The Economist

GUIDE TO EMERGING MARKETS

The business outlook, opportunities and obstacles

Edited by

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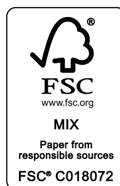

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Introduction: the big shift and what it means for business

HONEYWELL INTERNATIONAL, a multinational conglomerate, has doubled the size of its non-US business in the past ten years, driven by growth in emerging markets. Shane Tedjarati, president, global high-growth regions, says that the company's business in China and India has been growing by over 20% annually since 2004. He points to the huge opportunities:

> *There is massive urbanisation happening in high-growth markets, with very few exceptions. And these markets also require infrastructure. So there's huge spending on airports, seaports, on roads ...*

There is also huge growth in consumer spending, which extends well beyond the largest cities and often involves very different levels of purchasing power compared with consumers in developed economies:

> *The story of China is in tier two, three and four cities. It's in the mid-market, but a different mid-market than in the US. The Chinese mid-market is about $5,000 GDP per head.*

Honeywell's success in emerging markets over that period came by radically changing its approach. Until 2004, it was basically a West-to-East company:

> *One of our products could be slightly modified and sold in China ... But that model gets old very quickly. In 2004 we decided to take a fresh look at the market. We started by saying we were putting a lot more into understanding what the market is. So it was marketing,*

> *R&D and putting a sales force together that really understood what kind of products our customers want, what features and at what cost. And doing that with local speed. Because these markets are fast … and dynamic.*

Manufacturing then followed.

The approach continues to develop and to lead to radical transformations in how Honeywell operates:

> *Our strategy, which we call East-for-East – design and innovate in China for China and in India for India – has now evolved and we've become East-to-West, because the products we're developing here will be needed elsewhere in the world. That strategy has worked very well.*

This has required a major change of mentality, including empowering local operations. Tedjarati speaks of creating the spirit of an entrepreneurial Chinese company inside a large multinational company. Honeywell now expects "high-growth markets" to drive over 55% of its growth in the coming years.

Honeywell's experience reflects the rapid transformation under way in emerging markets. Companies cannot afford to ignore these countries, which will be the main source of global growth in the coming decades. But it also suggests that in order to succeed there Western multinationals will have to get used to doing business in different ways – and will fundamentally change themselves in the process.

Common characteristics

The very phrase "emerging markets" courts controversy. As a label, it lacks precision – being applied indiscriminately to countries which compete aggressively on the world stage, along with those trapped in subsistence agriculture or commodity extraction. More focused monikers, such as frontier markets (for those viewed as less developed and more challenging for business) and newly industrialising (for those bursting onto the global economic stage), may be more helpful.

Some companies, like Honeywell, are switching to growth markets

or high-growth markets. But these terms are insufficiently nuanced as well – do growth markets always grow, and are companies really writing off growth in the developed world completely?

Emerging markets probably retain a greater hold among business leaders or commentators, so for the purposes of this book we acknowledge the difficulties but use the phrase anyway, as a means of describing collectively the markets of Asia, Latin America, eastern Europe, the Middle East and Africa which are of most interest to business leaders as current or prospective sources of opportunity.

In any case, some characteristics do bind this group of countries together. All have incomes per head substantially lower than the US, western Europe and Japan. All are less efficient – productivity is markedly lower than in the world's richest nations. But in these seemingly negative traits lies their promise. If inefficiency can be reduced, if workers can become more productive, if firms can climb up the value chain, then living standards can rise dramatically. The promise, alas, is not always realised. There are many examples of countries that are barely better off today than they were 20 or 30 years ago. Putting in place the right policies, setting up the right political and legal institutions and creating the conditions for growth, too often elude countries.

But where countries are able to see best practice and implement a version of it at home, the opportunity for business success beckons. Because rapid growth for these countries means overcoming major challenges – and in the challenges lie opportunities for companies. These are challenges of affordability, of meeting infrastructure needs, of coming up with new and innovative products to satisfy local tastes and customs. And there are the challenges of keeping up with rapid social and economic change. The CEO of a US automotive components supplier says that in China, where his firm supplies a large local manufacturer:

> *The growth rates are just incredible ... The challenge of staying on top of the demand is certainly unlike any other country we have ever worked in.*

Of course, even where countries get it right and experience rapid growth and rising living standards, the economic, political and

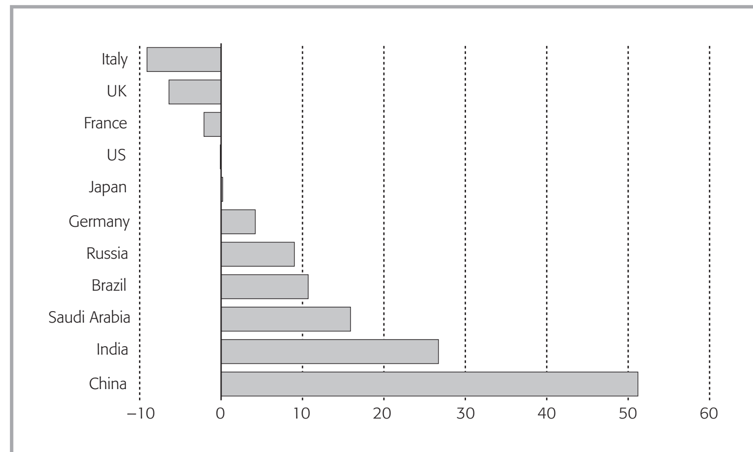
business environments hardly match up to those in the advanced economies. Growth may be fast, but is often extraordinarily volatile, with regular crises knocking the country off course. Political systems are generally immature – corruption is often rife, bureaucrats are ineffective and policy decisions are driven by narrow special interests. And businesses often compete on a highly skewed playing field. For foreign firms hoping to profit from emerging markets, the opportunities resulting from rapid growth come with the complexities and risks of a challenging and sometimes capricious business environment. Rewards, as ever, are balanced by risks.

Historical rebalancing

The countries which are currently described as emerging were once dominant world powers. According to research by Angus Maddison, who was a professor of economics at the University of Groningen, China alone accounted for approximately 25% of the global economy from about 1500 until 1800, with India only slightly smaller. The US, now the largest economy in the world, was scarcely economically active at that time. But in the late 1700s Britain, followed by western Europe and then America, started to industrialise. The introduction of machinery, the use of steam power and the expansion of factories allowed productivity to improve. In the British textile sector, which industrialised earliest, the gains are estimated to have been a 20-fold improvement in output per person over the 100 years from 1700 to 1800, with some activities seeing even greater advances. Although the impact on the economy as a whole was smaller (since many other important sectors, such as agriculture, did not experience the same degree of mechanisation), this was sufficient to put western Europe and America on a growth trajectory which led to their domination of the global economy. Their technological lead meant that the gap in living standards between Western industrialisers and other nations widened dramatically.

Why did the emerging markets lag behind for so long? While it is a gross simplification to point to a single cause, many non-industrialised markets followed economic policies which cut them off from world markets and best practices (often not by choice – the impact of colonialism was also a major factor). Some used tariffs to keep imports out, in the hope that this would

FIG 1.1 **The cost of the crisis**
Difference, in % terms, of real output per head before the crisis started in 2007 and in 2012



Source: The Economist Intelligence Unit

stimulate domestic industry to rise up and meet local demand. Often it did, but without the spur of competition such industries were weak and inefficient. Best practices from other countries – in everything from effective policymaking to institutional design, from application of the rule of law to corporate management techniques – were resolutely ignored as local leaders pursued narrow agendas often more concerned with retaining power than delivering growth. As a result, crucial infrastructure was not built and populations were left uneducated. Firms were not pitted against the best and therefore lacked the imperative to improve. Output per person languished and, as a result, countries remained poor.

Yet a 200-year period of Western dominance may be drawing to a close. Emerging markets are starting to narrow the gap with the West. Over the past 20 years, average growth in the emerging world has outstripped that of the developed markets by over three percentage points per year – even more at the height of the boom that preceded the 2008–09 crisis and while developed economies were laid low thereafter.

Catch-up between the emerging markets and the West has started because, one by one, countries have moved away from inward-looking strategies and

begun to embrace global competition and adopt best practices. Perhaps the biggest and most well-known change of heart was in China, where Deng Xiaoping approved a series of economic reforms from 1978 onwards. The country was opened to foreign trade and investment, markets for products and services were opened to private businesses, some state-owned industries were privatised, and foreign technology and business practices were adopted. India followed suit with an economic liberalisation of its own in 1991. South-East Asia famously embraced foreign trade and became the region of both the Asian Tigers (South Korea, Hong Kong, Singapore and Taiwan) and other ASEAN growth stars such as Indonesia, Thailand and Malaysia. Latin America gradually liberalised too, with Brazil moving away from its policy of global economic disengagement in the late 1960s and Argentina reforming from the 1980s. In central and eastern Europe, reforms had to wait until the fall of the Soviet empire from 1989. In much of the former Soviet Union and Africa liberalising reforms remain patchy even to this day.

The pay-off from reform has been tremendous. In China, for example, income per head has risen from just 2% of US levels (measured using GDP per head at purchasing-power parity) in 1981 to 18% in 2012. The gap is expected to close further in the years ahead: by 2030 Chinese incomes will be running at about a third of US levels. Other countries have done even better – some of the Asian Tigers can truly be said to have emerged, with incomes per head approaching US levels. While not all emerging regions have benefited to the same extent, there has been a widespread acceleration in growth across much of the emerging world over the past decade, as governments have adopted more market-oriented policies.

Key trends

What of the future? Here are a few pointers of what to look for.

Catch-up will continue, but more slowly

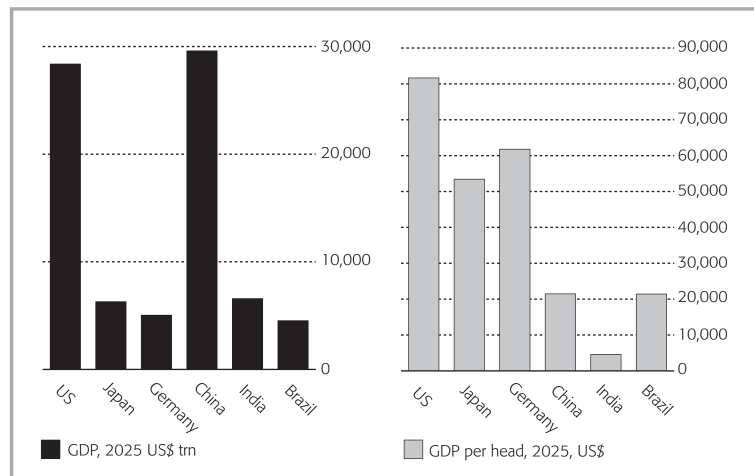
It seems likely, although not inevitable, that many emerging markets will continue on the road of reform, and that incomes will rise more rapidly than in the West. But the pace of catch-up may still slow, in part because the global financial crisis has been such a drag on the advanced economies although it is reasonable to assume that they

will recover at least some of their vim in the years ahead. Catch-up also becomes harder over time. Once the most effective policies and management techniques have been adopted in the emerging world, finding new ways to narrow the productivity gap becomes harder and growth therefore slower. And in countries such as China and Russia, demographic changes will further act as a drag on growth as their populations age. Nevertheless, even with a slower pace of catch-up, the emerging world will be where the growth is for business in the decades to come.

The biggest economies will not be the richest

China, India and other high-population countries are moving rapidly up the global economy league table. China is forecast to overtake the US by 2020. But China has five times as many people as the US, and its citizens will be considerably poorer on average than their Western counterparts. This means that companies will not just be able to farm out products developed with more affluent Western consumers in mind – pricing will be key.

FIG 1.2 **Collectively rich, individually poor**



Source: The Economist Intelligence Unit

No convergence of politics

It was once fashionable to predict that, as emerging economies liberalised their business environment and became wealthier, they would also become more socially and politically liberal. While it is true that new-found wealth does seem to bring popular demands for social freedom, there is little evidence that emerging-world governments are keen to respond to this. Companies will therefore need to get used to a world in which the largest economies are run according to very different rules and norms from those in the West.

Increased turbulence

Emerging markets are, by definition, immature economies. Often they have immature politics too. Economic and political crises are common – few countries that have embarked on the road to catch-up have proceeded smoothly (think of the 1997 Asian crisis, the maxi-devaluations in Argentina, Brazil and Russia, and the uprisings of the Arab spring). As emerging markets become more dominant in the global economy, such crises will continue – even though emerging markets' resilience has increased and the 2008–09 crisis showed that Western countries are not immune from boom and bust either. But as emerging markets account for an ever greater share of global demand and spending, emerging-market crises will hurt more. So companies will need strategies that can contain volatility.

Reversals

Just because emerging markets have the potential to catch up with the rich world, this does not mean that they will. In many countries the basic ingredients necessary to allow productivity to rise are absent: economies remain highly regulated, or are run for the benefit of their leaders, or are socially fractious, or have non-economic priorities such as territorial or tribal ambitions. Some countries will not join the catch-up party. Others will leave the party halfway through. Companies will need to be able to identify those countries with the best chances of sustained growth.

Intensified competition

The competition for companies is increasing and changing. This is partly because any multinational will find that its global peers are also trying hard to increase their share in emerging markets. It is also because emerging-market companies are rapidly becoming much more serious competitors. They may enjoy advantages, including better cultural understanding, more appropriate business models, better relationships with government, entrenched protectionism and possibly fewer restrictions on how they do business. Some 20% of the Fortune Global 500 are already emerging-market companies – Chinese, Indian, Brazilian, Russian, South Korean and Turkish firms all feature. They will increasingly challenge Western firms not just in their home markets but globally.

Rich-world angst

This is a book about emerging markets. But Western attitudes towards the rise of the emerging world will be central to the way in which individuals and firms engage in the fast-growing countries. As the status and weight of the West decline, it is inevitable that worries will increase about a loss of influence, a loss of jobs, pressure on pay, increased demand for raw materials, the environment and the geostrategic intentions of the newly powerful countries. Business engagement in the emerging world will be complicated by rich-world angst about the global rebalancing.

Corporate rebalancing

Attitudes of Western businesses to emerging markets have also evolved. In the 1990s and to some extent in the past decade, the rise in business investment in emerging markets was driven by cost cutting and outsourcing, still primarily directed at catering for final demand in the developed world. But as consumption in the emerging world has surged, companies have come to see these as key markets in their own right. A 2010 report by the Economist Intelligence Unit (EIU) showed that three-quarters of companies surveyed see emerging markets as a source of new business growth. Only 23% were looking for a low-cost manufacturing base.

Indeed, the rise of emerging markets touches every sector. A list of major investment successes in Turkey by the country's investment agency includes big names across a range of industries: fast-moving consumer goods (Coca-Cola, Nestlé, Unilever), clothing (Mango), consumer electronics (Bosch, GE), engineering (Alstom, Schneider Electric, Siemens), automotive (Ford, Hyundai, Pirelli, Toyota), energy (Shell), chemicals (BASF), pharmaceuticals (Pfizer), agribusiness (Cargill), telecoms (Ericsson), IT (Intel, Microsoft), logistics (DHL) and finance (BNP Paribas, Citi, HSBC). Nor is the big shift just a story for FTSE 500 companies – medium-sized and even small companies are getting in on the act too.

The rise of emerging countries as markets in their own right has meant a shift in priorities. Many multinational companies initially tried to tap the demand in these countries by selling unadapted (and often substandard) Western products. But as emerging markets have become a more important part of global strategy, and as multinationals have faced growing competition in these markets both from their peers and from local firms, companies are coming to accept that emerging markets require dedicated products and innovations. Multinationals have also come to understand the need to become more local. This means not just establishing a local presence, increasingly staffed by local talent, but empowering it to take decisions so that local needs can be met and companies can keep pace with the rapid pace of change.

But these shifts still have a long way to go. Companies are hindered by the difficulty of grappling with the complexity of the emerging world, by resource constraints and by corporate rigidity. The changes required for success are far-reaching, requiring radical transformations in company organisation and even corporate culture. Ultimately, emerging countries need to become just as much home markets as the US, Japan or western Europe – companies need to become truly globalised.

In conclusion, the balance of the global economy is shifting. The process will be bumpy and potentially unsettling. But it is also inevitable, and therefore needs to be accommodated by anyone hoping to prosper in the new world order that will result, even if it requires companies to undertake major changes.

A guide to emerging markets

This book gives some pointers to how business leaders can cope with the changes, identify where the opportunities lie, manage and mitigate the inevitable risks, and compete successfully.

It is divided into two parts. Part 1 looks at the main opportunities and challenges. Chapter 1 examines the trends driving the growth of emerging markets and gives a view on how emerging markets will fare in the future. Chapter 2 looks at the extent to which emerging markets share similar characteristics in terms of business opportunities and highlights the role of market research in identifying where the opportunities lie. Subsequent chapters discuss the major challenges for business: dealing with governments and their policies; managing talent and the workforce; infrastructure and property; supply, distribution and marketing; innovation and research and development; ethics and competition; market entry; and corporate rebalancing and transformation.

Part 2 is a guide to the leading emerging markets. It starts with a chapter on the BRICs (Brazil, Russia, India and China). They may be old news, but they still account for a huge chunk of the emerging-markets growth story, offer vast untapped opportunities – especially beyond the main cities – and are crucial for companies looking to rebalance towards the emerging world. Subsequent sections cover the principal markets in emerging Asia, emerging Europe, the Middle East and North Africa, Africa and Latin America.

In general, the selection of countries is based on their size in terms of population, close to 30m or above, and GDP, over $100 billion in 2012. There are a couple of exceptions. Chile should not qualify in terms of population, but it is included because it completes the round-up of the "big seven" economies in Latin America. Kenya should not make it by size of economy, but as sub-Saharan Africa is currently a focus for many companies, including it provides more of a flavour of the opportunities there – and it is one of the leading markets attracting interest. The selection criteria mean that countries such as Ethiopia and Myanmar, which have large populations but whose poverty means their economies are still relatively small, do not make an appearance. Some of these countries will become

important markets in time, and more adventurous companies are already expanding there.

Broadly, though, the countries selected are the ones that are likely to be of most interest to companies based on population and market size. This does not mean that they are necessarily bankers for growth. As the country sections make clear, some of them are considerably less attractive once dodgy business environments and questionable economic prospects are factored in. Including countries such as Venezuela and Iran does, though, have the advantage of giving a fuller picture of the diversity of the emerging world.

1 The economic megatrends

THE SHIFT IN GLOBAL ECONOMIC GRAVITY towards emerging markets was already under way before the financial and economic crisis of 2008–09. The concept of the BRIC (Brazil, Russia, India, China) economies, introduced by Goldman Sachs, a multinational investment bank, in 2001, had gained widespread currency, and the Beijing Olympics in 2008 were seen by many as marking the entry of a newly powerful China onto the global stage.

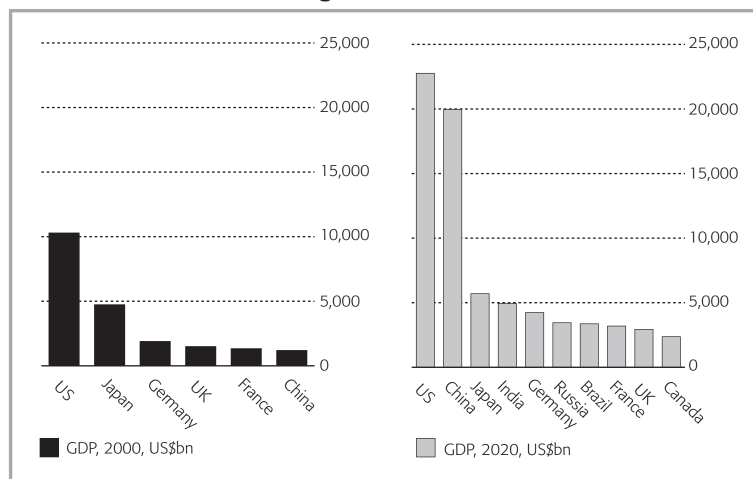
The global crisis accelerated the change. In 2007, before the crisis struck, Goldman Sachs projected that China's economy would overtake that of the US in size by 2027 at market exchange rates. The EIU now forecasts that this will occur as soon as 2025, and in 2019 in purchasing-power parity (PPP) terms.

The speed of change is startling: the economies of emerging markets as a whole have doubled in nominal US dollar terms since 2005, compared with tiny growth in advanced economies. Emerging markets will generate over 60% of global growth in the next five years.

One reason for this is the effect of the crisis on developed economies. These will remain encumbered into the medium term by households' need to rebuild their balance sheets, banking-sector deleveraging that will constrain credit and sharply expanded public debt burdens. Another reason is that emerging-market economies have – with such notable exceptions as eastern Europe – demonstrated a new-found resilience. Growth either held up well during the 2008–09 crisis or returned quickly thereafter.

Emerging markets have not fully "decoupled" from advanced economies. Most still find it difficult to sustain high growth rates if crucial export markets in the developed world are struggling. But,

FIG 1.3 **The world's ten largest economies, 2000 and 2020**



Source: The Economist Intelligence Unit

unlike in the past, it appears that emerging economies now have sufficient internal drivers to grow robustly even while the developed world is in the doldrums.

Unfettered by developed-world solvency issues, many emerging markets are likely to continue to grow more strongly than developed countries in the coming years, allowing them to further narrow the gap with the developed world. Growth will be driven above all by increased openness, productivity catch-up, the improving quality of labour, the development of information and communications technology, and regulatory and institutional reform.

Rapid economic growth not guaranteed

The rise of emerging markets might seem unstoppable, but continued strong growth of these countries is not inevitable, and forecasts for the balance of the global economy in 2020, 2030 or even 2050 have to be seen as essentially hypothetical.

Emerging economies face a number of challenges. Their continued success will depend on their ability to improve productivity, which in turn will require institutional reform, which also poses political

challenges. In countries that fail, growth will slow sharply once the easy gains of economic catch-up have been exhausted, and they will fall into a so-called middle-income trap of economic stagnation.

A key question is the future of China. The country has entered a new phase of its development, characterised by more balanced and slower output growth. It has already benefited from the productivity gains arising from the millions of peasants moving from farm to factory jobs, and future productivity gains will be harder to achieve. Its heavy reliance on investment to drive growth is also unsustainable.

There is also the real danger that economies in the West might respond to the rise of emerging powers by raising protectionist barriers. It is even possible that changes in the geopolitical order implied by the rise of the largest emerging powers will lead to armed conflict. And then there is the uncertain, poorly understood and often ignored impact that climate change may have on the global economy.

Developed economies will surely recover some of their spark in the longer term – there are already signs that the US economy is past the worst. Although prospects for western Europe and Japan look less promising, emerging markets will find it harder to narrow the gap in coming decades.

Moreover, not all emerging markets will succeed in making progress on catch up – some may fall further behind. For example, Venezuela's GDP per head in the 1950s was two-thirds that of the US; by 2012, following decades of economic mismanagement, it was one-quarter.

More complex picture

Overall, the outlook is more complex, and less certain than the "growth markets" tag might suggest. Growth rates vary across different markets including within the same sub-region. In central Europe, Poland's sizeable internal market helped it weather the 2008–09 global crisis. The more export-dependent Czech Republic struggled, while Hungary, which was undergoing a period of austerity following years of government overspending, fared particularly badly.

It is crucial to be able to pick out those emerging markets with the best chance of sustained growth. A decade ago, the BRIC markets

concept provided a simple summary of the principal growth opportunities. Moreover, until 2008, most markets were being sustained by an expanding global economy. Life is more complex today. Companies have to grasp the full complexity of the emerging world, if they are to identify the growth opportunities and allocate their resources efficiently.

The next frontier: emerging-market cities

Throughout history cities have played a crucial role in generating prosperity, but today's unprecedented scale of urbanisation worldwide is heralding a major shift in economic power from state to city. Over 50% of the world's population now lives in cities, generating over 80% of global GDP. By 2050, 70% will be living in cities – compared with 1950, when 70% lived in rural areas.

The dynamism of emerging-market cities is particularly noteworthy. According to McKinsey, cities' GDP will increase by $30 trillion in 2010–25, of which 47% will be generated in 440 main emerging-market centres. The most dynamic will be in Asia, reflecting the region's recent economic rise, with 12 cities there expected to expand annually by over 10% in 2010–16 according to the EIU. This compares with annual growth of less than 4% for developed economies' cities, even in the most dynamic urban centres such as Dallas and Seattle. Cities in Latin America and Africa are also expected to grow rapidly in this period, with Lagos (6.8%), Lima (6.3%) and Bogotá (5.4%) leading the pack.

Reinforcing the emergence of cities as key economic actors is the dynamism second-tier, mid-sized cities (with populations between 2m and 5m) will display. In China alone, around 150 cities now have at least 1m inhabitants, and the number of cities is expected to increase to between 220 and 400 by 2020. While the EIU expects megalopolises to expand by an annual average of 6.3% in 2010–16, in second-tier cities the annual average growth rate will be just over 9%. So middle-sized cities will increasingly be the ones where the highest growth and best business opportunities are to be found. McKinsey estimates that the proportion of global growth accounted for by megalopolises will decline from over 70% to about 35% between 2012 and 2025, by which time almost 40% of growth will come from second-tier emerging-market cities.

Emerging-market cities will increasingly compete among themselves and with cities in the developed world for investment and talent, focusing on upgrading infrastructure and education as well as on making their regulatory environment as business-friendly as possible (including by providing direct and indirect incentives for businesses to relocate to their territory). Attracting the best talent in particular will be paramount. Developed-world cities have a competitive advantage in this respect, as indicated by the EIU's Global City Competitiveness Index, since, besides top-notch education and an abundance of high-end jobs, they offer safe environments with plenty of leisure activities. Nevertheless, emerging-market cities' dynamism and targeted policies are likely to start to redress the balance.

The expansion of emerging-market cities brings both opportunities and challenges for investors and businesses. The most obvious opportunities are no doubt in the sheer size of the consumer market which the growth of these cities will unlock, as well as their infrastructure needs. Urbanisation is normally accompanied by an increase in disposable household income: in China, for example, over the past 25 years, the per-head disposable income of urban households has increased five-and–a-half times in real terms, compared with three-and-a-half times for rural households. According to McKinsey, the ascent of cities in emerging markets will create 1 billion new consumers by 2025, giving a total of nearly 2 billion consumers located there. These cities will also generate over $20 trillion in consumption and investment in physical infrastructure.

City-focused strategies

To tap these opportunities, businesses will need to shift from country-focused to city-focused strategies, which entails important challenges. At present, few managers are taking their location decisions at city level and, according to a McKinsey survey, even fewer envisage changing their strategic approach in the next five years. Lack of awareness of the economic importance of little-known emerging-market second-tier cities can make businesses overlook their growth potential and miss important opportunities. Furthermore, planning at city level often requires a shift in mindset and organisational structures, which could be difficult to justify in a short-term view.

Last but not least, what is required for a successful city-focused strategy varies across industrial sectors and according to the target market. For some