The Business Model of the New Economy

Globalization and the advent of new technologies have dramatically changed the way business, government and society are organized. A key driving force of these changes is a new business model. In an interview with *Economic Reform Today*, Charles Oman of the Development Center of the Organization for Economic Cooperation and Development (OECD) discusses the features of this new business approach and the implications for developing and developed countries of adopting this model in the context of today's new economy.

ERT: Many economists say that globalization is really just a catchphrase for long-term trends in the world economy. If this is true, then globalization doesn't mean that there really is a new economy. What is your view on this?

C. OMAN: The answer, in my view, is two-fold. Globalization, as a general phenomenon, is not new. Since the 19th century, or earlier, there has been a long-term global trend towards liberalizing international trade and investment. It is equally true that we are still very far from a fully integrated global economy. There is plenty of room to further liberalize policies on international flows of finance, trade, foreign direct investment and, for that matter, people. All this lends support to the argument that globalization is more a catchphrase than a word that designates something truly new. The problem for many economists may simply be that they fail to grasp the specific characteristics of the current wave of globalization.

It is equally important to recognize that globalization occurs in waves. There are periods of relatively fast or intense globalization, and periods when globalization slackens and may even be reversed. Each major globalization wave also has its own specific characteristics and driving forces, and each has major implications for business, government and the average citizen.

The last 100 years alone have witnessed three major waves of globalization. One is the decades-long period that began in the latter part of the 19th century and continued until World War I. Another began after World War II and lasted until the 1970s when productivity growth rates in Europe, North America and Japan dropped very sharply. The current wave started roughly in the late 1970s, or the early 1980s, and continues today.

The current wave of globalization is like the earlier waves in some respects, including the strong growth of international trade that is the hallmark of globalization. It is also remarkably reminiscent of the wave that preceded World War I—and unlike that which followed World War II as regards the importance of financial globalization. But each wave of globalization is also unique in important respects, which means that globalization can indeed be understood as something more than a catchphrase.

The key to understanding globalization today is not to be found in the liberalization of policies on trade and capital flows or in the speed of technological change. Both of these elements are important to all waves of globalization. Rather, the key lies in the nature of the business model that is driving competition in the leading economies. To illustrate this, let's compare the business model that drove globalization in the postwar period with the one driving it today.

Globalization after World War II was driven and shaped by the ongoing development and internation-

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al spread of a US business model known as "scientific management" or "mass production." That model is characterized by three key features. One is a tendency in the organization of production to separate "thinking" and "doing" between management and specialized engineers, on the one hand, and relatively unskilled workers on the other. This organizational approach facilitates managerial control, as well as the organization of large numbers of people in a single factory who may not all speak the same language, or know how to read and write. Another key feature is a tendency to narrowly define production workers' job responsibilities and push job specialization as far as possible in order to maximize potential econ-omies of scale. A third feature is a belief, promoted by the engineer Frederick W. Taylor, that at any given time there is a single best way of organiz-ing work and production. This is why he called this business model the "scientific management" approach to organizing mass production.

Scientific management spread across the globe, and in doing so drove globalization following World War II. This system took root and spread in Western Europe thanks in no small measure to the Marshall Plan. One of the plan's major (but often forgotten) contributions to postwar reconstruction was to bring large numbers of European managers and foremen to visit factories in the United States and to send many American managers and foremen to share their knowledge with their counterparts in Europe. Though given another name, the "Stalinist management techniques" that spread behind the Iron Curtain during this same period in the centrally planned economies of Central and Eastern Europe were virtual caricatures of scientific management.

Scientific management methods were also widely introduced during this period by multinational enterprises as well as by local firms in the so-called modern sector of many countries in Latin America, Asia and Africa. In those countries, scientific management was often used in relatively closed and highly protected local markets in a context of government-led import substitution industrialization programs.

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The work of government ministries and administrations in developing and developed countries—as well as that of international organizations around the world—came to be organized according to the principles of scientific management following World War II.

It must be emphasized that globalization during this period, which was driven by the ongoing development and rapid international diffusion of scientific management, contributed greatly to raising productivity levels and standards of living around the world for more than 20 years. Along with that remarkable productivity growth, however, it also contributed to a gradual buildup of bureaucratic rigidities in both the private and public sectors, notably in the leading economies in which scientific management was most widely used. Those rigidities came home to roost, so to speak, in the form of a marked slowdown of long-term productivity growth in the 1970s.

The sharp slowdown in productivity growth led many corporate managers to relocate some of the more labor-intensive segments of production for their home markets to developing countries that have cheaper and more flexible labor pools. These managers were responding to the rigidities that tend to be inherent in the logic of scientific management and that go far to explain the emergence of "stagflation" in the 1970s as well.

The late 1970s and early 1980s in turn witnessed the emergence of what one might call the new business model, whose remarkable competitive strength is driving the current wave of globalization. In many important respects this new approach turns the precepts of scientific management on their head. In particular:

- Production-related thinking and doing are re-integrated in order to take advantage of production workers' human intelligence and capabilities to problem-solve on the shop floor.

- Team work is emphasized. While specialization and economies of scale remain important, the new model is designed to take advantage of the potential synergies generated in working groups of 10, 15, or 20 people, and specialization is

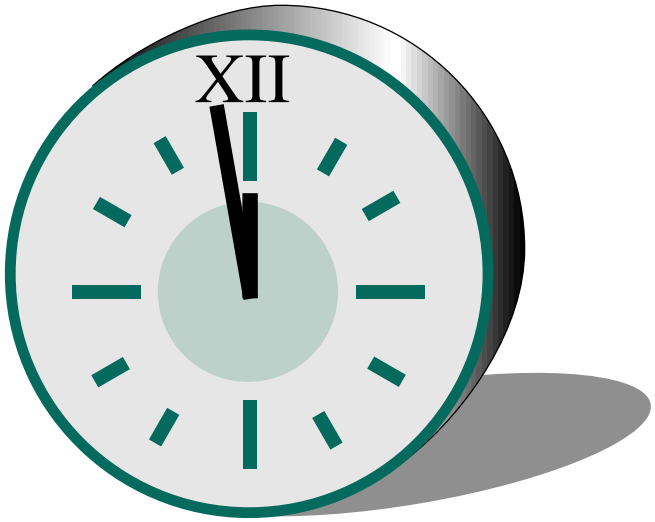
no longer blindly pursued to the detriment of teamwork.

❑ Rather than thinking there is one best way of doing things at any given time, the new approach emphasizes the importance of continuous innovation—not only in what is produced by constantly adapting to changing demands, but in how it is produced (i.e., how business and production are organized) using new technology and new ways of organizing and motivating people.

What is remarkable is that firms operating on this new model have achieved levels of capital and labor productivity significantly greater than the levels that even the most competitive businesses that operate according to the scientific management model can attain. This productivity differential in turn exerts tremendous pressure on all types of firms—from manufacturers to modern service providers—to adopt the new business model. In certain industries, this model is referred to as the "just-in-time" system.

Despite tremendous competitive pressure to adopt this new business approach, there remains much resistance to change. This resistance to making the transition from the "old" to the "new" business model goes far to explain both the growth and relatively high levels of unemployment in Europe and the significant growth in the number of working poor in the US over the last couple of decades. While globalization today is often blamed for these problems, the real culprit is the difficulty many firms and people have in making the transition to the new business model. The difficulty is amplified by the considerable resistance one finds in many firms to making that transition.

Groups resisting the change to the new business model tend to be those operating according to the precepts of scientific management. They include not only organized labor but also, in many cases, middle and top management in hierarchical organizations whose jobs often become redundant, or whose ways of addressing problems become dysfunctional in the new business model. A notorious example is that of General Motors (GM). The company's significant loss of market share and difficult reorganization during the 1980s is a story of top managers who proved unable for too long to see the world other than through the lenses of scientific management, and they had to be replaced.



ERT: What difference does globalization make for companies? Is the basic business model changing?

C. OMAN: My understanding of the new business model refers to a broad variety of different types of businesses. On the one hand, you have large companies such as Toyota that already in the late 1950s found they could not replicate what Ford, GM and Chrysler were doing in the US. Toyota gradually overcame certain production obstacles by establishing flexible production methods that led to the development, over many years, of what has come to be known as the just-in-time system. That is only one subtype of the new business model, however. For example, plenty of small and medium-size companies in the textile and furniture industries in parts of Italy and southern Germany developed into industrial clusters operating on the new business model, and they generated significant competitive pressures in these industries.

Because the US was a global leader of the old mass production model, it was not one of the first countries to produce many dynamic firms operating according to the new business model. The US society, economy and many US businesses are relatively flexible, however. As a result, beginning in the 1980s and especially since the recession of the early 1990s, many US companies have adapted quickly and reorganized production based on many new business model principles. It is not just new companies such as the dot.coms that are operating according to the new business model. Hallmarks of the old model, including GM, have had to move towards the model as well. (GM began integrating features of the new business model when it set up the Saturn production facility based on the just-in-time system.)

Above all, the new business model is a philosophy of human

organization based on conscious teamwork, networking, motivating people and reducing waste, including the cost of underusing human capabilities and retaining inventory. There is no inherent reason why old-style businesses cannot adopt the new model if their top people understand its underlying principles. But nobody can say it's easy.

ERT: What are the implications for the developing countries of the shift in business models? Are the fears evident at the WTO meeting in Seattle justifiable in the sense that developing countries are likely to be left behind?

C. OMAN: I happened to be in Seattle at the time of the WTO Ministerial. In my view, the Seattle demonstrators were mostly Americans expressing their lack of trust in their government and, in many cases, in large American businesses. Some of them protested on behalf of developing countries. While I don't necessarily question their good faith, I certainly do not think that they could actually speak for developing countries. Mexico, for example, is a bona fide developing country that doesn't seem to share many of the concerns expressed on the Seattle streets. Hence, I would not assume that any significant number of demonstrators in Seattle actually represent a cohesive Third World perspective.

Nonetheless, the way in which developing countries respond to the current forces driving globalization will have a major effect on their living standards, growth rates, quality of life, and development process in the coming decades. In countries where institutions are not deeply rooted, shifting to the new business model may meet less resistance than in countries where those institutions are more developed. Conversely, in countries where corporate and political governance structures are very rigid (typically in conflict or tension-ridden societies), adopting the new business model is likely to be difficult. As a result, these countries may fall even further behind during this wave of globalization than they did during the previous one. Some developing countries are flexible and can adapt quickly, but they may face obstacles instituting changes. In short, whether or not developing countries will benefit or lose from the new business model and its competitive strength remains an open question. It depends largely on how the governments of these countries respond.

The increasing internationalization of production is occurring within rather than between the major regions.

Two interesting questions are whether countries such as China, Brazil, Indonesia, or India should adopt the new business model, and what role should US companies play if they are considering investing in those countries? I'm not suggesting that the world is no longer interested in mass production based on low-cost labor. Certainly many companies are still interested in setting up such activities in China, India or Indonesia and exporting from these countries. What I am saying is that the 1970s-style move to relocate "offshore" to produce mainly for the investor's home market is not the wave of the future. Increasingly, companies invest to produce in developing countries with a long-term view of serving the markets in the region in which the country hosting the investment is located.

The wave of the future is flexible production and flexible organizations. In that regard, many developing countries should continue to improve the quality of their educational systems and their physical infrastructure (notably telecommunications and transportation), which will enable them to compete more effectively in local and regional markets and, in the case of some industries, in global markets.

In my view, the increasing internationalization of production is occurring within rather than between the major regions. By major region I mean greater Europe, North America, or even the Western Hemisphere, and Asia. Notwithstanding the 1997 Asian financial crisis, investment in Asia is surging, and most of it serves the greater Asian market. The same is true for investment in Europe and the Western Hemisphere. In other words, geography still counts. Physical proximity between firms and their clients, on the one hand, and between firms and their suppliers (particularly when it comes to physical inputs), on the other hand, can be an important competitive advantage that should not be underestimated.

This suggests that regional inte-

gration will continue to accelerate. Therefore, it is important that policymakers ensure that regional integration schemes, such as the North American Free Trade Agreement and the Free Trade Area of the Americas, and microeconomic, company-level forces driving globalization are compatible and mutually reinforcing.

ERT: How important is institution building to countries that want to participate in the new economy, particularly independent judicial systems, contract law and private property rights—especially trademark and copyright protection?

C. OMAN: The experience of countries that sought to internationalize their economies in the 1980s and 1990s by applying liberal trade and investment policies clearly demonstrates that liberal policies are necessary but not sufficient. Strong, credible, market-supporting institutions, including laws and property rights, are needed in order for countries to benefit from economic liberalization. What Russia provides is an extreme example of the fact that markets cannot work well without the requisite institutions. Over the past 20 years, many countries in Latin America and Asia have liberated market forces significantly, and those that also developed market-supporting institutions are faring much better than those that did not.

Many institutions are essential to sustain a well-functioning market. Of these, a strong, independent judiciary and an independent competition agency are particularly important. Regulatory institutions that ensure that regulations foster rather than obstruct competitive market forces are crucial for all market economies.

ERT: How important has the worldwide spread of democracy been to the advent of the new economy?

C. OMAN: It depends, to a certain extent, on your conception of the new economy. The spread of democracy is extremely important for economic development. I'm just not sure I would link it any more closely to the development of the new economy than to economic development as a whole. Clearly the development of democracy and of the economy go hand-in-hand. Beginning in the 1970s, repeated discussion has focused on the deleterious effects of financial repression on economic development, particularly in Latin American and other Third World countries that adopted the import substitution model. (This model is a relatively closed approach to development, characterized by trade barriers, financial repression and government-controlled savings and investment, and often by non-democratic political institutions.)

The experience of the 1980s shows that ending financial repression by establishing free, well-functioning financial markets coincides with the need to end political repression and develop democratic institutions that ensure political expression. The bottom line is that democratic political institutions and well-functioning financial and capital markets are mutually reinforcing.