to come.

The reasons for being cautious are all too understandable. We are bombarded daily with conflicting economic signals—the one-day good-news stories and the one-day bad-news stories. This favors a wait-and-see attitude. We have tried to take a long-term view of the economy, not letting ourselves be overly influenced by individual economic indicators. Our belief that growth will be slow in the West leads to a view that competitive intensity will increase as companies seeking growth realize that the only way to grow under such circumstances is to gain share.

Taking a view helps, because if you have a view, you can act. And if growth turns out to be higher than you expect, then so much the better. The enemy of action is uncertainty. And uncertainty abounds because we can see the return of the fabled two-armed economist.

A. Looking Beyond the Conflicting Economic Signals

On the one hand, economic indicators have shown some encouraging shifts in the first three months of 2010. For example, retailers in the United States are reporting stronger sales, at least compared with the dismal numbers from the same time last year—on a month-over-month basis, core retail sales increased by 0.5 percent in March 2010 compared with a 0.9 percent drop in March 2009. The March U.S. employment data delivered the first significantly positive news since the economic crisis started unfolding: jobless rates in 5 states decreased compared with the year before, 1 state experienced no yearly change, 17 states experienced decreasing rates over the course of the month, and 9 states had no monthly change. Seasonally adjusted home prices rose for the eighth month in a row in January 2010. The Institute for Supply Management’s PMI has been pointing toward growth in the overall economy for 11 consecutive months, and—helped by low interest rates and monetary easing—JPMorgan Chase, Citigroup, and Bank of America recently reported financial results that buoyed the stock market. The U.S. trade deficit widened by $2.7 billion in February as import growth continued to outpace exports, with imports (up 20.5 percent relative to February 2009) driven by consumption—providing more evidence of a consumer recovery. The more-optimistic observers argue that if this momentum can be maintained a little longer, it will become self-reinforcing.

Still, we tend to favor the “other hand” based on some simple fundamentals. We have long argued that most developed economies—the United States in particular—face a prolonged period of slower growth. If the United States enjoyed two decades of rapid growth on the back of unsustainable consumer borrowing, it stands to reason that the return to some sort of sustainable debt level must inevitably lead to slower growth. Add an aging population, significant drops in asset values (more than 11 million U.S. households were facing negative equity in their homes by the end of 2009), and a jobless recovery (about 30 percent of the new jobs in March were temporary positions created to undertake the 2010 U.S. census), and it is hard to see how we can expect a long-term upsurge in consumer spending. What is more, as the U.S. government stimulus runs its course and mortgage support is withdrawn, we expect momentum to be lost.

Readers of our last paper will remember our analysis pointing to a two-speed world, where much of Asia and also Brazil return to their precrisis growth trajectory while the economies of the West face years of lower growth. Since then, disparate growth has increased the tensions between China and the United States over currency and trade issues. We cannot see President Barack Obama being content to seek reelection in two years’ time against a backdrop of nearly 10 percent unemployment (17 percent when counted properly*), still-depressed real-estate values, and low growth, particularly when China is growing at about 8 percent and running a massive trade surplus with the United States. In March 2010, when China ran an overall deficit of $7.24 billion, it still achieved a $9.87 billion surplus with the United States. This stark difference in economic performance brings with it an increased risk of protectionism. (More on that later.)

There is one additional piece of context worth considering. The global recession was, in fact, a recession in the West, but it was just a slowdown in the East—and in the end, perhaps, a surprisingly mild slowdown at that. Even in 2009, according to the IMF, emerging Asia plus Korea grew at close to 5 percent, with most economists predicting a rebound to something close to 8 percent in 2010. However, these countries combined represented a little less than 17 percent of global GDP in 2009, according to the IMF. In contrast, the recession in the United States, Japan, and Western Europe (countries representing 76 percent of global GDP) was a deep one. There appears to be a relatively strong recovery in those developed markets in 2010 (at least in the first half) on the back of the heavy fiscal stimulus, inventory restocking, and the very weak 2009 comparable numbers. But with fundamentals still weak, the recovery is likely to run out of steam and low growth will prevail. And if a relatively robust Asia could not prevent most of the OECD countries from falling into recession, why should we expect Asia to save them now? For the next few years, Asia will still be too small.

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3. These results were significantly driven by central banks’ policy of low interest rates and quantitative easing, which led to very low refinancing costs.
4. That is, including all persons marginally attached to the labor force or employed part-time when their preference would be to work full-time.
5. Emerging Asia includes China, India, Hong Kong, Indonesia, Malaysia, the Philippines, Taiwan, Thailand, and Vietnam.
B. Executives Are Skeptical: Results of Our Most Recent Survey

In March 2010, BCG launched our third survey to assess how company management teams are responding to the economic upheaval of the last 18 months. We received responses from 440 executives in the seven largest economies of the developed world.\(^6\) When we compared the survey results with those from March 2009, we found some striking shifts in opinion. One thing, however, did not change. Our respondents remain somewhat less enthusiastic about the economic outlook than do many of their governments.

Overall, half of our sample expects to see an L-shaped recovery. (See Exhibit 1.) The outliers are Germany (where only 34 percent are so pessimistic) and Japan (where, perhaps influenced by recent history, 72 percent expect to see an “L”). Since March 2009, respondents from Italy and France have become far more pessimistic. Respondents from Germany, who had turned significantly more pessimistic in September 2009, have returned to where they were a year ago, reflecting the increased demand for German export goods.

With the passing of a year, our respondents have become far more resigned to the likelihood of significant changes in the global economic order: 78 percent of them now expect more trade protectionism (up from 57 percent in March 2009); 73 percent expect a rebalancing of global trade (up from 56 percent); and 69 percent expect growth to be harder to achieve (up from 56 percent). The private sector clearly expects governments in the developed countries to continue their interventionist policies: 82 percent (up from just 58 percent a year ago) believe that we will see more regulation, and not just in the financial sector. This expectation of further regulation may well be driven by the fact that 74 percent of respondents see a more negative attitude toward Anglo-Saxon capitalism prevailing in their markets.

Companies have clearly taken the consequences of such a worldview to heart. Some 79 percent of survey respondents expect an increase in the savings rate in their country (versus 54 percent a year ago), and a whopping 89 percent anticipate increased consumer price sensitivity (up from 71 percent). As an aside, we

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**Exhibit 1. Executives Remain Skeptical About the Economic Outlook**

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**Source:** Companies in the Downturn: Expectations, Actions, and Preparedness, BCG survey of 440 senior managers, March 2010.

**Note:** Because of rounding, numbers may not add to 100.

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\(^6\) Between 55 and 80 executives participated from each of the following seven countries: France, Germany, Italy, Japan, Spain, the United States, and the United Kingdom. About 70 of the respondents represent companies with revenues in excess of $15 billion; a further 150 work for companies with revenues of greater than $5 billion. Seventy-three represent companies that are market leaders in their industry, while a further 190 work at companies that were second or third in their sector.
were in New York in mid-April and the chairman of a large U.S. retail chain told us that although the sales figures were much better than a year ago, shoppers were much more focused on value, even if that did not always translate into simply buying the lowest-price goods. It is unsurprising, therefore, that 61 percent of respondents expect profitability to fall—and that the proportion expecting increased consolidation in their industry has risen from 42 percent a year ago to 60 percent today.

The worldview held by our respondents is not one conducive to job creation, investment, and risk taking. It provides further support to those who believe that economic growth will be slow overall.

C. The Globalization Squeeze?

As we have traveled the world engaging with governments and our clients on the subject of global economic developments, we have become aware of another twist relating to the shape of globalization. One possible scenario strongly reinforces the likelihood of slow growth in the West, increased long-term stress in the job market, and increased economic tension between the West and the East. This scenario goes as follows.

International trade has, of course, been around for centuries—starting long before the days of Marco Polo and the Silk Road. In modern times, however, true corporate globalization had modest beginnings, with companies in the West enjoying the gains from trade, typically exporting to the rest of the world. Then, in search of the labor-cost arbitrage opportunity, these companies relatively recently began exporting less-skilled jobs from the West to what were then known as the developing countries. In return, the West enjoyed lower-cost goods, a noninflationary boost to growth, the opportunity to offshore some polluting activities, and a labor force increasingly freed up to work in services and higher-tech industries. Unfortunately for the West, as we all know, some of these gains were squandered as huge levels of debt built up and insufficient investment was made in training its workforce—thereby sowing the seeds of a problem for the future.

Before long, the multinationals discovered that the developing countries (some of which had by then been relabeled RDEs, or rapidly developing economies) were also good places in which to market products for local consumption. Unfortunately, the business models and skills of some Western companies proved to be ill suited for the RDEs. These economies still have lower GDP per capita and often present unique local operating challenges—and their consumption needs can be quite different from those in the West.

Over time, increasingly educated workforces have also made the RDEs attractive places in which to develop products—and increasingly complex or technologically advanced products at that. (In fact, the Economist was recently moved to write about the West losing its leadership in innovation.7) These products are both sold locally and shipped to the West. And politicians would be naive to assume that today’s multinationals owe allegiance to any single economy. They are global citizens with globally diverse customers and ownership. It is not their responsibility to bail out the economies of the West. Moreover, the RDEs benefit enormously from their demographically younger workforces, their societal emphasis on math and science education, and their powerful work ethic. Many Western countries, with their aging populations, suffer besides from a younger generation less eager to pursue math and science. Worryingly for the West, therefore, we are probably only at the beginning of this phenomenon of shifting product development to the countries in the East.8

It is thus no surprise that the high-growth economies of the East are also spawning a group of global challenger companies: Huawei Technologies, Bharat Forge, Tata, and many others. These companies enjoy favorable conditions in their home markets (which were not damaged by the crisis), where local procurement practices (and even regulation) often benefit the local champions. These companies are aggressively expanding their global reach, intensifying the competitive pressure on Western companies.

This scenario is not an attractive one for some countries in the West. Take the United States and the United Kingdom as two examples. Having exported many lower-skilled jobs, they now risk being caught in a squeeze whereby the higher-tech jobs that they aspire to create are also migrating East. Failures in

8. See also Stimulating Economies Through Fostering Talent Mobility, a March 2010 report published by the World Economic Forum in collaboration with The Boston Consulting Group.
public education—in particular, the fact that neither country is producing enough engineers and scientists—could have significant long-term repercussions. Despite high U.S. unemployment, there are skills shortages in a number of industries. In fact, Intel and others have become so worried about the risk of the United States losing its technical edge that they have recently put together a $3.5 billion venture-capital fund to support U.S. technical leadership.9

2. An Update on the New Realities

In March 2009, we postulated some major changes in the established global economic order, along with increased government activism, fundamental shifts in the structure of industries, a prolonged period of lower profits for companies, changes in investor preferences and risk appetites, different patterns of buying behavior from a generation of consumers scarred by the economic whirlwind, and a shift in social mood as more people were exposed to the painful fallout of the crisis.10 And in January 2010, we discussed some emerging changes in the managerial mindset.11

In addition to analyzing whether the respondents to our survey share our views on the new realities, we have continued to observe statements, decisions, and actions by political and economic actors to determine whether the changes we predicted have become a reality. Unfortunately, many of the developments we have observed put a strain on the economy’s ability to recover. We now briefly look at a few of these.

A. The Increasing Importance of Politicians

The role of governments in the economy has changed significantly since the crisis began. Through bailouts and stimulus packages, governments have reacquired significant stakes in businesses and are likely to be much more influential than during the years before the crisis. Companies realize this and are preparing to engage with more activist governments: 85 percent of our survey’s participants consider it likely that their companies will increase their lobbying activities in the next two to three years. The fact that the gap between rents in Washington’s prime downtown area (K Street) and midtown Manhattan has narrowed from $20 per square foot to almost nothing not only reflects reduced demand from the financial services sector but also indicates that companies have discovered the increased importance of being close to political decision-making (in a country where lobbying is already something of an art form).12 And politicians have certainly been considering how best to address protectionism, trade flows, and reindustrialization.

B. Protectionism

In their recent report on the trade and investment measures of the G-20 countries, the Organisation for Economic Co-operation and Development, the World Trade Organization, and the United Nations Conference on Trade and Development found that most G-20 members were holding to their commitment to open trade and investment.13 However, they also warned that protectionist pressures might continue to gather force in the face of ongoing job losses and high unemployment. And they are right to be cautious:

In September 2009, the United States imposed punitive tariffs on tire imports from China—a move that fulfilled President Obama’s promise to “crack down” on imports that unfairly undermine American workers.14 And in March 2010, the U.S. government issued its final rules for greenhouse gas emissions by automobiles, paving the way for a law that regulates the maximum fuel consumption of cars.15 The calculation of thresholds will be based on wheel base and track width, with formulas calibrated in such a way that large U.S. manufacturers will exactly meet the guidelines. Porsche CEO Michael Macht has called this measure “close to economic warfare.”16

In January 2010, French President Nicolas Sarkozy, commenting on Renault’s plans to move a production site for its Clio model to Turkey, said, “We are not giving all that money to support the auto sector so that all our factories can leave.” He urged the company to reconsider its plans. More recently, commenting on his desire to see corporate strategy more closely aligned with government policy in France, President Sarkozy pointed out that the government would use its significant shareholdings in French industrial companies to make sure this happened.

The emergence of protectionist measures is reinforced by a dilemma that many governments face: having provided massive stimulus, many are now heavily indebted and have no financial firepower for additional measures. Protectionism, however, does not require any spending.

Governments opting for protectionism can find heavyweight intellectual support in a recent commentary in the New York Times by economist Paul Krugman (who was awarded the Nobel Prize for his work on trade), who proposed a 25 percent across-the-board tariff on Chinese goods. Given these dynamics, it is perhaps not surprising that about 74 percent of the participants in our survey expect trade, financial, and labor protectionism to increase over the next two to three years.

C. The Rebalancing of Trade Flows

Internal imbalances within the euro zone have always existed, but in this time of crisis political leaders are on the attack. French Finance Minister Christine Lagarde criticized Germany for its export strength, urging it to boost domestic demand and questioning whether the German model of improving competitiveness by reducing unit labor costs “is a sustainable model for the long term and for the whole of the group.”

Similarly, the simmering controversy between China and the United States over China’s exchange-rate policy (and by extension, its trade balance with the United States) is reaching the next level. There is increased public pressure on the U.S. Treasury to label China a “currency manipulator.” In March 2010, 130 members of the U.S. Congress sent a letter to Treasury Secretary Timothy Geithner in which they expressed their concern about “China’s continued manipulation of its currency.” Furthermore, they argue that China’s action “merits the WTO-permitted application of countervailing duties.”

The Financial Times’ chief economics commentator, Martin Wolf, joined in, criticizing “surplus countries [that] insist on continuing just as before. But they refuse to accept that their reliance on export surpluses must rebound upon themselves, once their customers go broke.”

A simple simulation shows the magnitude of the shift required to rebalance trade. If we assume that the key deficit countries (Greece, Spain, the United States, Australia, and the United Kingdom) try to reduce their debt levels by either balancing their current account or even running a current-account surplus, the corresponding effect on the major current-account surplus countries (China, Germany, Japan, and the oil-exporting countries of Canada, Kuwait, Norway, Russia, Saudi Arabia, and the United Arab Emirates) would be significant. (See Exhibit 2.)

Take the case of moderate deleveraging, in which countries with current-account deficits would seek to run a positive current-account balance equivalent to 2 percent of their GDP. For this to happen, other things equal, both Japan and Germany would need to run current-account deficits, which would in turn imply negative net domestic savings in those two countries. With governments trying to get their houses in order, most of this “dissaving” would have to be done by the private sector—be it household consumption or investment by corporations. It is important to remember, however, that Germany and Germans are not debt free—the debt outstanding of households, nonfinancial corporations, and government entities is

roughly 230 percent of GDP (compared with the U.S. level of more than 260 percent)—and given the country’s demographic challenges, it is only rational that German consumers would try to save for retirement. The Japanese government is already very highly indebted as well, and shifting demographics have led to a decline in the savings rate of Japanese consumers.

For China, it would imply a two-percentage-point deterioration in its current account—which could be achieved by liberalizing trade, being more open to products from the West, and funding growth in consumption through lower domestic savings. However, an inadequate safety net and uncertainty about the private burden of health care, education, and pensions have traditionally been drivers for a high household-savings rate in China. So until those issues are addressed, the savings rate is likely to remain stubbornly high. In addition, corporate savings have been high due to the fact that most state-owned companies in China do not pay dividends.

This simple trade-rebalancing simulation shows that even if the trade surplus countries were willing to go down this path, it is impossible to assume that trade flows would completely reverse. The surplus countries often have a competitive advantage in some industries that cannot quickly be replaced by domestic suppliers in the deficit countries. Perhaps the most obvious lever would be to reduce the dependency on oil imports by replacing oil with alternative energies—but such an approach will inevitably take a long time to be implemented.

This analysis reinforces our belief in the increasing risk of protectionist-inspired changes in industrial policy and investment as governments try to generate trade surpluses. These shifts could even trigger a downward spiral of beggar-thy-neighbor policies.

All of this is clearly a major test for the currency union in Europe. More than half of the respondents in our survey have doubts about the future of the current European and Monetary Union (EMU); 11 percent...
think that the EMU will break up, and 40 percent expect that weaker countries will have to exit the currency union. As we write, there is a lot of agitation in some circles for Greece to exit the euro.

On a global scale, this will tend to favor flexibility over a low-cost position. Companies need to revisit their supply-chain strategy: it might have been the right strategy in the past to shift production into one world-scale plant in a low-cost country, but in the new world a better strategy might be to have several plants in the key regions of the world economy.

D. Reindustrialization

Another strategy that many governments are exploring in response to the crisis is to call for reindustrialization. The British government, for example, announced that it will follow a policy of political activism to boost manufacturing. One initiative being proposed is to set up an “elite group of technology and innovation centers” similar to the German Fraunhofer Society to support the development of technologies for “large global markets worth billions of pounds a year” in which the United Kingdom “should have a world lead.”

In a similar vein, French President Nicolas Sarkozy recently announced a set of measures to reverse the decline of industry, promising a bigger role for the state in boosting innovation and saving jobs. Among the measures are a €200 million fund for “soft loans” (that is, at a below-market rate of interest) to companies repatriating manufacturing operations to France; €500 million in soft loans for green technology and energy efficiency; and a fund for closer collaboration between companies in the fields of chemicals, software, food, and electronics.

The United States is also working on strengthening its manufacturing sector. An early success has been the decision by Mercedes-Benz to shift major parts of the production of its next-generation C-Class line from Germany to the company’s plant in Tuscaloosa, Alabama. This was mainly for cost reasons—sweetened with up to $100 million in subsidies.

But reindustrialization is easier said than done. A recent survey conducted by Deloitte, Oracle, and The Manufacturing Institute reported a serious lack of necessary skills in the United States, with as many as 63 percent of respondents identifying moderate to severe skills gaps in defense and aerospace companies as well as in life-sciences and medical-devices companies. (See Exhibit 3.) The owner of a Chicago-based motor manufacturer put it bluntly: “It’s difficult to find people for jobs...that require math skills and the ability to read technical blueprints.”

E. Changing Investor Expectations

For a long time, we were convinced that investors would change their mindsets. The respondents to our survey think that investors have less appetite for risk and are focusing more on the long term: 83 percent expect that the investment philosophy pursued by investors will be more conservative and 84 percent expect that the importance investors attach to a company’s cash position will increase. Another 83 percent expect that companies’ dividends will become more important for investors. Strikingly, only 15 percent consider it likely that quarterly earnings will remain as important a gauge of company performance over the next few years as it was before the crisis.

But we are less convinced than we were. Recent stock-market movements and investor behavior suggest that many investors have put the crisis behind them and have once again switched their attention to quarterly earnings and short-term growth. We hope that we are wrong. We are currently testing investor sentiment in a separate survey that we will be releasing soon.

F. The New Consumer Mindset

Consumers that are deleveraging are already bad news for the economic recovery. The most recent flow-of-funds data from the U.S. Federal Reserve show that the fourth quarter of 2009 marked the seventh

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consecutive quarterly reduction in U.S. household debt. In 2009, household debt declined by 1.72 percent—the first annual decline in household debt on record. This is only the beginning—as we have pointed out before—to return to pre-bubble debt levels, U.S. consumers would need to reduce their debt load by up to 30 percent of GDP. Consumers that are not only deleveraging but also pessimistic are even worse. Even though consumer confidence indicators have recovered from their lows, they are now stabilizing at levels that are far below their precrisis averages and too low for a solid and strong recovery. In Germany, confidence measures from the GfK Consumer Climate MAXX Survey have been slipping since October 2009 and remain low. In the United States, the Conference Board Consumer Confidence Index dropped by ten points in February—a sign that improving inventory levels and a higher PMI index were not reflected in consumer sentiment. And the April Survey of Consumers conducted by Thomson Reuters and the University of Michigan showed consumer confidence retreating to the lower levels of five months ago, even as some other indicators showed improvement.

Consumer confidence is closely correlated with joblessness. And this is a jobless recovery, at least thus far. A recent report by the International Labour Organization shows that 27 million people worldwide lost their jobs in 2009, leading to more than 200 million unemployed people.\(^\text{28}\) Coupled with already-high consumer skepticism, growing unemployment will further dampen the customer’s willingness to spend.

Last year we argued that consumers will have to extend their working lifetimes. According to BCG’s own Consumer Sentiment Survey, many consumers have been heavily affected by losses on financial and real estate markets, especially in the United States, and are well aware of the impact on their retirement plans.\(^\text{29}\) In the United States, 47 percent of respondents claim to be affected by the crisis and cite losses in the financial markets, compared with 20 percent or fewer in Europe and Japan. More than one-third of U.S. respondents expect their retirement to be delayed by seven years, on average.

G. The Managerial Mindset

In the period leading up to the Great Recession, a number of companies (and not just financial institutions) suffered serious failures in corporate governance. The last 12 months have seen no diminution in managers’ belief that the role of nonexecutive directors will need to be strengthened. Some 70 percent of executives believe that nonexecutives will play a more important role in setting and challenging company

\(\text{Sources: Manufacturing data are from the United Nations; survey data are from Deloitte, Oracle, and The Manufacturing Institute, People and Profitability: A Time for Change (a 2009 survey of 779 individuals).}\)
strategy, will be more active in holding executive management accountable, and will need a greater technical understanding of the business of the companies on whose boards they sit. For the most part, there is little variation across the seven countries in our sample in whether executives expect to see these changes, although the strength of feeling in France is markedly higher.

Our respondents also expect boards to play a greater role in risk management. This is mirrored by the plans that executives around the world are beginning to formulate to bolster their risk-management capabilities and practices. More than three-quarters told us that they see risk management becoming more important.

Management teams also appear to have heard the compensation message loud and clear. About 60 percent of respondents expect executive compensation to be lower over the next five years as well as more closely linked to long-term shareholder-value creation—with bonuses, if any, less likely to be paid in cash.

3. A World in Search of Collateral

Throughout our Collateral Damage series, we have argued that we are facing more than just a financial crisis caused by subprime mortgages and overleveraged banks. We were much more concerned about the fallout from an unprecedented boom in credit across the major economies of the world.

Since the early 1980s, credit has been growing much faster than income in many Western economies. This is particularly the case in the United States and the United Kingdom, but it is also true of several countries in the euro zone, especially since the inception of the euro. This credit boom was only possible because debtors were able to provide collateral: individuals could offer financial assets, real estate, and (future) income, while corporations could provide tangible and intangible assets and profits.

Rising asset prices made it possible to increase the level of borrowing further, which itself led to more speculation. Banks were willing to provide credit on the assumption that the underlying collateral—a house, for example—would gain in value. And individuals were only too happy to borrow. It is interesting that in the United States almost all measures of personal indebtedness—household debt service as a percentage of disposable income, household debt as a percentage of net worth, and household debt as a percentage of disposable income—started to spike up in 1997, when the U.S. housing bubble started. (See Exhibit 4.)

In 2003, economists such as John Lipsky (the chief economist at JPMorgan Chase at the time, and now first deputy managing director of the International Monetary Fund) argued that the U.S. debt problem was not an issue at all, because assets gained value faster than the increase in debt. With the benefit of hindsight, however, everyone now agrees that the U.S. real estate market was already overvalued in 2003. It just took another three years for the bubble to start to deflate.

Credit cannot grow faster than income forever. Moreover, the value of assets is linked to the income those assets can generate, which explains why (in the absence of shortages) real estate prices in the United States fluctuate around a long-term trend linked to GDP. This implies that there is a limit to the amount of debt that an individual, a corporation, and an economy can pile up. This limit is determined by the value of the collateral and the earning power of companies and individuals.

Developments since 2007 show what happens when the value of collateral starts falling: the outstanding credit forces debtors to sell, leading to a fast drop in asset values, which amplifies the problem. This explains why bubbles rarely deflate in an orderly way; rather, they adjust abruptly and often violently.

After the big credit expansion reached its end in early 2007, the value of all collateral started to drop, leading to a higher relative debt burden and the first defaults. In the ensuing recession, the United States shed more than 8 million jobs and incomes fell. According to one source, more than 11.3 million of all residential properties with mortgages, or 24 percent, had fallen into negative equity by the fourth quarter of 2009.31

All these factors reduced the capacity and the willingness of corporations and individuals to take on more debt, and both started to reduce their debt levels by defaulting or paying down debt. Because of the close relationship between growth and credit formation, a downward spiral set in, with less credit leading to lower growth, and lower growth and lower incomes leading to less credit capacity.

To break this downward spiral, governments and central banks stepped in. Reduced interest rates allowed for a higher level of debt, while government spending helped soften the downturn and the loss of income, thereby allowing debtors to pay back their debts. There are presently few signs that governments or central banks will start withdrawing their stimulus measures anytime soon, because they are afraid of pushing the economy back into recession. Only 15 percent of our survey respondents consider it very likely that their country’s central bank will initiate a lasting exit from the monetary stimulus during 2010. A similarly low percentage believe that their government will withdraw the fiscal stimulus in 2010.

Investors, banks, and central banks were happy to invest in government bonds, which were perceived as low risk. Now, of course, we know that government debt is not necessarily safe. The credibility of governments is rooted in their ability to collect taxes. They may borrow to support overleveraged consumers, but those same consumers will, as taxpayers, have to pay the bill in future years. Exhibit 5 shows the magnitude of the problem.

Therefore, it is realistic to expect the fiscal crisis that began in Greece to spread to other countries, such as Portugal, Ireland, Italy, and Spain. Moreover, there is some doubt about the sustainability of the deficits of the United Kingdom and even the United States. As Niall Ferguson of Harvard University put it, “...[E]ven a casual look at the fiscal position of the federal government...makes a nonsense of the phrase ‘safe haven’. U.S. government debt is a safe haven the way Pearl Harbor was a safe haven in 1941.”

Recent research by Carmen Reinhart and Kenneth Rogoff suggests that government debt levels of more than 90 percent of GDP have a negative impact on an economy’s growth rate, further amplifying the problem for highly indebted nations, which are less able to grow themselves out of trouble.33 Not only are the annual deficits of many governments at historic peacetime highs, but overall government debt is approaching unsustainable levels given the lurking deficits necessary to fund future spending on public health and social protection (including pensions, unemployment insurance, welfare benefits, and other transfers).

If current government programs continue at the same rate, the present value of future obligations as a percentage of the present value of future GDP amounts to an average of 17.4 percent across all EU countries. In Germany and France, it would be close to 20 percent.34 The situation in the United States is no different: a simulation recently published by the U.S. Government Accountability Office reached the staggering conclusion that “roughly 93 cents of every dollar of federal revenue will be spent on the major entitlement programs and net interest costs by 2020.”35

The question, therefore, is which Western countries still have some debt capacity. On the face of it, much of the West (plus Japan) is running out of collateral. We will not be able to solve the debt crisis by taking on more debt. And living within our means will mean slower growth.

Although there has been a lot of attention paid to Greece and Portugal, we should be much more worried about any downside risk to the credit standing of the biggest debtor of them all: the United States. The Congressional Budget Office (CBO) is forecasting that the federal debt alone will reach 90 percent of the

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GDP by 2020, requiring $5 trillion in new borrowing just to roll over the debt and raise the amount required for new borrowing that year. As Roger Altman, former deputy secretary of the U.S. Treasury, put it in the Financial Times, “Annual interest payments on those borrowings will…rival the defence budget.”

The danger of such runaway federal borrowing is that interest rates will need to rise significantly, which will threaten private-sector investment. Unfortunately, avoiding this scenario would also have negative implications for growth because it would require some combination of reduced government spending and tax hikes. Otherwise, if debt climbs as the CBO predicts, the capital markets will eventually force a response.

It does not come as a surprise, therefore, that in a recent comment in the Financial Times, William White, chair of the OECD’s Economic and Development Review Committee, asked for “a plan B to curb the debt headwinds.” His assessment is no different from the one we made in late 2008. He sees four options for reducing the unsustainable debt overhang:

- Increasing private saving rates and reducing budget deficits of governments, which would lead to a prolonged recession caused by a drop in demand, making deleveraging more difficult
- Increasing the economy’s growth rate through structural reforms; unfortunately, it would take time before these had an effect, and experience shows that the frictions caused by implementing such reforms tend to further impede short-term growth
- Resorting to write-downs and defaults, which would mean acknowledging that a sizable part of the debt will not be paid back, leading to another banking crisis (because banks do not have nearly enough of a cushion against additional losses) and, ultimately, to losses for all those who have saved
- Increasing inflation to achieve write-downs, allowing creditors to get the nominal value of their credit back albeit with less purchasing power

In a recent “Aaa Sovereign Monitor” report, Moody’s argues that stretching savings rates beyond the tolerance limits of the public might lead to social unrest (as it already has in Greece) and that most AAA-rated governments lack the required economic tailwind to choose the second option. White acknowledges that it will be difficult to achieve a “controlled” inflation and even sees a risk of hyperinflation if the inflationary route is taken. However, we believe that, in reality, the ultimate goal of many governments and central banks is to alleviate the debt burden through inflation because the other alternatives would all lead to recession. This view is shared by our survey respondents. In the medium term, 76 percent said that they expect inflation rather than deflation.

It is difficult for central banks to create inflation in an environment of excess capacity and deleveraging. Indeed, U.S. core inflation has been dropping fast and currently stands at only 0.1 percent. In spite of the injection of vast amounts of money into the economy, credit volume is shrinking because the money multiplier (the relationship between central banks’ base money and the credit provided by banks) has collapsed. This is a problem because of the relationship between credit formation and GDP growth. About 50 years ago, $1 of credit helped drive 75 cents of GDP growth. Today, depending on whom you believe, it takes between $5 and $7 of credit to produce every $1 of GDP growth. Furthermore, shrinking credit is by definition deflationary, as it leads to a drop in demand. As we argued a year ago, the right approach would have been to stabilize the value of the real estate market by setting a floor on prices and setting up a program—ideally financed by the central bank—allowing the government to purchase homes. Doing so would have helped in two ways:

It would have preserved the value of the collateral underpinning the outstanding mortgages and encouraged people to stay in their homes and keep servicing their debt.

It would have set a target for future inflation, which would itself have led to inflation (since the expectation of inflation increases the demand for real assets).

These are drastic measures, but they are necessary if we want to avoid a prolonged period of deleveraging, low growth, high unemployment, and increasing international tensions.

4. Management’s Response to the Crisis

With executives preparing for an anemic recovery—characterized by greater trade problems, increased consumer price sensitivity, and more government interference—it is perhaps not surprising that many companies are not growing aggressively for the future.

We analyzed the results of our survey to understand how companies are pursuing credible growth opportunities. We found that only about one-half of respondents reported that their company would be undertaking significant and concerted attacking options. Digging behind the data, we found that nearly two-thirds of market leaders are beginning to think more offensively, while only 44 percent of middle-market companies (typically with revenues of between $1 billion and $10 billion) are looking to go on the attack. This may well reflect the strength of these companies’ economic resources and their differential ability to weather the storm.

We asked our respondents which types of growth-related initiatives they are planning in 2010. Almost three-quarters of our sample of top-three companies within their respective industries reported that they would be taking at least limited action in almost every category we listed: short-term moves, such as increasing sales force incentives and trade credits; medium-term initiatives, such as launching new products, expanding sales presence, entering new customer segments, increasing marketing spending, and expanding business for public programs; and longer-term moves, such as increasing R&D and innovation, moving into new geographic markets, expanding capacity, and exploring acquisitions.

But when we asked these market leaders in which categories they would be making significant efforts, only 41 percent said they are planning to increase R&D in 2010, only 35 percent are planning to hire new talent (reinforcing our prediction of a jobless recovery), and less than 40 percent are thinking of extending their geographic reach, expanding capacity, or exploring acquisitions.

The picture among middle-market companies is far more conservative. Reflecting the pressure on many of them, less than 25 percent of our middle-market sample plan to take significant action in any individual category.

We also asked the executives to answer the same questions with respect to 2011. Although these responses were a little more optimistic, the difference compared with 2010 was not significant.

The belt tightening we have witnessed over the last 18 months is set to continue. Between 67 and 80 percent of the executives in our sample reported that they would be taking at least some of the following short-term actions in 2010: focusing more on key customers, increasing promotions and discounts, further reducing administrative and travel spending, renegotiating supplier contracts, further reducing inventory levels, cutting bonuses, reducing marketing spending, freezing or even reducing wages, and postponing expansion plans.

We then looked at actions that large companies are taking to reduce their medium-term cost position. Most of these companies clearly feel the need to improve their economic fundamentals. Looking only at companies taking significant action in each area, we found that 35 percent of our sample plan to reduce their workforce, 34 percent will materially increase outsourcing, 29 percent plan big cuts in R&D spending, 31 percent will increase the proportion of variable pay, 34 percent plan to reduce production capacity, and 29 percent are working to reduce their sales presence.
Companies are also considering actions with much longer-term ramifications. Around 30 percent of the large companies we looked at are considering one or more of the following: disposing of assets in order to generate cash, selectively exiting product lines, offshoring production, exiting certain customers or regions, and divesting businesses.

We also asked the executives in our sample to list their top priorities. Although 59 percent of respondents cited maintaining revenue from the existing business or businesses as a critical concern for 2010, that number dropped to 35 percent for 2011—by which time the most important priority will be acquisitions and exploring new growth opportunities (cited by 41 percent).

Overall, our survey suggests that executives are more cautious about the economic outlook than the politicians are. But as we have argued in previous Collateral Damage papers (and in our book, *Accelerating Out of the Great Recession: How to Win in a Slow-Growth Economy*), companies that act decisively can significantly outperform their competitors even in the toughest of economic times. Indeed, history shows that companies that grasp the opportunities presented by crisis and upheaval can create an enduring advantage over those that wait for the economy to bounce back convincingly before they act.

We face many years of economic uncertainty because the economic and financial crisis is coinciding with the acceleration of a once-in-a-lifetime passing of the economic baton: the shift in economic power from West to East. This shift may be only beginning, but hopes for an orderly transition are likely to prove unfounded. The extraordinary upheavals of the Great Recession will make it a bumpy ride.
**For Further Reading**

See the related book by David Rhodes and Daniel Stelter:

**Accelerating Out of the Great Recession: How to Win in a Slow-Growth Economy**
McGraw-Hill, February 2010

The Boston Consulting Group’s Collateral Damage series includes the following articles:

**Collateral Damage, Part 8: Preparing for a Two-Speed World—**
**Accelerating Out of the Great Recession**
BCG White Paper, January 2010

**Collateral Damage, Part 7: Green Shoots, False Positives, and What Companies**
**Can Learn from the Great Depression**
BCG White Paper, June 2009

**Collateral Damage, Part 6: Underestimating the Crisis**
BCG White Paper, April 2009

**Collateral Damage, Part 5: Confronting the New Realities of a World in Crisis**
BCG White Paper, March 2009

**Collateral Damage, Part 4: Preparing for a Tough Year Ahead—**
**The Outlook, the Crisis in Perspective, and Lessons from the Early Movers**
BCG White Paper, December 2008

**Collateral Damage, Part 3: Asia, Advantage, and Action**
BCG White Paper, November 2008

**Collateral Damage, Part 2: Taking Robust Action in the Face of the Growing Crisis**
BCG White Paper, October 2008

**Collateral Damage, Part 1: What the Crisis in the Credit Markets Means for Everyone Else**
BCG White Paper, October 2008
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The authors would like to thank the editorial and production team that worked on this paper: Katherine Andrews, Gary Callahan, Mary DeVience, Angela DiBattista, Gina Goldstein, Simon Targett, and Janice Willett.

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