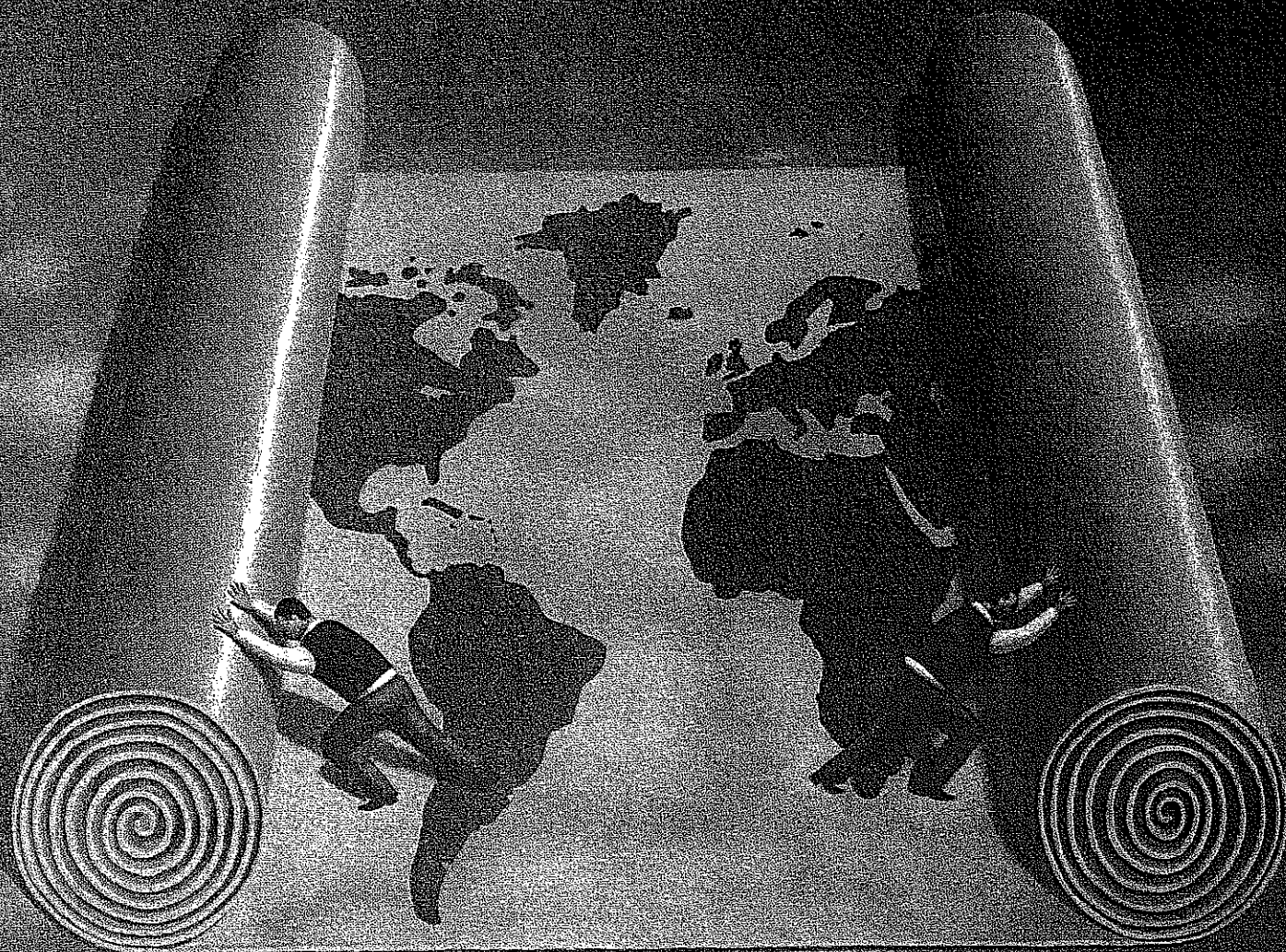


The
Economist

A bigger world

A special report on globalisation
September 20th 2008



A bigger world

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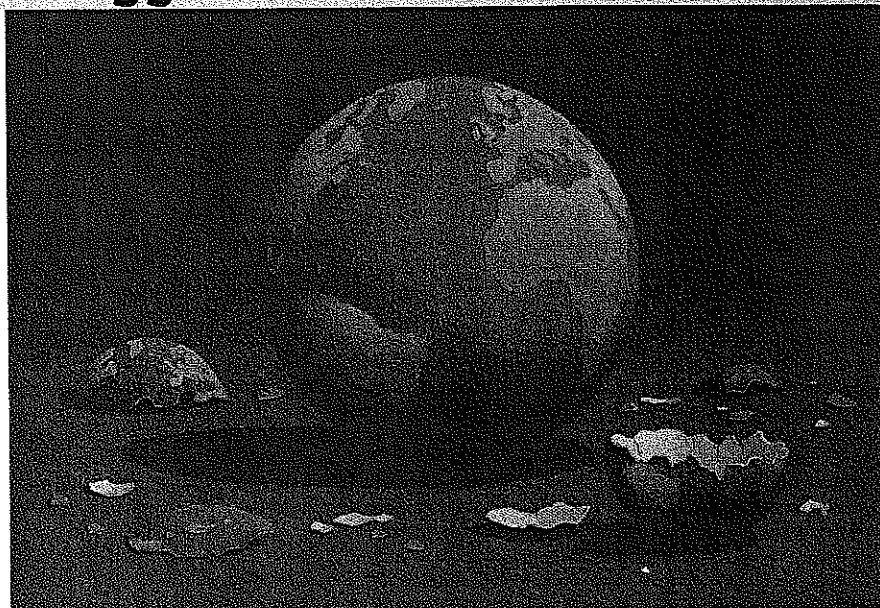
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Globalisation is entering a new phase, with emerging-market companies now competing furiously against rich-country ones. Matthew Bishop asks what that will mean for capitalism

GLOBALISATION used to mean, by and large, that business expanded from developed to emerging economies. Now it flows in both directions, and increasingly also from one developing economy to another. Business these days is all about "competing with everyone from everywhere for everything", write the authors of "Globality", a new book on this latest phase of globalisation by the Boston Consulting Group (BCG).

One sign of the times is the growing number of companies from emerging markets that appear in the *Fortune* 500 rankings of the world's biggest firms. It now stands at 62, mostly from the so-called BRIC economies of Brazil, Russia, India and China, up from 31 in 2003 (see chart 1, next page), and is set to rise rapidly. On current trends, emerging-market companies will account for one-third of the *Fortune* list within ten years, predicts Mark Spelman, head of a global think-tank run by Accenture, a consultancy.

There has been a sharp increase in the number of emerging-market companies acquiring established rich-world businesses and brands (see chart 2, next page), starkly demonstrating that "globalisation" is no longer just another word for "Americanisation". Within the past year, Budweiser, America's favourite beer, has been bought by a Belgian-Brazilian conglomerate. And several of America's leading financial institutions avoided bankruptcy only by go-

ing cap in hand to the sovereign-wealth funds (state-owned investment funds) of various Arab kingdoms and the Chinese government.

One example of this seismic shift in global business is Lenovo, a Chinese computer-maker. It became a global brand in 2005, when it paid around \$1.75 billion for the personal-computer business of one of America's best-known companies, IBM—including the ThinkPad laptop range beloved of many businessmen. Lenovo had the right to use the IBM brand for five years, but dropped it two years ahead of schedule, such was its confidence in its own brand. It has only just squeezed into 499th place in the *Fortune* 500, with worldwide revenues of \$16.8 billion last year. But "this is just the start. We have big plans to grow," says Yang Yuanqing, Lenovo's chairman.

One reason why his company could afford to buy a piece of Big Blue was its leading position in a domestic market buoyed by GDP growth rates that dwarf those in developed countries. These are lifting the incomes of millions of people to a level where they start to splash out on everything from new homes to cars to computers. "It took 25 years for the PC to get to the first billion consumers; the next billion should take seven years," says Bill Amelio, Lenovo's chief executive.

The sheer size of the consumer markets now opening up in emerging economies, especially in India and China, and their ►

Acknowledgments

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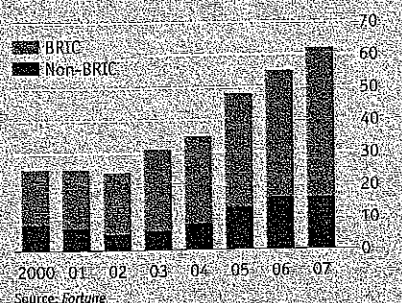
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Sixty-two, and counting

Emerging-market companies in the *Fortune* Global 500



► rapid growth rates, will shift the balance of business activity far more than the earlier rise of less populous economies such as Japan and South Korea and their handful of "new champions" that seemed to threaten the old order at the time.

This special report will argue that the age of "globality" is creating huge opportunities—as well as threats—for developed-world multinationals and new champions alike. The macroeconomic turbulence that the world is now going through after almost a decade of smooth growth will probably not alter the picture fundamentally, but it will complicate it. Despite all the talk of "decoupling", emerging economies have recently been growing more slowly because of their exposure to increasingly cautious American consumers.

Moreover, high oil and food prices are creating inflationary pressures in many emerging countries that had enjoyed years of stable, low prices along with extraordinary economic growth. The side-effects of rapid development, such as pollution and water shortages, also need to be tackled. "After a long period in which globalisation has been all about labour productivity, the business challenge everywhere, and especially in emerging markets, will increasingly be to raise resource productivity—using fuel, raw materials and water more efficiently," says Bob Hormats of Goldman Sachs, an investment bank.

A cheaper mousetrap

Assuming that the upbeat growth forecasts for emerging markets remain broadly on track and the developed economies get back on their feet, what will be the main competitive battlegrounds of global business? One is those new consumers, who often demand products at far lower prices and often in more basic forms or smaller sizes than their developed-country coun-

terparts. Emerging-market firms with experience of serving these consumers think they are better placed to devise such products than their developed-world competitors. Lenovo, for example, is going after the developing world's rural markets with a cheap, customised PC that enables farmers to become networked.

Some of these innovations have global potential. Lenovo's Chinese R&D labs developed a button that recovers a computer system within 60 seconds of a crash, essential in countries with an unreliable power supply. Known as "Express Repair", this is now being incorporated into its computers everywhere.

The same logic may apply to innovations in business models that allow goods and services to be delivered in fundamentally different ways and at much lower cost. Lenovo, for example, has developed a highly effective formula for selling to Chinese consumers that it has since taken to India and America.

Yet the rise of the new champions has brought a vigorous response from some of the old ones. IBM may have felt that it was no longer worth its while to compete in PCs, but Lenovo is facing fierce competition from American companies such as Hewlett-Packard and Dell everywhere, including in China. Nor was IBM's decision to sell its (low-margin) PC business due to a lack of commitment to emerging markets: it now employs 73,000 people in India, against 2,000 at the start of the decade, and hopes to increase the share of its global revenues coming from emerging markets from 18% now to 30% within five years.

Although multinational companies in developed countries must grapple with legacy costs of various kinds—financial (pensions, health-care liabilities), organisa-

The new giants

Ten biggest *Fortune* Global 500 emerging-market companies, 2008

| Company | Country | Global 500 rank | Revenue \$bn |
|---------------------------------------|----------|-----------------|--------------|
| Sinopet | China | 16 | 159.3 |
| State Grid | China | 24 | 132.9 |
| China National Petroleum | China | 25 | 129.8 |
| Pemex | Mexico | 42 | 104.0 |
| Gazprom | Russia | 47 | 98.6 |
| Petrobras | Brazil | 63 | 87.7 |
| Lukoil | Russia | 90 | 67.2 |
| Petronas | Malaysia | 95 | 66.2 |
| Indian Oil | India | 116 | 57.4 |
| Industrial & Commercial Bank of China | China | 133 | 51.5 |

Source: *Fortune*

tional (headquarters far away from new markets) and cultural (old ways of thinking)—they have advantages too. The greatest of these may be a deep well of managerial experience, which emerging-market firms often lack. Yet Lenovo has shown how to overcome this management deficit by hiring a group of seasoned international executives, including Mr Amelio, an American who cut his managerial teeth at IBM and Dell.

But Lenovo went further than hiring international managers. "We are proud of our Chinese roots," says Mr Yang, but "we no longer want to be positioned as a Chinese company. We want to be a truly global company." So the firm has no headquarters; the meetings of its senior managers rotate among its bases around the world. Its development teams are made up of people in several centres around the world, often working together virtually. The firm's global marketing department is in Bangalore.

A huge effort has been made to integrate the different cultures within the firm. "In all situations: assume good intentions; be intentional about understanding others and being understood; respect cultural differences," reads one of many tip sheets issued by the firm to promote "effective teamwork across cultures". Mr Yang even moved his family to live in North Carolina to allow him to learn more about American culture and to improve his already respectable command of English, the language of global business.

In short, Lenovo is well on its way to becoming a role model for a successful multinational company in the age of globality: a ►

Lean and hungry

Top five emerging-market M&As

| Year | Target | Buyer | Deal value \$bn |
|------|----------------------------|--|-----------------|
| 2006 | Inco Canada | Companhia Vale do Rio Doce, Brazil | 18.7 |
| 2006 | Rinker Group Australia | Cemex SA de CV Mexico | 16.7 |
| 2008 | Rio Tinto (12%) Britain | Alcoa; Aluminum Corp of China US; China | 14.3 |
| 2006 | Corus Group Britain | Tata Group India | 13.0 |
| 2007 | GE Plastics US | Saudi Basic Industries Corp; Saudi Arabia | 11.6 |

Source: Dealogic

► good reason to be optimistic about the future of capitalism, even capitalism with a Chinese face. Perhaps Lenovo and other new champions will become the first of a new breed of truly global companies, rooted in neither rich nor developed countries but aiding wealth creation by making the most of opportunities the world over.

Good and bad capitalism

But is such optimism justified? Indeed, would Lenovo even have been allowed to buy IBM's PC business today? Congress nearly blocked the deal at the time because it feared that valuable intellectual property might fall into the hands of the Chinese government. Since then, China-bashing has increased, there has been some Arab-bashing too, deals have been blocked and the rhetoric in Washington, DC, has become ever more protectionist.

One fear is that American jobs will disappear overseas. This is despite plenty of academic evidence that open economies generally do better than closed ones; that in America in particular many more and generally better jobs have been created in recent years than have been destroyed, and that the number of jobs lost to outsourcing is tiny compared with those wiped out by technological innovation. Mr Yang explains that "people thought we would manufacture all our products in China, but in fact we have opened new plants in Greensboro and also Poland, as we need to be close to our customers."

Lately a new fear has been adding to

the protectionist sentiment, turning even some usually enthusiastic global capitalists into protectionists. Could the rise of the new champions reflect the advance of bad forms of capitalism at the expense of good forms?

In their 2007 book, "Good Capitalism, Bad Capitalism and the Economics of Prosperity and Growth", William Baumol, Robert Litan and Carl Schramm identify four main models of capitalism around the world: entrepreneurial, big-firm, oligarchic (dominated by a small group of individuals) and state-led. Most economies are a mixture of at least two of these. The best economies, say the authors, blend big-firm and entrepreneurial capitalism. The worst combination may be of oligarchic and state-led capitalism, both of which are prevalent in many emerging markets.

The worriers point out that, through corporate acquisitions and the investments of sovereign-wealth funds, the role of the state (often an undemocratic one) in the global economy is rapidly expanding. Given the lamentable history of state intervention in business, they say, this does not bode well.

Such fears are not easily dismissed, if only because what is happening is so new that there is not much evidence either way. Sovereign-wealth funds insist that they are interested only in getting a good return on their money and will not meddle in politics. Perhaps they will turn out to be sources of good corporate governance and patient capital, in admirable contrast to the

growing number of short-termist institutional investors in developed countries. But perhaps they will not.

Again, Lenovo offers an encouraging example. Even though its largest shareholder is in effect the government of China, its acquisition of IBM's PC business does not seem to have had any troubling consequences. But maybe the Chinese government was restrained by its co-investors, two of America's leading private-equity firms. Besides, the new champions may be typified not by Lenovo but by, say, Gazprom, through which the Russian state can make mischief abroad. As Mr Yang points out, of the 29 Chinese firms in the *Fortune* 500, Lenovo is the "only one that is truly market-driven". Most of the rest enjoy monopoly power or operate in the natural-resources industries, where there is far more scope for politics and corruption than in consumer electronics.

At the very least, the growing role of states that often lack democratic credentials creates a sense that the competition from emerging-economy champions and investors is unfair, and that rich-country firms may lose out to less well-run competitors which enjoy subsidised capital, help from political cronies or privileged access to resource supplies.

So there is a real risk that bad capitalism will spread in the coming decades. Yet at the same time this latest, multidirectional phase of globalisation offers enormous potential for business to raise living standards around the world. ■

The new champions

Emerging markets are producing examples of capitalism at its best

SAFARICOM may not be a household name in the rest of the world, but in Kenya it is famous. On June 9th the country's most popular mobile-phone company, with 10.5m customers, listed its shares on the Nairobi stock exchange, raising over \$800m in the biggest initial public offering yet in sub-Saharan Africa. The offering was nearly five times oversubscribed, and Safaricom's share price quickly rose by 60%.

Even sub-Saharan Africa is feeling its way towards the emerging-markets bandwagon. In January Goldman Sachs published its first bullish report on the continent, "Africa Rising", noting at the time that sub-Saharan stockmarkets in 15 coun-

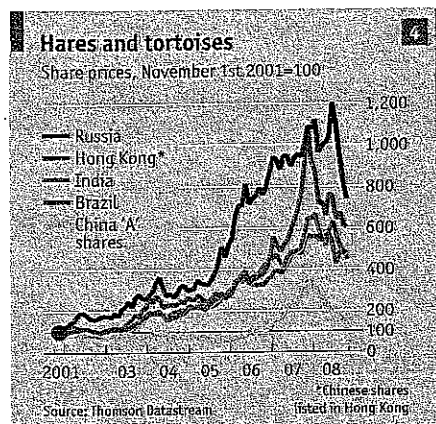
tries (excluding mighty South Africa) listed around 500 companies with a market capitalisation of nearly \$100 billion.

Seven years after Goldman Sachs invented the BRICS acronym, the performance of the emerging stockmarkets is running well ahead of the bank's high expectations. Even after recent falls, at the start of this month Brazilian shares were up by 345% since November 2001, India's by 390%, Russia's by 639% and China's, depending on whether you go by the mainland or the Hong Kong exchange, by 26% or 500% (see chart 4, next page). In 2001 Goldman Sachs had predicted that by the end of the decade the BRIC economies would

account for 10% of global GDP at purchasing-power parity (PPP); by 2007 their share was already 14%. The investment bank now expects China's GDP to surpass America's before 2030.

Most economists believe that this upward trend will not be seriously broken by the current economic slowdown. Nor is it restricted to the BRICS. In 2005, for the first time since the dawning of the industrial age, emerging economies accounted for more than half of global GDP at PPP.

Yet the emerging markets are not merely generating economic growth. They are also producing companies that are worth investing in, and that are even starting to ►►



► take on and beat the best of the developed world's multinationals. As well as Lenovo, the new champions listed by Antoine van Agtmael in his book "The Emerging Markets Century" include Haier, a Chinese white-goods firm; Cemex, a Mexican cement company; Embraer, a Brazilian aircraft-maker; Infosys, an Indian software giant; and Ranbaxy, an Indian drug company. The list of emerging firms in "Globality" that are said to be "changing the game in every industry" also includes firms such as Goodbaby, which has an 80% share of the market for baby buggies in China and a 28% share in America, and the Tata Group, an Indian conglomerate that spans cars and steel, software and tea.

Lately, Tata, which has operations in 85 countries, has been making a series of high-profile acquisitions that are fundamentally transforming a company set up in 1868. In 2000 it bought London-based Tetley, an iconic tea company. In 2007, after a fierce bidding war with CSN, a Brazilian steel firm, it paid \$12 billion for Corus, a European steel company. In March this year it paid Ford \$2.3 billion for two legendary car businesses, Jaguar and Land Rover.

Tata could afford to pay high prices for its acquisitions, reflecting the growing financial strength of some of the new champions. In part, they are benefiting from having large, profitable shares of fast-growing domestic markets. The rapid development of domestic financial markets in many emerging economies—not just stock exchanges, but also markets for corporate debt—has also made it far easier to get the capital needed to expand abroad.

Equally, rich-country capital markets nowadays are open to and actively recruiting emerging-market companies. The New York Stock Exchange is even seeking to list its shares on the Shanghai stock exchange. And the world's leading consultants, law

firms and investment banks are courting emerging-market companies at which, not so long ago, they would have turned up their noses. McKinsey, a consultancy, has advised Lenovo on how to unite its Chinese and American cultures. Goldman Sachs has appointed Lakshmi Mittal, an Indian steel magnate, to its board.

Tata rejects suggestions that it overpaid for its acquisitions—a charge that has been levelled at several of the new champions. It insists it is paying prices justified by its long-term investment horizon and its philosophy of deep decentralisation that gives plenty of freedom to the management teams it acquires (and typically leaves in place). The acquisition of Jaguar and Ford are a case in point. Short-term market pressure may have forced Ford to sell two firms that it had done good work restructuring, says Alan Rosling, Tata's (British) chief strategist: "Tata will reap the benefit of all Ford's hard work."

Another reason to be optimistic about Tata's growing global reach is its Indian origin, which makes it more sensitive to cultural differences than many of its peers in developed countries, claims Mr Rosling. And in its strategy, the firm has benchmarked itself against some of the world's best companies. It has borrowed ideas from firms such as Warren Buffett's Berkshire Hathaway, Mitsubishi, a Japanese conglomerate, and GE, says Mr Rosling.

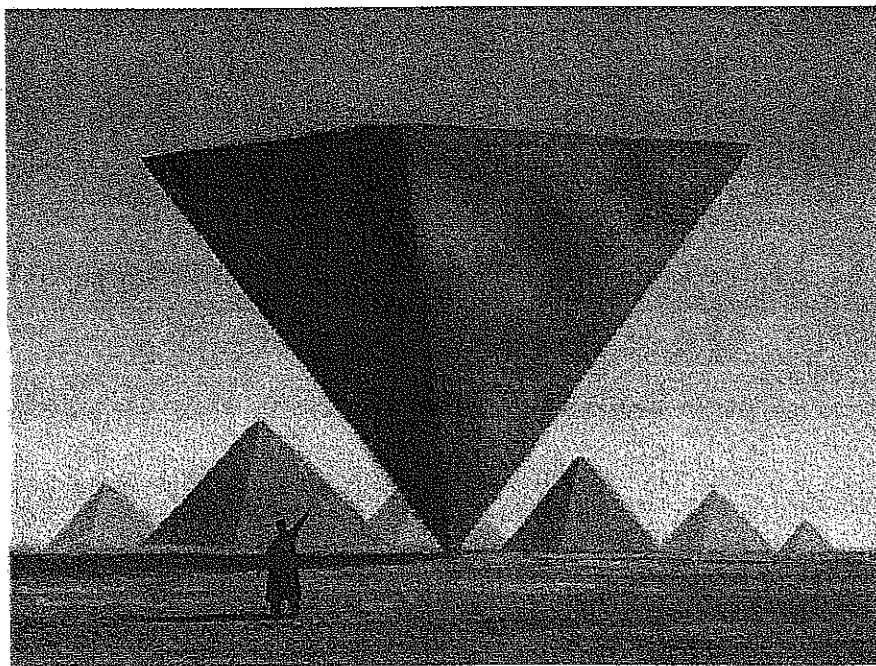
The new champions are becoming increasingly innovative, both in their busi-

ness models and in their products. For instance, Tata Consulting Services, along with Indian counterparts such as Infosys and Wipro, has built up a large organisation for outsourcing business processes, serving companies around the world. Initially this was a fairly low-tech operation, thriving largely on India's low labour costs. Increasingly, however, it has moved into higher-value businesses, as have its Indian peers.

Frugal engineering

Not so long ago, the most exciting thing about emerging markets was their cheap labour. Local firms supplied first manufactured goods and then services to developed markets and multinationals. That remains an attraction, but a declining one as wages in emerging markets and transport costs go up. No one expects Walmart, the world's largest retailer, to rethink its famously efficient supply chain, which brings billions of dollars-worth of Chinese goods to the developed world. But these days multinational firms are looking for the skills that workers from emerging markets can bring to a job as much as for lower labour costs.

Increasingly, though, the most exciting thing about emerging countries is the rapid growth in the number of consumers in their own markets, and in the number of entrepreneurs to serve them. Already, wealthy consumers in these countries have proved a godsend to the world's lead- ►



ing brands of luxury goods. But the emerging markets' new middle class may also have helped many new champions along.

Goldman Sachs calculates that the global middle class—which it defines as people with annual incomes ranging from \$6,000 to \$30,000—is growing by 70m a year and rising. By 2030, the bank predicts, another 2 billion people may have joined this group. At incomes of \$6,000 the consumption of energy starts to rise, and at \$8,000-9,000 purchases of higher-value consumer durables take off, so the growth in demand for these things already under way in emerging countries should continue for many years.

One of the first management gurus to note the rise of the emerging-market consumer was C.K. Prahalad in his book, "The Fortune at the Bottom of the Pyramid". He argued that to serve these new consumers—both in the new middle classes and at the bottom of the income pyramid—companies will need new business models and products that are profitable at much lower prices than in rich countries.

Companies from emerging markets may be more adept than their rich-country rivals at making do with the bare minimum of resources—"frugal engineering", as Carlos Ghosn, the boss of Renault-Nissan, calls it. And it may be much easier for a company starting from scratch than for an established firm with a "legacy mindset and legacy costs", says Mr Prahalad. The rapid spread of mobile telephony among poorer consumers in the emerging markets is one notable example. AirTel, the Indian market leader, charges what may be the lowest prices in the world—around two cents a minute for nationwide calls—yet is hugely profitable, thanks to an innovative business model in which many of its operations are outsourced to big multinationals such as Ericsson and IBM.

Safaricom joins a group of emerging-market mobile-phone companies with a combined market capitalisation which Mr Prahalad estimates at \$500 billion. "Poor people, once mobilised and provided with value, can create tremendous wealth for business," he says. He sees similar potential in a number of other industries, ranging from agribusiness to health care and water to finance.

What it takes to succeed

Mr Prahalad says he can now answer "yes" to five questions he posed seven years ago when he launched his pyramid idea. Is there a real market? Is it scalable? Is there profit? Is there innovation? Is there a global

Ins and outs

Acronyms BRIC out all over

IS IT time to retire the phrase "emerging markets"? Many of the people interviewed for this special report think so. Surely South Korea, with sophisticated companies such as Samsung, has fully emerged by now. And China already has the world's fourth-largest economy.

The term "emerging markets" dates back to 1981, recalls the man who invented it, Antoine van Agtmael. He was trying to start a "Third-World Equity Fund" to invest in developing-country shares, but his efforts to attract money were being constantly rebuffed. "Racking my brain, at last I came up with a term that sounded more positive and invigorating: emerging markets. 'Third world' suggested stagnation; 'emerging markets' suggested progress, uplift and dynamism."

Later in the 1980s the fast-growing economies of South-East Asia acquired the tag "Asian Tigers"—until they ceased to roar during the financial crisis of 1997-98. In 2001 Jim O'Neill, chief economist of Goldman Sachs, came up with the acronym "BRICs" for the next four coun-

tries it expected to enter the economic big league: Brazil, Russia, India and China. He says that the BRICs, Korea and Mexico "should not be really thought of as 'emerging markets' in the classical sense, as many still do. We regard these countries as a critical part of the modern globalised economy."

In its search for definitive rigour, the FTSE group has come up with three categories for what used to be known as third-world economies: advanced emerging, secondary emerging and frontier markets (which have a stockmarket but perhaps not much else).

"Emerging markets are places where politics matter at least as much as economics to market outcomes," says Ian Bremmer of Eurasia Group, a political-risk consultancy. That definition surely includes Russia. One Russian billionaire, after lambasting the "emerging" label as insulting, suggests using "high-growth economy" instead. Sounds good—but what if a recession comes along? That might call for a new tag: "submerging".

opportunity? Soon, he reckons, firms in emerging markets will develop products that "straddle the pyramid"—developing basic high-quality products, but differentiating between customers at different income levels by adding various "bells and whistles for the rich". For instance, a mobile phone may include a torch-light for poorer customers and a fancy camera for the better-off.

Tata, too, is at the forefront of this frugal-engineering trend. In January it unveiled its long-awaited Nano, a new "people's car" that will be sold for just \$2,500. This was "not just the result of using cheap Indian engineers", says Mr Rosling. Nor is it about accepting lower standards on safety or environmental emissions. The company used state-of-the-art virtual design technology and global teams to drive genuine innovation. Mr Tata saw the Nano as a safer alternative for Indian families currently travelling by motorcycle, but consumers in developed countries are already talking of it as a possible second car for use in towns because, being small, it is easy to

park. Still, the Nano will probably sell best in other emerging markets.

Already, new champions such as AirTel and Desarrolladora Homex, a Mexican builder of low-cost housing, are planning to take their innovative business models and pricing to other emerging markets, betting that they will transfer more easily between developing economies than from developing to developed ones. Homex hopes to serve communities "in highly populated and underserved areas where we believe our replicable business model will be most effective," says its chief executive, Gerardo de Nicolas.

The company is investing a total of \$4m in a joint venture called Homex India and has struck an alliance with the Egyptian Sawiris business dynasty to build 50,000 new homes in Cairo. Mr de Nicolas is one of a growing number of talented entrepreneurs making waves in countries that hitherto have not seen much entrepreneurship—a very different breed from the resource billionaires, the other face of today's emerging-markets business. A new ►►

► book by Tarun Khanna, "Billions of Entrepreneurs: How China and India are Reshaping Their Futures and Yours", may be overstating the numbers, but the basic idea is right.

For example, in Nigeria, an economy now showing more hopeful signs than for several decades, oil and mining is a big deal, but so are consumer-oriented businesses such as media. Brazil has a large number of entrepreneurial start-ups with global ambitions in the clean-energy sector, for example. Fadi Ghandour, a Jordanian who has built Aramex into the "FedEx of the Middle-East", sees entrepreneurship starting to take hold throughout that region as younger people realise that trading ideas may offer a better route to riches than land or oil.

Admittedly, venture capital is lagging behind other sorts of finance in establishing a presence in emerging markets. Yet almost everywhere in the developing world the outlook for entrepreneurs is far better than it was even five years ago.

The recent rise of the emerging markets has owed much to the combination of a benign global economy and relatively sen-

sible policymaking at home. Neither of these can be taken for granted in the years ahead because at least three of the forces behind the recent economic boom no longer apply: strong American consumer demand, cheap money and cheap oil. Indeed, the latest trends in the world economy are highlighting significant differences (eg, in reserves of natural resources) between emerging economies that tend to be grouped together as if they were essentially homogenous.

School of hard knocks

In turn, this is putting the competence of economic policymakers in emerging markets to the test, with potentially big implications for the new champions. In commodity-rich Brazil, for example, the boom in natural-resource prices and the central bank's determination to be tough on inflation has made the real one of the world's strongest currencies. This has hurt Brazilian exporters such as the widely acclaimed new champion, Embraer, whose regional jets have proved an unexpected hit with airlines the world over. The reliance of India and China on imported oil, which their

governments have long been subsidising for domestic consumers, may have nasty long-term consequences.

Yet the familiar emerging-market mix of volatility and bad economic policies may have been the making of the most talented bosses of emerging-market firms (admittedly not a large group), forcing them to concentrate on cutting costs, raising productivity and ensuring a strong cashflow. "Some managers from emerging markets have had to develop certain abilities that are proving very valuable when they go to a first-world economy, where productivity is crucial," says Antonio Bonchristiano of GP Investments, a big Brazilian private-equity firm. "Look at Lakshmi Mittal, who has done brilliantly in one of the world's most basic industries."

Another example is Carlos Brito, the Brazilian chief executive of InBev, a beer giant, which in July spent \$52 billion on buying America's Anheuser-Busch to become the world's largest brewer. Like Mr Mittal, Mr Brito has a reputation as an effective cost-cutter. That said, few old multinational champions are likely to admit defeat as easily as Anheuser-Busch. ■

The empire strikes back

Why rich-world multinationals think they can stay ahead of the newcomers

"YOU get very different thinking if you sit in Shanghai or São Paulo or Dubai than if you sit in New York," says Michael Cannon-Brookes, just off the plane from Bangalore to Shanghai. "When you want to create a climate and culture of hyper-growth, you really need to live and breathe emerging markets." Mr Cannon-Brookes is the head of strategy in IBM's newly created "growth markets" organisation, which brings together all of Big Blue's operations outside North America and western Europe. "This is the first line business in 97 years of our history to be run outside the us," he says excitedly, noting that "Latin America now reports to Shanghai."

IBM's thinking about emerging markets, and indeed about what it means to be a truly global company, has changed radically in the past few years. In 2006 Sam Palmisano, the company's chief executive, gave a speech at INSEAD, a business school in France, describing his vision for the "globally integrated enterprise". The modern multinational company, he said, had

passed through three phases. First came the 19th-century "international model", with firms based in their home country and selling goods through overseas sales offices. This was followed by the classic multinational firm in which the parent company created smaller versions of itself in countries around the world. IBM worked liked that when he joined it in 1973.

The IBM he is now building aims to replace that model with a single integrated global entity in which the firm will move people and jobs anywhere in the world, "based on the right cost, the right skills and the right business environment. And it integrates those operations horizontally and globally." This way, "work flows to the places where it will be done best." The forces behind this had become irresistible, said Mr Palmisano.

This ambitious strategy was a response to fierce competition from the emerging markets. In the end, selling the personal-computer business to Lenovo was relatively painless: the business had become com-

moditised. But the assault on its services business led by a trio of Indian outsourcing upstarts, Tata Consulting Services, Infosys and Wipro, threatened to do serious damage to what Mr Palmisano expected to be one of his main sources of growth.

So in 2004 IBM bought Daksh, an Indian firm that was a smaller version of the big three, and has built it into a large business able to compete on cost and quality with its Indian rivals. Indeed, IBM believes that all in all it now has a significant edge over its Indian competitors.

Being willing to match India's low-cost model was essential, but Mr Cannon-Brookes insists that IBM's enthusiasm for emerging markets is no longer mainly about cheap labour. Jeff Joerres, the chief executive of Manpower, an employment-services firm, also thinks the opportunities for savings are dwindling. "When you see Chinese companies moving in a big way into Vietnam, you think there is not much labour arbitrage left."

Perhaps a bigger attraction now, accord- ►►

ing to IBM, are the highly skilled people it can find in emerging markets. "Ten years, even five years ago, we saw emerging markets as pools of low-priced, low-value labour. Now we see them as high-skills, high-value," says Mr Cannon-Brookes. As for every big multinational, winning the "war for talent" is one of the most pressing issues, especially as hot labour markets in emerging markets are causing extremely high turnover rates. In Bangalore, for example, even the biggest firms may lose 25% of their staff each year. IBM reckons that its global reach gives it an edge in recruitment and retention over local rivals.

IBM also says it can manage the risk of intellectual-property theft—a perennial worry for multinationals in emerging markets, especially China—well enough to have cutting-edge research labs in India and China. And it is starting to "localise" its senior management, including moving its chief procurement officer and the head of its emerging-markets business to China. But as yet it has no plan to move its headquarters from Armonk, New York, whereas Halliburton, an energy-services firm, shifted its headquarters to Dubai last year. One notable success has been the company's partnership with AirTel in the Indian mobile-phone market, which it has already extended to other Indian phone companies and is likely to take to other countries. In this partnership IBM manages much of AirTel's back-office operations and shares the financial risk with the phone company. "We grow as they grow," says Mr Cannon-Brookes, noting that IBM is now the largest service provider to local customers in India.

Risk-sharing has worked well for other multinationals too. Vodafone, for example, is a big shareholder in Safaricom. In June Daiichi Sankyo, a Japanese pharmaceutical giant, bought a 51% stake in India's Ranbaxy Laboratories. Such deals increasingly involve strategic partnerships rather than the joint ventures of old. Daiichi hopes the deal will add value to its research and development expertise and provide access to Japan's fast-growing market to Ranbaxy, which in turn brings low-cost manufacturing and an understanding of the generics market.

In many emerging markets the most attractive potential customer is the government, thanks to an infrastructure boom that promises to span everything from mobile telephone networks to roads, airports and ports, energy and water supply. IBM is not alone in pitching directly to governments for this business, relying on its es-

tablished brand and on the growing pressure on emerging-country governments—even those that are not strictly democratic—to deliver high-quality, value-for-money infrastructure. Instead of trying to sell specific products, they say, these firms aim to help governments draw up plans for improving their country—plans which invariably require substantial spending with the company concerned. Both Cisco and GE have recently started establishing long-term problem-solving relationships with governments in which the firms help to design an infrastructure programme as well as build some or all of it.

Buy my strategy

Three years ago Cisco combined all its emerging-markets activities into a single unit. Since then the share of its revenues coming from emerging markets has risen from 8% to 15%, accounting for 30% of its total revenue growth. "We identify the country's most important industries and go to them with a blueprint for a strategy to improve them using our technology to beat global benchmarks; this is about revolutionary not incremental change," says Paul Mountford, head of Cisco's emerging-markets business.

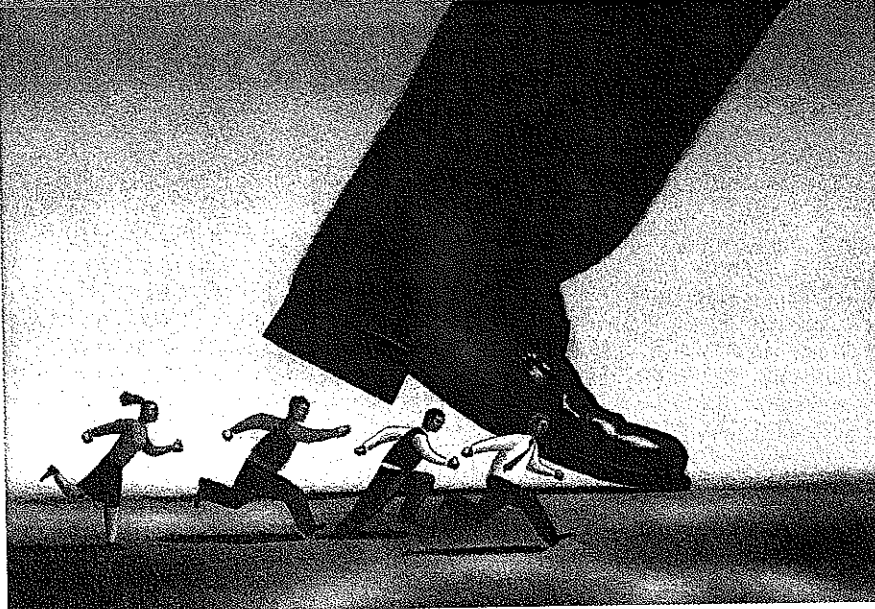
In 2006 GE—which since launching its Ecomagination strategy in 2003 has bet big on a boom in green technologies—signed a "memorandum of understanding" with China's National Development and Reform Commission to work jointly to safeguard the country's environment. It also wants to forge relations with local government in 200 second-tier Chinese cities, each of which will soon have a population of at least 1m and will need everything from a power supply to an airport.

More recently, top GE executives have got together with Vietnam's government to discuss the huge problems facing the country in water, oil, energy, aviation, rail

and finance—all areas in which GE has products to sell. At one meeting GE's president found himself in the same room with no fewer than three Vietnamese leaders who had taken part in a leadership programme at GE's famous training facility in Crotonville, New York, recalls John Rice, the company's head of technology and infrastructure. This programme of inviting groups of 30-40 senior government and business leaders from a particular emerging country to Crotonville for a week was launched more than a decade ago, starting with a group from China. "We transfer a lot of learnings between us, and we end up friends for life," says Mr Rice.

Today's leading multinationals "are no longer the slow-moving creatures they used to be. They are not going to be beaten up like the big American companies were by the Japanese," says Tom Hout, a former consultant at BCG who now teaches at Hong Kong Business School. With Pankaj Ghemawat, who last year published a well-received book, "Redefining Global Strategy", Mr Hout has analysed the emerging market in which multinationals have competed longest against local champions: China. Whether the established multinationals or their local rivals are winning "depends on the segment you're looking at", says Mr Hout. Established Japanese and Western multinationals dominate in the high-tech sectors of the economy; the Chinese are strong at the low end. The main battleground is in the middle. This is quite different from the conventional wisdom, which is that established multinationals are getting pushed out by local companies, he concludes.

A 2007 study by Accenture of China's top 200 publicly traded companies found that the best businesses in China are not yet on a par with the world's foremost ones. Although their revenue growth increased on the back of China's continued ▶▶



economic growth, their ability to create value was still only half that of their global peers. "It remains to be seen whether China's best players have built the management practices and supporting business operating models that will allow them to generate profitable growth in more mature markets over the long term," the study went on to say.

Their legacy thinking and cost structures notwithstanding, some established multinationals are increasingly trying to take on the frugal engineers of the emerging markets head-to-head, says Mr Ghemawat. "Smarter multinationals have all given up on the idea that they can simply deliver the same old products in the developing world," he explains. "If they just focus on pricing high in mostly urban areas, they will miss out on the mass consumer markets that are emerging. And they have to be able to compete as cost-effectively as the local firms, which can mean fundamentally re-engineering their products and business model."

A recent report by BCG, "The Next Billion Consumers", highlighted many innovative business models and products offered by multinationals such as Nokia—still the biggest mobile-phone producer in China, despite frequent predictions that it will fall behind a local rival—and Procter & Gamble, as well as similar efforts by emerging-market firms.

In search of excellent managers

The decisive factor may turn out to be management. Although some emerging-market firms are very well managed, by and large established multinationals still seem to have the edge. Mr Hout reckons that the expatriate managers now deployed by multinationals in emerging markets are generally of a much higher quality than the "young bucks or retirement-posting types" they used to send. "They are aggressive, smart, at the heart of their careers. And they tend to be married to more worldly women than management wives used to be."

That said, the multinationals' management advantage is based more on training and experience of running a large business than on exposure to other countries. Indeed, leading multinationals are reducing their use of expats, and those they do send are often expected to train a local manager as their successor. There is still a striking lack of executives from emerging markets at the top of developed-country multinationals. Even at GE, which is wholeheartedly committed to emerging markets,

around 180 of the top 200 managers are still Americans. "The single biggest challenge facing Western multinationals is the lack of emerging-market experience in their senior ranks," says Mr Ghemawat.

Such companies' boardrooms are even less globalised. According to Clarke Murphy of Russell Reynolds, a recruitment firm, American multinationals now have a "ferocious interest in attracting non-Americans to the board", but as yet even Europeans are a rarity, let alone directors from emerging markets. The share of non-Americans on the boards of American multinationals is less than 5%.

The main problem "is attendance, especially if there is a crisis and the board needs to meet a lot at short notice". Once again, Goldman Sachs seems to have found a clever compromise by appointing Lakshmi Mittal to its board. The Indian steel tycoon is based in London and often visits New York, where the investment bank has its headquarters.

Some European firms are doing slightly better than their American counterparts at internationalising their boards. Nokia recently appointed Lalita Gupte, an Indian banker who had just retired from ICICI bank, one of the world's most innovative practitioners of bottom-of-the-pyramid finance. And leading British companies have lots of foreigners in their executive suites and boardrooms.

Moreover, multinationals have great trouble retaining the managers they do have in emerging markets, says Mr Hout. "Well-trained, good, honest people are scarce in emerging markets. Multinationals are better at training these people than emerging-market companies, which prefer to poach them once they are trained."

The founders of emerging-market firms are often impressive, but such firms typically lack the depth of management talent of old multinationals, says Mr Hout. The best students he has taught on MBA courses in Hong Kong and Shanghai have typically worked for developed-country multinationals.

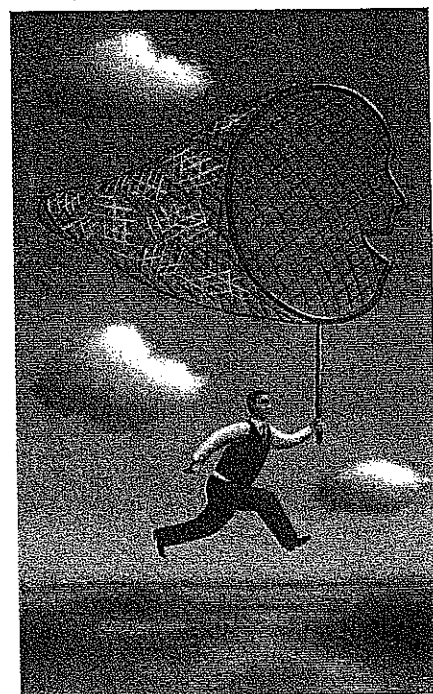
Part of the problem in China is that running a big company—even a giant such as China Telecom, with its 220m customers—still has a lower status than a political job such as governor of a province. And Chinese managers, being used to protected markets, often lack the skill to operate in more sophisticated markets overseas.

Anil Gupta, co-author with Haiyan Wang of a forthcoming book, "Getting China and India Right", says that recognition of their lack of management capability

may have been one reason why no Chinese steel firms joined their Indian and Brazilian peers in the bidding war for Corus, and why no Chinese carmakers entered the battle to buy Jaguar and Land Rover. "If one could create a Jack Welch index of leadership and assess companies on such a measure, the top 50 companies from India would come out way ahead of the top 50 companies from China," says Mr Gupta, a professor of strategy at the University of Maryland.

Certainly some Indian firms are extremely well run. The senior ranks of Tata, for example, are full of professional managers. On the other hand, many Indian firms are in family ownership, and "it can be hard to find room for professional managers when you have several sons demanding jobs of similar high status," says Mr Ghemawat.

Perhaps the best-known example of the problems of family ownership is the feud between the Ambani brothers, who after their father's death divided the family's huge conglomerate, Reliance, between them. The dispute still simmers on. In July a bid by Reliance Communications, run by Anil Ambani, to buy a South African mobile-phone company was thwarted by Mukesh Ambani, the boss of Reliance Industries. No wonder that the brothers, who live in the same opulent apartment building, have separate lifts to avoid chance meetings. ■





Oil, politics and corruption

Bad capitalism carries its own risks

TO MOST Western businessmen, this summer's hounding of Robert Dudley was clearly the work of the Kremlin. Never mind that the four billionaires whose court actions drove the British chief executive of BP-TNK out of Russia presented it as an ordinary business dispute over the terms of the oil joint venture, rejecting the idea that their origins in the Soviet Union made them Kremlin stooges. (One of them told a group of journalists in New York recently: "If you believe that the Kremlin likes me, you are very wrong. First, I am Jewish. Second, I am rich. Third, I am independent.") To the outside world, this was yet another reminder of the huge political risk involved in doing business in Russia.

Political risk is arguably more pervasive and fundamental to who makes or loses money than at any time since the second world war. And not just in Russia. Indeed, although political risk is most prevalent in emerging markets, it is not confined to them, as Dubai Ports World discovered in 2006 when it tried to buy some American ports from their British owner, P&O, only to be delayed in Congress. A year earlier the Chinese National Offshore Oil Company (CNOOC) had tried and failed to buy Unocal, an American oil company.

In 2006, when Lakshmi Mittal bid for Arcelor, a European steel firm, he met fierce and seemingly racist opposition from the governments of France, Luxembourg and Spain, which preferred to see their champion merge with a Russian rival rather than with "a company of Indians", as Arcelor's chairman put it. The deal went ahead only when India's government threatened a trade war.

"Developed-country governments do

unexpected things that are every bit as troublesome as emerging-market governments. If you are an oil or gas company today, do you worry more about emerging markets or a windfall-profit tax in the US?" says GE's John Rice. Look, too, at the recent heavy-handed interventions in the financial system by the American government. Yet most business leaders around the world reckon that political risk is a far greater problem in emerging markets. Ask the boss of Carrefour, a French retailer, whose shops in China saw violent protests this year after pro-Tibet campaigners disrupted the progress of the Olympic torch through Paris.

Western oil and mining companies, having started to improve their behaviour in Africa under pressure from NGOs, now face competition from Chinese, Indian and Russian rivals that seem willing to cut deals with even the most unsavoury African politicians. And how do Western firms compete in countries where bribes are seen as an ordinary cost of doing business?

Then there are the more humdrum uncertainties about emerging-market governments' attitude to the rule of law. Will theft of intellectual property be punished? Will lax regulatory enforcement allow your company's supply chain to be contaminated? (For example, Whole Foods Market discovered in July 2008 that Chinese powdered ginger it had been selling as organic contained a banned pesticide.) Might the government issue a decree that alters the fundamentals of your business, without consultation or recourse, as often happens in China? Will it decide suddenly to break up local monopolies, or alternatively encourage their formation?

On top of all this, there is the traditional game of guessing whether governments will abandon sound fiscal and monetary policy at the first sign of economic turbulence—ie, any day now. The leading multinationals insist that emerging markets are now so important to their long-term growth prospects that they have to be in them regardless of short-term macroeconomic policy risks. Gone for ever, they insist, is the shortsighted old habit of rushing into emerging markets as they get hot, and out again at the first whiff of trouble.

East, west, which is best?

There is not much consensus among leading businesspeople about the political risks of different emerging economies, though they agree that there are huge differences, even within the BRICS. However, Brazil (by far the richest of the four by income per person) is widely seen as remaining on the up, with the next president expected to continue with or improve on the country's current macroeconomic policies, and all the benefits of lively private and public equity markets, well-run big companies (Vale, Petrobras, Embraer and so on) and an increasingly innovative and entrepreneurial economy.

Some of the biggest disagreements are over Russia. "It's very risky, but it is also very profitable, especially if the Kremlin likes you," says another of the billionaire investors in BP-TNK. "They like the Germans, are afraid of the Chinese, don't like the Americans and British, don't mind the French." Foreigners should probably avoid industries that the Kremlin deems strategic, but which are they? Oil and mining, certainly, though that is also where the big- ➤

gest opportunities lie. Technology, commercial aviation, telecoms, chemicals and agriculture are all "grey areas", says Ian Bremmer of Eurasia Group.

What about property? Hank Greenberg, the former boss of AIG, is investing in commercial property in Russia because, he says, it is "not a strategic industry" for the government. But Gary Garrabrant, chief executive of Equity International, who has been investing in emerging markets since the mid-1990s with Sam Zell, a property billionaire, is avoiding Russia "because we can't get our arms around the risk". Nor is he particularly impressed with India, where there is a "culture of institutionalised corruption around obtaining land and permits for development". As for China, "there is a huge opportunity in urbanisation, but stay diverse, below the government's radar. Don't be a target."

The growing importance of emerging markets has provided plenty of work for advisers on political risk from Cambridge Energy Research Associates to Oxford Analytica. "The extractive industries, firms like Shell, got the message about political risk 30 years ago, but most of the *Fortune* 100 weren't thinking this way until recently," says Mr Bremmer. "Corporates in the tech area are among the worst, perhaps because their management is suffused with engineers."

Is the political context for business in the emerging markets likely to improve? Tom Hout is encouraged by the experience of Cummins Engine in China. The American maker of diesel engines has done very well in the high-performance segment of the market, but has missed out on diesel vehicles lower down the scale that fail to comply with local rules on emissions. Now, in the more sophisticated cities, "a higher-quality civil servant has started prosecuting trucks billowing smoke," so these trucks are being replaced with better ones, using engines made by Cummins and other firms from developed countries.

In a similar vein, as Chinese firms get better at developing intellectual property, they are starting to seek protection for it in court. This has meant that IP rights are being taken more seriously, which should benefit foreign firms too.

NGOs are beginning to spring up throughout the emerging markets, demanding higher ethical standards of business and political leaders. In Africa, for instance, much of the initial pressure for better governance and less corruption came from developed-country NGOs. But now some African NGOs too are starting to

challenge bad capitalism. One example is China-Africa Bridge, an NGO based in Beijing, founded by Hafsat Abiola, daughter of a former Nigerian president, to improve the effect of Chinese business on Africa, especially in resource industries. "For Africa, China's involvement will create winners and losers, but currently it will too often be African individuals who win, not communities and countries," she says. In particular, there have been many reports of unethical dealings between Chinese resource firms and leaders and officials of some African countries, including Sudan.

Ms Abiola's goal is to encourage China to do as it would be done by in Africa. When companies such as Microsoft arrived in China, the government required them to invest in a lot of infrastructure and R&D to foster the country's own development, she says, "but as China comes to Africa, it is not being required to transfer knowledge or skills or promote local jobs." Though China is certainly building a lot of infrastructure—presumably to help it procure all the natural resources its firms are gobbling up—it often brings in its own people to do the work.

As developed-country multinationals enter emerging economies, it is crucial they do not lower their standards on corruption, says Ben Heineman, a former GE general counsel who recently published a book, "High Performance with High Integrity". "Are these multinationals going to be good corporate citizens, to increase the credibility of globalisation?" he asks. Besides anything else, he argues, behaving consistently ethically is in their self-interest. Successful global companies need uniform global cultures, in which everyone adheres robustly to the same rules, even in places where the local companies do not. If people in one part of the company start

adopting a lower ethical standard, it can have a corrosive effect on the entire corporate culture.

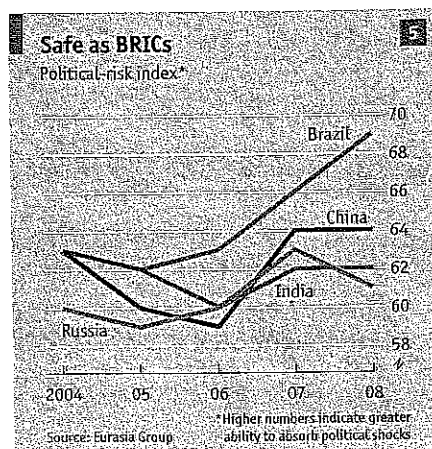
This may be why the global expansion of emerging-market champions is a good thing. As they increasingly operate in developed countries, where corruption is much less acceptable, they will have to abide by their host countries' standards. That will create pressure within these firms to raise their standards back home.

Doing well by doing good

In the early 1990s, when GE decided to adopt uniformly high ethical standards throughout the firm, "we accepted it was a cost, but that the benefits outweighed it. Siemens reaped the whirlwind on that," says Mr Heineman. (In 2007, Peter Solmsen, one of his protégés, moved to GE's German rival as general counsel to sort out a huge bribery scandal that had brought down Siemens's chief executive.) GE embarked on this course after the American government started to enforce its Foreign Corrupt Practices act more vigorously, and other American firms asked it to lobby against the law. Instead, "we said, level up, not down," says Mr Heineman. At times when corruption was especially rife, GE pulled back in Nigeria and Russia, he notes. The company also provided some early funding to Transparency International, an anti-corruption NGO.

GE's Mr Rice reckons that the firm's hard line on corruption is actually helping it win business in many developing countries. This may be because ethical standards are rising—or, at a minimum, fear of public reaction to low ethical standards is rising—in at least some emerging markets. Country leaders feel under growing pressure to deliver better infrastructure and to be seen to be doing the best they can, says Mr Rice. Increasingly, "they understand that corruption is a barrier to improving the standard of living of the poorest people, and they want to do business more and more with an ethical firm."

But there are plenty of governments that are not striving for good capitalism. Oil-rich Russia, for example, feels it can use Gazprom, its giant energy company, as an instrument for its geopolitical strategies, by threatening to turn off supplies to neighbouring countries that depend on them. And as emerging-country governments accumulate huge foreign reserves and start to invest them abroad through sovereign-wealth funds, developed countries fear that capitalism will become increasingly politicised everywhere. ■



The rise of state capitalism

Coming to grips with sovereign-wealth funds

"GOING overseas: a wrong investment decision," thundered Wu Zhi-feng on his blog, "The Invisible Wings". He was furious about the performance of the \$3 billion investment by China Investment Corporation, a sovereign-wealth fund established by the Chinese government, in shares of Blackstone, an American private-equity firm. Blackstone's shares have plunged since its flotation in June 2007, reducing the value of CIC's stake by \$500m.

The Chinese government's policy of "going out"—investing abroad through its companies and new sovereign-wealth funds instead of at home where it was needed—was about showing off to the world, wrote Mr Wu: "Chinese companies started acquiring businesses here and there in the world so that many countries would shout that 'the dragon is coming'."

If some sovereign-wealth funds are unpopular at home, they are viewed with even more hostility in the rich world, where CIC and others have been splashing their cash lately. Such funds have provided several top Wall Street firms (as well as some of their European rivals) with large injections of cash in the past year—including Citigroup, which received \$75 billion from the Abu Dhabi Investment Authority (ADIA). That probably saved a few of them from bankruptcy or a Bear Stearns-style forced sale, but it was controversial.

It is not just banks that have caught the sovereign-wealth funds' eye. In July the Abu Dhabi Investment Company bought a 90% share in New York's iconic Chrysler Building. Soon after that, Mubadala, another Abu Dhabi fund, announced that it intended to become one of GE's ten biggest shareholders (see box, next page).

Public criticism of sovereign-wealth funds has subsided a little as the crisis in the developed world's financial markets has made people grateful for any money they can get. Yet in private there are plenty of worries about the growing size and power of sovereign-wealth funds.

In an article in the *Financial Times* last year, Larry Summers, a former American treasury secretary, wrote that a "signal event of the past quarter-century has been the sharp decline in the extent of direct state ownership of business as the private

sector has taken ownership of what were once government-owned companies. Yet governments are now accumulating various kinds of stakes in what were once purely private companies through their cross-border investment activities." Mr Summers called for a new policy: "Governments are very different from other economic actors. Their investments should be governed by rules designed with that reality very clearly in mind."

The problem, if problem it be, may be just beginning. According to the US Treasury, sovereign-wealth funds are "already large enough to be systemically significant". But the McKinsey Global Institute in a recent report forecast a dramatic increase in the assets of sovereign-wealth funds over the next few years. It predicts that Asia's sovereign assets, which at the end of 2007 stood at \$4.6 trillion, will rise to at least \$7.7 trillion by 2013 on conservative growth assumptions, and to as much as \$12.2 trillion if economic growth continues at the fast pace of the past seven years.

As for the sovereign-wealth funds of oil-rich states such as Russia, the United Arab Emirates and Saudi Arabia, much depends on what happens to the price of oil. McKinsey looked at the impact of several

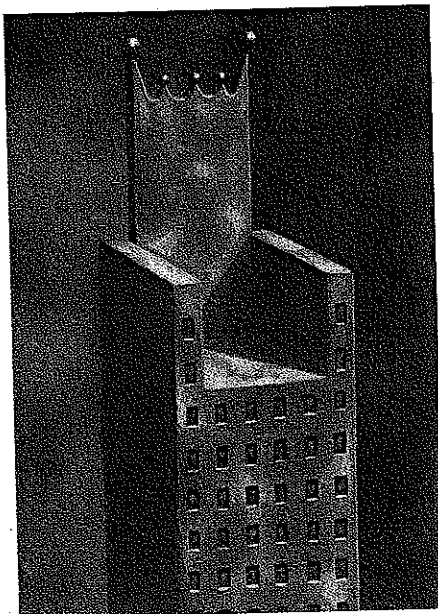
possible average oil prices over the next five years, all below what the stuff has been selling for in recent months. Even at \$50 a barrel (remember?), the assets of these sovereign investors will rise to \$8.9 trillion by 2013, from \$4.6 trillion at the end of 2007 (see chart 7, next page).

For good or ill

What are they going to do with the money? Will these funds become instruments of a "new mercantilism", with the controlling government attempting "to ensure that company-level behaviour results in country-level maximisation of economic, social and political benefits", as Ronald Gilson and Curtis Milhaupt suggest in a recent article in the *Stanford Law Review*? Will they be opportunistic, as Larry Summers fears? Will they be politically aggressive, as Russia has already shown itself with Gazprom (not, strictly speaking, a sovereign-wealth fund but certainly a well-endowed corporate arm of the state)?

Or are the funds simply investors, looking for nothing more sinister than a decent return on their money? Earlier this year, Youssef al Otaiba, Abu Dhabi's director of international affairs, in an open letter to America's treasury secretary, said that "it is important to be absolutely clear that the Abu Dhabi government has never and will never use its investment organisations or individual investments as a foreign-policy tool." And as Messrs Gilson and Milhaupt note briefly in their article, despite fears that sovereign funds will use their investments to secure technology, gain access to natural resources or improve the competitive position of their domestic companies, "no one can point to a reported incidence of such behaviour."

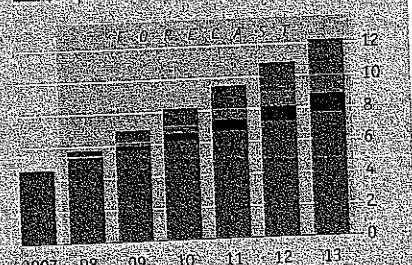
In fact, there is no such thing as an average sovereign-wealth fund. Some are new, like China's; others have been around for decades, such as the Kuwait Investment Authority (KIA), set up in 1953. They vary greatly in size: the biggest is ADIA, which with assets of \$625 billion is almost double the size of the next-biggest, Norway's. Some, like the KIA, are essentially passive portfolio investors. Others are more active, resembling private-equity firms (Dubai International Capital) or even industrial



See how they grow

Petrodollar foreign assets, \$trn
Assuming oil price of:

■ \$30 per barrel ■ \$50 per barrel
■ \$70 per barrel ■ \$100 per barrel



Sources: McKinsey, Global Insight, BP, Institute of International Finance

► holding companies (Singapore's Temasek). Most of them are increasingly shifting their focus to equity-investing. Many of them also invest in hedge funds and private-equity firms.

There are big differences, too, in their willingness to use professional managers and in their competence as investors. One reason why CIC bought its stake in Blackstone, and Mubadala its stake in Carlyle, may have been to tap the investment expertise of those firms. Another way of raising the quality of in-house staff is to appoint nationals who have gained qualifications abroad.

Singapore's Temasek is much admired by other sovereign-wealth funds for its investment nous and its effective corporate governance, and is thought to be seen as a role model by the Chinese. The deepest reserves of talent are at ADIA, says a veteran partner at a big American private-equity firm who has worked with many of the sovereign-wealth funds. However, some of its top managers have been taken by a new body, the Abu Dhabi Investment Council, set up a couple of years ago.

At the other extreme is the Qatar Investment Authority, which the private-equity veteran says is "always teaming up with the wrong people and operating a highly idiosyncratic management style". The QIA's ill-fated attempt to buy Sainsbury's, a British supermarket chain, may alone have lost the fund over \$2 billion, he calculates.

Russia and China may be exceptions, in that both their governments have been willing to use the companies they own to pursue political goals and might well try to do the same with their sovereign-wealth funds. If that starts to happen, they may need to be governed by different rules

Cities in the sand

A new sort of investment partnership

THE deal between GE and Mubadala concluded in July provides a useful test case of whether the rise of sovereign-wealth funds can be good for capitalism. Currently, both the company and the investor are claiming they have gained.

There is no doubting the ambition of the Gulf states as they set about building brand-new cities in the desert. Dubai has already become a cross between Las Vegas and pre-state Beirut, with its luxury hotels, international financial centre, leisure and shopping facilities and man-made islands. But Abu Dhabi, its richer neighbour-cum-rival, has ambitious plans of its own, bringing in the sort of high culture Dubai lacks (including outlets of the Louvre and Guggenheim) and even looking beyond the oil age by committing \$22 billion to building a futuristic carbon-free city called Masdar.

Masdar is one of the key ingredients of the deal, in which Mubadala agreed to become one of the firm's top ten shareholders. GE will invest heavily in Masdar to make it a showcase for its Ecomagination clean-energy programme. The firm and the sovereign-wealth fund will also put \$4 billion each into a joint venture to provide commercial finance in the region. Ultimately, the two are expected to invest

a total of \$40 billion in the partnership.

GE's strategy is to establish bases in cities throughout the Gulf, investing in things that are useful both to the city and to the region. It also has close relations with Saudi Arabia, which it has made into its regional infrastructure-services hub. Saudi Arabia is building six new "economic cities", in the hope of providing jobs that it desperately needs. It is trying to tempt energy-intensive international firms to move there with the promise of cheap fuel—which may not be such a boon for the environment.

The Mubadala deal represents the latest stage of a relationship that has continued to deepen since the fund's managers visited Crotonville in 2005 for a week's leadership training. GE says it is betting on a new generation of leaders in Abu Dhabi—and indeed across the Middle East—who are committed to building a more sustainable economic foundation that will survive the depletion of their oil and gas reserves. Mubadala, which also has a 75% stake in Carlyle, a big American private-equity firm, says that as a long-term investor it is keen to take big positions in such world-class companies. That must make Jeffrey Immelt, GE's embattled boss, feel more secure in his job.

from those applying to funds that try to concentrate mainly on getting good investment returns.

Many sovereign-wealth funds have been upset by the criticism they have received over their recent Wall Street investments. America's treasury secretary, Hank Paulson, is understood to have spent a lot of time reassuring them, especially about the reaction to their investments in Wall Street, after Merrill Lynch, Morgan Stanley and others persuaded the funds to shore them up. "They have lost money and then been subjected to complaints in Congress about the lack of transparency on their balance sheet or their agenda," says the private-equity veteran.

To try to reduce the criticism, the IMF has been working on guidelines for sovereign-wealth fund transparency, due to be agreed on at its autumn meetings in Wash-

ington, DC. As things stand, transparency ranges from next to none to a lot. Again, some sovereign funds protest that they are being subjected to far tougher disclosure rules than many big domestic investors in developed countries. It will be no surprise if the IMF proposals are given a lukewarm reception and then largely ignored.

"There is a huge amount of hypocrisy about sovereign-wealth funds in the West," says Richard Cookson, a global strategist at HSBC who keeps an eye on sovereign-wealth funds. "When did the developed world ever not use its economic and political clout to buy assets on the cheap?" In the Asian crisis of the 1990s, American banks bought into several troubled Asian banks. When local politicians complained, America accused these countries of protectionism, says Mr Cookson. The real reason the developed world is ►►

► now so upset, he suspects, is that the sovereign-wealth funds symbolise so clearly the shift in the balance of economic power to the emerging markets.

Yet when emerging countries set up sovereign-wealth funds, with separate governance and a clear investment mandate, it is often a sign of them "recognising that they got it wrong in the past, asking how to improve, and concluding that an endowment/portfolio approach is the best way," says Chuck Bralver of the Centre for Emerging Market Economies at Tufts University. "Leaving the Russians aside, they are mostly being highly professional." Even the Chinese sovereign-wealth funds are expected to hire hundreds of professional investment managers, mainly from developed countries.

Known unknowns

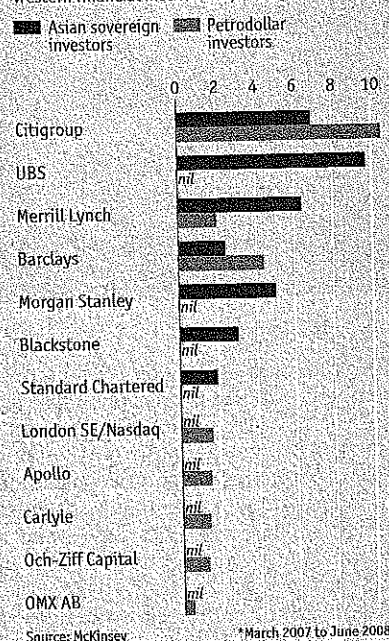
What is certain is that as sovereign-wealth funds grow, which they are bound to do, an increasing number of the world's companies will end up at least partly in state ownership. And there is a possibility that the sovereign-wealth funds' good behaviour is a Trojan-horse strategy which in time will give way to mercantilist interference.

In practice, sovereign-wealth funds so far have given little cause for alarm. Their biggest downside may be that they lack the capacity to find a sensible home for all the money that is likely to be flooding in over the coming decades, and that much valuable capital will be squandered on ill-advised projects.

"I'm struck by how responsibly China and countries in the Middle East are behaving," says Laura Tyson, who used to chair Bill Clinton's Council of Economic Advisers and now teaches about emerging markets at Berkeley. The Gulf states are try-

The new moneybags

Sovereign-wealth fund investments in Western financial institutions, \$bn*



ing to use their wealth to generate "higher living standards over the next 100 years, not squandering it on the high life like they did in the 1970s". Despite much talk about their desire to switch to the euro or even make it the next reserve currency, "they are not dumping the dollar, they are continuing to make long-term investments," she points out. Indeed, bailing out the developed world's banking system seems heroically generous of them.

All of which, says Ms Tyson, "underscores the extent to which emerging markets now recognise that their well-being

depends on the stability of the international system." Forms of state ownership will become more common, she concedes, "but so what? The simple dichotomy between private and state-owned does not tell us very much at this point."

To be on the safe side, Messrs Gilson and Milhaupt propose that shares in American firms that are bought by sovereign-wealth funds should have their voting rights suspended until they are sold again. This would beef up existing arrangements that protect American firms from foreign ownership where national security is seen to be threatened. Without the voting rights, the sovereign investors could not interfere in the activities of the firms they buy, but if the suspension is only temporary, the funds would not suffer any financial penalties.

This looks like an elegant solution, but it is not clear if it could be enforced. Moreover, it would make sense only if there really is reason to worry about the intentions of sovereign investors. If their intentions are good, the proposal would rob capitalists of their ability to play a value-creating role in the governance of the firms they invest in.

"We need to reconsider what is the best way to organise large-scale entities playing in global markets," observes Ms Tyson. After all, in recent years it has become clear that free-market public ownership of companies can give rise to conflicts of interest and principal-agent problems, which led to the rise of private equity as a partial solution. Perhaps well-motivated, well-run sovereign-wealth funds with long-term investment horizons could help create a more effective system of corporate ownership than today's often short-termist investors. Let's hope so. ■

Opportunity knocks

As long as the protectionists don't spoil it

"WE CAN only be defined as global," says Lakshmi Mittal. "We are not Indian, or French, or from Luxembourg. Among the top 30 managers of Arcelor Mittal there are nine different nationalities." The Indian-born steel tycoon is convinced that he is building a truly global company, transforming an industry that was manifestly failing to deliver while it was organised along nationalist lines. Not

so long ago every country felt it had to have its own steel giant, even if it was government-owned and losing a fortune.

Steel was also the first Western industry to go into decline, he points out—and by extension, though he does not say it, the first to be revived by a company started in a developing country by a businessman from an emerging market (albeit one who has long been based in London). He wants his

"customers to be able to buy our product anywhere in the world at the same quality". He wants to recruit the best talent in the world, and has established Arcelor Mittal University in a grand old building in Luxembourg to help him do that.

He is measuring the firm against the world's most admired companies—GE on human resources, leadership and purchasing, Royal Dutch Shell on R&D. He sounds like ►

► a misty-eyed internationalist when he describes the "seamless discussion the management team has on any subject—you would not think there are different nationalities in the room." In sum, "I want to create a truly great global company."

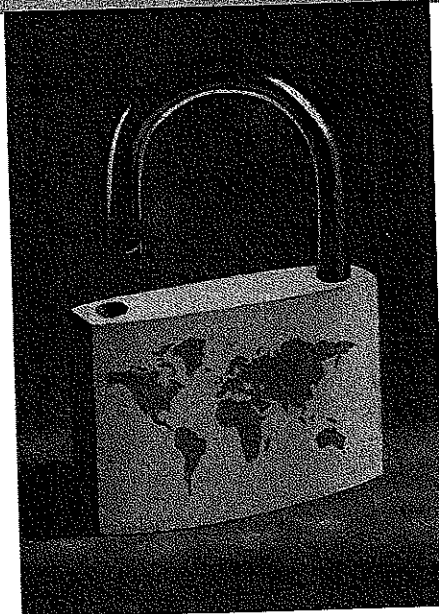
Can he do it? Some leaders in the less emerged countries where his firm operates may see how well he has done with the rubbish they thought they had sold him and demand their pound of flesh. Perhaps the policy of vertical integration which is prompting Arcelor Mittal to buy mines and energy producers at today's high prices will prove to be misplaced. But a bigger threat is what the world's governments may do next.

Think abundance

In particular, how will these governments choose to mix the various models of capitalism described by Messrs Baumol, Litan and Schramm in "Good Capitalism, Bad Capitalism"? Ominously, the governments of some of the bigger emerging economies—notably Russia and China—seem bent on a mixture of state-led and maybe oligarchic capitalism, rather than the potent blend of big-firm and entrepreneurial capitalism that has served America, Britain and other rich countries so well.

Should the rich world worry about it? There is no evidence so far that sovereign-wealth funds are trying to wield inappropriate influence in the companies they invest in. One day they might, but until then they probably deserve the benefit of the doubt. The most plausible scenario is that the growth of sovereign-wealth funds, along with other possibly mercantilist forays by emerging-country governments, will simply waste a lot of capital. However unfortunate, that would be largely a matter for them. Besides, some governments, even undemocratic ones, seem to understand that it is in their interests to move in the direction of wealth-maximising good capitalism rather than squander their country's wealth, since it is their citizens who will ultimately pick up the bill.

It is reasonable to worry about the activities of, say, Chinese resource firms in some African countries, which are thought to have shored up some of the continent's worst leaders—though it is hard to see how this can be changed other than by reforming the governance of these African countries themselves. Likewise, policies in emerging countries that allow corruption, cronyism and local monopolies or treat foreign multinationals unfairly are certainly undesirable. But in neither case is protec-



tionism the answer.

The rise of protectionist sentiment in developed countries is a serious cause for concern. As Messrs Baumol, Litan and Schramm observe, capitalism is a dynamic force and can change over time—including from good forms to bad. Just because America, in particular, has long been a force for good capitalism does not mean that it will continue that way.

Arguments for protectionism are based on fears that are wholly at odds with the evidence. The experience of recent years does not support the idea that millions of jobs will be outsourced to cheap foreign locations. Nor, as so-called techno-nationalists claim, is it likely that innovation will shift from America and the rest of the developed world simply because Microsoft and IBM have set up R&D centres in India and China, as they and the new champions start to make better use of all the clever engineers produced by those countries' education systems. As Amar Bhidé of Columbia Business School argues in his new

book, "The Venturesome Economy", it is in the application of innovations to meet the needs of consumers that most economic value is created, so what matters is not so much where the innovation happens but where the "venturesome consumers" are to be found. America's consumers show no signs of becoming less venturesome, and its government remains committed to the idea that the customer is king.

Except, that is, when it comes to protectionism, which will hurt American consumers as well as slow the rise of the emerging markets and hence the escape of millions of their citizens from poverty. Far better to engage the emerging markets in the global economy and help them understand why it is to everyone's benefit to promote the good models of capitalism, not the bad.

Mr Mittal, for one, remains optimistic. "There is currently an anxiety in the developed economies that is the opposite of the enthusiasm in the emerging markets—but in ten years a lot of the anxiety will go away and we will see a lot closer partnership and collaboration," he says. "I don't think we can really block globalisation."

The final word should go to an American, albeit one who works for a Chinese firm. Lenovo's Mr Amelio sees strong parallels between the challenge raised by the new age of globality and the cultural challenges his own firm initially faced, especially its American workers' suspicions of their new Chinese colleagues. The root of the problem is a "scarcity mentality in which people see things as a zero-sum game", he says. "Instead, we need an abundance mentality that believes everyone can become better off." ■

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