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Let's Talk About The "R" Word

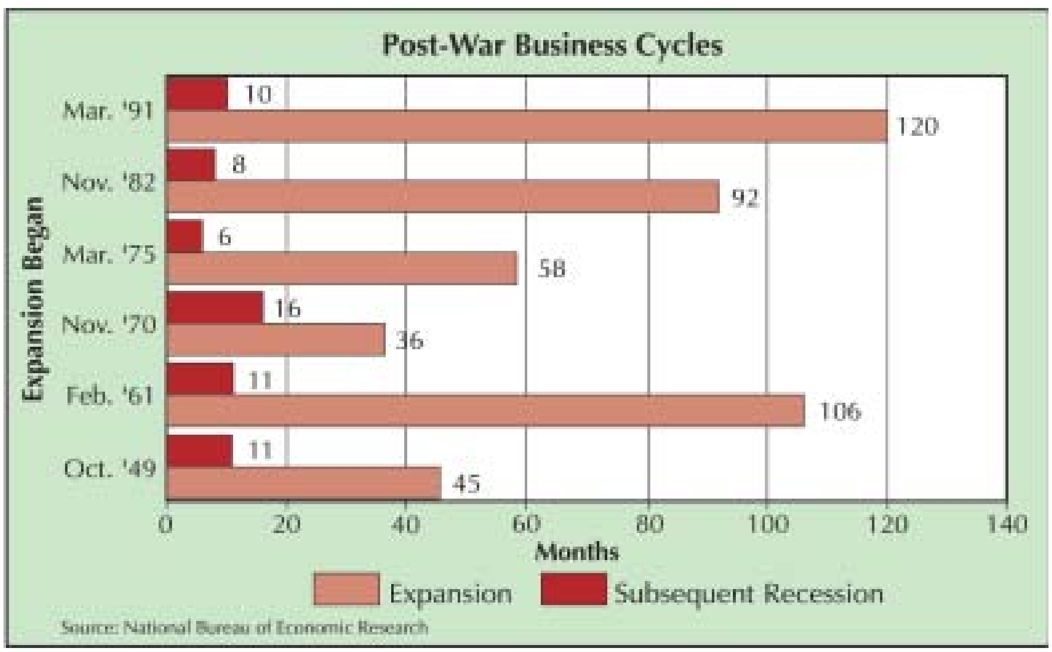
Harry Truman once said about economic cycles, "It's a recession when your neighbor loses his job; it's a depression when you lose yours."

By Mark G. Dotzour

After a historic ten-year economic expansion, the "R word" (recession) is being spoken in polite company. Listening to national media, one might get the idea that the recessionary economy could be "the end of life as we know it." Younger workers who graduated from college and entered the workforce after 1991 have never experienced a recession. Consequently, they have not experienced the trepidation of working in a slowing economy.

But exactly what is a recession? A recession is a fundamental part of the capitalist business cycle. Precisely defined, a recession occurs when the U.S. economy encounters two consecutive quarters of declining economic output — what crusty economists call Gross Domestic Product. The National Bureau of Economic Research is the official scorekeeper for the economy. They recently made the call that the current recession began in March 2001.

How long does a recession usually last? Since the end of World War II, there have been six recessions. The average recession during this period lasted 11 months. The shortest was six months (January through June 1980), and the longest lasted 16 months (November 1973 through March 1975).



Joseph Schumpeter, a noted economist, possessed keen insight into business cycles and the consequences of recessions and expansions. Born in Czechoslovakia in 1883, he studied in Vienna and taught at the University of Bonn. He left Germany in 1932 to take a position at Harvard where he remained until his death in 1950.

Schumpeter's wisdom remains pertinent today, particularly for those struggling to find the silver lining in a grim economic skyscape. This series of Schumpeter quotations helps keep today's news in proper context.

"The fundamental impulse that sets and keeps the capitalist engine in motion comes from the new consumers' goods, the new methods of production or transportation, the new markets, the new forms of industrial organization that capitalist enterprise creates."

The U.S. economy has just completed a decade of incredible innovation. Faster computers, wireless telephones, fiber-optic cable and the Internet have spawned a myriad of new business opportunities. New trade relationships with Mexico, China and other parts of the world have changed the map of American business.

"[Capitalism is] the perennial gale of creative destruction."

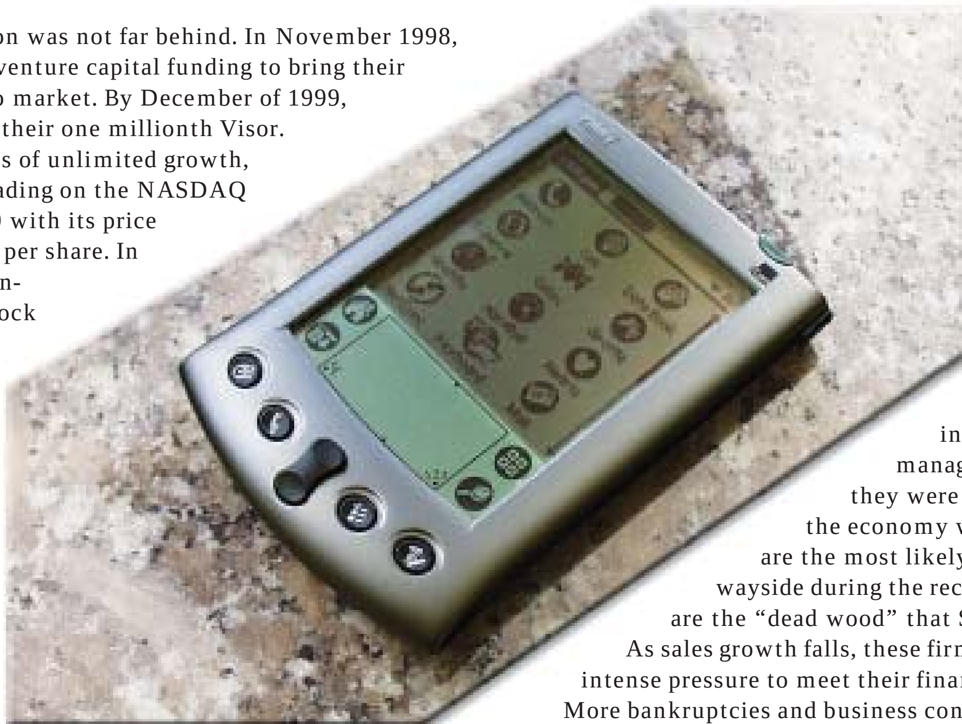
Business people throughout the world have some variation of this thought in the back of their minds every day. When they go to work, they are trying to win business away from their competitors and keep their competitors from taking business away from them.

". . . economic life is in a process of incessant internal change"

Nothing stays the same for long in the world economy. If a product or service hasn't kept up with customer expectations, the company producing it won't be in business much longer. And guess what? If a business comes up with a brilliant new product or service that everyone wants and is willing to pay for, it won't be long before it has hundreds of competitors offering similar products and services.

Palm Pilot is a good example. The Palm Pilot 1000 was introduced in March 1996. To American consumers, this was just the next step in the amazing technological revolution. They flocked to buy the new product. By May 1999, Palm, Inc., had achieved a 73 percent market share in the United States and 68 percent of the world market. The company looked like a true success story in the annals of American business innovation.

But the competition was not far behind. In November 1998, Handspring secured venture capital funding to bring their offering, the Visor, to market. By December of 1999, Handspring had sold their one millionth Visor.



Buoyed by hopes of unlimited growth, Palm began trading on the NASDAQ in March 2000 with its price quickly rising to $80 per share. In March, Handspring announced its initial stock offering. Its shares soon rose to over $80 per share as well. As competition increased, the prices for both the Palm Pilot and the Visor fell. So did the profitability of the firms.

Handspring lost money in every quarter of 2001 and is likely to repeat that performance in 2002. Its stock fell from just under $100 in October 2000 to $5.60 in January 2002. Palm, Inc., the innovator that brought the concept to market, has had a similar experience. After making a small profit in early 2001, the company lost money the rest of the year and is likely to continue losing money in 2002. Its stock has fallen from a high of $70 to $4.07 in 2002. These two companies are learning firsthand the lessons of competing in the perennial gale of creative destruction.

"Those revolutions are not strictly incessant; they occur in discrete rushes which are separated from each other by spans of comparative quiet. . . . Times of innovation . . . are times of effort and sacrifice, of work for the future, while the harvest comes after. . . . The harvest is gathered under recessive symptoms and with more anxiety than rejoicing. . . ."

During the past ten years, the U.S. economy has experienced a "discrete rush" of innovation and economic expansion riding the wave of technological advances. Americans have been reaping the benefits of incredible levels of innovation affecting many areas of our lives.

An impressive amount of money has been invested in many sectors of American business in the past decade. As a nation, we have bought a lot of houses, cars, computers and cell phones.

[During] recession . . . much dead wood disappears.

Three categories of businesses were in operation over the past ten years. The first tier was made up of the most innovative and best-managed firms. They did well during the expansion and will survive the slowdown, emerging bigger and stronger.

Second-tier businesses were less innovative, less well-managed or both. Most of these firms also will survive and be viable players in the next round of the economy.

Third-tier firms were those that did not innovate, were poorly managed or both. While they were able to survive when the economy was white hot, they are the most likely to fall by the wayside during the recession. These firms are the "dead wood" that Schumpeter refers to. As sales growth falls, these firms will be under intense pressure to meet their financial obligations.

More bankruptcies and business consolidations will occur this year. Tech firms, especially telecom businesses, are particularly at risk. Some of these firms have borrowed too much money and have substantial overcapacity for today's modest levels of demand.

However, keep this in mind. For every news story on a high-profile bankruptcy, there is a second, often untold, story of another firm buying those assets for pennies on the dollar. That firm will likely make money with those assets and may become a major employer.

"Most new firms are founded with an idea and for a definite purpose. The life goes out of them when that idea or purpose has been fulfilled or has become obsolete, or even if, without having become obsolete, it has ceased to be new. That is the fundamental reason why firms do not exist forever."

Schumpeter offers both a clear warning and encouragement for all businesses. To survive in the global capitalist world, all firms must continue to innovate, to serve their customers better and cheaper and save them time. Customers must believe that businesses are providing them with not just the cutting edge, but with the "bleeding edge" of service. Any business seen as "no longer new" is on its way to becoming dead wood in the marketplace.

The challenge of keeping business new can be both exhilarating and alarming. But successful businesspeople have been rising to the occasion for centuries.

The first goal in an economic slowdown is survival. The second goal is to gain market share from the competition. So strap on your armor, and march into the arena.

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