THE ENEMY IS

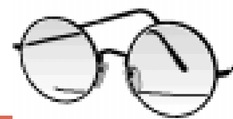
Ted W. Hall

UNTIL HIS DYING DAY IN 1601, Tycho Brahe believed that the sun and all the other stars revolved around the earth. For him, our planet was the center of the universe. It wasn't that he lacked the data to understand the error of his thinking; indeed, it was none other than Brahe's own meticulous observations that Johannes Kepler later used to develop the view of the solar system that is so familiar to us today. The devil, it turned out, was not in the details, but in the assumptions.

The choice we confront today as we consider the global economic system is not so different from the one that Brahe faced almost four centuries ago. Like Brahe, we can decide to interpret facts on the assumption that the sun, the stars, and the planets orbit the earth, and invent elaborate explanations for the observations that don't fit. Alternatively, we can adopt a more contemporary, but also quite threatening, view of the solar system.

Today, some of our most fundamental beliefs about the global economy need the same

Ted Hall is a director in McKinsey's San Francisco office. This article is based on a speech given at the Harvard Business School's Distinguished Speaker series. Copyright © 1995 McKinsey & Company. All rights reserved.



THE MINDSET

Headlines focus us on trade of manufactured goods

The reality of the global economy: local production of locally consumed services

Transferring best management practices would raise standards of living 25 percent

scrutiny that Kepler lent Brahe. We need, in Emerson's words, "to pierce through rotten diction and fasten again words to visible things."

Consider, for example, the following:

> *"The twenty-first century will be a century of head-to-head competition. Some will win; some will lose."* [1]

> *"Naturally, the global trading system has entered, quite quickly, into a win–lose situation in which one nation's rapid gains translate into losses for others."* [2]

> *"The most important reason for the long upward trend in European unemployment rates is the rise of nations that are competing with us."* [3]

All this is interesting. It's politically plausible. It's attractive. It motivates people. But it isn't true.

How could that be? How could we have a set of political premises and public views so fundamentally at odds with the reality of our world? To answer this question, we must deconstruct our most basic assumptions about the nature of the global economy.

An antiquated paradigm

The framework whose applicability I seek to challenge was developed during the Industrial Revolution, and it goes something like this. The world consists of a series of closed national economies, each with its own unique set of factors of production. These economies compete with each other on the basis of manufactured goods strapped to the decks of ships. What determines the standard of living of any one of them is the effectiveness with which it produces the goods that it exports.

This is the theory of comparative advantage. According to Ricardo, standards of living in all countries rise if the forces of comparative advantage are able to operate through free trade.

Over time, this framework has spawned other ideas, such as the notion that nations compete head to head. Lester Thurow's book of that title, which rests on the presumption that economic performance is about competing in

[1] Lester Thurow, *Head to Head: The coming economic battle among Japan, Europe, and America,* Morrow, New York, 1992.

[2] Hiroyuki Yoshikawa, President of the University of Tokyo, *Japan Economic Journal,* June 27, 1994.

[3] "Growth, competitiveness, and employment," The European Commission, White Paper, December 1993, quoted in Paul Krugman, "Does third world growth hurt first world prosperity?" *Harvard Business Review,* July–August 1994.

a zero-sum game to produce goods with the greatest added value, has been a best-seller. But there is a problem with this view of the world. It may have been applicable in 1860, and perhaps even in 1890. By 1910, however, it was beginning to break down. Today, it is largely irrelevant.

What is so wrong with this perspective? Not much more than what was wrong with Brahe's life's work: just two basic assumptions that have been left unchallenged for too long. These are, first, that the production of manufactured goods matters more than other activities in an economy, and second, that trade in goods is a primary mechanism for enhancing a nation's standard of living.

Something else that has gone unchallenged is the corollary of these assumptions: that nations are engaged in a head-to-head competition that yields clear winners and losers. This popular viewpoint simply fails to recognize the primary engine that generates economic wealth in the world today. It isn't the production of manufactured goods, and it isn't trade.

Not manufacturing

Consider the conventional wisdom, captured in a recent *Washington Post*/ABC News poll, that Japan is the world's foremost economic power. Only 29 percent of Americans questioned named the United States. Yet Japan's national income per capita is only 81 percent of America's (measured on a purchasing power parity basis). Perhaps more significantly, Japanese productivity is a mere 61 percent of the US figure.

These numbers may seem surprising; they are not, after all, what we are used to hearing. We are normally told that Japan's productivity exceeds that of the United States. Why? Because everyone *assumes* that the productivity of the manufacturing sector is a valid proxy for the productivity of the entire economy.

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The figures with which we are constantly deluged are certainly accurate when it comes to the manufacture of machinery, electronics, and transport equipment. But what is their relevance in a world where three-quarters of the US labor force – and nearly two-thirds of Japan's – is employed in the service sector?

Today, manufacturing resembles the agricultural sector of the late nineteenth and early twentieth century. Tremendous increases in productivity have meant that the required level of output of manufactured goods can be produced by a much smaller workforce. The labor freed in this way must

seek employment elsewhere. The workers released by agriculture a hundred years ago were absorbed into manufacturing; those released by manufacturing in our time, it turns out, are finding work in the service sector.

There are two conventional views of this situation, both negative. One is that "bad" service sector jobs (or "McJobs") at places like Wal-Mart and McDonald's are displacing manufacturing jobs. The other is that the "good" manufacturing jobs are moving to Japan and elsewhere. Recall Ross Perot's "giant sucking sound."

The reality is that manufacturing jobs are being lost all over the developed world. And, while it is true that many of the jobs that have replaced manufacturing work are clerical or sales jobs, the great untold story is that in economies where the service sector is allowed to be vibrant, managerial and technical jobs are the majority of new jobs created, and more than offset lost manufacturing jobs. Not only that, but wages in the service sector are equivalent to those in manufacturing.

Only when we break out of the mindset of looking exclusively at the manufacturing sector do we find that the service sector productivity of what was West Germany is 77 percent of America's, for example, and that Japan's retailing productivity is 44 percent of the US figure. Nearly half of the end-use consumption of manufacturing, moreover, actually takes place in the service sector, which raises a crucial question: Who is serving whom? Historically, the presumption has been that services exist solely to meet the needs of people employed in manufacturing, and to bring manufactured goods to market. Without manufacturing to prime the pump, so the logic goes, we won't have services.

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Now this may have made sense once, but not any more. Consider the innovation of Wal-Mart in the US economy. I'm a small manufacturer, and I'd like to take my goods to market on a reasonably large scale. Do you really believe that I am going to be able to induce a highly efficient distribution channel to spring up to serve me? Quite the reverse: the reason the United States has such a wellspring of small business activity, especially in manufacturing, is that it has an extremely efficient consolidated distribution system that is readily accessible to all.

The notion that, say, an innovation in a retailing format at Wal-Mart is inferior to the invention of the cotton gin is absurd. In fact, I would argue that many service sector innovations have had far more fundamental, powerful, and beneficial effects on much larger shares of the economy than the simple invention of the cotton gin ever did.

The great myth of the 1980s was that productivity in the United States was declining. In fact, it was probably rocketing up. Few people knew this, however, because the service sector was hardly ever measured. And when it was, nobody looked at output, because the Bureau of Economic Analysis was built around the 1910 concept of what was important to measure. How do you measure output at Wal-Mart? That was a hard question, and it didn't seem important. So it went unanswered.

The consequences of taking an antiquated paradigm and applying it to our very different world are grave. What usually happens is *a leap to presumption* – a perverse interpretation of the facts as reinforcing evidence for the old model, rather than as reasons for re-examining the assumptions behind it. This is unfortunate, because it leads to economic policies that are misguided in intent, in timing, and in recommendation. It produces business managers whose thinking is fundamentally in conflict with the economic realities of the businesses they are in – a conflict that paralyzes and short-circuits appropriate managerial action.

One consequence of this old model is policies that are misguided in intent, in timing, and in recommendation

Not trade

The problem with holding on to a manufacturing-based worldview is that with it everybody *presumes* that the way to improve global standards of living is through the process of trade across international borders. Not understanding the true structure of the economy allows us to continue to believe that somehow the convergence of different living standards is going to be brought about by an exchange of ever-better goods, manufactured by supremely efficient producers.

The difficulty with fixating on trade in a service economy is that a haircut produced in Hong Kong does me no good if I'm in New York. A vast part of the world economy simply is not traded and could not be. Rather, it consists of locally produced and locally consumed goods and services.

In such a world, where the bulk of the labor force finds its employment not in the relatively easily traded manufacturing sector but in the locally produced and locally consumed service sector, trade ceases to be the engine of prosperity. Put simply, the traded goods sector has such a small employment base that no matter how well it performs, it cannot raise national productivity in any meaningful way.

So, if you are a politician in Germany, or Japan, or France, and you want to raise your nation's standard of living, what is it that you should do? What

policies will actually alter your country's productivity? The answer must lie in influencing the dominant sector, namely services. And the fundamental source of improvement in this part of the economy has nothing to do with trade.

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Consider some of the important new ideas that have emerged in the service sector: hub-and-spoke systems in airlines, fast-food retailing, price clubs. If innovations like these are created in one country, what is the mechanism by which they are moved across the world? It certainly isn't the process of trade. It has far more to do with the ways in which management teams transfer technological and managerial knowhow from one point to another. The things that matter in this context are foreign direct investment, local ownership, the ability to control, lead, and manage facilities in overseas locations, and the willingness of managers to apply the best available managerial technology.

What all of this means

If trade isn't the engine of economic advance, what happens to the question of winners and losers? If a large portion of output is produced locally and consumed locally, and one country can find a way to increase its productivity, who is losing somewhere else? What does "loss" have to do with anything? And if much of the world economy is in this mode of local consumption, what is the relevance of the idea of head-to-head competition?

Our current public policy debates are stuck in the framework of producing something better and selling it somewhere else, while defending domestic markets from an invasion of products from outside. At best, we try to lower tariff barriers to ease the working of comparative advantage. Yet trade is no longer the primary mechanism by which standards of living can be raised, and it has little to do with the bulk of economic activity in the world. There is a far more important process: the transfer of innovation.

The key to prosperity is to create an economy where goods are locally produced, but globally exposed. As John Young, former CEO of Hewlett-Packard, remarks, "We achieve world-class productivity anywhere we build a facility." In fact, the HP experience is generally true and is shared, among many others, by Toyota, Benetton, Tower Records, and Toys "R" Us. Managerial method is transportable.

However, before it can have an effect, it must first be let in. In general, the lagging sectors in Germany, Japan, and the United States often have surprisingly low levels of exposure to competition from global best practice.

The sectors that are exposed to worldwide competition are nearly always top-notch performers.

Contrary to Secretary of Labor Bob Reich's claims, our research at the McKinsey Global Institute indicates that the skill level of a workforce has little to do with the productivity level it can achieve. Regardless of its source, managerial technique can be transported from one country to another while maintaining the same productivity it enjoyed in its place of origin. Toyota, for example, has achieved high levels of productivity in the United States with exactly the same workforce that is available to less successful domestic producers.

What this means is that we don't need to train people to make them smarter in order to do better. If the answer is better-trained workers, how do we explain the fact that nearly half of the unemployed in Germany are graduates of its prestigious apprenticeship program? What we really need is the ability to take the best innovations in management technology and apply them wherever we might be. And we need not worry about winning and losing, because much of whatever is produced will be consumed locally no matter what.

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The OECD countries produce about $14 trillion in 1990 terms. A complete dismantling of trade barriers between these nations would raise total world production by $1.4 trillion at best. That's 10 percent – an important but incremental difference.

If, however, we look at productivity across all of the OECD countries, and move every country not even to global best practice, but simply to the average performance of the United States, we would see a $3.5 trillion increase in output, and a difference of nearly 25 percent in standards of living.

These are not small numbers. Twenty-five percent represents a generation's worth of economic development, or a decade at 2.5 percent annual growth. We've never seen a decade like it. Think of what it would do to raise the living standards of the people on our planet. What is stopping us from capturing such an extraordinary opportunity? Just this: we are trapped in an outdated paradigm. The enemy is the mindset.