McKinsey&Company

SEPTEMBER 2009

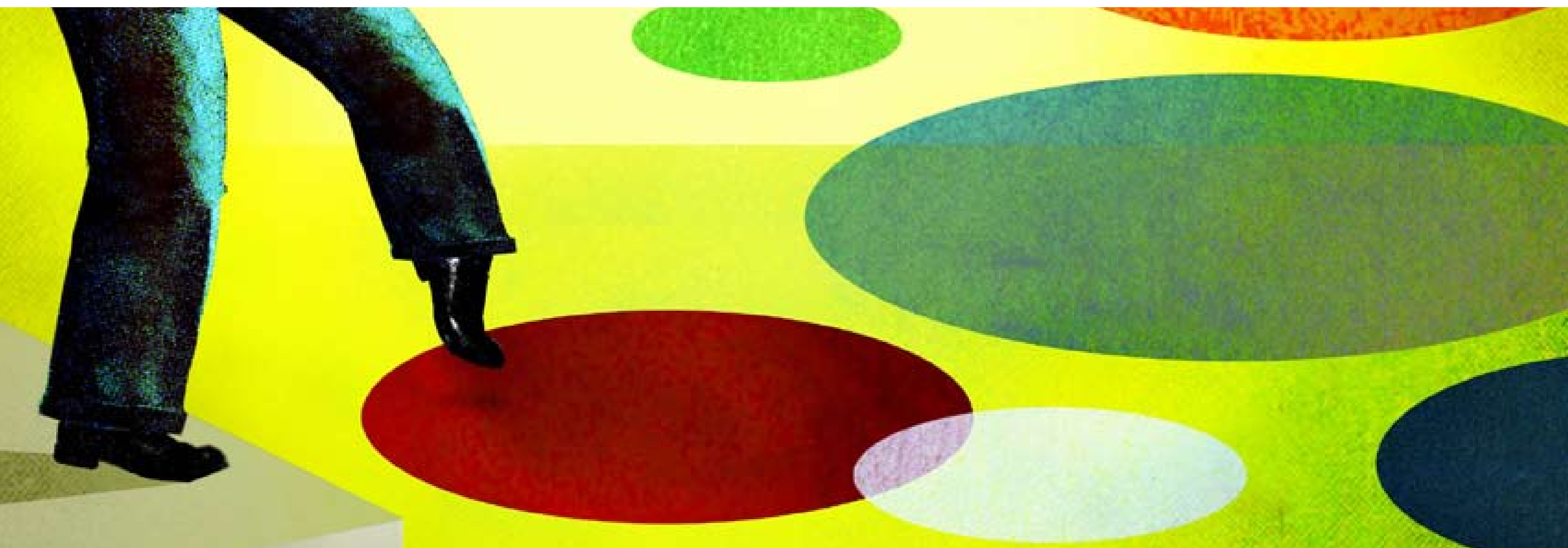
McKinsey Quarterly

STRATEGY PRACTICE

How managers should approach a fragile economy

For the immediate future, business leaders will have to master the disciplines of uncertainty.

Lowell Bryan and Bill Hoffman



A powerful tension is at work today in global economic sentiment. The financial markets, pundits, and policy makers think the global economy is out of the woods, but executives aren't so sure. Our research suggests that the executives are right—and that to thrive, companies must adopt some new approaches to management.

In early September, McKinsey surveyed more than 1,600 business executives around the world about their current views on and hopes for the economy. Only 20 percent believed that a "normal" recovery starting in late 2009 would be the most probable outcome. Some 42 percent thought that 2010 would be a year of flat economic activity. About a third believe that an extended period of anemic global economic growth (below 1 percent per annum) is likely for the next several years. The remaining 7 percent felt that something akin to a double-dip recession was probable. (The full survey results can be found in "The crisis—one year on: McKinsey Global Economic Conditions Survey results, September 2009," mckinseyquarterly.com.)

Simply put, the daily experience of business leaders suggests that a full recovery of economic activity to pre-crisis levels is further off than expected. Moreover, the distribution of responses suggests that, as a group, executives simply don't know what will happen. An improving global economy is not the same as a recovering one.

We see three main underlying reasons for this confusion and skepticism. Each of them presents tough management challenges. Let's start with public policy. Yes, the unprecedented monetary stimulus, government guarantees, and injections of capital seem largely to have ended the short-term crisis that landed the capital and credit markets in the hospital. But it remains unclear what will happen when the patient is taken off its meds—less risk taking and lower returns in the global financial system seem inevitable—or what will be the unintended consequences of the recent massive growth in public balance sheets and of rising regulatory costs.

A second reason for the uncertainty is the difficulty of comprehending the information available on unfolding economic events—information often delivered in the form of sound bites with little explanation of what various indicators really mean. We track 12 indicators of macroeconomic, credit, and capital market activity across nine developed and developing economies. If you compare the July performance of the indicators with those from the previous month, 60 of a possible 108 showed improvement. On the other hand, 68 of the indicators also highlighted a deterioration (often a severe decline) from pre-crisis conditions the year before. Each indicator might get reported with its own headline. We believe that without an analysis of a much broader picture, including how the indicators interrelate, there is no hope of understanding current conditions (exhibit).

The third reason is the very nature of the economic shift under way. This crisis wasn't and still isn't a singular breakdown. Rather it consists of many smaller crises, each with its own pace and impact, that are interrelated and still under way. The US financial crisis, which began a year ago, causing global credit markets to seize up, was the epicenter of the global economic shock. The strong defensive actions companies took in response caused an even-sharper-than-expected economic decline in the fourth quarter of 2008 and into the first quarter of this year. Companies just now regaining access to credit fell behind in restocking their inventories. Their efforts to compensate explain much of the nascent macroeconomic improvement and resurgence of trade observed across the world.

But that doesn't mean the problems are over: the change in the behavior of US consumers alone—they may well go on reducing their debts even when the economy recovers—is still playing out. Personal savings as a percent of disposable income has climbed to more than 4 percent, from pre-crisis readings near zero. In the absence of income growth, each 1 percent increase in US consumer savings results in $100 billion in foregone spending. As a result, the potential for a continued US economic contraction remains significant.

The countries of the European Union (including the United Kingdom), where consumers and financial firms alike are reducing debt, appear to be on the same slow improvement path as the United States. Russia and several Eastern European economies are lagging further behind.

Brazil and India have benefited from their relative lack of involvement with the global capital market. And while China seems well positioned for a true recovery, its ability to meet a year-end 8 percent GDP growth target is being driven by a massive government fiscal and monetary stimulus. This stimulus has has also raised the median price-to-earnings ratio of its listed stocks above 50 and caused new credit issuance to surge, by July of this year, to nearly twice the level for all of 2008.

Thoughtful economic modeling can start to capture all this complexity. Working with our colleagues in the McKinsey Global Institute, we recently modeled four economic scenarios corresponding to those the business executives evaluated in our recent survey. For the US economy alone, the results show possible outcomes that span nearly $2 trillion in GDP—the difference between the most optimistic scenario for GDP growth (10 percent higher than it is today) and the most pessimistic one (3 percent lower) by 2012. Although scenarios don't predict the future, they are a powerful tool companies should use to assess, plan, and prepare for a range of possible outcomes in the face of such great uncertainty.

What else must companies do these days to survive and thrive? First, they must drop the pretense that they can predict the future. Second, they must continue adapting their management processes and capabilities with an eye to making better decisions under

Exhibit: **Economic and financial indicators**

July 2009, change from previous month

■ Severe decline ■ Worsening ■ No significant change ■ Improving ■ Significant improvement

		Developed economies				Developing economies				
		European Union	United Kingdom	Japan	United States	Brazil	Central, Eastern Europe[1]	China	India	Russia
Macroeconomic	Real-estate market	Worsening	Improving	No significant change	Improving	Significant improvement	No significant change	Improving	Improving	No significant change
	Consumer spending	Worsening	Improving	No significant change	No significant change	Improving	No significant change	No significant change	Improving	Worsening
	Inflation	Improving	Improving	Worsening	Improving	Improving	Improving	Improving	Significant improvement	Improving
	Business environment	No significant change	No significant change	Improving	No significant change	Improving	Improving	Improving	Improving	No significant change
	Trade momentum	Worsening	No significant change	Improving	No significant change	Improving	No significant change	Improving	Improving	No significant change
	Consumer confidence	Improving	No significant change	Significant improvement	Worsening	Improving	Improving	No significant change	Improving	No significant change
	Business confidence	Improving	No significant change	Significant improvement	Improving	Improving	No significant change	Improving	Significant improvement	No significant change
Credit/capital markets	Equity performance/volatility	Improving	Improving	Improving	Improving	Improving	Improving	Improving	Improving	No significant change
	Credit availability	Worsening	No significant change	No significant change	No significant change	Significant improvement	No significant change	No significant change	Improving	No significant change
	Cost of capital[2]	Improving	No significant change	No significant change	Improving	Significant improvement	No significant change	Improving	Significant improvement	No significant change
	Risk premiums	Improving	No significant change	No significant change	Improving	Improving	No significant change	Improving	Improving	No significant change
	Foreign-exchange discontinuities	No significant change	Improving	Improving	No significant change	Improving	Improving	No significant change	No significant change	No significant change

Change from pre-crisis to July 2009

■ Severely worse ■ Significantly worse ■ Moderately worse ■ Near normal ■ Pre-crisis or better

		Developed economies				Developing economies				
		European Union	United Kingdom	Japan	United States	Brazil	Central, Eastern Europe[1]	China	India	Russia
Macroeconomic	Real-estate market	Severely worse	Significantly worse	Severely worse	Severely worse	Significantly worse	Significantly worse	Near normal	Severely worse	Significantly worse
	Consumer spending	Severely worse	Moderately worse	Severely worse	Significantly worse	Moderately worse	Significantly worse	Moderately worse	Moderately worse	Significantly worse
	Inflation	Near normal	Near normal	Moderately worse	Near normal	Pre-crisis or better	Pre-crisis or better	Moderately worse	Moderately worse	Significantly worse
	Business environment	Significantly worse	Significantly worse	Severely worse	Significantly worse	Significantly worse	Severely worse	Moderately worse	Significantly worse	Severely worse
	Trade momentum	Severely worse	Moderately worse	Severely worse	Significantly worse	Significantly worse	Severely worse	Significantly worse	Significantly worse	Severely worse
	Consumer confidence	Severely worse	Severely worse	Severely worse	Severely worse	Near normal	Severely worse	Severely worse	Significantly worse	Severely worse
	Business confidence	Severely worse	Severely worse	Severely worse	Severely worse	Near normal	Severely worse	Severely worse	Significantly worse	Significantly worse
Credit/capital markets	Equity performance/volatility	Significantly worse	Significantly worse	Severely worse	Severely worse	Moderately worse	Severely worse	Near normal	Near normal	Severely worse
	Credit availability	Significantly worse	Near normal	Near normal	Significantly worse	Moderately worse	Significantly worse	Near normal	Near normal	Significantly worse
	Cost of capital[2]	Significantly worse	Near normal	Near normal	Moderately worse	Pre-crisis or better	Moderately worse	Near normal	Pre-crisis or better	Severely worse
	Risk premiums	Pre-crisis or better	Significantly worse	Significantly worse	Significantly worse	Near normal	Significantly worse	Moderately worse	Near normal	Severely worse
	Foreign-exchange discontinuities	Moderately worse	Moderately worse	Significantly worse	Moderately worse	Near normal	Severely worse	Moderately worse	Moderately worse	Severely worse

[1]Czech Republic, Hungary, Poland.
[2]Cost of capital based primarily on central bank interest rates and commercial paper spreads; risk premiums based on industry specific interest rates, bond spreads, or credit default swap spreads.

Source: McKinsey Global Institute analysis

Related articles

"The crisis—one year on: McKinsey Global Economic Conditions Survey results, September 2009"

"Setting strategy in the new era: A conversation with Lowell Bryan and Richard Rumelt"

"The crisis: Timing strategic moves"

uncertainty—for example, by abandoning the fixed calendar and planning schedules typical of annual budgeting and operating processes. This change will require a shift to monitoring macroeconomic indicators in real time, something akin to "just in time" manufacturing approaches applied to decision making. It also means building greater flexibility into strategic activity by putting a greater focus on acquiring options, contingency planning, and the use of stage-gating techniques for committing resources.

All this portends a shift to more dynamic management in a more complex and unpredictable environment. The industry leaders of the future—stalwarts and upstarts alike—will be able to adopt, adapt, and build these capabilities for navigating uncertainty.

The authors would like to thank Ezra Greenberg, Matt Hirschland, John Horn, Ina Kota, Jeff McBride, and Kazuhiro Ninomiya for their contributions to this article and the research underlying it.

Bill Hoffman is an associate principal in McKinsey's Minneapolis office, and **Lowell Bryan** is a director in the New York office. Copyright © 2009 McKinsey & Company. All rights reserved.