The post-crisis business climate

The current financial crisis is affecting developing countries in two major ways: sharp reduction in capital inflows and the collapse in global and local demand. Global output is expected to shrink by 2.9 percent in 2009; while the GDP growth in developing countries is projected to decline from 5.9 percent in 2008 to 1.2 percent in 2009 it will still outperform those of developed countries whose aggregated GDP is projected to fall 4.5 percent.1 Lack of demand and limited access to capital are causing a sharp contraction in the production and global trade of manufactured goods. Global industrial production declined by 20 percent in the fourth quarter of 2008, as high-income and developing countries’ activity plunged by 23 and 15 percent, respectively.2

Weak global demand is compounded by a decrease in trade finance as well as increased costs. International trade is likely to experience its largest decline in 80 years. Unemployment is rising with unprecedented job losses, in some countries poised to hit double-digit rates. Furthermore, employment is increasingly moving out of dynamic export-oriented sectors into lower-productivity activities.
Foreign capital inflows—remittances, international syndicated bank lending, private capital investments, and bond issues—collapsed in the aftermath of the crisis. Global financial markets remain uncertain and unstable, and prospects for capital flows to developing countries are dim. Global investors retreating from developing countries resulted in a decline of total private capital flows in 2008 to $707 billion with an expected further decline in 2009 to $363 billion. MSCI Emerging Market Index sank 55 percent in 2008, erasing about $17 trillion in market valuation. Net private debt and equity flows to developing countries are projected to decline to 2 percent of GDP in 2009, compared to 8.6 percent of GDP in 2007.

At the same time, much of the external debt of approximately $1.2 trillion, raised by developing country banks and firms between 2003 and 2007, is now maturing. The cost of external borrowing has increased to 11.7 percent, compared to 6.4 percent in the pre-crisis years.

Business response

Not only governments but companies as well were surprised by the speed and scope of the downturn. As demand for goods and services collapsed, and uncertainty about future demand is increased, companies have found it difficult to make any serious commitment to new investment. Governments can mitigate the impact of the crisis by helping to stabilize the financial sector, preserving jobs, and protecting people. The focus should be on restoring confidence in the financial system and supporting increases in aggregate demand. By reducing the risk of doing business, governments can stimulate the private sector to mobilize the substantial financial resources waiting to be invested.

Small and medium enterprises (SMEs) are especially affected by limited access to finance. It is critical for governments to help entrepreneurs emerge from the crisis by facilitating access to finance for SMEs and microfinance institutions, and to support the recovery process through policies that promote growth and employment generation. A recent study by the Kauffman Foundation indicates that many leading companies today were formed in uncertain times. For example, more than half of the companies on the 2009 Fortune 500 took shape during a recession or bear market.

Although individual circumstances vary, companies generally have a broad range of options for responding to the crisis. One of the most urgent needs is to ensure rapid debt workouts. The financial crisis contributed to a sharp increase in corporate bankruptcies and “fire sale” of assets. The challenge for many developing countries is that institutional constraints, such as weak judicial systems, make bankruptcy procedures inefficient and time consuming. The way in which corporations respond to this challenge—their ability to roll over their maturing debt—will have a big impact on the developing countries’ ability to meet their external financial needs. Companies account for some 75 percent of the medium- and long-term private debt coming due in 2009.

The role of business in poverty alleviation

After a decade of strong growth and significant poverty reduction, weaker growth in many developing countries will lead to an increase of some 46 million people living in poverty in 2009. The world is facing another crisis—a poverty crisis that is going nearly unnoticed in the midst of the financial crisis. While putting their “business house in order,” corporations will likely face another dilemma—how much, if at all, can they help meet the needs of the poor, especially in developing economies. Our view is that the financial crisis is an opportunity.

Some strategies

As sales, profitability, and investor confidence continue to deteriorate, for many companies the most urgent need is to reduce costs. According to a recent Ernst & Young survey, cash remains a major concern for 82 percent of businesses worldwide. Almost 9 out of 10 companies are looking for cost reductions, and 4 out of 10 companies accelerated significant employee reductions.

Companies looking for ways of preserving cash and pursuing growth should reassess their tax positions, since taxes are normally their 3rd to 5th biggest expense. Many government stimulus packages have included significant tax measures as a response to the crisis. According to a recent OECD report, tax measures represent 56 percent of the net effect of fiscal stimulus on average among OECD countries. However, the issue of how favorable tax policy can support business development is complicated by the increasing government deficits and revenue needs.

Global GDP is forecasted to increase a modest 2.0 percent in 2010 and 3.2 percent in 2011. This will result in a very slow job recovery, and recession-like conditions will continue to prevail. Companies are employing various strategies to deal with employment issues. Some companies utilize their corporate social responsibility programs to create new jobs or preserve existing ones through temporary salary cuts and reducing shorter working hours. Some companies use more than one business model to achieve both profitability and job-creation objectives. For example, the Grameen group has generated significant profits through its GrameenPhone group which employs only about 600, while at the same time creating more than 100,000 through the GrameenTelecom group which yields lower profits.

The growth rates in emerging markets will continue to be higher than in OECD countries and more emerging-market multinationals are building very strong positions in their industries. Hyper competition will speed the declining growth and fast commoditization of high-income market segments, thus putting an additional pressure on companies to expand their markets in developing countries. Furthermore, pressure on companies to create jobs and do business with low-income groups will increase. The traditional corporate response to financial crises based on cost-cutting, restructuring and
layoffs, aimed at preserving cash and increasing efficiency and productivity, should not be pursued alone and at the expense of more innovative solutions. In a recent McKinsey & Company survey more than 50 percent of the respondents said that innovation is more important to growth now than it was before the crisis. Long-term global prosperity and stability need to be supported by expanding growth, especially among the low-income segments.

For example, because severe competition with local companies in India resulted in reduced profit margins at the high-income market segment, Unilever felt pressure to cultivate low-income groups. The company has had outstanding success in these markets, offering products in single-use packaging (for example, sachets of shampoo and mini-size soaps), that were affordable to consumers. By extending its distribution networks to rural towns through travelling sales agents (on bicycles and even bullock-carts), the company has continuously increased its market share in countries like India, Indonesia, and Brazil.

The multinational cement producer CEMEX learned a similar lesson during the last financial crisis in Latin America. For CEMEX the crisis was an opportunity to reengage with low-income market segments, and profitably provide housing to the poor, while also creating jobs. CEMEX chose to put an interdisciplinary team of its own employees on the ground in Mexico to better understand the social and home-building practices of low-income communities, using that knowledge to develop a successful product line of affordable housing just for the poor. This approach has also been used in several other Latin America countries and in Egypt.

Growth based on tapping into low-income markets should aim primarily at wealth creation, including providing access to jobs, healthcare, education, and vocational training. This objective should even preclude the marketing of consumable goods and services that help improve the quality of life of the poor. Arguably, businesses that have provided jobs and income to low-income people have been the most successful. They have given people the ability to buy healthcare and education for their children, and acquire property to improve their quality of life. They normally base their business models on a holistic assessment of how their labor policies and supply chain relationships can shape their strategy. Nestlé’s Milk District Model illustrates this approach. By providing opportunities for training, education, and a steady income to poor rural farmers in exchange for a consistent milk supply, Nestlé effectively integrated poverty alleviation into a business model that was mutually beneficial: the company has been able to increase its supply of fresh milk and poor communities have benefitted from job security, improved nutrition, and a better standard of living. Similarly, Bimbo in Mexico offers its 30,000 travelling salespeople the opportunity for continuing education, supplementary health care in addition to the government-supplied plan, and even a cooperative to help them acquire housing material to upgrade their living environment. The company has also attempted to bring microfinance to its 100,000 small retailers, and acted as an agent for health and property insurance. Admittedly all this has been done in order to ensure the success of its main line of business: making and selling bread and other edible foods and snacks.

Because of the financial crisis, access to basic services, as well as their quality has deteriorated. Education is one example, since school attendance tends to decline in low-income countries as incomes drop. The potential for partnering with business in addressing these issues has not been fully tapped. Business can play an important role in reducing the number of school dropouts by implementing innovative programs. For example, Tetra Pack has a program in Nigeria that provides school meals as part of its philanthropic corporate social responsibility strategy; while Britannia has a similar program in India which, was initially supported in part by the Global Alliance for Improved Nutrition (GAIN), but which is now primarily profit based.

The financial crisis creates unique opportunities for government and companies to reassess their strategies and identify innovative solutions, including creative partnerships, to tackle the new economic reality the world is facing. Those who react quickly and forcefully will most likely be the rule makers and winners in the post-crisis world.

Endnotes
2 “Swimming Against the Tide: How Developing Countries are Coping with the Global Crisis.” The World Bank. 2009
7 “Swimming Against the Tide: How Developing Countries are Coping with the Global Crisis.” The World Bank. 2009
8 “Opportunities in Adversity.” Ernst & Young. 2009.

Ernst & Young interviewed a large number of managers and owners of companies around the world, first in January 2009 and again in June 2009. The main findings include: about 82 % of respondents still having difficulty in accessing credit and this is impacting upon their investment strategy; companies are facing heightened concerns over risks while managing their assets, and over the likelihood of more regulations; companies are using this crisis to outsource (23%) and use strategic acquisitions (34%); about 32% are disposing off assets to increase cash and liquidity; in January 2009, only 20% planned for entering new geographic markets but by June 2009, 33% expect to.
10 GAIN has formed a Business Alliance to explore the space between philanthropy and strategic private sector interest by developing new business models to fortify foods with necessary vitamins and minerals and making it available and affordable to the poor.