Special Report

ASIA GROWS, BUT HOLDS ITS BREATH
Emerging economies such as China, India and Indonesia have been on a roll for the past few years. Their GDP has been growing at a robust pace while the U.S. and Europe have been struggling to recover from the financial crisis of 2008. Today, while these economies are still growing, the pace is beginning to slacken. Trepidation is the dominant mood.

In this special report, prepared to coincide with Wharton’s Global Alumni Forum in Jakarta, Knowledge@Wharton explores these issues in detail. The report features an overview of the strengths and challenges of the fast-growing Indonesian economy as well as trends in consumer spending and commodities trading, the twin engines of growth in that country. In addition, the report analyzes what a slowdown in China might mean for the world economy and examines the key issues facing China’s financial system. It also looks at Microsoft’s growth strategy in India and the lessons it holds for companies that seek new opportunities in emerging markets in these challenging times.

Contents

Indonesia’s Economy Is Surging Forward, but Challenges Abound  Page 1
With GDP growth of more than 6% expected this year, Indonesia’s economy is stronger than it has been in years. The country is soon expected to join the club of nations with an annual GDP of more than $1 trillion, and foreign direct investment is at a record high. The stock market is booming and net foreign debt is less than 10% of GDP. Still, according to experts from Wharton and elsewhere, Indonesia faces several challenges. The country will need to continue economic reforms in order to sustain its performance.

China’s Antiquated Financial System: The Creaking Grows Louder  Page 4
China’s 30-year economic miracle is now up against an antiquated financial system that threatens to hold it back. If the country is to fulfill its aspirations to move from a low-wage manufacturing and export-based economy to a higher-margin, knowledge-based economy, it will take a far more efficient financial system to support the innovation needed to advance. And that requires a new financial relationship with the rest of the world, based on trust and transparency. A big question is whether that is politically possible yet.

Ravi Venkatesan: Winning in India Can Help Companies Win Globally  Page 7
Under Ravi Venkatesan’s leadership from 2004 to 2011, Microsoft India’s revenues grew fivefold and the country became one of the fastest growing markets for the software firm. Last year, the 49-year-old Venkatesan quit as chairman of Microsoft India to explore new ground. He is now working on a book about why it is imperative for multinationals to succeed in India. In an interview with India Knowledge@Wharton, Venkatesan suggests that the capabilities that companies develop in India can help them win all over the world.

Twin Engines: How Consumer Spending and Commodities Drive Indonesia’s Growth  Page 12
Domestic consumption accounts for almost two-thirds of Indonesia’s gross domestic product, while sales of lucrative commodities – such as coal, palm oil and gold – make up much of the remaining third. Rising prices for the natural resources that Indonesia has in abundance have helped push millions of people into the middle class, increasing their purchasing power and driving a boom in sales of everything from cars to cosmetics to air travel.

China’s Gravity-defying Economy: How Hard Will It Fall?  Page 15
As China’s high-octane economy shifts into lower gear, virtually everyone agrees that the double-digit, super-charged boom years are drawing to a close. Speculation over the possibility of a so-called “hard landing” for the country flourishes with each boom and bust cycle, only to die down as China’s growth revs up again. This time, however, both external and internal factors — including global conditions, domestic politics and financial trends — are reinforcing the downturn. Many experts warn that without some painful reforms, there will be worse trouble to come.
In the middle of Jakarta stands a statue of Krishna and Arjuna, central characters in the *Mahabharata*, the Indian epic. They are on a chariot pulled by 11 horses in full gallop. It is an appropriate metaphor for the Indonesian economy, which has surged forward to its highest level in years. While growth is expected to be 6.1% in 2012, on June 7 the *Jakarta Globe* reported the government reckons it to be 7.2% next year. (World Bank estimates previously had suggested 6.4% growth in GDP in 2013.)

That’s not all. By the end of this year or early next year, Indonesia may join the club of 15 countries with an annual GDP of more than $1 trillion. In 2011, foreign direct investment reached a record $19.3 billion and exports grew by 29%, reaching $203.62 billion. Fitch Ratings in December granted Indonesia an investment-grade credit rating after 14 years of junk status, and Moody’s Investors Service followed in January.

Indonesia’s net foreign debt is now less than 10% of GDP, and a real possibility exists that the country might become a net creditor by the end of next year. Moreover, Indonesia’s stock market is booming. It was one of Asia’s best-performing markets, gaining 3.2% at a time when other exchanges suffered due to the global financial crisis. In April, the World Bank noted that “despite both domestic and international risks, Indonesia’s economic fundamentals are solid.”

Indonesia has seen rapid economic growth before — but the country also faces several risks and challenges. Experts at Wharton and elsewhere wonder whether this growth is sustainable. Philip M. Nichols, a professor of legal studies and business ethics at Wharton, is upbeat. He believes Indonesia’s large internal market has enabled the country to weather the global economic crisis relatively unscathed. According to him, Indonesia is finally beginning to climb out of the “institutional hole” that it found itself in pre-1997 when rapid growth papered over deep faults and eventually led to a crash. Indonesia’s large internal market — two-thirds of its consumption is internal — makes its economy resilient. Furthermore, the country has better institutions, less distortion and greater reliance on markets.

Indonesia is in the middle of an unprecedented consumer boom. Scooters, cars, smartphones, ice-creams and skincare products are all in demand. The middle class is growing, and newly affluent Indonesians are spending. Big brand names are visible on televisions, bill boards and on Jakarta’s streets. When it comes to commodities, the growth of China and India has given a fillip to the Indonesian economy. Both demand coal and gas while the entire world is hungry for palm oil.

**Indonesia’s large internal market – two-thirds of its consumption is internal – makes its economy resilient.**
Dutch Disease?
While commodities are driving growth, they are also creating the risk of a Dutch disease for Indonesia. The Dutch disease refers to the fact that an increase in exploitation of natural resources leads to a decline in the manufacturing sector in the economy due to exchange rate appreciation. Manufacturing has lagged behind almost every other sector of the Indonesian economy. This is unhealthy in the long term, according to Richard J. Herring, co-director of the Wharton Financial Institutions Center, who believes Indonesia should focus on infrastructure and human capital formation to wean itself away from its resource base. Other regional competitors, such as Vietnam, have been focusing on education and infrastructure while Indonesia has been lagging behind on both fronts.

Indonesia ranks 124th out of the 187 countries surveyed by the 2011 Human Development Index. Apart from the University of Indonesia, its universities have slipped in the 2011 World University Rankings. The overall level of educational attainment is relatively low; some 50% of the labor force has an elementary school certificate or lower. Only 40% of the labor force has secondary education and a little more than 5% has diplomas and university degrees. This leads to a problem of labor underutilization, such as unemployment and underemployment.

These challenges are compounded by a shortage of infrastructure. Indonesia desperately needs ports, roads, railways, power and broadband. Broadband use is only about 18% of all Internet users in Indonesia. More importantly, while its neighbors are busy building new ports or expanding old ones, Indonesia appears to be lagging behind. The World Bank's Logistics Performance Index ranked Indonesia at 75th out of a total of 155 countries surveyed. Malaysia, Thailand, Philippines and Vietnam are all ranked above it, and the differential is only likely to increase as they are all investing in infrastructure.

Role of Government
As a young democracy, Indonesia’s government institutions are still evolving. The highly decentralized political system makes decision making arduous and protracted. Forging institutions for a sprawling archipelago with a population of 240 million people from more than 300 ethnic groups speaking 737 languages is tough. This is made tougher because of the legacy of Dutch colonial rule followed by decades of authoritarian rule after independence in 1945. Indonesia has a gargantuan bureaucracy that is often criticized for acting too slowly.

To add to Indonesia’s woes, its political system is fragmented. President Susilo Bambang Yudhoyono is the head of a six-party coalition who seeks to rule by consensus, but this is often difficult to achieve because of conflicting agendas. Politicians draw their power from patronage, which means that there is an incentive to create policies that benefit wealthier segments of the population.

Consider fuel subsidies, for example. According to the 2009 household survey conducted by the World Bank, 40% of the direct benefits to households from fuel subsidies go to the richest 10% of households, and less than 1% of the subsidies go to the bottom 10%. Further, with the price of Brent crude oil topping $105 a barrel, fuel subsidies are costing the exchequer a huge sum. Recent attempts to cut back the subsidies have resulted in street protests and parliamentary rebellion. As a result, fuel subsidies remain unchanged. In light of the continuing high price of oil, Shubham Chaudhuri, the World Bank’s lead economist in Indonesia, remarked last month that the government would end up spending between $20 billion and $30 billion every year on subsidies instead of using funds “for roads, health care, alternate energy sources and helping poor households.”

Corruption poses another challenge for growth. For instance, Muhammad Nazaruddin, the former treasurer of the ruling party, was convicted in April of defrauding the exchequer to the tune of $365 million by inflating construction tenders for the 2011 Southeast Asian Games. He claims that he did this to raise funds for the party and not for personal gain. Senior party members and even ministers are now suspects in this scandal, which, according to The New York Times, has “riveted the nation and shaken the party of President Yudhoyono.”
What will this combination of growth potential and serious challenges mean for Indonesia’s future? According to Herring, “Indonesia could be one of the leading economies in the world,” but to get there, the country will need to implement reforms. At the moment, the International Financial Corporation and World Bank rankings for doing business place Indonesia at number 129 out of a total of 183 countries. The same index ranks Indonesia at 155th for starting a business, at 156th for enforcing contracts and at 161st for getting electricity.

With reforms, over time, things are likely to get better. A new land acquisition act was passed in December. This is likely to increase spending on infrastructure, and already there are signs that this is beginning to happen.

One of Indonesia’s greatest strengths is its culture of tolerance. No other Islamic country has a statue of Krishna, who is revered by millions of Hindus, in the middle of its capital. If the country can build upon such strengths while also being mindful of its challenges, there is a strong chance that the metaphorical chariot will continue to speed forward without faltering.
In April, Chinese Premier Wen Jiabao took aim at China’s powerful state-owned banks. According to Reuters, he said at a discussion with local businesses: “Frankly, our banks make profits far too easily. Why? Because a small number of major banks occupy a monopoly position, meaning one can only go to them for loans and capital. That’s why right now, as we’re dealing with the issue of getting private capital into the finance sector, essentially, that means we have to break up their monopoly.”

Wen’s attack on China’s big banks, followed two weeks later by the Chinese central bank’s move to widen the renminbi-to-dollar trading range from 0.5% to 1%, raises the question of whether China is about to accelerate bank and financial system reforms. Against the backdrop of the spectacular fall of Chongqing Communist Party boss Bo Xilai, who upheld the heavy hand of the state-owned enterprises in the economy, and the dramatic escape of political prisoner Chen Guangcheng, are liberal reformers now gaining momentum as China undergoes its next leadership transition this fall?

Experts say further financial liberalization is in the cards, as both domestic and external pressures mount. “The fall of Bo Xilai pushes up reform forces in the Chinese party, government and society, and that’s a good sign,” says Hoest Loechel, professor at Frankfurt School of Finance and Management in Germany and a visiting professor at the China Europe International Business School (CEIBS) in Shanghai. Pieter Bottelier, senior adjunct professor at the Johns Hopkins University School of Advanced International Studies (SAIS) and former World Bank chief of resident mission in Beijing, predicts: “Liberalization of bank interest rates could come very soon, by the end of the year, linked to further internationalization of the renminbi (RMB).” He notes that the People’s Bank of China (PBOC) says the time is right for China to open its capital account in phases, starting over the next three years, transitioning to full financial liberalization in five to 10 years.

To date, the state-dominated financial sector has funded the extraordinary growth in China’s real economy, averaging 10% a year over the last 30 years. “The striking thing about China’s reform model is that they have used the financial sector as a tool to achieve reform in the real economy,” says Bottelier. But, says Gary Liu, deputy director of the China Europe International Business School’s Lujiazui International Finance Research Center in Shanghai, this system can also end up holding back the domestic economy. “Soon, this lag in financial sector reform will drag down growth in the real economy,” especially as China aspires to transition from a low-wage, investment-led, manufactured export-based
Asia Grows, but Holds Its Breath

Economy to a higher-margin, consumption-led, knowledge-based economy. “If you want innovation, one precondition is an efficient financial system,” Liu notes. “That’s why the U.S. is so strong in innovation, because U.S. companies, at whatever stage of growth, can borrow money — from private equity, banks or the stock market. In China, many small- to medium-sized enterprises (SMEs) have to bribe government officials to get loans.”

Though China’s top banks have acquired private shareholders via initial public offerings over the last decade, the government still controls bank deposit and lending rates, and maintains ownership stakes and considerable control of banks. The Big Five — the Bank of China, the Industrial and Commercial Bank of China, China Construction Bank, Bank of Communications and Agricultural Bank of China — together dominate the sector with a 50% market share of total assets, according to Loechel. Under China’s controlled deposit and loan rates, banks receive a guaranteed spread of about three percentage points. In turn, the banks lend at favorable terms to state-owned enterprises, often for large infrastructure investments. About 90% of Chinese companies’ financing comes from bank loans, according to the World Bank.

Internal and External Pressures

Meanwhile, ordinary household savers are on the short end of the stick. Factoring in inflation, they earn negative interest rates of about 2% from their deposits. With China’s bank deposits totaling 80 billion RMB last year, that negative return amounts to $1.6 trillion RMB, notes Liu. CK. Raising interest rates on household savings deposits would boost domestic consumption, drive growth and help alleviate social inequality.

Household-funded nation building can work as long as the economy is growing. But it can foment discontent when the economy starts slowing, say experts. “This kind of financial system can generate tremendously high levels of economic activity because it forces the household sector to subsidize borrowing costs very heavily,” says Michael Pettis, a professor at Peking University’s Guanghua School of Management, specializing in the Chinese financial system. “As long as growth rates are high and the investment is not being wasted, this system is sustainable and wealth generating, but … once we shift into a phase where investment is being misallocated, the system tends to generate unsustainable levels of debt.”

Add Wharton finance professor Franklin Allen: “The economy can keep growing at 7% to 8% per year by building infrastructure in Tier II and II cities, but China probably wants to start some reforms to make sure the economy doesn’t fall any further when that infrastructure development is completed.”

Meanwhile, external pressures are building, too. The biggest driver is China’s desire to internationalize its currency, says Allen. China must lessen its dependence on the U.S. dollar and euro, viewing both as becoming less reliable as a store of value for China’s massive foreign reserves. To internationalize the RMB, “China needs to open up the capital account, and let money in and out more easily,” Allen says.

To maintain a stable RMB-to-dollar exchange range so far, China has had to ensure that Chinese and U.S. interest rates do not diverge widely, to prevent higher Chinese interest rates from driving up the RMB’s value. Since that makes China unable to use interest rates as a monetary policy tool, the PBOC has relied primarily on administrative controls, such as bank reserve requirements and loan growth rate targets, to control inflation. Allowing greater exchange rate flexibility will open the way for more market-based interest rates in the domestic financial system — both for inflation control by the PBOC and for more efficient, market-driven capital allocation by the banks. “If China continues to be the world’s largest exporter and second-largest importer, and holds aspirations for RMB to be at least one of world’s reserve currencies, they have to make these changes to the financial system over the next five to 10 years,” says Wendy Dobson, a professor at the University of Toronto’s Joseph L. Rotman School of Management.

Yet, some experts say true liberalization cannot occur until banks stop performing the government’s fiscal functions. Yukon Huang, a former World Bank economist and now senior fellow at the Carnegie Endowment for International Peace in Washington, D.C., notes
that government expenditure in Europe is 45% of GDP; in the U.S., 30% to 35%; and in China, only 28%. “How can a socialist economy have such a low share of government spending?” asks Huang. “Government spending is done through the banks.” While there is nothing wrong with government spending through the banks or the budget, “as long as the money is well spent,” he says, in the long run, “the broader question is how to reform the budget system. Are the country’s institutions strong enough” to be able raise and collect taxes, rather than relying on household bank deposits?

But, as Wharton management professor Marshall W. Meyer notes: “China rarely institutes sweeping reforms in one stroke. Maybe now is the time to experiment seriously in banking.” For now, to continue the path of financial liberalization, analysts are recommending that China take the following major steps:

**Liberalize interest rates.** A flexible exchange rate will bring pressures to liberalize bank interest rates. Wharton's Allen anticipates China’s first step in bank reform is to lift controls on deposit and loan rates. That move could shrink the spread between the two from three to one percentage point, “challenging the business model of the big banks,” says Loechel. Today, about 80% of Chinese bank revenues come from lending, compared to an international average of 50%, he says. But Chinese banks can still thrive if they follow the example of the Bank of China, which already makes 30% of its revenues from asset management. If banks double their current commission business, even while their interest spreads decline and labor costs rise, the big Chinese banks will still have a greater return on assets than their Western counterparts, he says.

**Promote private-sector lending.** To address the pressing need to finance private SMEs, China should allow private investors to invest in the banking system, says Liu. The handful of privately owned Chinese banks, including China Minsheng Bank, Ping An Bank and Zhejiang Tailong Commercial Bank, are doing well, he notes. In March, Chinese officials named Wenzhou in Zhejiang province a “special financial zone,” to encourage the growth of private lending institutions. Separately, the Supreme Court overturned its earlier death penalty ruling for Wu Ying, a Zhejiang-based entrepreneur accused of illegally raising money from private investors, signaling government openness to private-sector financing.

**Create other capital markets.** To give banks more competition, companies an alternative source of funding and households potentially higher-yielding investment vehicles, China should set up a corporate bond market, says Dobson. In March, China Securities Regulatory Commission chief, Guo Shuqing, said China could open up a junk bond market soon to help finance private SMEs. If so, China needs to strengthen the rule of law, says Dobson. “Financial markets are transparent and run on trust and confidence, based on rules and laws that are enforced;” she notes.

**Strengthen bank supervision and deposit insurance.** As China liberalizes its banking system, it must concurrently build bank supervisory capabilities, notes a former Morgan Stanley banker who has worked in Greater China for two decades. Widening the RMB trading band and liberalizing bank interest rates can take place relatively quickly, but developing strong supervision could take at least 10 years, including the training of competent personnel, he notes. Likewise, creating a deposit insurance system will help safeguard against potential banking crises.

As China faces its next leadership transition, these reforms are an economic imperative that even conservatives in power cannot overlook, say experts. “If China cannot reform its banks and financial sector, it will have a deep negative impact on economic development and for social stability,” says Loechel. But the magic elixir of these reforms may be the true test of leadership. Says Dobson: “The really hard part is you need the rule of law for a modern financial system, based on trust and transparency, to function. Whether it's Bo Xilai or Chen Guangcheng, many roads can lead to political reform. That’s the great opportunity now and the great unknown.”
Under Ravi Venkatesan’s leadership from 2004 to 2011, Microsoft India’s revenues grew fivefold and the country became one of the fastest growing geographies for the software firm. Last year, the 49-year-old Venkatesan quit as chairman of Microsoft India to explore new ground. He is now working on a book on why it is imperative for multinationals to succeed in India. Venkatesan suggests that the capabilities that companies develop in India can help them win all over the world.

In a conversation with India Knowledge@Wharton, he notes that India “may be one of the hardest markets [to break into] across the world, but if you succeed here, then you are like an Olympic athlete.” Venkatesan is yet to finalize the title of his book, but the working title pretty much sums it up: Learning from Chaos. Win in India to Win Everywhere. The book is scheduled to be published later this year.

Prior to joining Microsoft, Venkatesan worked with U.S.-based engine and power generation firm Cummins for more than 16 years and was the chairman of Cummins India. He is currently a director on the boards of AB Volvo and Infosys Limited and is also a member of the advisory boards of the Harvard Business School and Bungee.

An edited transcript of the conversation follows:

India Knowledge@Wharton: Why did you think of this particular topic for your book?

Ravi Venkatesan: My original interest was to understand why India matters so little to most multinational corporations (MNCs). This was a result of my contrasting experience at Cummins and Microsoft. While [his stints at both firms] were extremely successful, there was one big difference. At Cummins, India contributed close to 15% to 20% of global profits, while at Microsoft, India accounted for only 2%. As I looked around me, I found that a vast majority of MNCs in India are still subscale, with India contributing only around 1% of their global businesses. I was puzzled by this. Interestingly, the companies themselves think that they are successful here. They think they are doing well because they are growing here in the double digits, which is not the case in developed markets. Most of them say that they are at their target profitability [in India]. But the fact is, India still makes an irrelevantly small contribution. And that’s what intrigued me.

“I then looked at a number of companies. For instance, I looked at Nokia, which went from a 65% market share [of the mobile phone market] in India to 30% in two years. I looked at General Electric (GE), which was the pioneer of outsourcing in India. But the 2000s was the “lost decade” for GE in this country. It hardly grew its revenues here during this period. [More recently, GE has been growing very strongly again in
India.] Then I looked at McDonalds. This is a company that has built its identity around the Big Mac — a beef product. It comes to a country that is largely vegetarian, where the cow is sacred and US$1 is still a big price point for the mass market. And yet, it has created the fastest-growing restaurant chain in the country. So I began to look at why a few companies are spectacularly successful in India, while for others the revenues from India are largely irrelevant. I then started looking at what this could mean for them.

India Knowledge@Wharton: How do you define a “successful multinational” in India? Is it purely based on its revenues and market shares or are there other parameters also?

Venkatesan: If you look at major economies and growth rates, then China’s impact is crushingly dominant. India is next, even with our slowdown to below 7% [projected GDP growth for this fiscal year]. If a company’s revenues broadly reflect global GDP as an opportunity, then India as a market should contribute at least 10% to 15% of the new growth at a company on a global basis, China should contribute 35% to 40% and emerging markets as a whole should contribute around 50% to 65% of the growth. That’s a healthy portfolio. If you haven’t done this, it means that you have not got your engines working right. That’s metric number one.

When I looked at the really successful companies, I found that the CEOs of these companies were driven by the conviction that strategically they need to be a dominant player in this market. They need to be an early mover and build an unassailable leadership position before their competition. Those who come late get reduced to being marginal players. JCB Construction’s 60% share of construction equipment and Cummins 60%-plus share of engines and diesel generator sets are good examples of doing this right. So the second definition of success is that you had better be a market leader in the important economies of the world. And China and India are the most obvious ones.

The third piece is that the best companies are beginning to see that the capabilities they develop in India help them win around the world. I have begun to believe that this may be the single most important reason for a multinational to figure out and crack the code in India. If you think about it, China is unique. You are not going to find too many countries in the world that are run like a company — where there is fantastic infrastructure and where the government tries to make things as predictable as possible. Many more countries resemble India more than they do China. India is all about getting things done despite the government, dealing with a difficult policy environment, working in an environment of extreme uncertainty and volatility, and dealing with people who have aspirations but don’t have disposable incomes. India may be one of the hardest markets across the world, but if you succeed here, then you are like an Olympic athlete. The capabilities that you develop here will help you win all over the world. I like how Stephen Elop [CEO] of Nokia put it: “India is like a petri dish for innovation. If we win here, we can win everywhere. Conversely, if we lose here, we could end up losing in lots of other markets.”

India Knowledge@Wharton: Does this mean that we are likely to see a lot more reverse innovation from India? Will this also be a measure of a company’s success in India?

Venkatesan: Yes. But it will not be restricted to innovation only in products. Like I said, it applies to dealing with uncertainty and unpredictability, it applies to how you grow and develop talent and how you build partnerships, and it applies to … your management method to create an agile system in a large bureaucracy. All these parameters apply not just in other emerging markets but in developed markets as well. In the medium to long term, this may be the single most important reason for a company to succeed in India. The ROI [return on investment] on this will be greater than from the India market itself. It is no longer about the developed and developing markets but in developed markets as well. In India Knowledge@Wharton: When you studied the MNCs that have been successful in India, what did you find are the key factors for their success?

Venkatesan: At one level, the answer is obvious. Once the top of the pyramid is saturated, a company needs to address the middle. It needs to
make the necessary investments in supply chain and distribution, localize manufacturing, set up engineering capabilities, develop market specific products, localize management, empower the local team and so on. But doing all this [in India] is so different from how the company operates in other geographies, apart from China, that there is tremendous resistance to change. So the most important step is commitment from the global CEO. Unless the global CEO says that India is strategically important and personally commits to the India journey, things will not change. The India market is very hard. Every decade, there are seven or eight tough years and two to three good years. You have to survive the tough years and run hard in the good years. The CEO must have the vision and commitment to say that despite the chaos and the turbulence, we must stay invested. The CEO must realize that it is not just about winning in India. It is about leveraging India to win in other geographies.

Once the global CEO is committed, you have to get the next level of management engaged with the India story. Typically what works is that you take a transformational opportunity — like the IBM-Bharti outsourcing partnership — and make that your Trojan horse for transformation. You get the whole company focused on making it work. Also, like Dave Cote at Honeywell, you need to hold the presidents of global businesses accountable for growth and leadership in China and India - not just [for] meeting their [overall] numbers.

Also, if you want transformation, it's critical that the country head in India is someone totally trusted by the [top management], especially the global CEO. And he must have easy access to the global CEO. Otherwise, they will not listen to him; they will be tone deaf. This trust is even more important than market knowledge and an India network.

One of the most important attributes of the India CEO is courage. This is because almost on a daily basis, he will need to take a tough stand both internally and externally. For instance, even if the firm has frozen salaries globally, the India CEO must have the courage to say that his team deserves a raise because they have grown their market by 30%. If he doesn't have the courage, he will end up toeing the company line and making a complete mess. In other geographies, the local CEOs don't need to make such tough calls on a daily basis because the company's business model and the country environment are well aligned.

Another vital quality of the local CEO is that he must be a person for whom India is not just a stepping stone to the big job: It is the big job. For this, the company also needs to do its bit. Nothing significant can be achieved in India in less than five to seven years. So the company has to say that India is important enough to let this person grow within the hierarchy without having to move him or her to another geography.

India Knowledge@Wharton: Why have so many multinationals not been able to adopt these measures?

Venkatesan: It is like health. We all know that we must eat right and exercise well, but most of us ignore it until the body sends us a big alarm. Many CEOs understand intellectually what needs to be done to win in India. But that is not enough. There needs to be an experiential moment of truth that gets the CEO committed to the country. This often happens when the global CEO spends enough time on the ground in India to see past the surface and get a visceral feel for the potential of the market. This is what happened with Sam Palmisano in IBM in 2003.

India Knowledge@Wharton: Does the success of a multinational in India depend on the sector in which it operates?

Venkatesan: Yes. In any country you have a spectrum of firms across B2C [business to consumers], B2B [business to business] and B2G [business to government]. The closer you are to B2C and B2B, the easier life is. There is less corruption, less harassment and less regulation. The closer you are to B2G, like infrastructure, the more harrowing it is. The more a business depends on access to natural resources like land, minerals or spectrum, the tougher it is for an MNC to succeed in India.

India Knowledge@Wharton: Isn’t this true for other countries also?

Venkatesan: Yes, it is. But it is far more magnified in India.
**India Knowledge@Wharton:** Does the size, the age and the country of origin impact the success of a multinational in India in any way?

**Venkatesan:** I have some anecdotal evidence, but don’t have robust data to support it. I have not seen any correlation of success with respect to age, but I think size does make a difference. Size is an advantage when it comes to making long-term investments and the ability to take risks. Country of origin also makes a difference. Western European countries, particularly Sweden, Germany, France and the U.K. have a history of being global. They also tend to take a longer-term view.

Scandinavian firms place a very high level of trust in their local managers and therefore are more willing to do things differently. American firms are globally oriented, but many of them are very arrogant. They take a very export-oriented and a one-size-fits-all approach. Korean [firms, such as] Hyundai and Samsung, do extremely well because they are willing to make big preemptive investments to win in India. Japanese firms, with a few exceptions, do badly; they are ultra-cautious and lack trust.

**India Knowledge@Wharton:** Are joint ventures a good way for companies to enter India?

**Venkatesan:** Yes. If you want scale and want to get to the middle of the pyramid fast, then joint ventures are a good vehicle provided you find the right partner with similar values. If you get the right partner, then [that firm] brings in the brand [recognition], the distribution capabilities, and policy and regulatory influence. All these are extremely important. Also, a strong partner allows the multinational to get the right balance between local and global. However, a bad partner can set you back many years; it’s a lot about due diligence.

**India Knowledge@Wharton:** In what way is operating in China different for multinationals than operating in India?

**Venkatesan:** The biggest difference is the way one has to engage the government in China. There is also a massive part of the Chinese economy that is export-driven — this really doesn’t exist in India beyond information technology services. China is a vastly bigger and more affluent market with a much bigger middle class. In that sense, it’s an easier market than India. But in almost everything else, it’s pretty similar.

**India Knowledge@Wharton:** With increasing globalization, how important is it to have a globally integrated workforce?

**Venkatesan:** Having the whole workforce globally integrated is neither possible nor practical. What you need is a very high degree of cultural diversity ... at the senior level. What is important is to have a very strong talent flow around high potential leaders. Firms need to have India, China and other emerging markets as crucibles of leadership development and send the best and brightest of their top and middle-level people of any nationality to these countries.

You also need to move people around to build capabilities. So if you want to develop engineering capability, you must send your people to countries like Japan, Germany and the U.S. for two- to three-year assignments. But this is not easy to do. Companies need to have enlightened policies to make this happen.

**India Knowledge@Wharton:** Indian firms are now increasingly going global. In what way are their challenges different from companies based in other countries? What measures do they need to take to ensure a smooth passage?

**Venkatesan:** Everything I said about multinationals operating in India applies to Indian firms going global. Most Indian firms are not doing these things because they are in the first stage of globalization. I see it as a journey. They will go out, they will stub their toes and they will get burned. Then they will reflect and course correct.

**India Knowledge@Wharton:** Indian IT companies in particular are currently having a rough time in the U.S. Some analysts have suggested that it is the success and growing size of these companies that is attracting the adverse attention. What are your views on this? Is this part of the globalization journey?

**Venkatesan:** Yes. As long as you are small, you are below the radar. The problems start when you become big. The single biggest problem in developed markets today is jobs. If Indian firms want to operate at scale and over a long period...
of time in developed markets, then they need to invest in creating jobs [in those markets]. This means that they need to localize their leadership and their teams as quickly as possible.

They also need to create large programs to give the local people skills and make them employable in their core business. Further, they need to be seen as giving back to the communities in which they operate. They need to cultivate goodwill and policy influence there. And of course, they need to behave in a culturally sensitive manner. In America it must feel like an American company, in the U.K. like an English firm.
In 2009, when Chris Kerrigan helped launch Brightspot, Jakarta’s first pop-up market (short-term retail space), it was meant to inject some spice into the city’s growing retail sector. Drawing on a concept that would help support up-and-coming Indonesian designers, he and his partners aimed to create a temporary shopping experience that might appeal to young consumers with rapidly rising disposable incomes. They were hoping for a party that would generate some sales. What they got was a sold-out show and demand that seemed unquenchable. “We knew immediately we were on to something,” Kerrigan recalls.

Some 5,000 people attended that four-day event in 2009. Three years later, Brightspot drew 55,000 buyers, and Kerrigan and his team have expanded their operation to include a “curated” department store – or a collection of Indonesian designers grouped under a single shop — and two cafés.

In many ways, their story is the story of Indonesia, Southeast Asia’s biggest economy and one of Asia’s fastest growing. In 2011, the economy grew by 6.5%, and economists predict it will top 6% again by year’s end. That the country has remained mostly sheltered from the economic crises impacting the United States and Europe is mainly because of the two things driving its economy: consumption and commodities.

Domestic consumption accounts for almost two-thirds of Indonesia’s gross domestic product. Sales of lucrative commodities – such as coal, palm oil and gold – make up much of the remaining third. Rising prices for the natural resources that Indonesia has in abundance have helped push millions of people into the middle class, increasing their purchasing power and driving a boom in sales of everything from cars to cosmetics to air travel. “Indonesia’s consumer economy is actually in better shape than that of China or India,” said Debnath Guharoy, Asia director for Roy Morgan Research, an Australia-based market research company.

Money from the export of metals and minerals, particularly the thermal coal needed to feed China’s 1.3 billion people, is what feeds the country’s growth engine, he continued, while the consumer economy is what keeps the engine turning. “That motor will keep ticking over – and it will create wealth.”

Growing Middle Class

Between 2003 and 2010, roughly 50 million people entered the middle-income bracket, defined by the World Bank as those who spend between $2 and $20 a day. In 2011, Indonesia’s GDP per capita topped $3,600, exceeding that of India, Asia’s second largest consumer market after China.
Brands are now betting on the growth of those buyers to support sales of cappuccinos, cosmetics and home decorations. Established names like McDonald’s and Dunkin Donuts have all registered strong profits over the past year, while shares in some retailers, such as Mitra Adiperkasa — which holds franchise rights to Burger King, Starbucks and department store Debenhams — have climbed more than 20%. Major international retailers are seeing that growth and are scrambling to get a foothold. Swedish retailer Ikea, for instance, plans to open its first Indonesian outlet in 2014.

Some of the strongest growth over the past year has come from the convenience store segment, particularly Tokyo-based 7-Eleven, which has more than 60 outlets in Jakarta and is aggressively expanding. Most of its clientele is under 30, and to reach them the brand has altered its marketing approach. It serves affordable ready-to-eat food and drinks for people on the go but also offers outdoor seating and Internet connectivity – an appeal to a culture partly defined by its love for social networking.

Outside Indonesia’s major cities and among the sizeable low-end of the middle-income segment, purchasing decisions focus more on big-ticket items and daily needs. “If you own a television set, a refrigerator and a motorcycle or a car, you qualify in my mind as a middle-class home,” notes Guharoy, who prefers to use those three pegs to define the middle class in emerging economies. Gauged in that way, Indonesia’s middle class has grown from 28% of households to 45% since 2007. It is this segment that is driving sales of noodles, juices and household items, boosting profits at companies such as Unilever, Kraft and Nestle.

Given easier access to credit, the middle class is also propping up sales of cars and motorbikes, many of which now offer cheap new models to appeal to low-income earners. Car sales in Indonesia hit nearly 900,000 units in 2011, beating out Thailand to become the No. 1 car market in Southeast Asia, with sales projected to reach one million units by the end of this year. “Production and sales in Asia are double what they are in the U.S. and Europe,” says Michael Dunne, a leading expert on Asian car markets, adding that Indonesia could be the next China if it provides the incentives needed to attract outside investment. “The trick for Indonesia is to convince foreign investors that this is a good place to make money.”

**Booming Auto Sales**

Signs are pointing in the right direction. Carmakers including Nissan, Toyota and General Motors have already pledged up to $2 billion in the coming years to expand their manufacturing operations in the country, and they are not just coming here to produce cars for export. “People are looking at the domestic market,” notes Jongkie Sugiarito, the co-chairman of the Association of Indonesia Automotive Industries and president director of Hyundai Motor Indonesia. Today the hottest auto market is for Toyota Avanza minivans that consumers are snapping up for around $15,000. In five years, they will be spending $20,000.

The biggest concern among investors is Indonesia’s gross lack of infrastructure. While sales of cars and motorbikes have skyrocketed, road networks have barely expanded. A new land use law passed early this year will make it easier to procure land for the development of toll roads, and other much-needed infrastructure is still awaiting implementing regulation.

In addition, President Susilo Bambang Yudhoyono has set out an ambitious $400 billion 15-year development plan, nearly a quarter of which will go toward projects such as highways, ports and power plants. But a decision by Parliament in April to continue supporting fuel subsidies constrains the government’s ability to redirect spending toward vital infrastructure and improve the country’s business climate, which still ranks low on global indexes.

Airport expansion has been a top priority due in no small part to blistering growth in the airline industry. Last year, more than 68 million people took to the skies in Indonesia, growth of 15% from the year before. Industry analysts predict growth will continue at around 20% in the coming years. “Indonesia has huge potential,” says Brendan Sobie, a senior analyst for Southeast Asia at the Center for Asia Pacific Aviation. “It’s become one of the hottest markets in Asia.”
Dozens of new airlines have been created since a 2004 regulation made it easier for new players to enter the market. In recent years, plane manufacturers looking to take advantage of strong growth have feted Indonesia at international air shows. Boeing and Airbus are competing for orders and offering training and maintenance support to major buyers Garuda and Lion Air, which recently signed a record $22 billion deal for 230 Boeing 737s.

Air travel is a natural fit for a country comprised of more than 17,500 islands and constrained by a lack of road and rail infrastructure, says Sobie, who notes that the industry has boomed thanks to an influx of low-cost carriers. But some analysts worry that the number of new airlines makes it harder to ensure safety monitoring and strains an industry with a reputation for poor safety standards. New technology would help, they say, but this, too, is an area where Indonesia is lagging.

Facebook Nation

“Indonesia has adapted very quickly to cheap access to technology and is a huge Facebook and Twitter nation,” says Roy Morgan’s Guharoy, referring to the large population of Indonesians who use social networks. That is mainly because of easy access to affordable smart phones and pay-per-use data plans.

But when it comes to sleeker, more modern systems – ranging from the latest mass rapid transit to updated air traffic control to mobile banking – Indonesia is still far behind neighboring Thailand, Malaysia and Singapore. It may not be too far behind China, however, in terms of rapid growth, and Indonesia’s central bank and Ministry of Finance have kept a close eye on consumption patterns to keep the market from overheating.

Bank Indonesia has done well to keep inflation fairly stable while also lowering interest rates to support consumer spending. Consumer goods have seen the impact, but so, too, has the property sector. Sales of homes and condominiums grew by 130% last year, according to property firm Jones Lang LaSalle. Prices have been rising in parallel, with condominiums in the middle-class market 60% more expensive than they were in 2007.

Such growth has fed fears of potential pricing bubbles, pushing the central bank to launch new policy measures that will require higher down payments for automotive and mortgage loans. Industry players say the move is pre-emptive and will only hurt growth. Guharoy is more bullish. “The consumer economy has real legs and very few threats,” he notes, highlighting Indonesia’s consumer-driven economy as one of the strongest tools in its growth arsenal. And that means Indonesia – a basket case economy just 15 years ago – may maintain its sweet spot far into the future.
As China’s high-octane economy shifts into lower gear, virtually everyone agrees that the double-digit, super-charged boom years are drawing to a close. Speculation over the possibility of a so-called “hard landing” for the country flourishes with each boom and bust cycle, only to die down as China’s growth revs up again. This time, however, both external and internal factors — including global conditions, domestic politics and financial trends — are reinforcing the downturn. Many experts warn that without some painful reforms, there will be worse trouble to come.

Still, economists’ opinions about just how far China’s economy will fall range widely. Also, exactly what constitutes a “hard landing” for a country that has until now been viewed as an almost unstoppable economic powerhouse varies from analyst to analyst, although most point to China’s growth rate as a key defining factor. “People give different definitions,” notes Wharton finance professor Franklin Allen. “Mine would be growth below 5%.”

China’s growth slowed to 8.9% in the final quarter of last year, after months of attempts by the government to cool inflation through curbs on bank lending, interest rate hikes and stringent increases in banks’ reserve requirements. The government has said all along that it expects growth to slow: In his “State of the People’s Republic” address to China’s legislature on March 5, Premier Wen Jiabao set the annual growth target for 2012 at 7.5% — the first time the official benchmark has been set below the 8% level long viewed as the minimum needed to create enough jobs and ensure social stability. And in the current five-year plan, the government has set the annual growth rate at 7%.

Despite the fact that China is one of the few countries that routinely surpasses growth projections, this time reality might come closer to the government’s target. Wei Yao, a Hong Kong-based economist at Societe Generale Cross Asset Research, forecasts that China’s economy will grow at an 8.1% pace in 2012, slowing to 7.7% growth in 2013 and 7% in 2016. “I do not think that China will have a hard landing this year, but what will happen by 2014 really depends on what the government does in the next few years,” she says. Given the many issues the country’s leadership is juggling — including the property bubble, local government debts, income gaps between rich and poor and rampant corruption — “it will be a challenging task to avoid a hard landing.”

“I do not think that China will have a hard landing this year, but what will happen by 2014 really depends on what the government does in the next few years.” — Wei Yao, economist, Societe Generale Cross Asset Research

Patrick Chovanec, a professor at Tsinghua University’s School of Economics and Management, sees China heading for a “bumpy landing,” with ups and downs in the next few years. The country’s leaders, preoccupied with the upcoming shift to a new generation of Communist officials and distracted by the global
financial crisis, have put off several tough but crucial structural reforms, he notes. These include liberalizing exchange rates and interest rates, improving the distribution of wealth, carrying out tax reforms and shifting away from the increasing dominance of state-owned industries. The worst thing China could do, Chovanec and other economists say, is to unleash another flood of stimulus to counter weaknesses in exports and investment. “That would be … kicking the can down the road for another year, presuming they could. All it would do is set up the economy for an even bigger fall later,” Chovanec notes. “China needs corrections in the property market and broader economy to refocus growth on activities that earn genuine returns. The longer you put them off, the more painful it will be.”

China’s handling of those challenges matters more now than ever. Political stability will hinge on overhauling the economy to ensure that growth is more sustainable and equitable, suggests a report issued in late February by the World Bank. “This is not the time just for muddling through. It is time to go ahead of events and to adapt to major changes in the world and national economies,” World Bank President Robert Zoellick said during a news conference for the report’s launch in Beijing. “As China’s leaders know, the country’s current growth model is not sustainable.”

The Next Middle East?

China’s transition to an era of lower growth in some ways parallels Japan’s abrupt shift in the early 1990s. Both countries allowed excessively cheap, often politically influenced use of credit to create a massive bubble in their property sectors. But there is one key difference that could lead to ugly consequences in case of a hard landing, notes Wharton management professor Marshall W. Meyer. “You still have a lot of poor people in China, many more than Japan in the 1990s. Japan was essentially middle class, with all [citizens] having medical insurance and social security. That is where the political trouble is,” Meyer says. Dissatisfaction over lagging incomes and inadequate social services could spiral if the growth that has underpinned Communist Party rule were to stall: “Neither China nor the world would like to see turmoil [in China] like [what we saw last spring] in the Middle East.” Indeed, in mid-March, Premier Wen noted that if the country doesn’t initiate key reforms, it could experience enough social unrest to precipitate another Cultural Revolution like the one that shook the country between 1966 and 1976.

Chief among the World Bank’s recommendations is a call for China to ensure that growth is more reliant on consumer demand than on the heavy investment in construction and capital equipment that has been the main source of dynamism in recent years. Even if the structural changes outlined in the report are carried out, the World Bank said growth is destined to slow from an annual average of 8.6% in 2011-2015 to 7% in 2016-2020, 5.9% in 2021-2025 and 5% in 2026-2030. [Editor’s note: The World Bank has lowered its forecast for GDP growth in China for 2012 since this article first appeared in Knowledge@Wharton. At the end of May, it was projecting 8.2% GDP growth for 2012, down from the 8.4% forecast in January. It raised its forecast for 2013, however, from 8.3% to 8.6%. For 2014, the Bank expects growth in China to fall back slightly to 8.4%. Others are less optimistic. In early June, JPMorgan Chase & Co. reduced its China GDP forecast to 7.7% for this year.]

The old trick of relying on heavy government-directed investment financed by state-run banks is no longer working, notes Chovanec. “The underlying reality indicates that a big chunk of what was driving GDP growth in China” — fixed asset investment — is now flat-lining. China’s fixed asset investment growth fell 0.14% in December from November’s total, which fell 0.4% from October. When fixed asset investment slackens, the result is a sharp decline in GDP, he adds. “Now, whether that is reflected in the official GDP numbers, I cannot say. GDP is a very political number in China.”

Economists, wary of trusting the usual statistics, have racked their brains for ways to corroborate trends, citing measures such as construction equipment orders, demand for cement and electricity generation. There is no tried and true method, while distrust of China’s statistics remains nearly universal. Even if they have improved from earlier decades, the temptation for padding or distortions is intense for local party bosses, whose career prospects depend
on what they report to higher levels. Andy Xie, an independent Shanghai-based economist who travels extensively in China, believes that the real situation is much closer to a “hard landing” scenario than statistics show. “There is no reliable data to verify whether it is a hard landing or not,” he says. “The GDP statistics are not meaningful at all…. They are not just incorrect, but way off.”

Even taking the Statistics Bureau’s data at face value, the signs are not encouraging. Its figures show that out of the 9.2% GDP growth for 2011, 5.0 percentage points came from increases in fixed asset investment. Fixed asset investment (FAI) grew 23.8% in 2011, down from 24.5% growth in 2010. But investment growth slowed through the year, to an 18.5% year-on-year increase in December, after 21.2% in November and 25% in October. “If everything remained constant, and FAI [this year] merely matched last year’s absolute amount ... we’d be looking at 4.2% GDP growth,” Chovanec notes. So far this year, fixed asset investment in the first two months rose 21.5% from the same period a year earlier, against market expectations of slower year-on-year growth for all of 2012.

**The Weakest Link**

Although construction also has been slowed by shortages of financing for various infrastructure projects, Pieter Bottelier, professor of China studies at the School of Advanced International Studies at Johns Hopkins University, views the real estate sector as the weak link in the economy. The risk is not so much a residential market meltdown like those seen in the U.S. and Europe in recent years, since Chinese homeowners rely much less on borrowing than their counterparts in those markets. The greater threat is in the massive, unsustainable borrowing by property developers whose projects are unlikely to pay the originally anticipated returns due to a downturn in prices. “If we get a sudden dip, say a 10% to 20% plunge in prices in the big cities, then we will have a new situation that could become very dangerous,” Bottelier says. China has more than 10,000 real estate developers who are highly leveraged and may have to default on their bank loans if prices fall far enough.

Apart from the damage to banks, which would receive state support if necessary, the spillover into the construction, construction materials and other related sectors would likewise be damaging. Construction activity accounts for about 15% of GDP and a large share of jobs for the unskilled rural workforce. “The construction industry is such a big part of the Chinese economy, it could trigger more serious problems. This could lead to a hard landing,” Bottelier notes.

So far, housing prices have fallen only marginally, although there are anecdotal reports of double-digit declines for some projects in the biggest cities as well as in provincial ones. Overall, prices in China’s largest 100 cities fell 0.3% in February from a month earlier — the sixth consecutive month of decline, according to the China Real Estate Index System. Property prices in 72 cities dropped in February compared with January, while they rose in 27 cities and were flat in one city. In Xie’s view, the property bubble has already burst, though the results are less dramatic than in other major economies, partly because Chinese banks are constrained by political influences and generally do not foreclose on bad loans. “Instead, you see a lot of empty buildings. China has built too many buildings,” he says.

The government holds the power, still, to open the taps and allow faster growth in the property sector if it chooses to do so, Bottelier notes, but it has to act with caution. “If [the government does this] too quickly, the bubble will return.” But China’s leaders are insisting that they intend to keep firm curbs in place until prices come down to more affordable, less politically risky levels.

At the same time, with the U.S. and European economies still frail, the export manufacturing sector is no longer providing the momentum it once did. China’s export growth declined to 20.4% in 2011 from 31.4% in 2010, and economists are predicting from zero to 10% growth this year. Crisis-stricken Europe accounts for 20% of China’s overall exports. Wharton’s Allen views the risk of a hard landing as only one-in-five — unless things in Europe blow up. “If things in the U.S. and Europe stay as they are at the moment, then [a hard landing] is much more unlikely,” he says. According to the IMF, a deepening of the European debt crisis could pull China’s GDP growth down to 4%.
**Beijing’s Balancing Act**

Despite the myriad internal and external constraints confronting China’s leaders, Beijing has various options for helping to shift the economy from an investment driven model to one fueled by consumer demand.

First, China needs to improve its allocation of resources to better balance the economy — a step that only can follow reforms in interest rates and other pricing mechanisms. “China has all the wrong prices — including exchange rates, interest rates, gasoline prices and land prices. Those prices are all controlled and managed by the government. If you have the wrong prices, you will have wrong allocations,” notes Yao of Societe Generale. Mispricing of credit makes investment costs cheap for state-owned companies and local governments, encouraging excess construction and waste on projects that yield little or no returns and do not necessarily improve productivity or public services.

China's handling of its 10.7 trillion RMB in local government debts is typical of this imbalance in the economy. In early February, the central government asked Chinese banks to roll over local government debts that accrued during the massive recession-fighting stimulus binge in 2009 — essentially sweeping them under the rug for a later reckoning. More than half of those loans are to come due over the next three years.

By far, many analysts say, the biggest shift required is a redistribution of resources that will unleash the potential spending power of the Chinese public. “China needs to rebalance the composition of its GDP more toward consumption, develop a more market-based monetary policy, reduce the excessive privileges of state-owned enterprises, ease income inequality and focus on promoting more productive and environmentally friendly industries,” according to Rob Subbaraman, chief economist with Nomura International in Hong Kong. Moving toward a more market-based monetary policy, involving a more flexible exchange rate and deregulated interest rates, would push bank deposit rates higher, helping to reduce the need for saving and also improving investment options so that families do not rely so heavily on real estate to grow their nest eggs. Meanwhile, the government needs to make the politically difficult choice of reducing preferential treatment for state companies, which now includes preferential access to bank credit and government subsidies of land, labor and electric power. The aim is “to redistribute income from the corporate sector to the household sector,” he says.

Subbaraman sees a one-in-three likelihood of a hard landing and believes China could resort to extra stimulus spending to avert such a worst case scenario. But without the necessary reforms, the stimulus money would just go to waste, he notes. “The key with future fiscal stimulus is to direct it more efficiently at consumption and more productive areas of investment.”

**Repairing the Net**

Apart from the overall structure of the economy, another key reason for the Chinese obsession with scrimping and saving is the dire lack of public services and social welfare. Education, likewise, is a huge cost for most families. “Right now, taxes are too great a burden for households and the private sector, while China spends too little on social security, medical care and education. There is a lot they can do there,” says Yao.

Meyer agrees. “There is room to repair the social safety net. Since there is not adequate medical care and social security in China, people feel they have to save 40% to 50% of their income. If they feel they have some safety net in their old age, they will be less prone to save.” As China’s population ages, it will have a growing need for services for the elderly, and spending on such areas will increase if the supply is there to meet demand, Meyer says. “You can increase consumption if customers get what they want.”

In fact, Bottelier sees China’s services sector as one of the most powerful potential engines for growth, and one that has not been fully realized. “Even at lower growth rates of 6% or 7%, China can maintain full employment if the contribution of the service sector to the economy expands more rapidly than the contribution of construction or manufacturing. You can get more growth in the service sector per dollar invested,” Bottlier says. He views such changes as inevitable. “We have to see how China responds to this in coming years. If they postpone...
these kinds of reforms] again, messy political consequences will be waiting."

Overall, the consensus among most economists is that it is time for China to bite the bullet and move ahead on politically difficult, painful reforms that could lay the foundation for sustainable growth in the future. It would not be the first time: In the 1990s, then-Premier Zhu Rongji carried out the first big overhaul of state industries, laying off millions of workers. Housing reforms helped create a commercial property sector from scratch that, despite its ups and downs, has helped establish a growing middle class. Given the strong hold of vested interests, especially at the local level, such changes are difficult but necessary for a rebalancing of the overall economy, notes Chovanec.

“My advice [to the government] is to drop this obsession with high-level GDP growth,” Chovanec says. “Driving 8% to 9% GDP growth through investment may not pay off, and is not in the long-term interests of anyone in the Chinese economy. Accepting lower rates of expansion is a first step to putting China on the path toward long-term, sustainable growth.”
Special Report

Asia Grows, but Holds Its Breath

http://knowledge.wharton.upenn.edu