Risk management and economic storm warnings

Economic indicators are a useful risk management tool and come into their own in times of crisis. With their help companies can avert dangerous situations and consistently exploit business opportunities.

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The Swiss economy is facing tough times. There has been practically no growth for two years – and the situation is not likely to improve before the end of the year. But it is not only in Switzerland that the economy is stuck in the doldrums. In the rest of Europe and the US too, downswings in the business cycle have rarely been as synchronized and pronounced as this last one. Observations of the ebb and flow of economic activity go back to times immemorial, long before scientific studies began to focus on economic phenomena some 200 years ago. Such ups and downs are largely unavoidable but the last downturn was sharper than expected, and may perhaps be more accurately described as a mid-sized economic crisis rather than merely a slowdown in growth. Businesses can enlist the aid of predictive risk management to help protect themselves from economic risk and impending crises.

Not a new phenomenon

Although economic crises have only been statistically documented in the last 180 years they are by no means a purely modern-day phenomenon. The seven fat and seven lean years of biblical fame can be regarded as the first historically documented economic cycle. The rise, zenith and fall of cultures, peoples and dynasties can be viewed as cycles in the broadest sense. While wars, famines and other exogenous shocks were often the initial cause of decline, such events were – as they still are today – closely linked to what was happening in the economy. The failure to make economic or political reforms and the absence of an effective risk and crisis management were in most instances contributory factors to the decline of great cultures.

> Keeping an eye on the economic risk radar

Disequilibrium in the markets

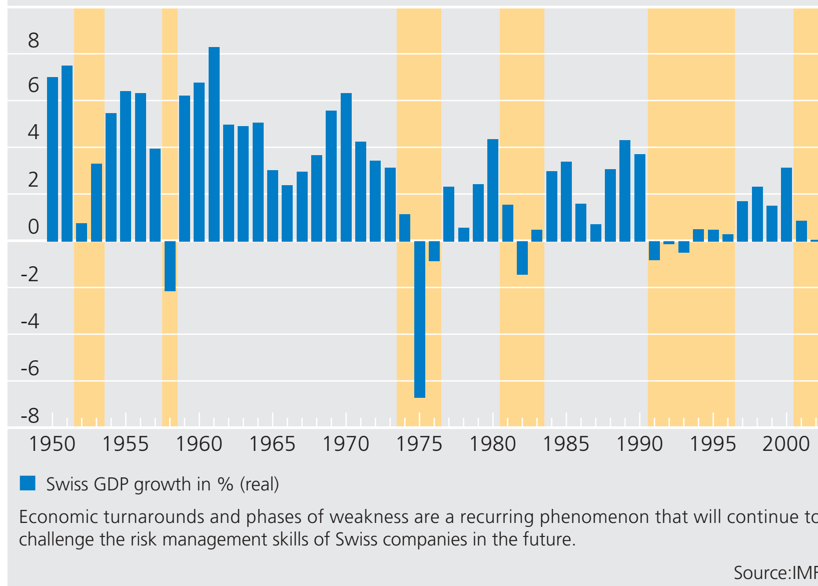
What then are the features that characterize an economic downturn? Academic observers are not yet in agreement on what primarily causes downswings in the business cycle. The reasons are manifold and difficult to reduce to a single factor in an economy's development. What we do know, however, is that supply and demand become increasingly out of sync in a downswing phase. This may be due to excessive business investment or weak consumer spending. Companies are faced with a declining inflow of new orders and turnover and production capacity is no longer adequately utilized. Companies then do the rational thing and scale back their investments and workforces. This further exacerbates the situation by additionally depressing demand as consumers buy less because of dwindling job security. As a result, some firms are forced to cease operations. Last year in Switzerland, for instance, the number of company failures rose exponentially – with some 10% more companies filing for bankruptcy than in the year before.

Recessions clear away dead wood

In times of crisis large areas of the economy start to struggle as more and more individual companies fight for survival during extended periods of harsh economic conditions. This phase with a rising number of bankrupt companies acts as a kind of "shakeout", eliminating the weakest in the battle for survival of the fittest. Companies with weak positions in contracting markets, which

have failed to develop new strategies at an early stage or which are not sufficiently innovative, succumb and disappear from the market. In this way competition strengthens the quality and position of the remaining firms and creates space at the macroeconomic level for new businesses to grow up. In this view of things the business owner plays a key role as an innovative, forward-looking individual. As far back as the first half of the last century, the economist Josef Schumpeter – a member of the Austrian school – highlighted this fact very clearly by focusing his research on the entrepreneur as the driving force behind economic development.

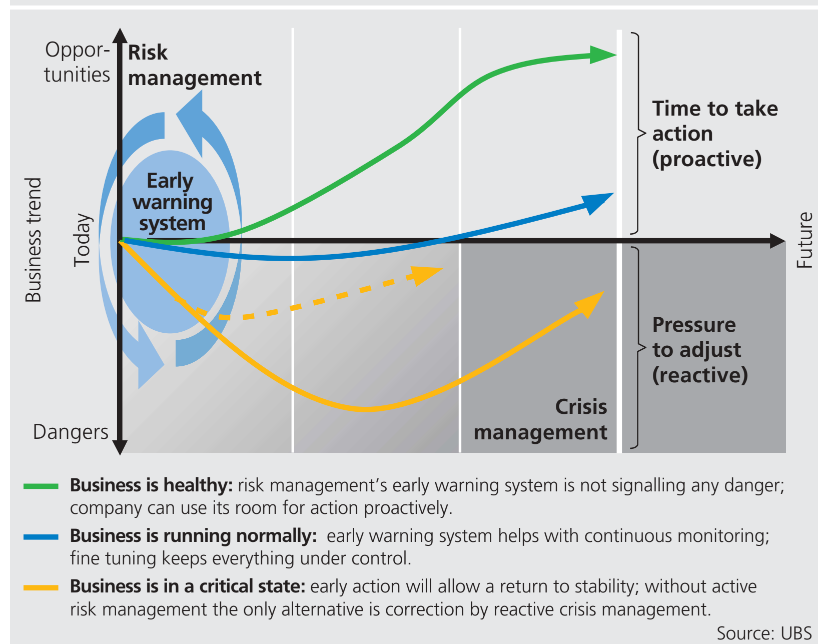
The Swiss economy has seen its share of crises



Economic turnarounds and phases of weakness are a recurring phenomenon that will continue to challenge the risk management skills of Swiss companies in the future.

Source:IMF

Risk management today instead of crisis management tomorrow



Business is healthy: risk management's early warning system is not signalling any danger; company can use its room for action proactively.

Business is running normally: early warning system helps with continuous monitoring; fine tuning keeps everything under control.

Business is in a critical state: early action will allow a return to stability; without active risk management the only alternative is correction by reactive crisis management.

Source: UBS

Exposure of different sectors varies

Not all business owners and firms are equally exposed to the rigours of the economic evolutionary process, though. Some industries and service sectors are more in jeopardy in periods of economic weakness than others. One of the hardest hit in recessions is typically the capital goods industry because of its extreme cyclicality, whereas sales in consumer-related sectors are generally significantly less affected. Companies can ride out these fluctuations to some extent, depending on the size of their margins. Sectors also display a different pattern over the course of the economic cycle. Since the upward leg of the business cycle often starts with capital investment – the beginning of the value chain – machinery manufacturers or foundries will tend to emerge from recession earlier than luxury goods producers who do not reach their peak sales and earnings until the economy is in full swing. Taking Switzerland as a whole, it is clear that export companies will feel the rebound much earlier than those who sell to the domestic market and are thus largely reliant on the pace of the Swiss economy.

Risks in the economy

Entrepreneurs thus face a regularly recurring challenge: that of recognizing the dangers and the opportunities presented by the ups and downs of the economic cycle and of taking appropriate action to ensure the company's continued survival and prosperity. The general principle holds that the further an event lies in the future the greater the deviation from its expected outcome is likely to be. Risk can thus be defined as the possibility of divergence from a target occurring with a certain level of probability. A comprehensive risk management process

that also takes account of the development of economic variables is the most reliable means of being optimally prepared for the unexpected. However, even detailed, long-term planning cannot totally eliminate uncertainty. It was Aristotle who asserted that “Probability also includes the possibility of the improbable happening”.

Economic early warning signs

As with an upswing, the downturn does not come from out of nowhere. Signals that the economy is headed downwards can be identified relatively early with the aid of indicators. What is more difficult to assess, however, is how far down it is likely to go. Often it will only be a temporary slowdown in growth, as happened in the period 1998-99. Or the economy really takes a dive and enters an extended period of stagnation or even recession, as is the case with the current cycle. Besides the intake of new orders and surveys of business expectations there are a number of other industry-specific leading indicators that should be monitored. The individual business owner can deduce from these what the future business prospects for his own company will be. Even if new orders and order backlogs have lost some of their value as an advance warning of future developments due to just-in-time production and generally shorter lead times, they are nevertheless a good yardstick for assessing future production volume. The trend of incoming orders to the machinery, electrical engineering and metals industries is, for instance, a very reliable indicator of turning points in the business cycle. Export-reliant companies should also monitor economic growth in their specific markets abroad as well as the trend in exchange rates in order to assess how demand for their products is likely to develop. Since the Swiss economy is heavily dependent on the contribution of exports to GDP and exports in turn move in tandem with the economic trend in Switzerland’s principal markets Germany, France, the US and Italy, it is wise to take a look at how foreign trade is doing. The expected average change in production, sales or prices as shown by our quarterly industry survey (see page 18f.) also gives a rough guide.

Internalizing the risk perspective

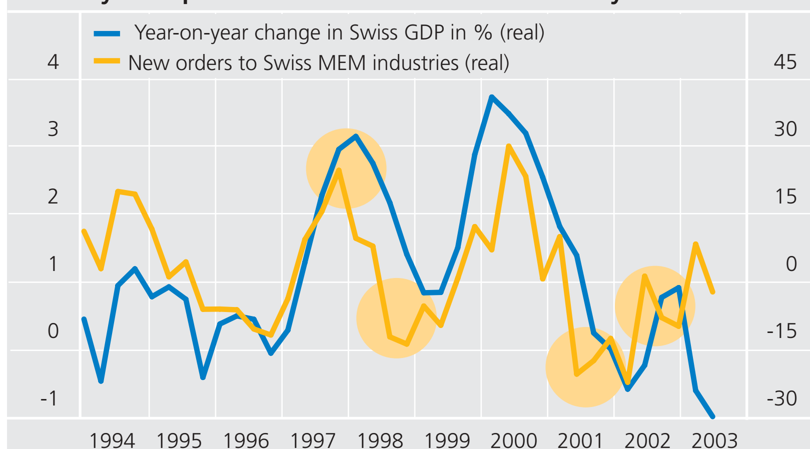
Reading the signs ...

A risk management concept can be implemented as a continuous circle made up of four basic elements. Risk identification is followed by risk measurement and assessment. Once a more exact picture of the risk scenario for a particular firm is obtained, the third stage involves taking action through control and steering measures followed by the compilation of a strategic risk matrix. Since weak periods in the economy show up in a multitude of components on the corporate risk radar, it will require an understanding of the chain of economic cause and effect and of possible remedial measures to be able to feed such systems with those leading economic indicators that are relevant for the company. Declining sales and earnings thus indicate a liquidity risk, unhedged interest and exchange-rate risks among a company’s market risks, combined with wobbly counterparties, can present a financial threat. Excess capacity due to lack of planning, offerings that are not competitive or bad positioning when demand is weak are signs of inadequate operational and strategic risk management. The challenge to businesses is to identify the individual, mutually interdependent risks and to understand them as an overall system.

... and acting accordingly

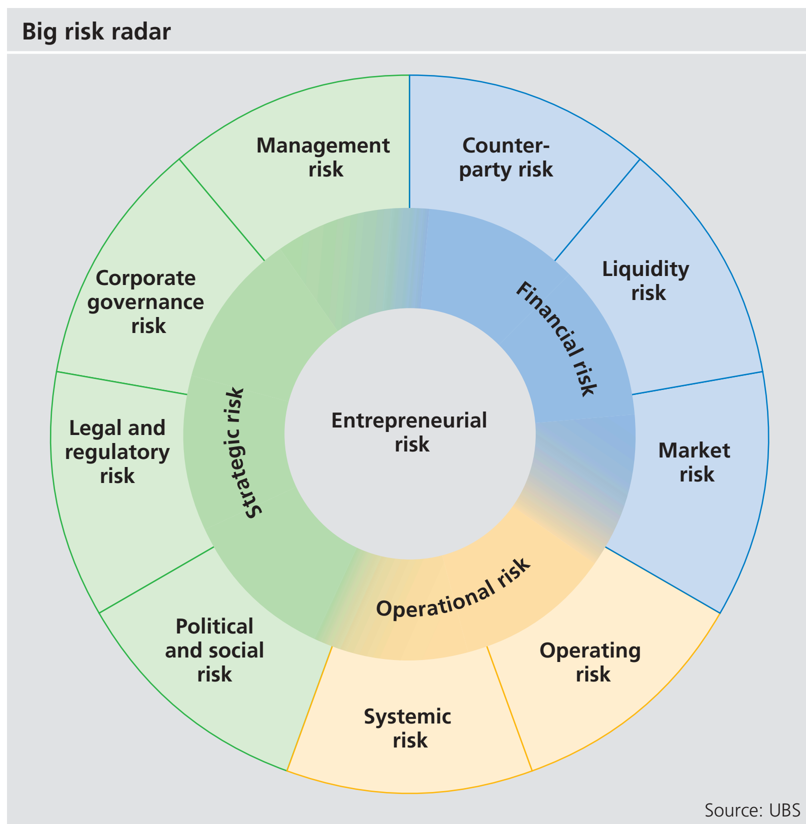
The aim of risk analysis is the qualitative assessment and quantitative

Industry anticipates the trend of the overall economy



Even if industry loses its significance in the overall economy in the course of structural change, it nevertheless retains its indicator effect for economic turning points. Reversals in the trend of new orders to the Swiss machinery, electrical engineering and metals sectors generally lead turnarounds in GDP by one to two quarters.

Sources: seco; Swissmem



Source: UBS

measurement of individual risks with a view to modelling their cause and effect relationship and the company's risk portfolio. Besides constructing scenarios in order to assess the range of possible outcomes, value-at-risk computations (VaR) and stress tests offer additional information parameters. Value-at-risk is the negative change in a variable measured in monetary units that will not be exceeded with a certain degree of probability within a fixed period of time. Stress tests assess the impact of worst case scenarios. Once the risk situation affecting a company and/or its activities has been recognized and modelled, the subsequent steering and control phase aims to optimize the opportunity risk profile. The latter process should take into account the company's business objectives and the objectives of risk management derived from these.

Four strategies can be used to manage the risks. In addition to completely avoiding risks – by cutting out transactions in foreign currencies for example – the prime focus is on reducing and transferring risk. By hedging interest-rate and exchange-rate risk, broadening the geographic diversification of the company's foreign markets or extending its activities in less cyclical segments, the risks which the business must carry itself can be reduced.

Are the warning lights flashing?

Risk management fulfils its purpose when a company is enabled to make the most of its opportunities to increase its enterprise value long-term while ensuring it achieves its business goals. By building a selective, efficient and cross-divisional information radar, companies have a solid tool for promoting rapid responses and risk-conscious behaviour throughout their organizations. Economic warning systems help companies recognize a downturn and its dangers as well as the more propitious forces of economic recovery in good time and make the most of the opportunities these present. ■

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Recognizing and overcoming company crises

Proactive analysis of possible disturbances in a company's development can be decisive for the company's success, especially in turbulent times. UBS is organizing an Outlook Workshop on this subject on 27–28 November 2003 in the Wolfsberg Executive Development Centre. A small group of entrepreneurs, company directors, CEOs, CFOs and technical experts will be discussing such issues as how corporate crises arise, what course they take and how they can be managed. Besides teaching participants the basic methods involved and providing them with the practical experience required, this workshop aims to highlight priorities, paths of action and executive guidelines for the operational management of corporate crises and strategic turnaround management.

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