

Survive the Downturn using the Business Economics Recession Model™

Can you survive?

- Do you know how recession will hit your business?
- Do you know where to cut and where to invest?
- Have you adjusted your strategies for Marketing, R&D and Pricing?

The current situation

The UK economy is on the brink of a recession. In our August bulletin on the economy we described the situation as “almost unremittingly bleak”. That was before the meltdown in financial markets that occurred in September which has rocked confidence in the banking system both in the UK and more especially in the US. These are uncharted waters for the global economy and not surprisingly our prediction for the outlook for the UK economy has worsened significantly.

Inflation, as measured by the consumer price index, continues to rise and looks certain to reach 5% before the year is out. Business and consumer confidence continues to fall, signalling that the downturn has spread from banking and housing to the economy as a whole. Consequently, the Business Economics Recession Model (BERM) predicts that the probability of a recession beginning in the UK in the next month has risen to over 70% in September.

The Business Economics Recession Model is designed to predict, in advance, the probability of the UK economy being in recession. It is a statistically-based model that relates a variety of historical financial, economic and business indicators to the occurrence of a recession.

There are two popular definitions of a recession. The first, often referred to as a “technical recession”, is defined as two successive quarters of negative growth. This definition has the advantage of simplicity but fails to distinguish between a minor blip and a major fall in economic activity. The second definition of a recession is a period between when economic activity has passed its peak and starts to fall until the time when economic activity bottoms out and before it begins to rise again. It is this definition of recession we predict using the Business Economics Recession Model.

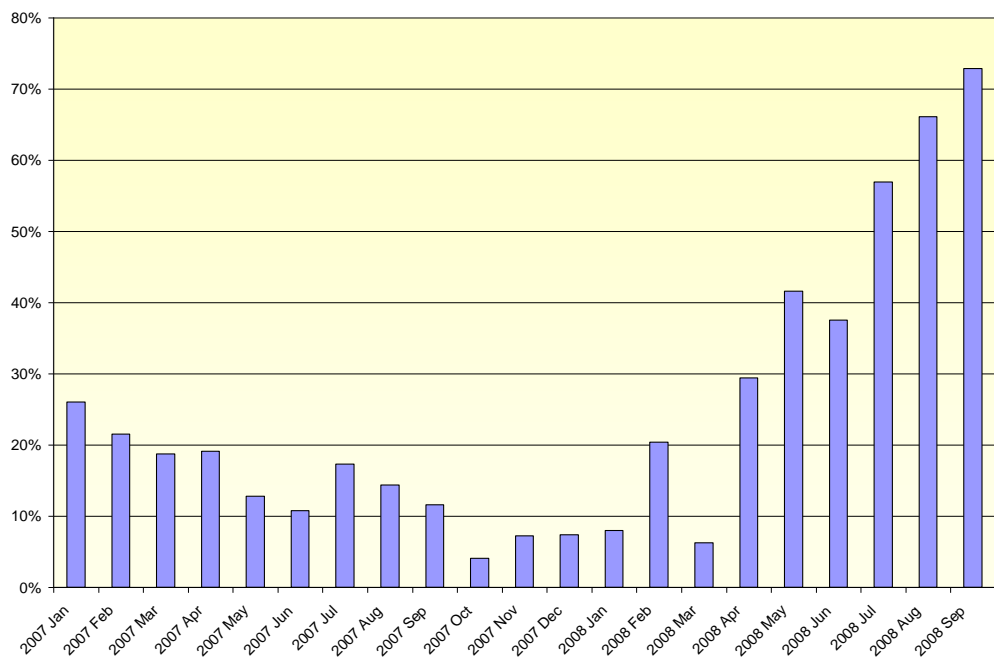


Figure 1: The chart tracks the probability of a recession beginning in the UK in the following six months since the beginning of 2007. The likelihood of recession fell throughout 2007 despite the arrival of the credit crunch because the economy continued to display solid growth. Indeed, it was not until April 2008 when it became clear that the inflationary pressures in the economy were set to rise alarmingly, that the odds on a recession in 2008 rose towards 30%. By July, the economic outlook had worsened to such an extent that a recession in 2008 was an odds on favourite.

What is different this time? Keep reading to look at the bigger picture. And to see what strategies may be open to you . . .

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Predicting the next recession

The Business Economics Recession Model correctly predicts the beginning of a recession up to six months in advance. Since the last recession in 1990, the model has also signalled two near misses, where the risk of recession rose significantly but did not exceed 50%. The first was at the end of 2002 when fears that the housing bubble would burst led to a loss in business confidence that in the end proved short lived. The second was at the end of 2005 when a series of interest rate hikes led to a sharp slowdown but stopped short of an actual recession.

If the Business Economics Recession Model is correct and a recession begins in the second half of this year, the key question will be: how long will it last?

If the past is any guide then the omens are not good. The 1973 recession lasted only for nine months, but it was followed by a second recession within six months so in fact seven of the nine quarters between mid 1973-late 1975 were in recession. The 1979/81 recession lasted seven quarters, and the 1990/1 recession technically ran for 5 quarters but was followed by a further 3 quarters of exceedingly slow growth. Many observers argue that the economy is now in much better shape than it was during previous recessions and therefore the UK economy will bounce back much quicker than in the past. Hopefully, this will be the case but even so we expect the recession to last for at least five quarters and continue well into 2009.

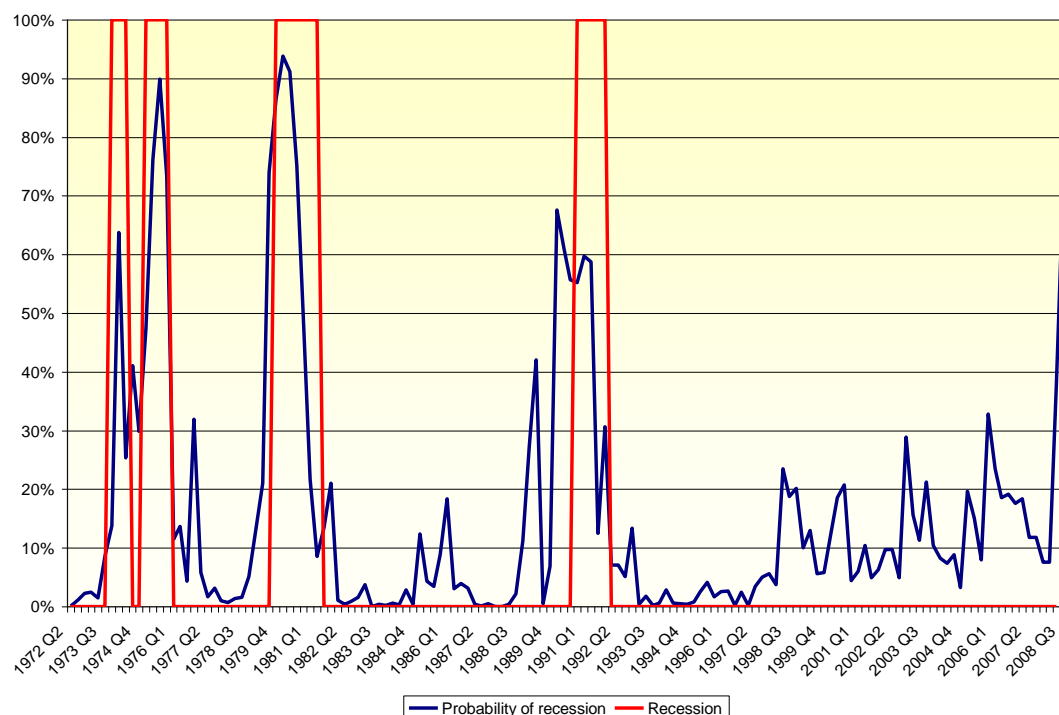


Figure 2: This puts the current predictions in historical context. There have been four fully-fledged recessions since 1970. Each of these recessions has been associated with a sharp rise in oil prices, a dislocation in the financial markets and a catastrophic collapse in both business and consumer confidence. The first recession which lasted from the summer of 1973 through to the spring of 1974 was brought on by the quadrupling of oil prices following the Arab-Israeli war; six months later an already weak economy slipped back into recession as business confidence collapsed in the midst of a balance of payments crisis, mainly due to high oil prices. The third recession was also ushered in by a huge rise in oil prices in the summer of 1979 which again hit business confidence hard. The last recession is also associated with a much more modest oil price rise sparked off by the first Gulf War in the summer of 1990.

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So how can businesses manage a downturn?

What should businesses do differently in a recession than in the grand expansionary years of the last twenty five years? The obvious answer is to cut costs! In broad terms this advice is undoubtedly sound. But cost cutting needs to be selective, and closely related to maintaining shareholder value. Otherwise, the long-term value of the enterprise will be compromised.

Marketing is a good example. Many marketers, with enthusiastic support from their marketing agencies, will be eager to make the case for maintaining marketing spend in a recession. They will be emphasising the importance of the brand and that marketing is an investment and not a cost. Meanwhile, the financiers will be arguing for draconian cuts in marketing spend as a quick win in cutting “soft” discretionary budgets.

Both views are wrong! Of course, for most businesses it makes sense to cut marketing spend in a recession when profits are falling. The marginal spend on short-term marketing initiatives that were profitable in a boom is probably going to be loss making in a recession; this spend needs to be cut. But the core

spending on marketing whose pay off can only be measured over the full cycle needs to be evaluated over the long term.

The same principle is true of **spending on innovation and R&D**. A longer term cyclical approach to evaluating effectiveness of innovation and R&D is vital if businesses are to remain competitive in the future. The costs of innovation and R&D are generally short term whereas the benefits will accrue over a long period of time. Counter intuitively, it may make sense to up spending on pure research in a recession when resources are cheap in order to reap the benefits in future years when profits will be enhanced.

Pricing in a recession is of crucial importance. Most businesses will be under pressure to cut prices, and quite rightly so. Markets generally become more competitive in a recession as buyers (both households and corporate) become more price conscious. But segmentation is key in implementing price cuts. Some customers for some brands in some markets will still pay premium prices for premium products and services. In many markets it will make sense to cut prices through selective promotional activity rather than cut list prices. Promotions are more selective than across the board price cuts, and much easier to reverse than a cut in list prices.

Business Economics Ltd for Fact-Based Business Transformation

We are a consultancy that specialises in providing advice and analysis in the field of business economics. Our approach combines the application of leading-edge technical expertise to client problems, the intelligent use of information available and a user-friendly presentation of the issues and recommendations resulting from our analysis. We have extensive experience across a broad range of sectors but regard each client and problem as different. We work closely with clients to understand their requirements and to explain our approach.

We use a wide range of analytical techniques including econometric analysis, media mix modelling, optimisation techniques, risk analysis techniques and financial modelling. We are happy to hand over our models to clients and provide training in their use.

Our overall aim is to help clients take better business decisions by providing analysis and advice that is clear and actionable.

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