Economic Crisis and Its Impact on Strategic Decisions

How to protect **(and grow!)** your company, in a context of crisis?

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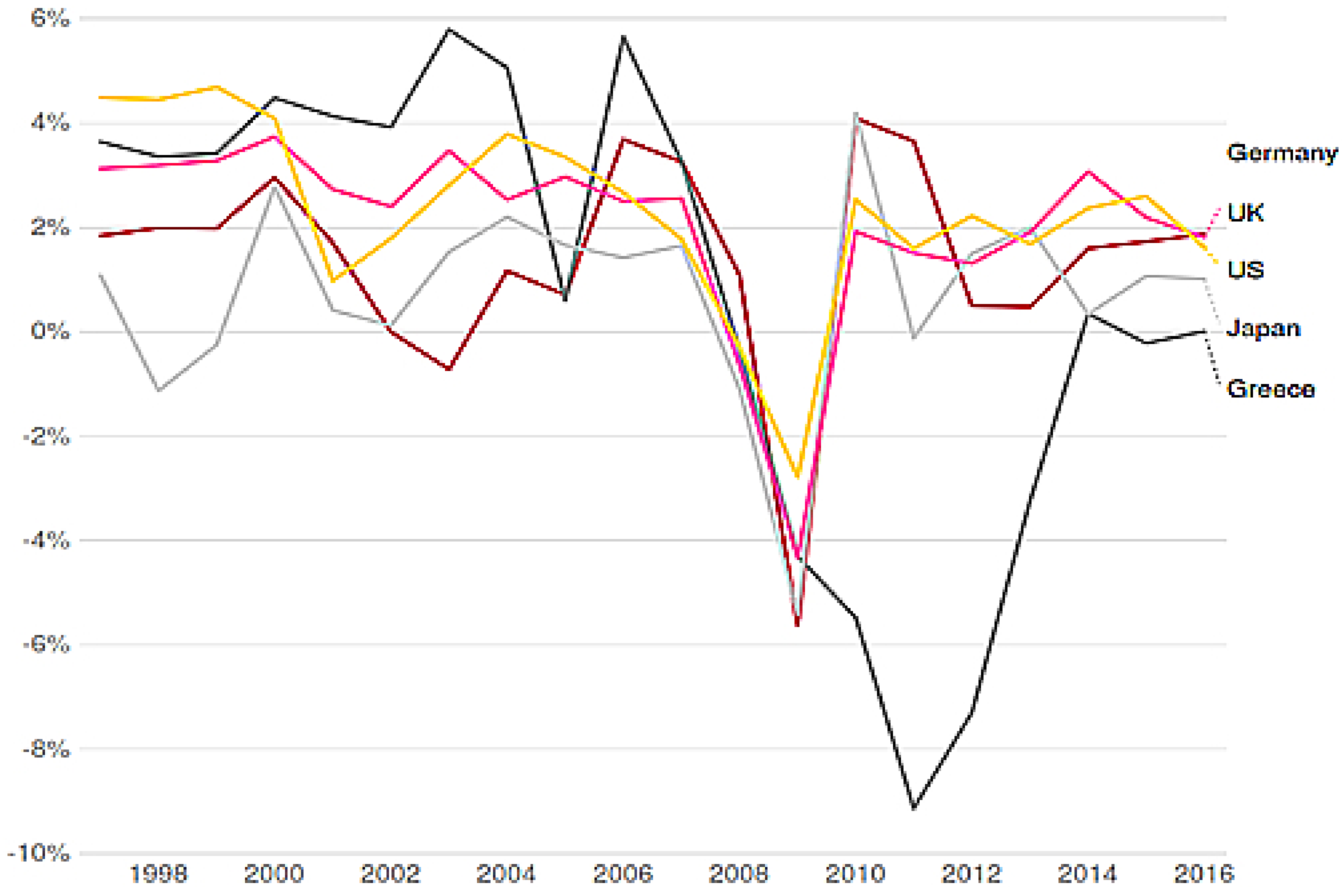
Introduction

The COVID-19 - coronavirus poses a serious risk of sending many countries into recession and has sent the US stock market into a bear market (Alpert, 2020). However, it is not the first time the world has faced a crisis, and certainly will not be the last. The Asian financial crisis that began in 1997, spread rapidly throughout the globe and caused stock market declines, reduced import revenues and government upheaval (Chappelow, 2019). The economic effects of the September 11 attacks resulted in decreased global stock markets and approximately $40 billion in insurance losses (Amadeo, 2020). In 2009, the world GDP shrank from $63.07 trillion to $59.78 trillion due to the global financial crisis ignited in the USA (Ross, 2016). The consequences were huge, resulting in bank failures, depressed wages, austerity and deep political instability. Economic recessions may be caused by different factors, such as loss of business and consumer confidence, corporate or government mistakes, wars, terrorist attacks and diseases.

A recession is a tipping point in the business cycle when ongoing economic growth peaks, reverses, and becomes ongoing economic contraction (Kenton, 2019). This e-book explores corporate strategy adaptations and changes, that companies should apply to face business environment volatility. The discussion is particularly relevant in emerging countries, since instability in these economies tends to be higher than in developed countries. Highlighting main factors that must be considered in business strategy in times of crisis, the e-book offers conceptual models that can guide managers to make adjustments that protect their companies amidst economic turbulence.

Managers of various companies deal with a mixture of anticipation and fear with each new set of data on the world economy. The reason for that is because macroeconomics has a significant impact on business strategy, particularly in times of crisis. GDP, interest rates, exchange rates, unemployment rates, and other economic indicators are all part of the daily conversation amongst managers, who are in search of benchmarks to aid in adjusting their corporate strategies. They must explore market opportunities while also being cautious of threats coming from the environment.



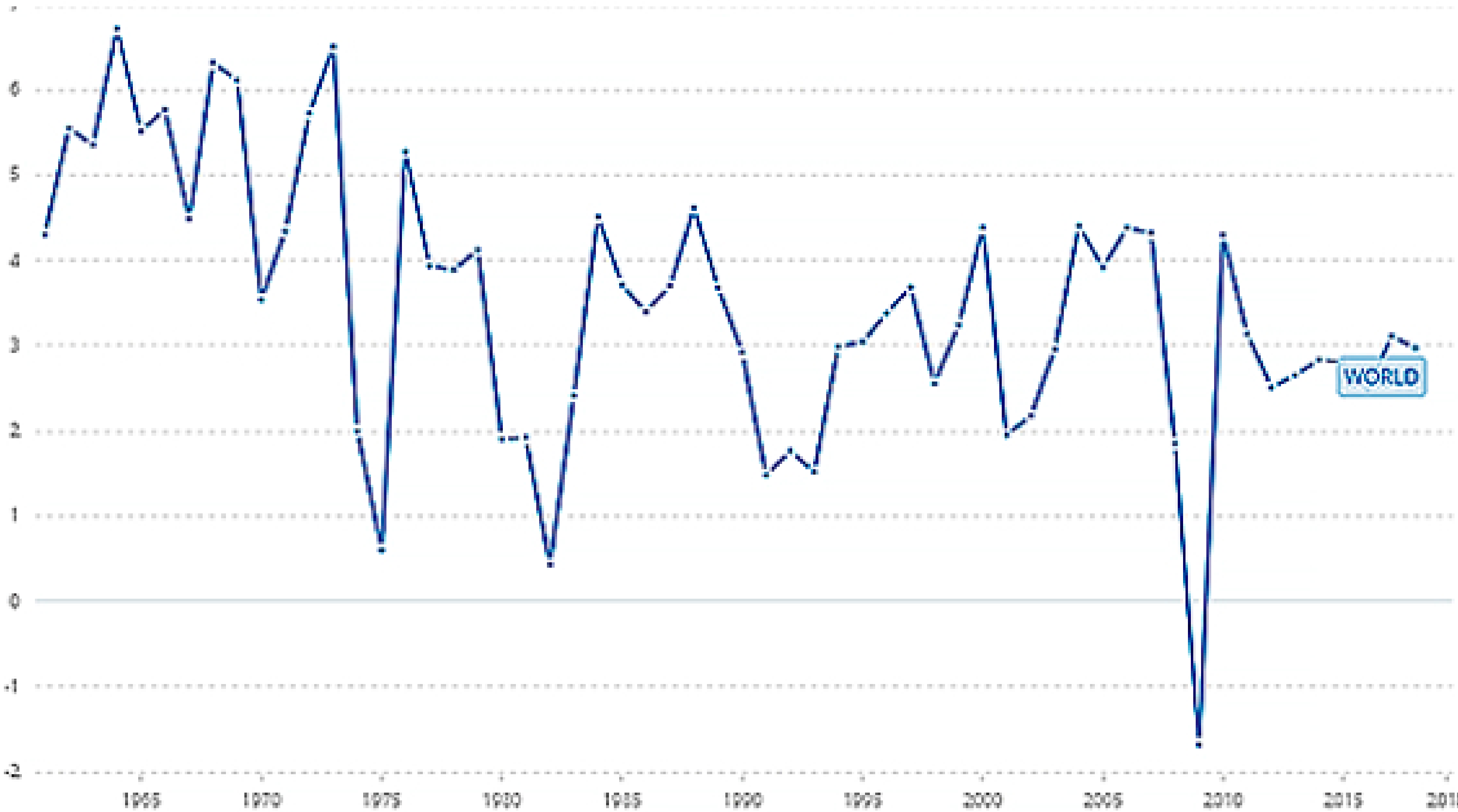
Graph1: Fluctuations of Real GDP Growth Rate As a Result of 2008-2009 Crisis (Six Charts That, 2017)

There is a broad business strategy literature, that discusses how organizations should undertake market positioning driven by competitive advantage. Although allusion to environmental analysis is quite frequent, it is remarkable how this subject is treated with superficiality (Meyer et al, 2011; Hitt et al, 2003: p.59; Hooley, et al, 2005, p.70). The main ideas and suggestions of the Business Management literature on how to adjust corporate strategy in times of crisis is summarized here. Managers are challenged to adapt their decisions to new economic contexts, especially while avoiding damaging the company's strategic position in the long run.

Economic Cycles and Strategy: How to integrate?

Economy does not evolve in a linear and constant fashion. Its evolution is marked by periods of growth, alternating with periods of low growth or even shrinkage of the economy. This combination of phases sustains the so-called "business cycle". Seen by managers as periods of difficulty, economic downturns are part of the mechanics of economic development, important moments of adjustment for long-term economic growth.

As shown in Graph 2, even global economic growth has cycles, marked by the differences between moments of high and low growth rates – or even decrease in global output (Tiryaki, 2008). Given general market conditions, such as the regulatory environment and other factors, emerging economies have greater volatility: periods of stronger growth, alternating with the sudden deceleration of economic activity. Although several studies have already raised conflicting data on this subject, there seems to be no relationship between volatility and long-term growth (see Lin, 2012; Ramey and Ramey, 1994). It means that even countries with higher volatility can, in theory, reach a high average growth rate in the long run, being an environment conducive to the development of markets.

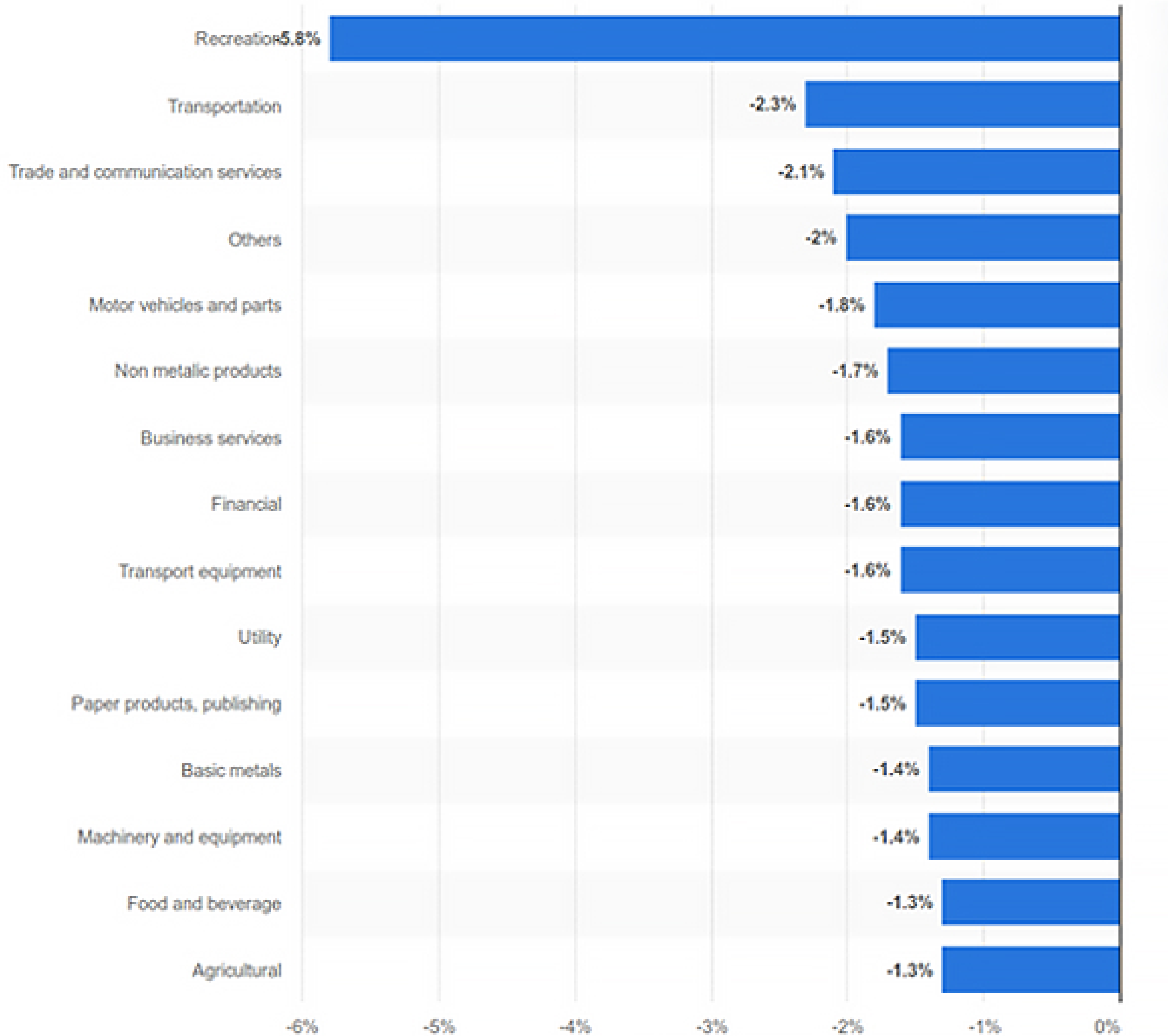


Graph 2 - Evolution of world GDP - 1980-2018 - %Source and Preparation: IMF - World Economic Outlook Database, 2020

Economics and Strategy: The basics

Growth rates vary with the fluctuation of the economy, along with the rest of the major macroeconomic indicators, such as the exchange rate, inflation, employment, and interest rates. What is the expected reaction of managers in times of crises? What are the necessary changes and adaptations in corporate strategy? The role of the macroeconomic manager of the country is to improve the overall average of the economy. However, the role of a company's manager is to place his or her company above the average for the economy. Both roles can be seen as complementary - and they certainly are - yet they are distinct in their specific goals and tools.

In a classic article on the topic, Bourgeois discussed this matter in 1985. For him, both the literature on strategy and the practice of companies seem to be detached from economic analysis (Bourgeois, 1985). A few years later, McCabe conducted a study in two sectors of the American economy - logistics and aviation - concluding similarly, that the environmental analysis produced disconnected effects on strategic business decisions (McCabe, 1990).



Graph 3: Estimated percentage point change in economic sectors caused by the outbreak of coronavirus COVID-19 in China in 2020 (Statista, 2020)

Porter, the most influential author in the field of strategy, said that developing a strategy should lead the company to be different, as it takes on unique challenges that represents value to plenty of customers, in order to justify the effort and investment (Porter, 1996). Such companies should be different in the way they position themselves in the markets, in the way they present their value propositions, in their willingness to invest in scale economies, etc. Such choices are ultimately determined by matching the enterprise's characteristics with environmental conditions. Porter's model suggests two basic positioning models: cost leadership and differentiation. The impact of Porter's ideas were so influential that much of the literature in strategy that has evolved since then, was ultimately derived from these two main paths. Holley, Piercy and Saunders (2005), for example, suggest a list of alternative strategies that will be further discussed here, each clearly inspired by Porter's thoughts.

Thus, if economic conditions change, the company's strategy should be reassessed. Not all sectors are equally affected by changes in climate of the economy (See Graph 3). Evidence shows that some sectors are less affected by crisis and by consumption expansion - there is even empirical support asserting that there are "anti-cyclical" sectors, which grow more in times of downturn than in times of expansion (Besley & Brigham, 2008). Health, food, and basic clothing, are commonly cited examples of anti-cyclical sectors. But the central issue remains the same: what are the most appropriate policies in response to economic changes? Even in a company operating in an anti-cyclical sector, economic transformations will affect its performance, however, in the opposite direction to the other sectors. One might argue that the recession for example, affects all companies at the same time, and therefore, the relative position between them would be remain the same. But this is not exactly correct. And even if it was correct, organizations that react better and faster in a crisis context would gain an advantage, so crisis could be considered in any case, a trigger to the changes of competitive advantages (Laeven and Valencia, 2013).

In contrast, the volatility of growth rates, defined as the distance between the peaks and valleys of these rates is greater in emerging markets, manager's ability to reassess their strategy is vital to company's success in these countries.

How can International Businesses protect your company in times of crisis?

Market volatility has been the only “constant” in a globalized world, especially since 2008. Growth rate fluctuation demands public sector actions, which impacts interest rates and global currencies. All of these factors impact a company's performance in international business. The moment that global currencies swings down, caused by dollar strengthening, it harms imports but increases the export competitiveness between some countries. Cavusgill, Knight and Riesenberger (2013) suggest two set of actions to enjoy benefits in the international business in times of volatility.

- Combination of exports with imports: This policy acts as a "natural hedge" as opposed to a "financial hedge," which is a banking product to protect businesses against currency fluctuations. The benefit is twofold. Firstly, this combination mitigates currency risk itself, leading the company to have receivables and assets in foreign currencies simultaneously. Secondly, it offers the company the chance to explore the relative attractiveness of international markets in different conditions - while a country is more likely to export, others will be more likely to import at least considering the exchange rate factor. A concrete example of this practice can be seen in the automotive industry. Firms that internationalize their production with assembly facilities scattered in various continents, by implementing a strong policy of intra-group international trade in order to benefit from exchange rate changes, outperform those who do not who do not develop this strategy (Anfavea, 2015).

- Diversification of markets: It dilutes the volatility, producing an effect at least partially like a natural hedge. Although the currencies of emerging countries depreciate against the dollar more than the average, other currencies in developing countries depreciate as well. The US’s only products face greater difficulties as they largely depend on consumers abroad. For instance, Apple has a significant overseas customer base, so the demand in times of crisis is heavily affected due to currency fluctuations (Nguyen, 2020).

Managers must be aware that strategic implications of these actions are immense. A company that’s in any way, linked to foreign trade, either as a producer or as a distributor, tends to specialize in certain markets or products and do not have the above diversification (Douglas & Craig, 2011). Therefore, the organization should make an effort to implement or, if this is not feasible, at least structure well defined plans to "reverse" the direction of its international trade flows at the start of the economic context’s transformation (Luo & Wang, 2012).

Diversify your Strategy

Low economic growth, impacts at different levels, both families' and companies' purchases. Classic consumer behavior in these contexts is migrating to cheaper products - pushing the company towards a strategic change (Kunc & Bandahari, 2013). Similar to Cavulgil's suggestion, diversification seems to be the key to this strategic impasse. If a company seeks to position itself in a market, with a focus on differentiation, it will suffer the consequences of a change in economic growth with greater intensity than a company with a family of more extensive products, including more affordable items. Given the possible restrictions of expanding product families for reasons of brand management, a different option to consider would be the opening of new business units, presented to the market under different brands. This would offer more affordable products in unfavorable economic conditions.

Such structure can be placed permanently with differentiated products even if low-cost products are offered as well. Otherwise, the company can position itself and plan options to be implemented in times of market change.

On the other hand, companies adopting the classic strategy of leading with cost will also be affected. With lower sales volumes, companies will observe the growth of their average total unit cost. If the increase in costs is absorbed by the company, it will impact profitability. If it is passed on to the consumer, it compromises its competitive position. Similarly to what has been said for companies focusing on differentiation, the firm that operates with Cost Leadership positioning can, in times of crisis and low production scale, seek to add value to their products, create families of products, or business units aimed to pursue opportunities in this context. But of course, it is not feasible within a short period. This approach is more feasible for organizations already structured accordingly or already offering products within a differentiation strategy. Success is also greater for companies that have prepared the entire structure and plan of action preemptively, ready to be put in action in times of crises.

Business literature has discussed the difficulties of this hybrid positioning, though. Companies like Indian group Tata, which in 2008 acquired the Jaguar and Land Rover brands, highlights the challenges of managing such different business units in terms of positioning. Therefore, below we present some considerations and suggestions of strategies, to circumvent the effects of the crisis within the same market approach.

Cost Leadership Strategy: How can a cost leader cut costs?

A company that adopts a Cost Leadership approach in the market may also be affected by a crisis. It needs to react by evaluating additional options to keep its operations up and running. There are three main ways to promote cost cuts in companies: Downsizing, Downscoping, and Strategic Alliances.

• **Downsizing:** Defined as the effort of streamlining company's operations, this strategy is used to keep all the main operations of the organization running, but with widespread cutting of costs. Much criticized in the 90s as a strategy that did not produce the expected results and even punished the organization because of the layoffs and other cost cuts, downsizing is now seen as an action that should be taken routinely by businesses, a natural cost management tool (Hitt, 2002). Companies may prohibit nonessential travels or professional events: In 2020, tech and culture festival South by Southwest laid off roughly one-third of its full-time workforce due to the spread of coronavirus (Sonnemaker, 2020). While, Norwegian Air planned to lay off up to 50% of its employees across all departments because of a decline in flights (Pietsch, 2020).

• **Downscoping:** Similar to Downsizing, Downscoping has the particularity that it does not propose the widespread cost cutting, but instead, over specifically unattractive business units that are less relevant to the company core business. In 2019, Bayer sold its Animal Health unit in order to reduce costs and, at the same, to be able to focus on Life Sciences (McCormick, 2019).
Strategic Alliances: These alliances aim to promote cost sharing between companies. There are three main types of Strategic Alliances as described below.

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• **Synergistic:** The goal of this strategy is the search for scope economies, an alternative to the loss of scale economy provoked by the crisis. Synergistic relationships can be in the form of joint operations such as a merger, acquisition, or opening of a joint venture. Ambev's and Whirlpool's joint venture is a good example. Together, they created a company called B.Blend to develop a home appliance for making drinks. Alone, both companies would've had great difficulty to thrive in the Brazilian market (Brigatto, 2016).

• **Franchising:** Best known for creating retail models with third capital contribution and transfer of rights, there are several possible ways for a company to benefit from Franchising. It may grant another company the right to use a trademark, and it may also share market stock, using third-party trademarks, or attract capital to operate in specific markets.

• **Complementary Alliances:** Similar to Synergistic, this is characterized by the decision of two or more firms to mutually relinquish part of their operations before competitors. Two companies operating in the market offering a full range of services, can use alliances to complement their portfolio of services. BRFoods from Brazil and Singapore Food Industry struggled for the food market in Asia where both performed the whole process, from production to distribution. BRFoods appeared to be stronger in production while the SFI had more expertise in logistics. A joint venture between the two provided mutual benefits for their operations in Asia: while BRFoods could devote more intensely to food production, SFI entered the partnership structure offering local logistics support (BRF, 2015).

Adaptating your Differentiation Strategy in context of crisis

Instead of migrating towards a strategy of cost leadership, a firm focusing on differentiation can also address a crisis by deepening its positioning. This option carries risks, like all other anticrisis strategies, but may represent an exit strategy that preserves the brand's positioning in the long run, rather than compromise it. Some of the recommended strategies are as follows (Hooley, 2005):

- **Increase the Quality:** The organization can look for ways to better understand what their customers expect in terms of quality and increase its key elements. The result of increasing quality may be the loss of customer loyalty as they migrate to more affordable alternatives. Yet, price increases may help offset the margins lost by the lower sales volume.

- **Innovation:** Like the “Increase the Quality” strategy, this approach aims to bring to the market an innovative product, that is capable of increaseng the product lines which were being substituted with lower-cost competitors (Battistella, Biotto, De Toni, 2011). Some firms started to view the coronavirus outbreak that happened in 2020 as a unique business opportunity. In China, robot manufacturers, such as Rocos Global, managed to create new products that could perform cleaning and food preparation jobs - considered dangerous for humans to carry out, due to possible increase of infection spread (Demaitre, 2020).

- **Increase in Service:** This is another variation in order to increase the value delivered to customers. Distinct from Innovation, this has the advantage of lower cost and faster deployment time than strategies involving physical changes to products.

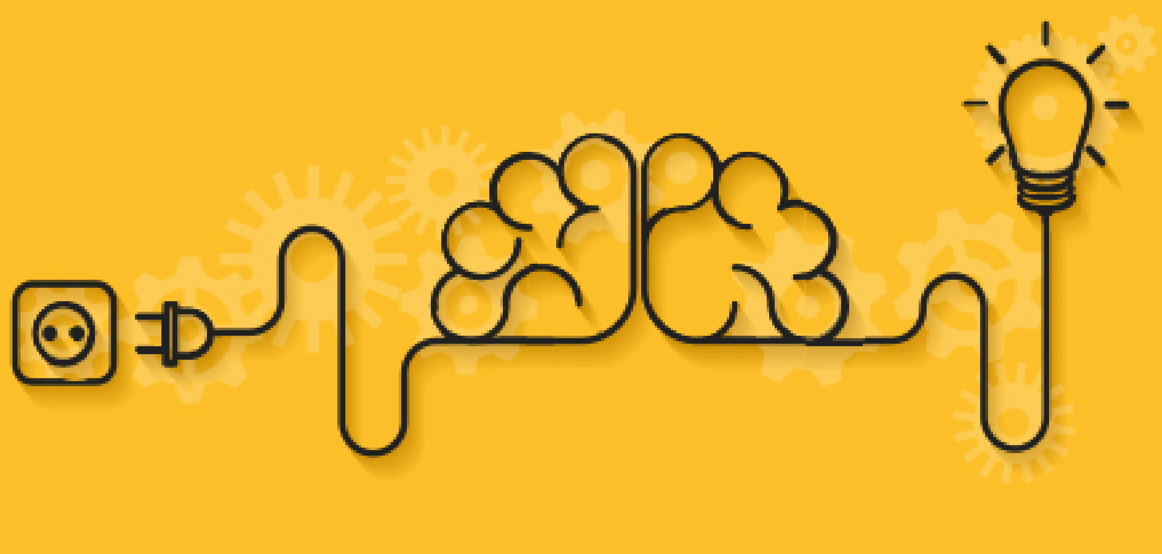
• **Increase in Communication Value:** Many customers stop buying the products of a company active in the differentiation strategy for failing to see the benefits embedded in their products. This factor tends to be accentuated in times of crisis. This strategy is very simple to perform, but depends on the ability of managers to identify the amounts not perceived by customers and formulate ways to communicate them.

• **Sub-Segmentation or Niche Strategy:** This action aims to identify sub-groups, or even individual customers, whose specific needs are not adequately met by the firm. The firm utilizes this understanding to promote the actions needed to retain these customers through customized value delivery. The term "homebody economy" was invoked in 2018 to describe a phenomenon of people who like to stay home either doing home office or even not woking at all. While the broader market may tumble in unfavorable economic conditions, stocks for the homebody economy, which include the video-conferencing service Zoom, the fitness equipment maker Peloton, and technology companies like Netflix, are rising (Nguyen, 2020).

Keep moving, keep innovating

The main conclusion of this discussion points to the need for organizations to observe their value chain carefully, and to look for opportunities to adapt their strategies to large movement of macroeconomic indicators, especially in times of crisis.

Faced with the evidence of this work it will be imperative that companies in general, particularly those of emerging countries, seek to develop a competitive advantage in times of crises. This presents superior attributes or differentiation in comparison to competitors, considering the limiting factors of the economic environment in which they are operating. The volatility of markets evidenced by this study indicates that the strategy for sustainability of business is closely linked to innovation. Innovation here is focused not only in products, but mainly in production processes and innovation in the relationship with the market in terms of negotiations, logistics, etc. In this context it can be considered fundamental for the company to prepare managers to be leaders in innovation. Managers should understand environmental changes and their impact on the company's strategies and seek strategies in the literature the foundations necessary to enhance their decision making process.



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