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The new normal

The business landscape has changed fundamentally; tomorrow's environment will be different, but no less rich in possibilities for those who are prepared.

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It is increasingly clear that the current downturn is fundamentally different from recessions of recent decades. We are experiencing not merely another turn of the business cycle, but a restructuring of the economic order.

For some organizations, near-term survival is the only agenda item. Others are peering through the fog of uncertainty, thinking about how to position themselves once the crisis has passed and things return to normal. The question is, “What will normal look like?” While no one can say how long the crisis will last, what we find on the other side will not look like the normal of recent years. The new normal will be shaped by a confluence of powerful forces—some arising directly from the financial crisis and some that were at work long before it began.

Obviously, there will be significantly less financial leverage in the system. But it is important to realize that the rise in leverage leading up to the crisis had two sources. The first was a legitimate increase in debt due to financial innovation—new instruments and ways of doing business that reduced risk and added value to the economy. The second was a credit bubble fueled by misaligned incentives, irresponsible risk taking, lax oversight, and fraud. Where the former ends and the latter begins is the multitrillion dollar question, but it is clear that the future will reveal significantly lower levels of leverage (and higher prices for risk) than we had come to expect. Business models that rely on high leverage will suffer reduced returns. Companies that boost returns to equity the old fashioned way—through real productivity gains—will be rewarded.

Another defining feature of the new normal will be an expanded role for government. In the 1930s, during the Great Depression, the Roosevelt administration permanently redefined the role of government in the US financial system. All signs point to an equally significant regulatory restructuring to come. Some will welcome this, on the grounds that modernization of the regulatory system was clearly overdue. Others will view the changes as unwanted political interference. Either way, the reality is that around the world governments will be calling the shots in sectors (such as debt insurance) that were once only lightly regulated. They will also be demanding new levels of transparency and disclosure for investment vehicles such as hedge funds and getting involved in decisions that were once the sole province of corporate boards, including executive compensation.

While the financial-services industry will be most directly affected, the impact of government’s increased role will be widespread: there is a risk of a new era of financial protectionism. A good outcome of the crisis would be greater global financial coordination and transparency. A bad outcome would be protectionist policies that make it harder for companies to move capital to the most productive places and that dampen economic growth, particularly in the developing world. Companies need to prepare for such an eventuality—even as they work to avert it.

These two forces—less leverage and more government—arise directly from the financial crisis, but there are others that were already at work and that have been strengthened by recent events. For example, it was clear before the crisis began that US consumption could not continue to be the engine for global growth. Consumption depends on income growth, and US income growth since 1985 had been boosted by a series of one-time factors—such as the entry of women into the workforce, an increase in the number of college graduates—

that have now played themselves out. Moreover, although the peak spending years of the baby boom generation helped boost consumption in the ’80s and ’90s, as boomers age and begin to live off of retirement savings that were too small even before housing and stock market wealth evaporated, consumption levels will fall.

Companies seeking high rates of income and consumption growth will increasingly look to Asia. The fundamental drivers of Asian growth—productivity gains, technology adoption, and cultural and institutional changes—did not halt as a result of the 1997 Asian financial crisis. And Asian economies—though they have rapidly deteriorated in recent months—are unlikely to be stopped by this one. The big unknown is whether the temptation to blame Western-style capitalism for current troubles will lead to backlash and self-destructive policies. If this can be avoided, the world’s economic center of gravity will continue to shift eastward.

Through it all, technological innovation will continue, and the value of increasing human knowledge will remain undiminished. For talented contrarians and technologists, the next few years may prove especially fruitful as investors looking for high-risk, high-reward opportunities shift their attention from financial engineering to genetic engineering, software, and clean energy.

This much is certain: when we finally enter into the post-crisis period, the business and economic context will not have returned to its pre-crisis state. Executives preparing their organizations to succeed in the new normal must focus on what has changed and what remains basically the same for their customers, companies, and industries. The result will be an environment that, while different from the past, is no less rich in possibilities for those who are prepared.

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