

Scenarios for the Downturn & Rebound

How to spot the early signs of *Capitalism 2.0, Global Depression, Visible Hand, or Obama World*

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When facing profound uncertainties of the kind now paralyzing the global economic system, managers can adopt one of three strategic postures. The first is the ‘zero-future’ option, where no one tries to systematically anticipate or predict anything, and people just wait until the fog lifts. As unwise as this might sound, this is what many organizations and leaders are doing implicitly. Although the future is addressed in daily discussions, there is no disciplined attempt to analyze the unfolding dynamics, gain a deeper understanding of the underlying forces or creatively imagine where it all may lead. The present is so pressing that thinking about the future is viewed as an unaffordable luxury or an impossible task.

The second posture is to bet strongly on one particular future. The positive side is that leaders provide clarity, reduce anxiety in the organization, and take bold action that may later be viewed as brilliant. The danger is that they place the wrong bets, cut muscle instead of fat, or fall victim to wishful thinking. Such well-known biases as *selective perception* (if something doesn’t fit, we make it fit our mental model), *rationalization* (interpreting evidence in a way that sustains a desired belief) and *confirmatory thinking* (look for evidence that confirms our perspective) are the downsides of this ‘one-future’ approach.¹ In short, the danger is that of ‘tunnel vision’ and betting wrong in a big way (as with the dotcom and telecom bubbles).

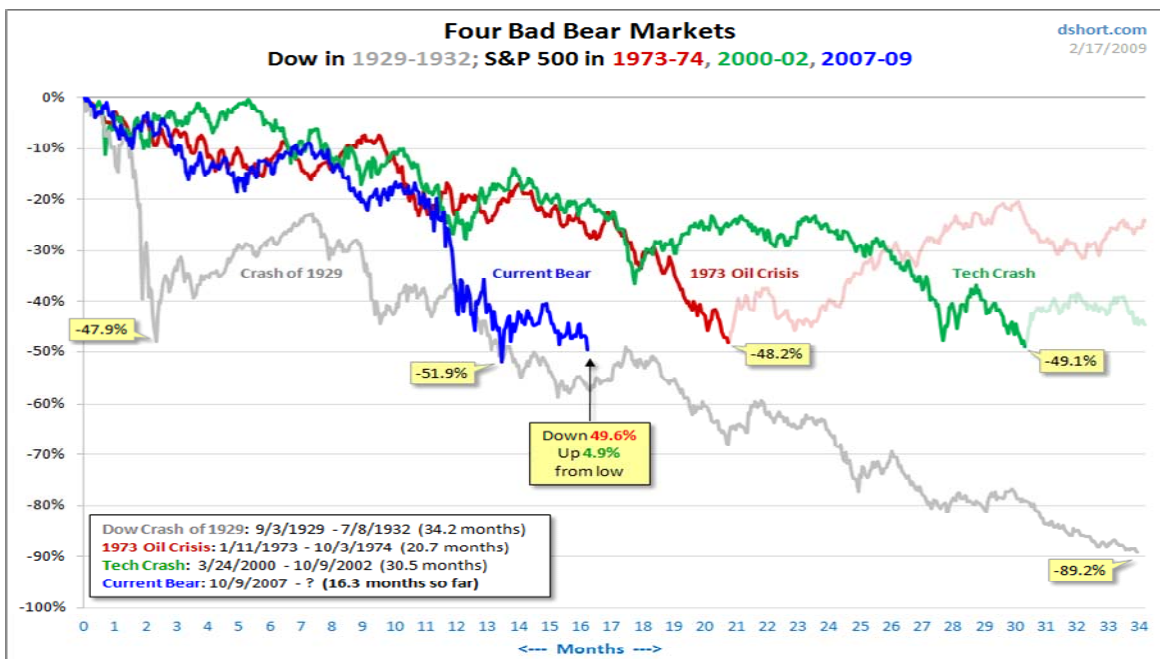
The third posture entails a deliberate attempt to separate what we do and do not know about the future. As economist and Nobel Laureate Paul A. Samuelson noted “What we know about the global financial crisis is that we don't know very much.” It takes courage to admit our collective ignorance since it conflict with our common notion of leadership which prizes omniscience. However, our world is too complex for heroic leadership of the past, where a great leader rides up on a white horse and points the way to the future. A better approach is to embrace uncertainty and examine it in detail where hidden opportunities lurk.² The sentiment was well expressed by Nathan Rothschild who observed that “great fortunes are made when the cannon balls fall in the harbor, not when the violins play on the ball room.”

Pivotal Uncertainties

One way to embrace uncertainty is to create and explore different stories about the future. We offer four below that are applicable to western economies as they emerge from the global crisis

that became very visible in 2008. Our scenarios look three years ahead, to the year 2012, and describe diverse futures that will largely shape the next decade. These scenarios are built around two pivotal uncertainties.

The first concerns the depth and nature of the economic downturn. It is no longer debated that we are in a deep down-turn. What remains uncertain is whether it will follow conventional recession dynamics or whether this crisis is of a different kind, entailing profound systemic dislocation from which it cannot lift itself. A systemic global crisis, of the L rather than U-shaped variety, will occasion fundamental shifts in values and behavior among economic actors and regulators, just as the Great Depression did. Using historical benchmarks, the down-turn could last anywhere from 2 to 10 years. The Great Depression of 1929, the Oil Crisis of 1973 and the Tech Crash of 2000 entailed bear markets that lasted between 20 and 35 months.³ Assuming the current bear market started in October 2007, we are now 20 months into the economic crisis. Once stock markets improve, as leading indicators of economic performance, the real economy's recovery tends to occur 6 to 12 months later.



So, an optimistic view about the current crisis assumes a downturn of 18 to 24 months, with the first signs of sustained economic recovery becoming visible toward the end of 2010. But there

are far more pessimistic views as well, including a prolonged downward spiral lasting well into 2012. Japan's lost decade is often cited as a recent example of this less rosy view, as well as of course the Great Depression.

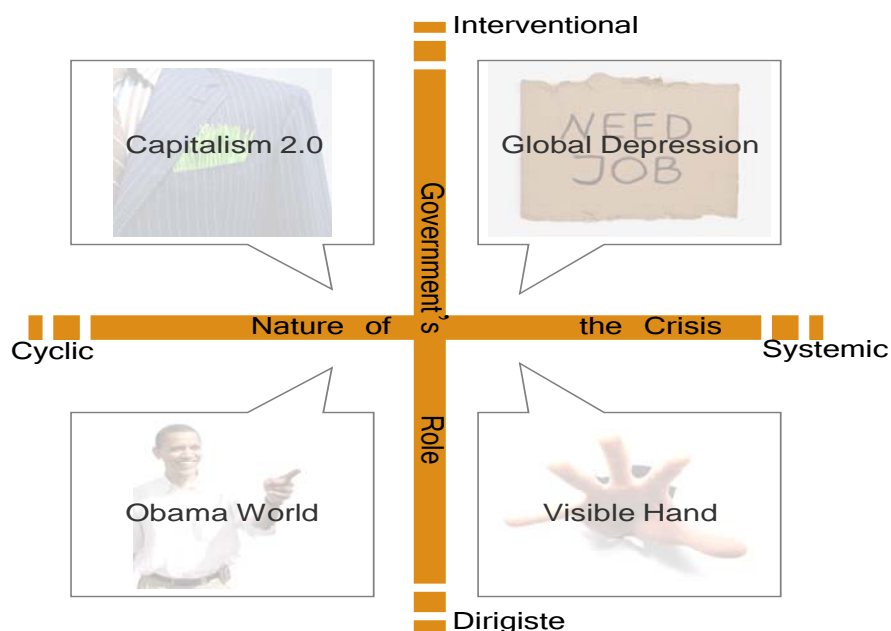
The second pivotal uncertainty concerns the role of government versus the free market in lifting us out of the current malaise.⁴ In most western economies, the market is the driving force behind recovery. The role of government is to facilitate and regulate the market, although in some countries a more dirigiste (conductor) style of government is found, such as France and Japan. But the current crisis has sown doubts in many quarters, especially in Europe, about the market's ability to self-regulate and rebound. Proponents of the free market are perplexed about how events unfolded. Capitalist champions like former Federal Reserve Chairman Alan Greenspan are supporting a temporary nationalization of banks.⁵

This crisis was not supposed to happen. It does not fit the risk models of Wall Street, the rational efficient market theories of the University of Chicago, or the mental models of the stock market which was slow to see it coming.⁶ In hindsight, people point to many causes: misaligned incentives, deregulation, easy money, lax regulatory oversight, moral hazards with Fannie Mae and Freddie Mack, underestimation of systemic risk, consumer overconfidence about rising real estate prices, unscrupulous sales tactics, complex secondary markets, mistakes by rating agencies, and a global collapse in confidence. The deeper question is to what role governments will play in stimulating and managing the economy? Will they view their role more as catalysts and enablers, after temporary massive interventions to save the system from collapsing into a deadly downward spiral? Or do they favor more of a dirigiste role, whereby they impose a master blueprint, pull many strings, force solutions onto to private sector, and operate from more authoritarian or central planning viewpoint? Although the answers will differ by country, our concern here is with the overall global impact of shifts in the role of governments around the world.

Four Scenarios

These two dimensions in combination suggest four very different scenarios. The first scenario assumes a deep but conventional economic recession which rebounds largely on its own, with governments playing a supportive role. We call this **Capitalism 2.0** since the market collects

itself after the sharp downfall, learns valuable lessons, and shows remarkable adaptability and resilience. The second scenario is a combination of a prolonged downturn, with governments initially taking an enabling posture to support the market as driving force behind recovery. However, the crisis is too deep for self-correction and governments proved too timid in their stimulus policies, resulting in a continued downward spiral. We call this bleaker scenario **Global Depression**, since the free market as well governments are impotent in accelerating the recovery process.



The third combination is a long lasting downturn with a strong, directive role government which in turns shapes the contours of the economy for many years. We call this scenario **The Visible Hand** in contrast to the failed invisible hand of free market economics. The last combination is a deep but relatively short crisis, with the government as main driver of recovery, called **Obama World**. We see here a new form of leadership, build on trust, inspiration and renewal, where governments - in partnership with industry, labor and other key stakeholders - lift us out of the current global malaise.

We describe each scenario in greater detail below, with some signposts of what to look out for to see each future emerge. These scenarios are intended as starting points for a strategic discussion, not as specific predictions of what will happen. The actual future may be a hybrid of these archetypes. Each scenario is deliberately pushed to its extreme in order to clearly bring out its underlying assumptions and early warning signals. However, they can emerge in parallel in different parts of the developed world, and even unfold in sequence within a single country.

SCENARIO A: Capitalism 2.0

Fast-forward to 2012...

- Redefinition of capitalism: free market thinking still reins, but in a reconceived form
- Academic theories are revised to include behavioral economics, with bubbles and panics
- Gradual retreat of the government from industry, after the crisis has mostly subsided
- More international cooperation in dealing with systemic risk; circuit breakers installed
- Tighter regulations and new watchdogs try to improve corporate governance and reporting
- Emerging economies which played a key role in the global rebound now sit at the table
- New signs of serious food, water and energy crises emerge as economic growth resumes

How we got there...

During the period of 2009 to 2011, the economic downturn has hit hard and wide, forcing many to ponder if unbridled global capitalism can remain the *Leitmotiv* for business and society.

Thanks to swift and massive government support, the unprecedented downturn has been slowed just enough to give businesses, and especially the financial sector, time to regroup. In spite of massive lay-offs, businesses regain a modicum of social trust and slowly work their way through the downturn.

Towards 2012, a new form of capitalism has emerged, in which liberalism and the free market are still key drivers, but under the watchful eye of government. Fortified by their major role in the recovery process, governments enhance their traditional watchdog roles. This is broadly accepted in society, as government is expected to assure a stable, honest and ethical functioning of the market place.

“the efficient market hypothesis has been disproved. A new system must be put in place before the crisis can be solved and for the global economy to move out of recession” – George Soros at the World Economic Forum, 2009.

Unfettered capitalism at high noon has lost its appeal as people smart for many years from the deep wounds inflicted by the melt-down. Business, and especially the financial sector, have lost public confidence in terms of competence and integrity. A new social contract is emerging.

Government wisely accepts that its strong interventions must be temporary emergency measures, aimed at restoring confidence and creating a new economic order. As the crisis years evolve to-

“The second half of 2009 may see a period of anemic growth. In fact, a return to robust growth may not occur until well into 2010, even if the long climb starts a few months from now.” – Ken Goldstein, The Conference Board, 19 February 2009

ward normalcy, government relaxes its heavy hand and rekindles the flames of capitalism, while keeping a close eye on animal spirits gone wild. Several governments are announcing IPOs for the banks they acquired, in the hope of stimulating innovation and competition through market forces. Governments also realize, however, that many looming problems, from healthcare and pension burdens to global poverty and global warming, require a strong role for government to avert a greater tragedy of the commons. Many large public companies, especially those who received financial support, heed their hard won lessons. They embrace a broader stakeholder model, reduce misaligned incentives, empower their boards, and try to reward ethical behavior. Large companies become more susceptible to addressing, collectively with other stakeholders, such pressing issues as sustainability, social responsibility, and clean energy. They seek to regain trust by becoming responsible citizens again.

Early Warning Signals

- Announcements of IPO for government-owned institutions, especially banks
- Oil price surpass the US\$100 per barrel barrier; China resumes high growth
- Indian and Chinese join the G-10, with more influence in the IMF and UN
- Business schools revamp their curriculum: fewer orthodoxies – new lessons⁷
- Housing prices start to climb again; stock markets back to 2007 levels
- Investment in clean energy and green technologies picks up after a lull

Scenario B: Global Depression

Fast-forward to 2012...

- Impotent governments and shell-shocked businesses are caught in a slow downward spiral
- Governments try hard to stimulate business growth through deregulation and tax incentives
- Social turmoil due to unemployment, pervasive pessimism and decreased welfare support
- The EU is ensnarled in deep political disputes and protectionism; some members step out
- Asia loses its growth momentum, and is too weak to reboot global commerce alone
- What started as a deep western recession has broadened into a genuine Global Depression

How we got there...

Although originally dismissed as alarmist, the dooms day scenarios foretold in early 2009 proved more accurate than those predicting rapid recovery. In 2012, stock markets are still struggling to regain territory ceded during crisis, which has now entered its 4th year. The breadth and depth of the downward spiral have been so rapid and unprecedented, that nothing seemed to be able to reboot the fly wheels of the global economy. Economists lack models for what they describe as a singularity, akin to a space-time warp in physics where normal laws no longer seem to apply. We are in an economic dead zone, like a sail ship lost at sea without wind, and leaders prepare to face the abyss. Contrary to expectation, China and India – representing the factory and office of the world – cannot decouple from the rest of the world and succumb to recession as well. The USA remains burdened with deep looming crises in healthcare, pensions, education, and global warming which together continue to weigh down the economy.

“The Asia crisis was a dress rehearsal for what we are going through today. The crisis in Japan was an omen” – Paul Krugman.

The massive government interventions in the early crisis years of 2008 and 2009 slowed the melt down a little but it proved insufficient. To paraphrase Senator Dirksen, a trillion here and trillion

“In many countries the banks may be too big to fail but also too big to save, as the fiscal/financial resources of the sovereign may not be large enough to rescue such large insolvencies in the financial system” – Nouriel Roubini, Financial Times 9 Februarv 2009.

there, and pretty soon you are talking real money. Unfortunately, these trillions proved little more than buckets of water tossed onto a fire out of control. The exploding budget deficits and rise of inflation made governments rethink their Keynesian policies. Public injections of capital into individual companies stopped and government is asking business to spark the re-

bound. Cutting bureaucracy and lifting barriers that stand in the way of conducting business has become the new government mantra, but immediate results are elusive. In addition, geopolitical

conflicts have worsened: Iran has merged with major regions of southern Iraq to unite the Shiites; Israel has bombed nuclear facilities in Iran in response, which further derailed peace talks; Pakistan and Afghanistan remain a deep quagmire for the US; N. Korea's continued decline into starvation led to a failed coup with further isolation and heightened military tensions.

In 2012, business has not sufficiently recovered and lacks the financial muscle to rise to the occasion. Global turmoil makes investment in global markets risky business, and few companies dare to expand their global footprint. On the domestic front, the Conference Board continues to report consumer confidence well below 75, reflecting a pervasive lack of trust among consumers.

⁸ Society is a prisoner of the status quo and in the grip of wide scale inertia. Parallels are drawn with the lost decade of Japan, where deflation diminished the economy. This time, however, it moves from deflation to prolonged stagflation since the printing presses have spewed out money as though there were no tomorrow. The impact of our collective failure to reboot the economy is profound: people are fearful, savings have dwindled, unemployment is sky high, the housing market remains flat, and social safety nets are lacking in many layers of society. Jimmy Carter's misery index is resuscitated and sets new records, a macabre reminder of how bad things really are.⁹ President Obama is not reelected.

In Europe, the very foundation of the EU is severely tested. Individual member states myopically challenge, and even sabotage interventions, that could have an overall positive effect for the EU. There is little appetite in old Europe to bail out its latest members, and even within the old guard there is limited capacity to bail out Portugal and Spain, let alone Romania and Estonia. Trust and leadership are lacking in the EU; where are the modern day equivalents of Konrad Adenauer, Charles de Gaulle, and Margaret Thatcher to offer pan-European guidance? The weight of the economic crises shifts attention mostly to more pressing national concerns. The depressed economy, and the alarming social unrest it spawns, prompts countries like Greece and Italy to step out of the EU. In addition, weak countries from Portugal to Romania set aside lofty dreams of a unified Europe as they fight for economic and political survival. The growing healthcare and pension burdens in Europe, due to unrealistic past promises and a weak economy, require draco-

nian measures. Reduced access to healthcare and postponed retirement fuel social discontent and undermine pan-European harmony.

Emerging markets, especially China and India, are the first to show some signs of resurgence as they are less encumbered with entitled programs and other locked-in budget components. Their economies have continued to grow through most of the crisis years, but at much lower rates than before 2007. Thanks to their momentum, the fly wheel of the global economy has not completely come to a halt but more time and energy are needed to turn these first signs of recovery into a new dawn. Although the Great Depression still ranks as the worst of economic times, the present Global Depression is a close runner up, and much too close for comfort.

Early Warning Signals

- Unemployment grows to 12% in the euro-zone (vs 7.8% in 2009) and over 10% in USA
- Downgrade of the triple A rating of the US Government bonds; no more safe haven
- International component of global GNP declines; protectionism is on the rise
- Chinese and Indian currencies gain strength, at the expense of the US dollar and Euro
- Gold prices peak as investors fear excess money supply, after a period of deflation
- Governments' attempt to fight inflation push interest rates high and suppress investment

Scenario C: The Visible Hand

Fast-forward to 2012...

- Public disapproval of capitalistic excess, notably private planes and large carbon footprints
- Increased levels of protectionism, at national, state as well as regional levels across the world
- A new form of capitalism that incorporates modern socialism without its ideological baggage
- Willingness to sacrifice economic growth for stability and greater social justice¹⁰
- A strong community-orientated form of identity, in which the greater good takes precedence
- A new social contract that blends Big Brother with economic freedom in a way that works

How we got there...

The pervasive damage of the economic crisis has poisoned people's appetite for unbridled capitalism. The population longs for a visible hand to guide the mysterious, and at times frightening, movements of Adam Smith's invisible hand. Encouraged by this yearning for paternalism, governments strive towards capitalism with a human face, in which fairness and security are paramount. Increasingly, society expects personal and social responsibility from all. Government's role is to provide stability as well as a fair distribution of wealth, while at the same time encouraging entrepreneurship within moral and ethical boundaries set by the state.

"Policymakers should take pre-emptive action rather than assuming that the system is capable of self-regulating itself. Our default position should be one of cautious scepticism."

Sir John Gieve, deputy governor of the Bank of England, 20 February 2009

Stability and sustainability are the main themes toward which society as a whole gravitates. In business, corporate values such as growth, performance and innovation take a back seat to cohesion, endurance and solidarity. It has dawned on many that there are no 'quick fixes' for the economic downturn, and that a fundamental change in perspective, expectations and values is called for. With energy and food crises looming on the horizon, various countries are looking for insights at the "Singapore model", in which the government is strongly involved in the design, oversight and management of the economy. Large infrastructural projects are launched to prop up the economy, dampen unemployment and reassure citizens that their government is providing proactive leadership in the face of monumental challenges.

The rocky road toward globalization has taken a serious blow. The highways of the Global Village are under major repair, with lower export volumes due to protectionist policies and inward orientations. Import tariffs proved effective for many countries in slowing international trade, so as to protect local jobs and steer consumers toward locally manufactured goods. These globalization setbacks greatly affect the growth of emerging economies, especially China where thousands of small factories feeding the global supply chain went out of business. Other Asian growth engines, like India and South Korea, are also affected and likewise refocus on internal and regional markets. Shedding their images as low cost producers and off-shore suppliers for developed nations,

"We want to stop moving factories abroad, and perhaps we will bring them back. If we are to give financial assistance to the auto industry, we don't want to see another factory being moved to the Czech Republic."

Nicolas Sarkozy February 2009.

the self image and confidence of the Asian region improves. ASEAN starts to resemble the EU of the late 1980s, with rumors that several member countries are entering talks about a single Asian currency.

The days of ostentatious individualism are fading. The *me generation* is transitioning toward an *us generation*, with a corresponding shift toward collectivism. The cult of personality is giving way to active participation in community-based activities via schools, sports clubs, churches and other local venues. Protecting the environment, social justice, ethical behavior and fair distribution of wealth is no longer viewed as starry-eyed idealism, but a pragmatic imperative of the new world. Similar to how smoking moved from mainstream to outcast, so is anti-societal behavior now. Luxury brands like Mercedes, Gucci and Rolex are suffering, as their signals of freedom, success and individualism clashes with mainstream values. The age of consumption, with its frantic desire to keep up with everything the Jones have, is on its final leg. Minimalism, which used to be a niche phenomenon, is a growing trend. Flaunting wealth and affluence is rapidly losing its popular appeal, forcing economists to rethink models in which wealth maximization, consumption and debt are the cornerstones of the market place.

In the mean time, the economy is only gradually recovering from its downturn. The significant decrease of personal wealth is somewhat eased by the changed societal values. Also, Milton Friedman's relative income hypothesis carries the day, as shared misery is experienced by most as less misery.

Early Warning Signals

- Stock value declines for companies offering luxury-oriented brands
- Export levels remain far below the levels reached in 2007
- Church attendance up, with increased community participation
- Increasing interest in non-profit careers and government jobs
- Further regulation of the economy, guided by industrial policies
- Increased public spending on welfare program and universal healthcare

Scenario D: Obama World

Fast-forward to 2012...

- Public trust is regained thanks to sound and bold governmental actions; GM rebounds
- Increased government regulation of free markets and tighter oversight of companies
- New styles of leadership, with higher moral standards and values;
- Positive, blossoming image of government, attracting the best and brightest
- Obama expects landslide victory and prepares for his second term in office

How we got there...

The electrifying election of Obama as President of the USA had a desired effect on the poor economy. Notwithstanding the intensity and depth of the downturn, Obama's audacious message of hope, integrity and compassion significantly contributed to the economic recovery that started to take place early in 2010. Obama's version of Keynesian economics ended up being a peculiar brew of ideology, compromise and pragmatism. But since it seemed to work, other governments concocted their own elixirs, resulting in a global tipping point toward economic recovery.

"I don't care whether you're driving a hybrid or an SUV. If you're headed for a cliff, you have to change direction. That's what the American people called for in November, and that's what we intend to deliver." – **Barack Obama**, February 2009.

In Western countries, the recovery came at a hefty price for business, with more government oversight of companies and greater influence in the free market. The negative consequence of

"What I'm arguing for looks more like the Canadian system than the American system" **Paul Volcker**, former US Federal Reserve chairman, advisor to president Obama, February 2009.

free market liberalism that surfaced at the start of the downturn provided ample political justification for governments to take the reins. The upshot is that markets are much more closely managed, akin to the Scandinavian and Canadian models of govern-

ance. In these markets, maximizing shareholders value is no longer the only, or even the main, business mantra. Governments actively intervene to ensure that not only shareholder interests are served, but above all the greater social good.

Obama, like John F. Kennedy, proved a source of inspiration for many. Young talent joins the Peace Corp and similar ennobling endeavors. In business, a new generation of leaders emerges that blends a strong social conscience with a competitive ethos aimed at service, collaboration and innovation. These new multi-cultural and open-minded leaders operate from a different set

of moral and ethical values, are less technocratic and actively seek to inspire and motivate. Innovation thrives, in particular in the area of sustainability, clean energy and social entrepreneurship. The looming energy and food crises, which appeared as omens just before the downturn, fuel visionary investments in green energy, technology, biosciences and agriculture. Open innovation and collaboration are viewed as the answer to many looming issues, and become vital pillars supporting new economic growth.

As a consequence, the public image of government has grown in stature. Government is no longer viewed as an inept operator or faceless Kafkaesque bureaucrat, but an active player in creating wealth and welfare for many. Human capital flows once again toward the public sector as well, as it once did in England, France and Japan. The best and brightest see the non-profit sector as rich with opportunity, redeeming social causes, and personal challenge. Obama's fresh leadership and style was indeed transformational, blending JF Kennedy and Martin Luther King into one.

Early Warning Signals

- Increased popularity of new generation of leaders; more social entrepreneurship
- MBA graduates sign their version of the Hippocratic oath and pledge to do no harm
- Government enacts more regulations and increases the power of watch dogs
- Government does not re-privatize the major financial institutions it acquired
- Keynesian economics taught vigorously in universities, with an Obama twist

What to Do Next?

The above scenarios are set at a global stage in order to provide insight in the socio-economic conditions facing developed nations. However, they can be recast at a national or industry level by resetting the resolution of our telescope. This process of elaborating, exploring and monitoring more tailored scenarios will help an organization navigate through today's tumultuous times. Embracing the future this way can offer inspiration, motivation and energy to those in the organization who are confused or paralyzed.

Our experience with scenario planning shows that organizations approach this process in diverse ways. At the most basic level, organizations might orchestrate a one-time scenario exercise to help frame key issues and stimulate debate. The benefits are quick responses, but the effort may remain episodic. The next level is to design the process as ongoing strategic conversation, maintained over longer periods. The benefit is that scenario planning gets embedded in the normal strategy process. This more sustained approach allows for systematic monitoring and scanning, in order to see threats or opportunities sooner.¹¹ A third level is to move the process from scanning to option generation, by using the scenarios to support the innovation process, create new market propositions and develop better business models. And lastly, there is the possibility to integrate scenarios into the many decision making processes that occur across the organization, from strategic to tactical. This way, every important decision is benchmarked against different possible futures, resulting in a better risk assessment and greater strategic flexibility with clear sign posts.

Our scenarios present a platform to pursue any of the approaches mentioned above. They allow leaders to change their stance from ignoring the future or betting on one narrow view to embracing the many uncertainties surrounding us in systematic ways. Those who do will navigate the unruly waters much better.

ENDNOTES

¹ Paul J.H. Schoemaker and George S. Day, “Making Sense of Weak Signals, *MIT Sloan Management Review*, Spring 2009

² Paul J.H. Schoemaker, *Profiting from Uncertainty*, pg 40-66 (New York, The Free Press, 2002).

³ Doug Short, dshort.com, 17 Feb 2009

⁴ We mean by ‘government’ the set of public sector institutions that have a role in managing and controlling the market and society at large, through policies, incentives and regulations.

⁵ *Financial Times*, February 18, 2009

⁶ An early voice in the dessert was Robert Shiller, *The Subprime Solution: How Today's Global Financial Crisis Happened, and What to Do about It*, 2008.

⁷ For specifics see Schoemaker, Paul J.H. “Rethinking Business Education: The Future Challenges of Business, *California Management Review*, Spring 2008, pp. 21-27.

⁸ This is an established indicator that measures consumer confidence in the USA. Index scores below 100 denote negative consumer sentiments about their own economic outlook.

⁹ Economic indicator, created by economist Arthur Okun and popularized by Jimmy Carter in 1976; it adds unemployment rate to the inflation rate to gauge overall economic pain.

¹⁰ See John Rawls's book *A Theory of Justice* (1971) where he challenges society to think about a fair distribution of scarce resources; see also a more recent book by Peter Singer, *The Life You Can Save*, Random House, 2009.

¹¹ George S. Day and Paul J. H. Schoemaker, *Peripheral Vision*, Harvard Business School Press, 2006.