The Economist

MANAGING UNCERTAINTY

Strategies for surviving and thriving in turbulent times

Michel Syrett and
Marion Devine

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Preface

WHEN IN 2009 we first thought of writing a book on managing uncertainty, it was through intellectual curiosity about what our research would reveal.

A wealth of work on the topic had been published in the previous decade, but as much of it was written by academics, it was theoretical and not based on commercial good practice. Much of it was dated and nothing had been written since the global financial crisis that unleashed a new era of uncertainty for organisations to cope with.

Our initial instinct that the 2008 crisis was out of the ordinary proved correct. When it occurred, many senior executives assumed that it was another turn in the boom-and-bust cycle that had characterised macroeconomics in developed economies since the end of the second world war. They reacted accordingly, cutting costs and "hunkering down" for what they supposed would be a painful but short period of austerity.

However, the crisis has ushered in a period of unprecedented uncertainty, with the economic unknowns augmented by political and social unknowns arising from such developments as the Arab spring and the anti-capitalist and anti-austerity protests in a number of developed countries.

Uncertainty is here to stay. Not for nothing did a secretary-general of the United Nations recently comment that the first years of the 21st century may well prove "a decisive moment in the human story", requiring co-operation by politicians and business leaders across all boundaries to respond to the interconnected threats the world currently faces (see Chapter 1).

A book that examined the implications of managing uncertainty

in more practical terms seemed overdue when this book was first commissioned. By the time it was written the case was overwhelming.

We wanted to use the research to explore three questions. First, how do business people define uncertainty? – because precise definitions lead to concrete solutions. Second, is managing uncertainty becoming a defined management discipline like change or talent management? Third, what are the implications, not just for strategy determination (the focus of most of the early work on the topic) but for an organisation's overall development and culture?

The feedback gleaned from senior executives interviewed for the book suggests that, in their eyes, there is no precise definition of uncertainty and therefore no precise solution. Some see the task of managing uncertainty as no more than an extension of financial risk management, entailing the need for financial "buffers" brought about by greater liquidity.

Others saw the challenge in broader terms, entailing a more flexible approach to strategy formulation and shorter, more regular reviews of progress and change, using non-financial measures as well as more conventional fiduciary ones. There was no consensus on a distinct and coherent set of skills to help support the task.

The imperative stressed over and over again by the business people we talked to related to an organisation's "strategic readiness" for sudden and unexpected threats and opportunities – through a combination of strategic flexibility, strong navigational leadership, resilience, collaborative partnership, predictive learning and agility. This focus is reflected in the book's structure and conclusions.

Michel Syrett and Marion Devine
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1 Introduction: managing in an uncertain world

There are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns – the ones we don't know we don't know.

Donald Rumsfeld, US defence secretary, 2001–06

Historians may well look back on the first years of the 21st century as a decisive moment in the human story. The different societies that make up the human family are today interconnected as never before. They face threats that no nation can hope to master by acting alone – and opportunities that can be much more hopefully exploited if all nations work together.

Kofi Annan, UN secretary-general, 1997–2006

DONALD RUMSFELD GOT IT RIGHT. When he used the above analogy, he was speaking at a press briefing in 2002 about the absence of evidence linking the government of Iraq with the supply of weapons of mass destruction to terrorist groups. His words were criticised at the time as an abuse of language by, among others, the Plain English Campaign. However, Geoffrey Pullum, a linguist, disagreed, saying the comment was "completely straightforward" and "impeccable, syntactically, semantically, logically and rhetorically".

Whatever the rights and wrongs linguistically, the quotation provides a perfect starting point for this book.

We are now living in a world which combines known knowns, known unknowns and unknown unknowns, and the growth of the

last category presents business leaders with a new and little-charted management challenge.

At the heart of the traditional approach to strategy lies the assumption that by applying a set of powerful analytical tools, executives can predict the future of any business accurately enough to allow them to choose a clear strategic direction.

But what happens when the environment is so uncertain that no amount of analysis will allow us to predict the future? What makes for a good strategy in highly uncertain business environments? How can organisations prepare themselves for the challenge of anticipating and responding to unanticipated events? What individual and organisational capabilities are required?

The uncertain world order

The need to focus on the challenges of an uncertain world has never been more urgent. Much of the academic and consultancy work undertaken on managing uncertainty was conducted in the 1990s and the first few years of the 21st century and the resulting analysis was largely theoretical. Furthermore, it is now apparent that the research and analysis were carried out during a period when world economies were enjoying what proved to be an Indian summer of growth and stability.

This book will argue, among many things, that the financial crisis of 2008 has proved a watershed. What was originally thought by many organisations to be just another cycle in the boom-and-bust that characterised the post-war era has turned out to be the harbinger of an enduring period of financial instability. This has been accompanied and aggravated by political and social upheaval and environmental crises – all of which have profound implications for international business.

In-depth interviews with 40 senior executives supported by 50 responses to an online survey by the Ashridge Consulting Group in 2010[1] found that business leaders experienced an abrupt and dramatic change in their organisation's environment as a result of the economic downturn. Many of these executives believed this change was likely to persist long after the downturn's immediate effects.

All participants had sufficient experience to be able to recall previous economic downturns. However, they felt that the 2008 crisis was different because of the:

- speed and abruptness of change in their markets;
- depth and magnitude of decline in some markets (such as automotive, property, construction, shipping);
- inconsistency in and unpredictable nature of changes across different sectors;
- breakdown of trust in institutions, particularly financial ones, that had always been considered reliable;
- global nature of the recession such that all regions and most countries had been affected;
- interconnectedness of markets, geographies and institutions;
- lack of availability of credit and finance.

The report's authors commented:

> *[Business leaders] have been thrown into a world of uncertainty and ambiguity. Any sense of stability in the present or confidence in their ability to predict reliably the future has disappeared ... A wave of anxiety has been unleashed across organisations, markets and society. This reflects a "fear of not knowing".*

Ashridge is not alone in this conclusion. Ronald Heifetz, a management thinker, in an article published in *Harvard Business Review* in 2009, concluded:[2]

> *It would be profoundly reassuring to view the current economic crisis as simply another rough spell that we need to get through. Unfortunately, though, today's mix of urgency, high stakes, and uncertainty will continue as the norm even after the recession ends. Economies cannot erect a firewall against intensifying global competition, energy constraints, climate change, and political instability. The immediate crisis – which we will get through, with the help of policymakers' expert technical adjustments – merely sets the stage for a sustained or even permanent crisis of serious and unfamiliar challenges.*

How we ended up in this situation was also described vividly by Mark Thomas, a business strategy expert at PA, and author of *The Zombie Economy* in an interview conducted for this book:

> *I think perhaps we have all been spoiled. The truth is that in some ways, the last 20 years until the crisis were a relatively easy period for managing in. The cost of capital was coming down and down and it was, in theory, ever easier for companies to earn a return above the cost of capital and to generate shareholder value. It was therefore by and large a boom time in the stockmarket. We believed the NICE decade – non-inflationary, continuously expansionary growth – was going to go on forever. In that sense, it was a benign environment for quite a long time.*
>
> *But I think what is happening now is so big that even people who are very experienced are still taken aback by the scale of uncertainty. It is genuinely a difficult time to be managing, even if people have not been spoiled in the last decade. This is genuine uncertainty on a scale none of us have ever seen before. There are very few people out there with useful frames of reference.*

Speed and multiplication

It is worth pinpointing two facets of the turmoil that the world has endured since 2008.

The first is the sheer speed of events and the extent to which they multiply. What began as a bursting of the American housing-market bubble and a rise in foreclosures ballooned rapidly into a global financial and economic crisis. Some of the largest and most venerable banks, investment houses and insurance companies declared bankruptcy or had to be rescued financially. By October 2008 credit flows had frozen, lender confidence had dropped and one after another the economies of countries around the world dipped towards recession.

The second is the knock-on effect the original crisis had on world markets. The crisis exposed fundamental weaknesses in financial systems worldwide. Despite co-ordinated easing of monetary policy by governments, trillions of dollars in intervention by central banks and governments, and large fiscal stimulus packages, the crisis failed to abate.

What began in industrialised countries quickly spread to emerging markets and developing economies. As an American Congressional Report published in October 2009 commented:[3]

> *The global crisis now seems to be played out on two levels. The first is among the industrialised nations of the world where most of the losses from subprime mortgage debt, excessive leveraging of investments, and inadequate capital backing credit default swaps (insurance against defaults and bankruptcy) have occurred.*
>
> *The second level of the crisis is among emerging-market and other economies who may be "innocent bystanders" to the crisis but who also may have less resilient economic systems that can often be whipsawed by actions in global markets.*
>
> *Most industrialised countries (except for Iceland) have been able to finance their own rescue packages by borrowing domestically and in capital markets, but many emerging-market and developing economies have insufficient sources of capital and have turned to help from the International Monetary Fund (IMF), World Bank, or from capital surplus nations, such as Japan, and the European Union.*

Yet the very measures taken by industrialised companies to protect themselves from the effects of the crisis precipitated even bigger problems. Excessive borrowing by governments to finance rescue packages, particularly in the euro zone, led quickly to unmanageable debt. This was aggravated by a lowering of credit ratings by financial institutions and a consequential increase in interest rates.

Convergence and interconnectivity

The steady stream of global upheavals that followed in the wake of the 2008 economic crisis illustrate how events that were previously thought to be unconnected are converging – a fact stressed time and again by executives and others interviewed for this book. (See Appendix for a list of executives' names and job descriptions.)

Eric Beinhocker, a senior fellow at the McKinsey Global Institute, and author of *The Origin of Wealth*, highlighted how the world has

always seemed uncertain but that technology has changed perceptions and emotional reactions to uncertainty:

> *If you read history, you have to feel that everybody thought their world was pretty unstable. If you were sitting here in the 1930s, the world would look like a pretty uncertain place and in fact, they would have been right. Each era has its own big issues and effects. What has changed, because of technology, is our ability to understand what is going on around the world and the way this influences our own decisions and actions.*
>
> *Previously in history, your own patch of the world might have felt okay and you would have been blissfully unaware of the great traumas going on in another patch of the world. Sitting here today, London is pretty calm but all sorts of things are happening in the Middle East which are on the news on a 24/7 basis. So our perception and feeling about uncertainty is certainly different.*

World events like the Arab spring of 2011 and the contemporaneous earthquake in Japan that devastated its eastern coast illustrate how interconnected the world has become – and consequently much more uncertain.

As Lewis Booth, executive vice-president and chief financial officer of Ford Motor Company, commented when asked whether we are living in a more uncertain world than in the past:

> *Interdependence has without doubt brought in much more uncertainty. As an example, think of the issues you see arising out of the earthquake in Japan, which is affecting very small suppliers that supply global manufacturers, with the impact rippling around the world affecting any number of large manufacturers. Think also about the consequences of the Arab spring and the impact that this is likely to have not only on the supply and price of oil but on migration and the composition of Middle Eastern markets. The sheer scale of events piling one on top of the other is making business keener to anticipate and respond effectively to the unexpected.*

Dick Nanto, a specialist in industry and trade for the American Congress, explained the consequences in 2009, anticipating both

the Arab spring and riots and protests in Europe and the United States:[4]

> *Financial crises impact on political leadership and regimes within countries through two major mechanisms. The first is the discontent from citizens who are losing jobs, seeing businesses go bankrupt, losing wealth both in financial and real assets, and facing declining prices for their products.*
>
> *In democracies, this discontent often results in public opposition to the existing establishment or ruling regime. In some cases it can foment extremist movements, particularly in poorer countries where large numbers of unemployed young people may become susceptible to religious radicalism that demonises Western industrialised society and encourages terrorist activity.*

Looking ahead

Is this period of intense disruption temporary, or will the state of uncertainty of the past half decade persist? A report by Foresight, part of the UK Government Office for Science (see Chapter 2), pinpointed 11 "dimensions of uncertainty", which will determine the political and economic environment in which businesses will operate in the period leading up to 2050.[5]

An important question, for example, is whether increased globalisation will cause countries to veer towards nationalism to protect their power or towards more federal and economic blocs via bilateral and multilateral agreements. Will global economic shocks help create a global model that is laissez-faire or highly regulated? Will future international and civil wars be fought state versus state, state versus non-state, or non-state versus non-state? Who will own and have the right to benefit from scientific and technology-based innovation? Will new communications technologies lead to the emergence of borderless or virtual communities? Will future or continued economic development be contingent upon sustainable development?

The main aim of the report is to show how these dimensions of uncertainty affect each other. For example, the supply of well-educated and trained labour on which business relies is related

directly to the interaction between advances in science, technology and innovation (which determine the skills required by industry), the domestic government's education and skills policy (which determines the internal supply of skilled labour) and migration trends and policy (which determine the external supply).

TABLE 1.1 **Dimensions of uncertainty**

1	Balance of power and governance architecture
2	Economic integration, governance and models
3	Security and conflict
4	Science, technology and innovation
5	Education and skills
6	Communities and communities
7	Demographics and migration
8	Health and well-being
9	Climate change
10	Natural resources
11	Values and beliefs

Source: UK Government Office for Science, 2009

If, during a period of rapid technological advance, a government simultaneously cuts back on education and professional training funding and restricts immigration, for economic reasons, there are likely to be shortages of skilled labour in key industries. In a completely different sphere, better-educated individuals are generally more aware of the relationship between lifestyle, diet and health leading to greater consumer demand for products and services supplied by industries that are shaped by or connected to health and well-being.

The report's authors conclude:

> *Today's problems can be so immediate and all-pervasive that they can act as blinkers which result in a myopic focus on the present, to the exclusion of a more strategic vision of the future. Given that some elements of the future will be profoundly different from*