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Emerging Economies

Game over?

By Karen Crennan

Far from it. But fundamental free-market factors are changing the rules about how and to what extent emerging markets will grow in the next 10 years. For companies considering major investments, here are four possible scenarios for these economies in the coming decade.

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Why is China growing so fast?

The question isn't from a recent headline. It was the title of an International Monetary Fund paper published in 1997—and it's a question that is every bit as intriguing to today's business leaders and policy makers as it was to their predecessors.

In fact, the issue of growth informs a significant part of the current business dialogue about every major emerging economy. Reflected in the myriad assertive moves seen over the last decade—Brazil's Vale buying control of Canada's Inco to become the world's second-largest mining company; South Korea's recent win of a massive nuclear-power plant deal in the United Arab Emirates; Mexican telecom mogul Carlos Slim Helú's major stake in The New York Times Company—the discussion can encourage the perception that growth in most emerging markets is virtually unstoppable.

Applied more broadly, the question of growth matters more today than it did a dozen years ago. Business leaders and government officials are increasingly involved in evaluating how their organizations will benefit from their interactions with emerging nations. Meanwhile, their definition of "emerging nation" includes many more countries than it did then.

While most senior managers in the late 1990s would have quickly listed Brazil, Russia, India and China—later christened the "BRIC" nations—as alluring places to do business, today's savvy executives also short-list countries ranging from Egypt and Malaysia to Nigeria and Indonesia.

To be sure, no right-minded business executive or government official will make decisions about investments in emerging nations on the basis of perceptions alone, astonishing growth rates notwithstanding. When

evaluating the attractiveness of a particular nation, they will pore through report after report on everything from foreign direct investment trends and education levels to tax rates and consumer spending patterns. They will make sure they can assess the transparency of financial institutions and the rigor of intellectual property protection.

Recent research, however, suggests that many of those in charge of decision making about emerging-market investments are still not doing enough to manage their risks. That became all too apparent as nations such as Russia, Nigeria and Malaysia were caught in the down-draft of the global financial crisis (see sidebar, "What happened when the economic tide ebbed," page 7).

What's needed is a new framework for understanding what drives self-sustaining economic growth in emerging economies.

The growth puzzle

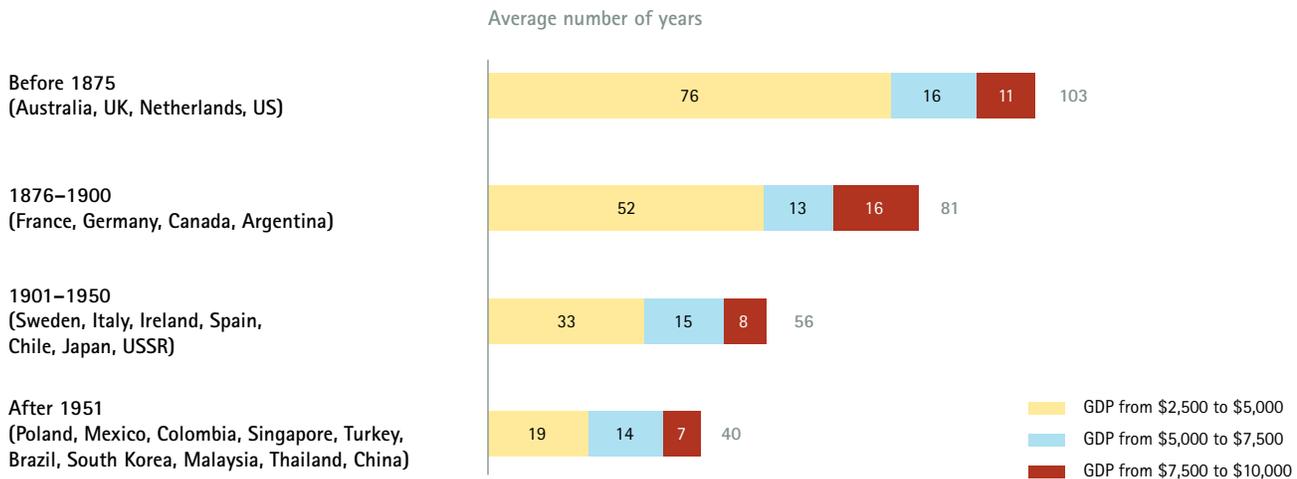
The distinction is critical. The factors that sustain growth—for nations as much as for organizations—are very different from those that drive the first spurt of growth. Let's look more closely at the differences between nations' early- and late-stage growth rates.

Accenture's research indicates that early-stage growth has actually been accelerating over the past century—the result, certainly, of factors such as steady improvements in manufacturing automation.

Taking \$2,500 as a GDP-per-capita baseline and calculating how long it takes to double GDP to \$5,000, we see some surprises. Prior to 1875, economies took almost 80 years, on average, to double their growth. Successive waves of then-emerging economies achieved that early-growth milestone in less time; post-1950, the early-stage growth

Sustaining growth

Early-stage growth—in which GDP per capita doubles from \$2,500 to \$5,000—has accelerated dramatically since the end of the 19th century, particularly among emerging economies in the post-1950 period. However, there are much smaller differences in how long it takes all economies to triple and quadruple per capital GDP—first from \$5,000 to \$7,500, then to \$10,000.*



* Calculation based on GDP per capita measured in Geary-Khamis, or international, dollars. The "international dollar" is a hypothetical unit of currency that has the same purchasing power that the US dollar had in the United States in 1990.

Source: Accenture analysis of statistics on world population, GDP and per capita GDP, 1–2006 AD; Professor Angus Maddison, University of Groningen

cycle had shrunk to 19 years, with several countries doing it in 10 years. Singapore, for example, doubled its GDP between 1962 and 1972, as did South Korea, from 1973 to 1983, and China, from 1994 to 2004 (see chart, above).

But what is most interesting, from the point of view of long-term investments in emerging economies, is that there are much smaller differences in how long it takes different economies to triple and quadruple per capita GDP.

Research shows little variation in those statistics throughout the 20th century, and little between nations. Accenture's research found that it takes a further 13 to 16 years to treble per capita GDP and about the same span beyond that to quadruple the figure. In other words, growth rates in emerging economies will not always astonish.

Although emerging countries' later-stage growth rates are destined to flatten out, there will nonetheless be differences in how soon they begin to do so and in the specific growth rates they trend toward. And there will be marked differences in what drives those growth rates.

So what will lead to noticeable differences among growth trajectories?

When evaluating opportunities and deciding on investments in emerging markets, business leaders and policy makers consider the usual stew of data and information about the availability of skilled labor, education, local capital markets, the rule of law, corruption and government involvement in the economy.

But there are two factors that deserve stronger weighting when those decisions are being made.

Multiyear research points to two critical uncertainties: the extent to which innovation in a nation is pervasive or selective, and the extent to which capital flows

freely and in abundance across its borders and into its markets.

Each factor deserves a closer look.

Pervasive innovation

Innovation is the process by which value is created for customers through public and private organizations transforming knowledge, technology and know-how into new products and services.

Innovation can be selective—a new product here, an improved process there—but without any robust innovation infrastructure, it is hit or miss. Taken to extremes—as seen in some instances of industry nationalization—it can prove disastrous. Adroitly handled, as in the careful bets that South Korea made to become a dominant force in steel and shipbuilding, selective innovation can be highly effective.

Brazil is following a similar path. The nation already has a highly diversified economy, but the government's latest policies are intended to support 24 sectors, ranging from agriculture to motor vehicles to oil. One of the core policy objectives is to position and maintain Brazilian companies among the top five players in their areas, especially in the mining, steel, aviation and bio-fuels sectors. Also, a government-backed sovereign wealth fund has been set up to invest in fledgling Brazilian companies abroad.

But in any economy, selective innovation is insufficient. The more pervasive the innovation environment within a nation, the more it will be able to demonstrate self-sustaining growth.

The pervasiveness of innovation is measured not so much in the number

of patents granted or the percentage of students graduating from higher education. It is demonstrated best by a nation's levels of entrepreneurship—both static levels, which gauge the number of enterprises in an economy, and dynamic levels, which trace factors such as the number of new firms and, perhaps, the number of individuals who are in the process of starting a business.

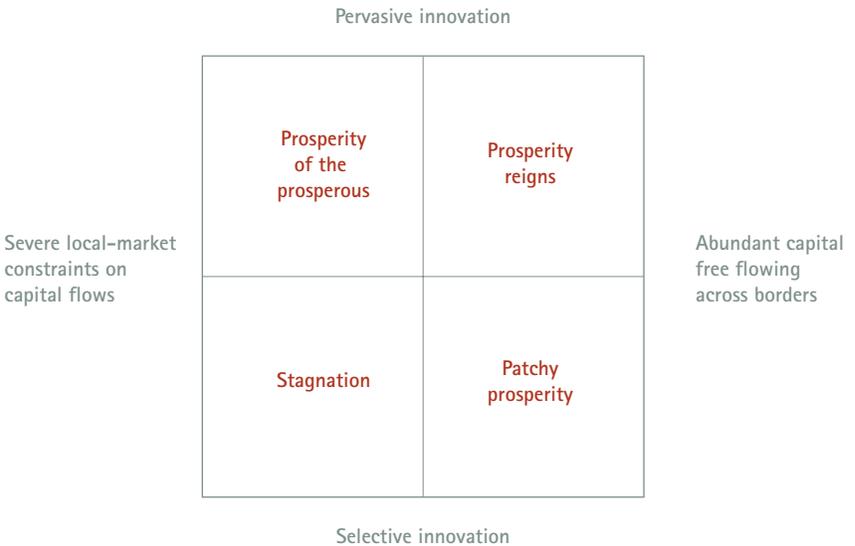
China, for example, is making a major effort to foster entrepreneurship. Its National Bureau of Statistics reports an 81 percent rise in the number of private enterprises nationwide between 2004 and 2008.

Several factors bolster pervasive innovation. It is fed by the widespread availability of seed capital—through structured venture capital channels and bank lending, for example. Strict protection of intellectual property rights is critical, particularly for high-tech and biotech industries. Tax incentives play a role—more so than direct subsidies, for instance.

The more open and flexible the society and the more easily its labor force can be retrained, the better a nation can innovate. Further, the presence of foreign companies—often significant investors in R&D—can foster a wider range of innovation.

Long-term investment prospects

We envision four possible scenarios for global growth. Two local characteristics—the pervasiveness of innovation and the free flow of capital—will determine how attractive individual emerging economies are under each scenario.



Source: Accenture analysis

Also, innovation “clusters” built around the whole value chain (suppliers, business services, subcontractors, technical services) allow efficient access to specialized expertise and the rapid diffusion of best practices. California’s Silicon Valley, Japan’s

auto industry and the silk industry in northern Italy all exemplify the success of regional innovation hubs. The more a country nurtures a wide variety of such hubs, the more pervasive and diffuse its innovation portfolio will become.

Abundant and free-flowing capital

The commercializing of innovation and the opening of new markets requires capital; the more innovation, the more capital is required.

In many ways, the world before the credit crunch of late 2008 was one in which capital flowed freely—arguably, too freely. Capital was cheap; risks were perceived as low. Investors were very open to new ideas and instruments in their search for returns (see “What

happened when the economic tide ebbed,” page 7).

One gauge of the free and abundant flow of capital across borders is The Heritage Foundation’s Index of Economic Freedom—in particular, its measure of investment freedom,

which looks at 10 specific factors, including property rights, tariff and non-tariff barriers to trade, and the mobility of labor. Hong Kong and Singapore are the top scorers in the foundation's 2010 rankings; the United States, long viewed as the beacon of free enterprise and the free movement of capital, ranks eighth, behind Canada and Ireland.

By contrast, Venezuela and Bolivia have some of the lowest scores in terms of investment freedom. These nations suffer from cumbersome bureaucracy, pervasive corruption, uncertainty about future nationalizations and social unrest. Government intervention in the economy is a potent deterrent to capital flow.

While much emphasis is given to FDI statistics—particularly concerning capital flows into emerging nations—it is important to recognize the significance of two other factors: the extent to which a country can self-generate investment capital and the impact of accumulated current account surpluses on the growth of demand at home.

In the first case, countries with abundant natural resources and fiscally responsible management of those resources are often able to self-fund investments in areas like infrastructure, education and health care, not only raising their citizens' standard of living but creating an environment that nourishes growth. In the latter case, nations such as China, which has a large current account surplus, are in a far better position to support their plans to boost domestic growth than those that have been absorbing exports and paying for them by running a current account deficit.

Four growth scenarios

So how can business leaders and policymakers best evaluate the ef-

fects of pervasive innovation and the free flow of abundant capital when making decisions about investments in emerging markets?

When the two factors are plotted together, it's easier to see how they play out under different external conditions. We envision four possible growth scenarios for the global economy, any of which could materialize over the next decade (see chart, page 77). The best emerging-market investments will be those that work well in most of the scenarios.

1. Prosperity of the prosperous. In this scenario, innovation and entrepreneurship are widespread around the globe, but many nations have erected protectionist measures that stem the free flow of capital.

This scenario could occur if the innovation engine fueled by the conversion of technologies, mobility, information and media continues at a steady pace but governments react to the recent downturn by erecting trade barriers, encouraging citizens and businesses to “buy local,” or instituting overly rigid fiscal policies that limit financial institutions' ability to fund enterprising ideas.

Two categories of nations will flourish under this scenario: those that are already mature and prosperous, and those that have abundant natural resources, such as oil, gas and minerals. The developed markets will continue to prosper, because they can finance their growth by accessing their existing capital bases. Innovators in these countries will have ample access to the funding sources they need—both equity and lending.

Some emerging markets with natural resources will also do well under this scenario, particularly those that use revenue from those resources

What happened when the economic tide ebbed

As liquidity dried up, many emerging nations found themselves at the back of the queue for capital. Bank lending all but evaporated; instead, banks focused on rebuilding their own balance sheets and refused credit to even their best corporate clients. Calls from riskier clients often went unanswered.

The nations that had failed to put in place basics such as an effective rule of law, proven ways of reducing corruption and legal protection of intellectual property rights fared particularly poorly.

Concurrently, some emerging economies discovered that their dependence on exports left them vulnerable to the downturn in trade. The commodities boom suddenly evaporated, resulting in large income reductions in some countries. Those reliant on oil revenues experienced the “natural resource curse.” The annual GDP of Russia—which not long ago billed itself as the “energy superpower”—dropped precipitously (although not all of the decline can be attributed to the downturn in oil prices).

Others that had leveraged low labor costs to drive exports—China foremost among them—found themselves worrying about how to stimulate home markets to sustain growth. Now, as part of its upcoming 12th Five-Year Plan, China is sharply focused on building much more vigorous domestic markets.

It also became clear that the financial infrastructure and capital markets in many emerging nations have lagged those in the developed world. In particular, their bond and stock markets have remained relatively small and shallow, leaving these economies far more reliant on bank finance than is typical in the West. Deutsche Bank estimates that Asian financial assets are just 90 percent of GDP, compared with 360 percent in the United States.

Exacerbating the problem: high rates of consumer savings that go into bank accounts rather than capital markets, especially in nations where inadequate public services mean that citizens must take care of their own health care and other needs.

to diversify their economies, build infrastructure and create environments conducive to innovation and entrepreneurship. One good example is Abu Dhabi, the capital of the United Arab Emirates. The metropolis is tapping its vast energy reserves to fuel the development of universities, educational institutions, hospitals and health-care facilities, and improvements in physical infrastructure.

Investors who fare best in this scenario will have this in common: They will have correctly identified the countries with abundant natural resources and rapidly growing middle classes, and then invested substantially there.

2. Prosperity reigns. In this case, a steadily rising economic tide is lifting most boats. Confidence is high among policy makers, business leaders and citizens. Forecasts are bullish; bets are big. Innovation

continues at a rapid pace, and valuable new products and services continue to lure customers.

Under this scenario, investment flows easily to good ideas wherever they appear. Innovation—not just low-cost labor—spurs growth across the emerging markets, creating new multinational companies and global brands. A good example is South Korea, where Samsung and LG Electronics became household names worldwide during the last boom and are now actively pursuing diversification, both organically and through selected cross-border acquisitions.

However, widespread prosperity does not necessarily mean that prosperity is evenly spread within a country’s borders. Emerging markets will have to create more balanced economies that stimulate domestic demand if they are to avoid social unrest generated by inequality in wealth.

For further reading

"Creating a winning geographic strategy," *Outlook*, February 2010

China is all too aware of this; its upcoming 12th Five-Year Plan will accelerate earlier efforts to narrow the gap between the nation's haves and have-nots—especially between rural areas and the country's affluent east coast.

The winners in this scenario are those that bullishly invest in geographic expansion broadly across the emerging markets—after reading the economic tea leaves well enough to be able to make their investment decisions early.

3. Patchy prosperity. In this scenario, economic progress is uneven but capital remains accessible and can move around the globe with ease. However, high-quality innovative ideas, products and services are scarcer and less evenly spread. Potential entrepreneurs are inclined to keep their heads down; business leaders are more apt to keep research budgets trim.

Since innovation is not as widespread in this scenario, it is likely that more capital will go toward building infrastructure, and shoring up productivity and efficiency with investments in automation and technology. With less innovation in products and services to propel top-line growth, companies will focus more on improving profitability.

An interesting potential downside to this scenario: With investment chasing fewer innovations, those ideas could receive excess funding, prompting investment bubbles such as the notorious dot-com phenomenon of a decade ago.

In such circumstances, the environments that encourage innovation become more important. Consider Singapore, which has done much to present itself as innovation-friendly. The state has one of Asia's strongest intel-

lectual property rights regimes, and foreign and local entities may establish, operate and dispose of their own enterprises. Singapore prides itself on clean streets, safe neighborhoods, good schools, a high standard of living and efficient transportation—all factors that make it highly attractive to the world's "best brains" and make it more conducive for them to relocate there with their families.

The business leaders and policy makers who have an eye for the more subtle signs of innovation will have an edge in the "patchy prosperity" scenario.

4. Stagnation. In the worst case—a double-dip recession, perhaps, or a large-scale regional natural disaster or pandemic—GDP growth stalls and expansion of the middle class is reined in. Under this scenario, capital is constrained and the climate encourages selective rather than pervasive innovation.

While selective innovation will be of benefit, the prevailing emphasis will be on improving existing ways of doing business, with a focus on productivity and efficiency. The great danger here is of a rise in protectionism in developed markets, pushing whatever capital is available toward infrastructure projects.

Protectionist sentiment can restrict pervasive innovation in other ways. Governments that aggressively tighten border controls and monitor the movement of non-native residents limit the flow of talent—curtailing not only the flow of ideas but also the means of implementing ideas.

Prudence and conservatism must be the watchwords for the stagnation scenario. During times like these, business leaders and policy makers will not be rewarded for making big bets on emerging markets.

When evaluating the long-term investment prospects in emerging economies, business leaders and policy makers will do well to look more deeply at the nature of innovation and the ease with which capital flows into and around the nations they are short-listing. It is no longer enough to spotlight levers that have more immediate and quantifiable impact—levers such as tax rates or the ease with which profits can be repatriated.

Executives who use the four scenarios described to map their emerging-markets bets—whether those bets involve entry to a new market, a new manufacturing center or a new research facility—can make better judgments not only about how big to make the bet but how fast to make it.

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