strategy+business

ONLINE JUNE 11, 2013

China: The Mother of All Black Swans

Low-probability, high-impact events can be catastrophic for companies doing business in the Chinese market.

BY JOHN JULLENS

pwc | strategy&
Formerly Booz & Company

China: The Mother of All Black Swans

Low-probability, high-impact events can be catastrophic for companies doing business in the Chinese market.

by John Jullens

China pundits tend to come in two flavors: true converts and apocalyptic non-believers. On the one hand, the converts generally view China's reemergence as an economic and geopolitical superpower as more or less inevitable and with a sense of awe—and sometimes more than a little fear, as well. History is replete with examples of one country's dreams becoming another's nightmares. The non-believers, on the other hand, usually believe that China's so-called economic miracle is nothing more than a Beijing-led Ponzi scheme that will soon collapse in spectacular fashion under the combined weight of lower export volumes, a major banking crisis, and the bursting of a massive property bubble.

In truth, a financial meltdown remains highly unlikely, as China's central government still has plenty of cash reserves and maintains considerable control over various macroeconomic policy instruments. Politically, too, Beijing has over the last 20 years become adept at containing local unrest and preventing potential spillovers at the national level. At the same time, however, China remains quite vulnerable to an unusually large number of economic, political, and natural high-risk events, including a domestic financial crisis, as well as potential international trade, currency, and military conflicts, a full-blown avian flu pandemic, and, of course, social unrest on par with the Arab Spring. The impact of any of these events could be disastrous, not just for China, but for the rest of the world.

A Chinese financial crisis would not only trigger a domestic economic crash, but also deliver yet another shock to the U.S., Japanese, and European economies—which already face a potentially prolonged period of stagnation. Moreover, such a crisis could destroy social and political stability, increase lingering nationalism and xenophobic sentiments among the Chinese populace, and lead to military conflicts with, for example, Taiwan and Japan. A true doomsday scenario would leave a devastated China unable to prop up North Korea, resulting in a chain reaction of uncontrollable events that would eventually lead to a catastrophic war on the Korean peninsula.

In other words, a Chinese financial crisis is precisely one of the low-probability, high-impact events that Nassim Nicholas Taleb so memorably described as "black swans" in his best-selling 2008 book. In fact, China could very well be the mother of all black swans, due to its exceptionally large size and increasing interconnectivity with other parts of the world. China is also vulnerable to numerous "ugly ducklings," such as labor unrest and earthquakes, that may not have quite the same global systemic impact of their larger avian cousins—but which could still have a significant impact on individual companies. It's no wonder Taleb himself

John Jullens
john.jullens@booz.com
is a partner with Booz & Company based in Shanghai. He co-leads the firm's engineered products and services practice in Greater China. Connect with John at www.johnjullens.com.

has admitted to feeling "a little nervous about China."

Unfortunately, few corporate enterprise risk management (ERM) departments have the resources or local understanding to contain a true black swan event in China. Most Chinese firms simply haven't yet developed the sophisticated risk management capabilities that would be required. Yet even the advanced ERM systems of foreign multinationals are typically inadequate, as black swans are inherently too complicated and their potential repercussions far too great to be effectively managed through standard crisis management plans and public relations activities. In addition, mitigating black swan events inevitably requires investing in redundancy, which may be difficult to justify while simultaneously trying to deliver quarterly financial results. But by underinvesting, executives could be effectively "betting the company" against events that statistically seem improbable, yet actually occur surprisingly often. To protect themselves, companies need to supplement their everyday ERM activities with a three-step process.

1. Map the extended enterprise. Companies should start by mapping their geographic footprint and operations in China, including supply chains, channel partners, and customers, as well as sources of revenues, profits, and capital—including those tied up in their go-to-market activities. Given the multilayered nature of the Chinese market, it is important to map not only first-order, but also second-order and even third-order supplier relationships to fully understand and quantify the impact of a potential disruption, such as lost sales, inventory holding costs, and reputational damage.

2. Create a disrupter list and run "what if" scenarios. Companies should create a comprehensive list of potential black swan events that could result in demand shocks or supply chain interruptions. It is important to initially catalog all events that could have a catastrophic impact before developing a more practical short list that nonetheless still captures the various black swan events that could disrupt the company's future operations. Simulations and business games can help determine the relative impact of each potential black swan event as well as educate and train key executives.

3. Develop contingency plans. The various scenarios must then be translated into detailed contingency plans for each black swan and prioritized based on their risk exposure, ease of implementation, and cost. Each plan should include the structural changes required to make the organization more resilient (for example, redundancy investments in additional suppliers and higher inventory buffers) as well as emergency plans for managing residual risk (for example, alternative transportation in case of marine, rail, or airport shutdowns). Special consideration must be given to ensuring each plan can actually be implemented within China's unique institutional environment, given the general lack of transparency, communications restrictions, poor and fragmented emergency response capabilities, and reluctance to accept bad news, especially at the local level. The latter has led to several scandals in recent years, such as the attempted cover-ups and misinformation released in the aftermath of the 2011 Wenzhou high-speed train collision.

Finally, remember that protecting your business in China from black swans is an ongoing effort. Of course, companies can never completely inoculate themselves. But they can, and should, carefully assess and evaluate the risks and consequences of such events, so they can better prepare themselves for the (nearly) impossible. +

strategy+business magazine
is published by PwC Strategy& Inc.
To subscribe, visit strategy-business.com
or call 1-855-869-4862.

For more information about Strategy&,
visit www.strategyand.pwc.com

- strategy-business.com
- facebook.com/strategybusiness
- http://twitter.com/stratandbiz

101 Park Ave., 18th Floor, New York, NY 10178

pwc | strategy&
Formerly Booz & Company