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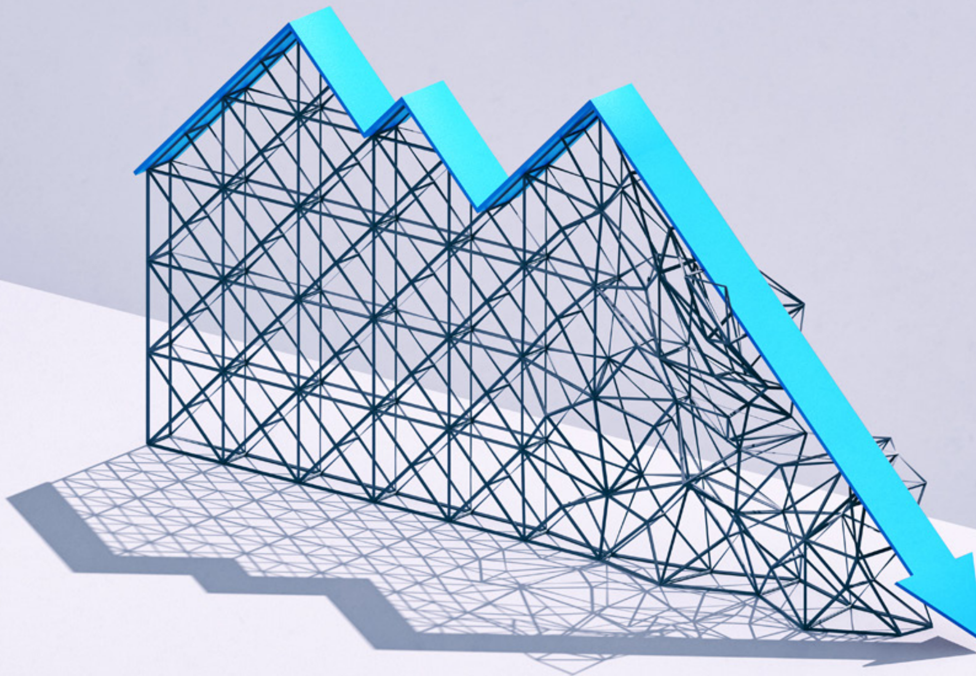
What is recession?

A recession is the part of an economic cycle that involves an economic contraction.



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One popular definition of recession is two consecutive quarters of economic contraction. Recessions are always caused by imbalances in the market, triggered by external or internal factors. But, to repurpose Tolstoy's famous quip about unhappy families, recessions are each unhappy in their own way—as we'll see in the three case studies highlighted below.

Recessions often cause (or follow) big declines in asset prices. It's human nature to follow the pack, and it takes nerves of steel to stay in the game when everyone else is getting out. In business, a steady hand—and meticulous preparation—can help steer the ship through the storm intact.

Read on to learn more about recessions and concrete steps companies can take to minimize the impact.

Are recessions inevitable?

Yes, according to modern economic thought. Prior to the late 19th century, most economists believed recessions were caused by external factors, like wars or weather events. Neoclassical economic thinkers developed the idea of business cycles, alternating peaks and troughs of economic expansion and contraction. Recessions, they argued, start at the peak of the cycle, and end at the bottom of the trough, when the next period of expansion begins. Today, we know that recessions are caused by imbalances in the market. While we can't know *when* the next recession will come, or how much value will be shed, it's pretty much guaranteed that another recession will come around sooner or later.

Can a recession be predicted?

Recessions happen—that's just the price of doing business in a capitalist system. Knowing when one will happen, obviously, confers a lot of benefits to societies, businesses, and individuals. But foretelling the future is always a risky and uncertain proposition. As the old joke goes, experts have predicted seven out of the last three macroeconomic events.

That said, there are a few things we've learned about recessions, according to McKinsey senior partner and chairman of the McKinsey Global Institute Sven Smit. Market imbalances that cause recessions can be triggered by geopolitics, economic cycles, and many other forces. The financial sector is always involved. Recessions usually start in one geographical area and spread to another. And unfortunately, higher volatility in the business environment has become a new normal.

How are different companies prepared for uncertainty?

Companies head into periods of uncertainty—like the unprecedented post-COVID-19 economic

Case study: The Great Recession (2008)

The financial crisis and recession of 2008 were caused primarily by an imbalance in which banks lent more money to house buyers than they could ultimately afford to pay back. As long as housing prices continued to rise, the imbalance was not a problem. But when housing prices started to fall—a possibility that many credit models did not include—homeowners struggled to pay their mortgages, and banks started having financial problems. This triggered the recession.

Case study: Asian financial crisis (1997)

In the 1990s, the Asian financial crisis was caused by an imbalance where too much money had been invested in factories. In the late 1980s and early 1990s, companies in Southeast Asia invested huge sums in building factories to make products for export. This created too much capacity; factories couldn't fully utilize the new equipment. As a result, they couldn't service their debt. When enough companies began having serious financial difficulties, it led to a recession.

climate—with varying degrees of readiness and health. Most fall into one of four camps:

1. Some are *poised to thrive*. These businesses experience relatively steady demand for high-margin products, easily attract and retain talent, and have simple supply chains. From a financial perspective, they have strong balance sheets, low leverage, and lots of cash. These companies are the lucky few.

2. Another category of companies is more susceptible to a slowing economy. These companies have more complicated supply chains, smaller market share due to new competitors, and thinner margins due to inflation. These companies can *resolve to reform.*

3. Other companies are in worse shape and will *fight to survive* a recession. These companies have balance sheets loaded with debt, low cash reserves, and potentially high exposure to geopolitical disruption (for example, Russia's war in Ukraine).

4. A fourth group is newer companies that have thus far primarily focused on growth and market share rather than profitability. The challenge for these companies is to *pivot to profit*, as funding usually dries up in a recession.

Companies in all four categories should focus on building systemic resilience. Any company can benefit from putting in place some key defensive elements, like cost cutting, price adjustment, cash preservation, and shoring up supply chains. Offensive tactics can also be useful; these include programmatic mergers and acquisitions, new business building, and better talent attraction and retention.

How can business leaders prepare for the next recession?

Recessions are like health problems—at some point in our lives, we're likely to face some sort of issue, whether minor or major. The healthier you are to start with, the more likely you are to come through just fine.

According to Sven Smit, the healthier a business is today, tomorrow, and next quarter, the more resilient it will be in a downturn, because it will have a buffer to take on new, unexpected challenges.

One way to prepare is to put in some prep work now for the next recession, whenever it comes. That means scenario planning, putting together a risk management strategy, ramping up your organization's agile processes, and ensuring your organization has rock-solid environmental, social, and governance (ESG) metrics.

What are the implications for people when a recession hits?

Businesses and institutions have responsibilities to the people they employ, and to society at large. Companies that lay off staff have felt the backlash from communities, customers, politicians, and workers. "We are not living in a Milton Friedman-esque system where if you don't have demand, you just fire the people and the market will solve what happens to [them]," says Sven Smit. Conversely, a recession only intensifies society's demand that businesses and governments are run responsibly.

Case study: The Great Depression (1929–39)

This one is the benchmark by which all others are measured. In 1929, stock markets crashed, setting off a deep and lasting global recession. Economists have proposed many theories about which imbalance was most responsible. Some argue that a string of bank failures caused considerable wealth to evaporate, lowering the money supply by a third. Others believe the Depression was triggered by insufficient consumer demand, which governments tried to address during the 1930s with deficit spending. A final group thinks the market crashed because of a surplus of credit, like the margin loans that investors used to speculate on stocks.

What's more, layoffs don't necessarily save as much as other cost-reduction models. Two years of research with major manufacturing businesses across a range of sectors shows that traditional cost-reduction methods (like layoffs) save only about 2 percent of costs, while digital and analytics tools can reduce costs by 5 percent.

But recessions do demand change. One way companies might fulfill their responsibility to their people is by investing in reskilling the existing workforce to meet the requirements of the changed organization.

How did the most resilient organizations weather the Great Recession?

According to McKinsey research on how various companies fared during the Great Recession, some companies are significantly more resilient than others. They had marked outperformance and total shareholder returns. What were the resilient companies doing differently?

For one thing, they focused on margins, or the difference between a product or service's selling price and the cost of production. Companies that showed resilience during the Great Recession focused on improving their margins during the recession by proactive operational cost cutting, which less resilient companies put off until after the recession. Resilient companies also were more likely to have divested themselves of underperforming parts of the organization, which they were then able to reinvest in ways that reflected the new economic parameters.

Continued investment can be scary in a recession—hitting the brakes when the road gets shaky is a natural reaction. But organizations that invest in the pockets of known demand have shown resilience in downturns. Another way to take advantage of a recession is to keep an eye on opportunities that come up when competitors make a misstep. Snapping up assets and talent shed by competitors allows organizations to take a proactive stance in a recession. That's a position of strength.

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