

The 10 Trends You Have to Watch

by Eric Beinhocker, Ian Davis, and Lenny Mendonca ¹

After a full year in heads-down crisis mode, business executives are looking again to the future. As they reengage in strategic thinking, many are struck by a sense that the world has changed: The turmoil was not merely another turn of the business cycle but a restructuring of the economic order. Is that impression accurate?

To answer this question, it is necessary to examine the underlying forces that shape the business environment and to look for discontinuities. McKinsey & Company tracks the most important of these forces, from the growth of emerging markets to the evolving role of business in society. Here we discuss how the crisis may affect their trajectories, and we address the implications for strategy.

Some trends, we argue, remain firmly on track, but uncertainties are cropping up around others. We also see signs of new forces emerging, which we will be exploring in more detail in the months ahead. The overall picture is of an altered business landscape. It does seem there will be no going back to the pre-crisis world.

KEY

-  Accelerating trends
-  Steady trends
-  Decelerating trends

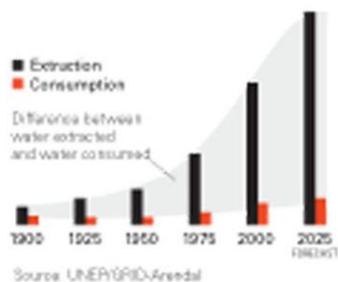
Resources feeling the strain

Just prior to the financial crisis, rising demand for commodities ranging from energy to foods caused a sharp spike in prices. The downturn changed that. Crude oil, for example, dropped from roughly \$140 to \$40 per barrel in six months. Yet fundamental supply-side constraints remain and may worsen if investment in production capacity is delayed by the crisis. Depending on the depth and length of the recession, spare capacity in the oil market could return to the low levels seen in 2007 (when crude oil prices were sky-rocketing) somewhere between 2010 and 2013. Meanwhile, water resources are under increasing strain from population growth, industrialization, and

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climate change. By 2030, 40% of global GDP and 85% of the world's population will be in regions where water demand exceeds supply.

Against this background, strategists should plan for a future of resource price increases, volatility, and even shortages. Google, for instance, has procured land for server farms near hydroelectric power sources in the Pacific Northwest. We believe that, in the years to come, “resource productivity” (the output achieved from every unit of oil, power, water, or other resource input) will become central to company competitiveness.



Globalization under fire

Of all the trends we followed before the crisis, globalization seemed the most secure. Today, however, big and important question marks hang over some aspects of global economic integration.

Although growth in the *globalization of goods and services* may stall for a period because international trade has declined along with demand, it is unlikely to reverse. There is little political appetite for further trade liberalization—for example, by completing the Doha round of negotiations—but a full frontal attack on liberal trade would threaten large numbers of jobs, raise prices for consumers, and endanger prospects for economic recovery. While a populist backlash cannot be ruled out, the more likely outcome is increased protectionism on the margins and recovery of the global trading system as growth returns.

As for the *globalization of talent*, immigration will slow if governments tighten restrictions in response to popular concerns about job losses. Yet aging populations mean that many Western countries will eventually find themselves short of workers, and emerging markets will keep producing a growing share of the world's college graduates. Additionally, the relentless march of information and communications technology will enable the global distribution of knowledge work. Overall, we remain confident that the global market for managerial and technical talent will continue to grow.

Financial globalization is more vulnerable. Observers have legitimately argued that increased linkage among the world's markets allowed problems to cascade uncontrollably. We could see, as a worst-case response, a return of capital controls (which prevent the allocation of resources to their most productive uses), an increase in inconsistent regulatory regimes, insular financial policies, and a regulatory environment that stifles innovation. Best case would be more transparency in the global financial system, greater regulatory and central bank coordination, and improved international approaches to risk management.

For now, strategists should stress-test their business models under different globalization scenarios—such as free and fair movement of goods and services, capital, and talent across borders; movement subject to uneven cross-border regulatory and tariff regimes; and the wild card of a return to widespread protectionism. The goal of such analysis is to uncover the circumstances under which the desirability of certain production locations might “flip” because of tariffs, the value of overseas business units might fall given capital constraints, or the ability to carry out core activities—either at home or abroad—might diminish as a result of restrictions on the movement of people.

Protectionist measures taken by G-20 nations Oct. 2008–Feb. 2009

Proposed without decision	17
Implemented	47
Rejected	2
Liberalizing	12

Source: World Bank



Trust in business running out.

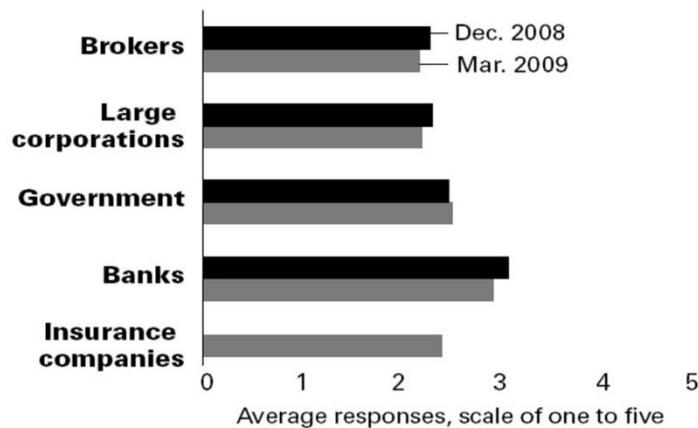
The relationship between business and civil society was showing signs of strain even before the crisis. Since the recession began, there has been a precipitous decline in trust. The Edelman Trust Barometer found that 62% of adults in 20 countries trusted corporations less in December 2008 than they had a year earlier.

Why should this concern strategists? Because a low-trust environment makes everything about doing business more difficult. For an individual company, loss of trust leads to higher transaction costs, lower brand value, and greater difficulty attracting, retaining, and managing talent. Ultimately, it can mean boycotts, negative publicity, and unwanted regulation. For business in general, loss of confidence in judgment-based systems of corporate governance could result in the imposition of rules-based systems,

potentially increasing compliance costs and reducing flexibility (as happened when Sarbanes-Oxley regulations were put in place after the scandals in the 2000 downturn).

The strategic imperative for most companies is to do what they can to regain the trust of stakeholders and to more effectively manage relationships with them. This starts at the top. Corporate leaders need to demonstrate to civil society that they understand popular and political concerns related to executive compensation, risk management, board oversight, and the treatment of employees facing layoffs.

How much Americans trust...



Source: Chicago Booth/Kellogg School Financial Trust Index

Regaining trust also means dispensing with the view that the only objective of management is to increase shareholder value. Broadening the list of key stakeholders to include employees, customers, suppliers, communities, the press, unions, government, and civil society will help companies rebuild credibility.

In continental Europe and Asia, this multi-stakeholder approach is already ingrained. But it will be a challenge for U.S. and UK companies, which have historically been more shareholder-centric in their decision-making, compensation practices, and performance management.



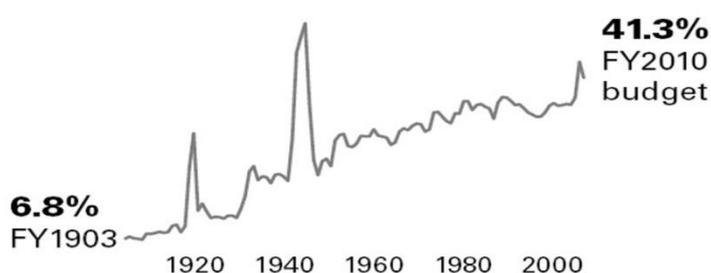
A bigger role for government

Increased government involvement in business is one of the most striking features of the crisis. Policy makers have enacted massive stimulus packages, propped up faltering companies, and pledged regulatory reforms. They are taking part in decisions that were once the province of managers and boards. Previous crises have resulted in permanent changes in government's role, and this one is likely to do the same. Managers should revisit their strategies on two fronts: First, help shape—and prepare to

compete under—new regulatory regimes. Second, recognize that the public sector will grow in importance as a major customer for many industries because of rapid increases in spending.

Beyond the current crisis, however, rising deficits and aging populations point to a future fiscal crunch for many countries. Governments will find themselves under intense pressure to deliver social services at lower cost. Creative partnership between the public and private sectors will be important in meeting this challenge.

U.S. government spending as a percentage of GDP



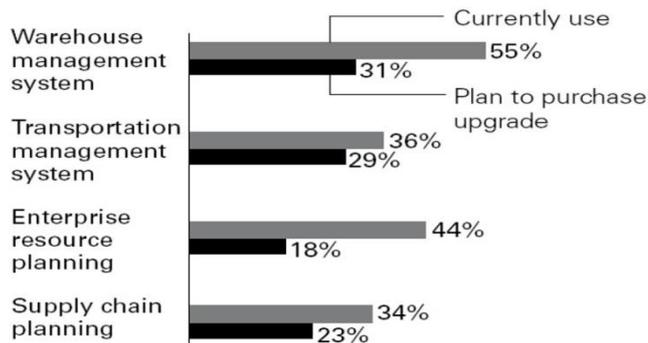
Source: usgovernmentspending.com

Management as a science

Data, computing power, and mathematical models have been transforming many realms of management from art to science. But the crisis exposed the limitations of certain tools. In particular, the world saw the folly of the reliance by banks, insurance companies, and others on financial models that assumed economic rationality, linearity, equilibrium, and bell-curve distributions. As the recession unfolded, it became clear that the models had failed badly.

It would be wrong to conclude that managers should go back to making decisions only on the basis of gut instinct. The real lessons are that the tools need to incorporate more-realistic visions of human behavior—most likely by drawing on behavioral economics, becoming more dynamic, and integrating real-world feedback—and that business executives need to get better at using them. Companies will, rightly, continue to seek ways to exploit the increasing amounts of data and computing power. As they do so, decision makers in every industry must take responsibility for looking inside the black boxes that advanced quantitative tools often represent and understanding their functioning, assumptions, and limitations.

Reconsidering investments in decision tools



Source: *Logistics Management* survey



Shifting consumption patterns

Crisis or not, it was inevitable that U.S. consumer-spending growth would slow from the 3.4% real annual rate enjoyed since 1985. The 1980s and 1990s were peak consumption years for the now-retiring baby boomers, whose spending spree was financed by a mountain of debt. Thanks to the recession, what would have been a gentle decline has become an abrupt fall. While consumption growth will return with economic growth, an aging population and depleted household savings mean that U.S. consumption is likely to expand less rapidly than it did pre-crisis.

For strategists, the question implied is this: If the U.S. is no longer the world's consumption engine, will another country or region assume that role? Here are two possible scenarios:

Asia could become the new center of gravity. China and India together have more than a billion people whose incomes are just below a middle-class level. When growth returns to that part of the world and those households achieve more than \$20,000 per year in disposable income (adjusted for purchasing power parity), expect a boom in discretionary consumption. If, as some forecasts indicate, China becomes the world's third-largest consumer economy (behind the EU and the U.S.) by 2020, and India the fifth-largest (behind Japan), then three of the five largest consumer economies will be Asian. Alternatively, the map of consumption could become multi-polar. Suppose growth continues in China, India, and other emerging markets, but government policies and long-ingrained behaviors keep savings rates high and consumer spending low. The EU, the U.S., and Japan might then retain their positions as the top three consumer

markets, but with lower rates of consumption growth. In this case, global consumer-spending growth could stay below pre-crisis levels for years or even decades.

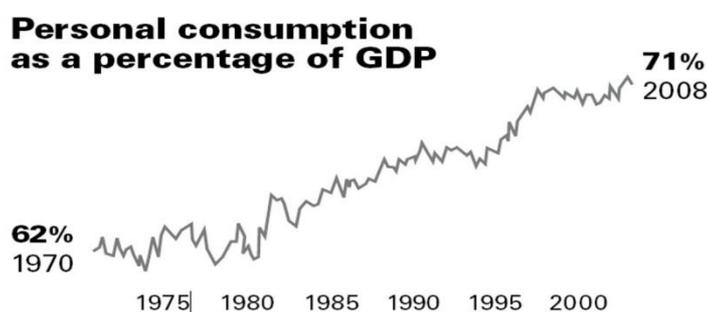
Strategies will hinge on which scenario materializes, but for the moment companies should:

Prepare for slower long-term growth in global consumption. Companies that have relied on fundamental market growth, especially for mature products, now need to fight for market share or compete in new categories.

Shift investment to Asia. Consumption is clearly growing faster in China and India than in developed markets.

Focus on older consumers. Within five years, more than half of all consumer spending in the U.S. will be by consumers over 50, and the proportion of older households is rising in Europe and Japan as well.

Find ways to offer luxuries on a budget. Tighter household budgets don't mean lower aspirations. Our research shows that stretched consumers in slow-growing economies will still want to feel that they are living the good life.



Source: Sitar-Rutgers Regional Report

— Asia rising

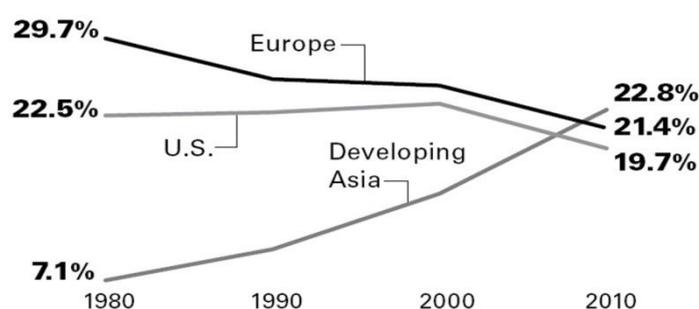
For a while it looked as if Asian countries would coast through the crisis relatively unscathed—but late last year investment flows dried up, exports collapsed, and stock markets and consumer confidence plummeted. So why are we predicting continued economic growth in Asia?

It would be difficult to overstate the power of the fundamental drivers of Asian growth. First, Asian economies have been enjoying a remarkable period of “productivity catch-up,” adopting modern technologies, industrial practices, and ways of organizing—in some cases leapfrogging Western competitors. Even in the depths of the crisis,

Chinese labor-productivity growth is projected to rise from 7.7% in 2008 to 9.1% in 2009. Second, high savings rates have fueled capital formation, enabling businesses and governments to invest in expanding production. The combination of more productive labor and more capital has ramped up GDP. The crisis has slowed this growth but not stopped it.

Strategists therefore should keep investing in Asia, working with carefully chosen local partners, fostering strong relationships with governments, and adapting products, value propositions, marketing strategies, operations, and supply chains to local markets. Many companies are beginning to saturate the major urban areas; the next frontier of growth will be smaller cities and even rural markets, which create distribution and service challenges.

Changing shares of global GDP



Source: IMF World Economic Outlook Database

Organizations are also starting to shift R&D, innovation, and design activities to the region.

The trend, of course, contains a threat for Western companies. Asian powerhouses like Haier, Chery, and Tata have significant experience providing high-value products at very low cost to choosy middle-class Asian customers. As Western consumers tighten their belts, expect these and other, less-known players to bring their value-oriented propositions to global markets.



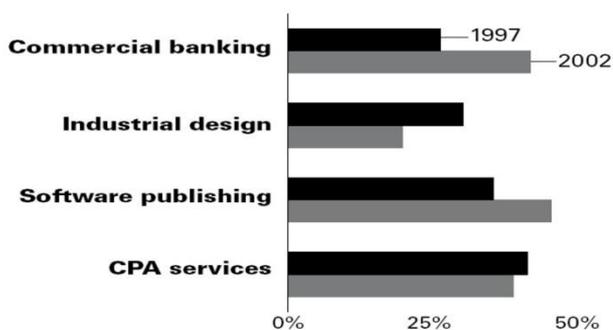
Industries taking new shape

Roughly one in three industry leaders was toppled during the previous recession as attackers used the downturn to their advantage. Recent big acquisitions in sectors such as pharmaceuticals and information technology suggest that the current slump will be no different.

Our research shows that while all companies in an industry typically suffer during a recession, the performance gap between strong and weak rivals tends to widen. This gives strong players more opportunities to reshape their competitive environment. The manner of re- shaping will differ by industry. In consumer electronics, for example, we may see small players using network-based business models to further disaggregate the value chain and compete successfully with industry giants. In automobiles, the trend is leaning strongly toward consolidation.

It is important to remember that few industry structures will remain untouched by the crisis. Managers must be ready to play at two speeds—seizing immediate opportunities presented by the recession, particularly in M&A, while also examining how they can shape the evolution of their industry’s structure over the long term.

Change in market share of top eight U.S. firms



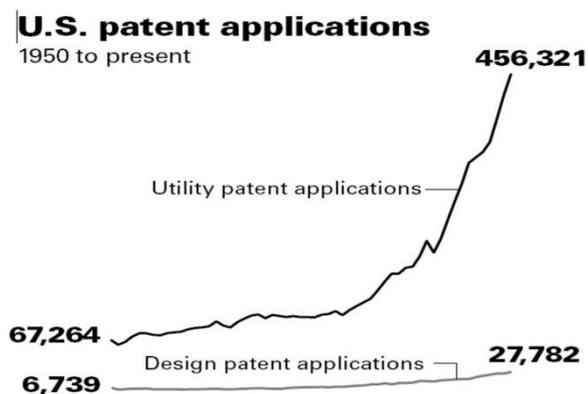
Source: U.S. Economic Census

Innovation marching on Commercial investment in R&D and new ventures has slowed, but the downturn does not alter the “headroom” for innovation in fields such as information technology, biotechnology, nanotechnology, materials science, and clean energy. Progress will continue, even if the full commercialization of discoveries lags for some time.

The implication for executives is clear: In spite of scarce resources, do what you can to protect R&D spending. Don’t hesitate to improve efficiency—by consolidating research facilities, rationalizing project portfolios, re- evaluating licensing agreements—but use the freed-up cash to double down on promising investments for a post-crisis world.

Research shows that companies investing counter-cyclically in R&D during downturns tend to outpace their competitors on the up- swing. Note, for example, that Apple’s resurgence as a force in consumer technology was fueled by R&D conducted from 2001 to 2003 despite a sharp decline in sales and margins. This bet paid off

handsomely, putting the iPod in the pantheon of game-changing innovations born of hard times, alongside Depression-era breakthroughs such as nylon and the jet engine.



Source: U.S. Patent and Trademark Office



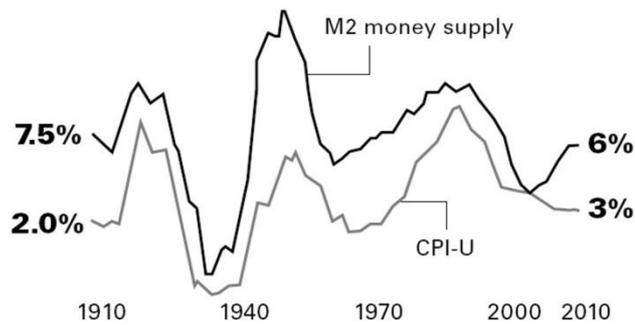
Price stability in question

Over the past three decades, companies became accustomed to a generally stable price environment, at least in the developed world. But recently managers have been forced to question this basic assumption. For many, the immediate threat is deflation, with excess capacity putting significant downward pressure on prices of everything from fresh produce to building materials. Yet government efforts to rein in the crisis and bolster economic growth have raised the possibility that inflation could rear its head. In the words of the former Federal Reserve vice chairman Alan Blinder: “At some point, and without knowing the timing, the Fed is going to have to destroy all of the money it is creating.” The prices of inflation-linked bonds prove that investors are certainly aware of the risk. When economic growth returns, central banks will need to contain inflationary forces while not choking off recovery—a delicate balancing act that will be all the more difficult against a backdrop of rising commodity prices.

Although the risk of inflation has clearly increased, it is too early to call that a trend. Unlike labor markets in the 1970s, when double-digit inflation was fueled by a wage-price spiral, those in most countries today are flexible. Rather than trying to accurately forecast inflation or deflation—an impossible task—companies should focus on how they might manage price instability. This is a good time to review supplier contracts, wage agreements, pricing policies, and hedging strategies to determine where the dangers may lie.

The key is to maintain flexibility, to remain cautious in long-term commitments on both the buy and the sell side, and (when possible) to create links between input costs and sales prices. In an inflationary environment, it does not pay to get caught between rising short-term prices for inputs and long-term customer contracts with fixed prices. In a deflationary environment, the reverse is true. Either way, the purchasing function assumes strategic importance. Companies that have failed to refine their purchasing practices will find doing so a priority now.

**As money supply changes,
so goes inflation**



Sources: BLS, Federal Reserve, nowandfutures.com