Managing in the New Economy

Edited with an Introduction by
Joan Magretta

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Managing in the New Economy

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Managing in the New Economy, Edited with an Introduction by Joan Magretta

Introduction

Joan Magretta

There has been so much hype on the subject of the so-called new economy that it's tempting to join forces with the economists who dismiss the notion as mere wishful thinking. No less an authority than U.S. Federal Reserve Chairman Alan Greenspan is among the skeptics: "Our economy, of course, is changing every day, and in that sense it is always 'new.'" The deeper question, says Greenspan, is whether there has been a fundamental, discontinuous change in the way our economy works that promises significantly higher growth. In this more profound sense, his answer to the question "Is there a new economy?" is no.[1]

But if the new economy tends to evaporate when viewed from the lofty perspective of the macroeconomy, it looks more solid when the sight line shifts. As even Greenspan acknowledges, down in the economic trenches "important technological changes . . . are altering, in ways with few precedents, the manner in which we organize production, trade across countries, and deliver value to consumers."

Those three categories cover a good deal of what goes on in the pragmatic realm of managerial work. For those who worry day in and day out about creating value for customers, and buying and selling in the global marketplace, there surely is a new economy—or at least a new set of activities, a new set of issues, a new set of priorities that simply did not exist 15 years ago and that today constitute a significant piece of the managerial agenda.

While some industries are more immediately affected by that new agenda than others, it is relevant to leaders across the full spectrum of organizations—high tech or low, large or small, old or new, businesses or social enterprises. The new agenda is taking shape at the intersection of three long-term trends, which will continue to gather momentum in the decades ahead.

1. **The rise of networks.** Information technology, by breaking the trade-off between richness and reach, is changing the economics that underlie industry and organizational structures. The scope of an organization's activities is one of the fundamental questions of strategy. As more individuals and businesses connect electronically, the economics of scope will continue to shift, and with that shift come changes in relationships within an organization, in who competes with whom, and in what is made internally versus bought from outside.
2. **The growth of knowledge work.** Increasingly, value creation is a function of information and ideas, and this is true across a wide spectrum of businesses including those firmly rooted in the world of tangible products. Knowledge can turn products into services, or it can make physical products more valuable and smaller at the same time (think about cell phones, for example). The result is that much of our economic growth in recent years has been "weightless." Along with this fundamental shift in how value is created comes a new management challenge: managing knowledge work and innovation.
3. **The globalization of trade.** As political and logistical barriers to global trade and competition drop, every organization needs to reexamine its own economic landscape. Who are the relevant customers, suppliers, and competitors in a reconfigured world? What shifts in strategy and organization are required to manage effectively across geographic and cultural boundaries?

Every industry will feel the impact of these three forces in its own way. But the direction in which these forces drive industries is always the same: toward more dynamic, faster-paced competition and change. In some industries, new competitors have already emerged; in others, major restructuring is underway. Most industries have felt and will continue to feel growing pressure to innovate and to increase the pace of innovation. Uncertainty—always a constant of business decision making—appears to be on the rise.

Much of the writing about the new economy fuels this heightened sense of uncertainty. With its numbing incantation about relentless forces and continual reinvention, such writing lulls us into accepting uncritically that *everything*—including the fundamental logic of business—has changed and that all the old rules are useless. In their place, a set of punchy aphorisms is served up as a new recipe for success.

Such writing is misleading on two counts. First, it is simply nonsense that everything is changed. Neither the basic principles of business economics nor the enduring realities of human nature have been abolished. If anything, they are more relevant today than ever before, because anyone struggling to lead an organization through the maze of changes wrought by the new economy needs to know where the ground is solid.

Second, people who have to make real business decisions every day and then live with the consequences know that there is no list of five, or seven, or ten rules that will guarantee success, however clever the alliteration. They also know that there are few absolutes in management and that frameworks are helpful only if you know how and when to apply them.

There are no silver bullets in this collection of articles from the *Harvard Business Review.* What it offers instead is some of the best recent thinking in print about managing in the new economy. As the *Review*'s strategy editor over the past five years, I had the privilege of editing almost all of the pieces I have selected for this volume. Read as a book, rather than as individual pieces, the collection is intended to help readers make sense of the new managerial agenda. It suggests there is a good deal more continuity and coherence to the new work of management than would appear on the surface.

The book has three parts. Part I, "Competition and Strategy," frames the strategic issues of the new economy. How do changes in information technology alter the familiar structures of industries and of organizations? How do companies create value in a knowledge-based economy? How does globalization change the way companies compete and the way they are managed? How should executives develop strategies in light of the huge uncertainties they face and the information they have?

Written by authors often associated with different "camps" in the strategy wars, I find these articles remarkable for what they have in common. All are grounded in the bedrock of economic thinking that is as relevant to the new economy as to the old. Each in its way teaches us to apply robust analytic models of strategy and competition—value chain thinking, for example—to new conditions in the business environment.

Part II, as the title suggests, turns to issues of "Leadership and Organization." The knowledge economy makes new demands on managers. More than ever, it is critical for an organization to tap the creative energies of its people. What does effective leadership of knowledge work look like? Will free agency obsolete big organizations? In an economy where organizations are temporary, how can individuals take more responsibility for their own effectiveness? In a culturally diverse global economy, what become the foundations for ethical leadership?

So much of the buzz about managing in the new economy has left the impression that all companies must be run the same way—with empowered workforces in flat organizations. The articles here go deeper, beyond the contemporary fads. There is a good deal of wisdom—coupled with hardheaded economic thinking—about enduring values, about people as people and not as "human resources," and about the purposes organizations serve.

In Part III, "Ideas at Work," all of the themes and theories discussed earlier come to life as we listen to three CEOs describe how they and their organizations are tackling the challenges of managing in the new economy. Articles about management tend to be analytic, focusing on one dimension of what we all know to be a multidimensional beast. They enrich our intellectual understanding of one piece of the puzzle.

These interviews attempt to capture the whole puzzle. Each of the CEOs faces opportunities and obstacles in one way or another characteristic of the new economy. Each has crafted a unique and coherent competitive strategy. Each is leading an organization in creative ways tailored to execute that strategy.

Part I: Competition and Strategy

The collection begins with "Strategy and the New Economics of Information" by Philip B. Evans and Thomas S. Wurster of the Boston Consulting Group. It is the most lucid account I have read about why the revolution in information technology is having and will continue to have such a profound impact on all businesses, and not just on high-tech or information companies. It provides a framework for understanding the "deep structure" of the network economy and the principles underlying the massive restructuring of industries, which will continue well into the next century.

The fundamental shift in the economics of information currently underway is less about technology than about the fact that a new behavior is reaching critical mass. Millions of people at home and at work are connecting electronically. When information is carried by things—by a salesperson or by a piece of direct mail, for example—it goes where the things go and no further. But once everyone is connected electronically, information can travel by itself. What is truly revolutionary about the explosion in connectivity is the possibility it offers to unbundle information from its physical carrier. And that, in turn, allows companies to create new value propositions and to split apart and reconfigure existing value chains.

Value chain thinking—one of many seminal ideas in strategy we owe to the earlier work of Michael E. Porter of the Harvard Business School—underlies many of the articles in this collection. The concept captures the fundamental and enduring economic logic of business. A company's value chain consists of all the activities a company performs to design, produce, market, deliver, and support its products. The value chains of companies that supply and buy from one another collectively make up the industry's value chain, its particular configuration of competitors, suppliers, distribution channels, and customers.

While we tend to think of value chains as a succession of physical activities, Evans and Wurster remind us that value chains also include all the information that flows within a company and between a company and its suppliers, distributors, and customers. They explain how the cost of information, especially the trade-off between richness and reach, plays a determining role in the structure of any company or industry. The new connectivity breaks that old trade-off.

Rethinking strategy in light of the new economics of information is one of the core issues of the new economy. Rethinking how value is created in a knowledge-based economy—and how that affects competition—is a second major issue and the subject of Porter's "Clusters and the New Economics of Competition."

Today's economic map of the world offers striking evidence that innovation and competitive success in many fields is geographically concentrated in clusters. Silicon Valley and Hollywood are among the best-known examples, but there are hundreds of similarly configured clusters around the globe. By demonstrating how clusters work, Porter shows us the dynamism of modern competition: Competitive advantage rests on productivity, which in turn demands a steady drumbeat of innovation.

Vibrant clusters stimulate innovation. They function as an alternative organizational form to vertical integration, allowing individual enterprises to coordinate effectively with each other without sacrificing the flexibility so critical to the fast pace of global competition. Within the confines of a cluster, specialized know-how and the transfer of knowledge across organizations and institutions help individual companies to innovate continually and to stay at the productivity frontier.

Clusters offer a pool of skilled employees and specialized suppliers, as well as access to information and new ideas. Local rivalry and peer pressure play an important role, motivating executives to outdo each other. What Porter describes as a paradox of the global economy is at the same time a truism of the knowledge economy: Competitive advantage lies increasingly in local things—knowledge, relationships, and motivation that distant rivals cannot match.

Clusters highlight the uniqueness of a location as a source of competitive advantage. Looking at the global economy through a different lens, C.K. Prahalad and Kenneth Lieberthal see the uniqueness of locations as both an opportunity and a threat. Their focus is new markets. Specifically, they lay out what it will take for Western companies to succeed in the four biggest emerging markets, which together promise the lion's share of future economic growth. "The End of Corporate Imperialism"—the title refers to the assumption that everyone must be just like "us"—tackles globalization, the third of the defining issues of the new economy.

Many observers worry that Western multinationals will overrun traditional local cultures in places like China and India. Prahalad and Lieberthal, professors at the University of Michigan, turn this familiar concern on its head. The question they urge business leaders to ask is how the multinationals themselves will be changed. Success in the emerging markets, they argue, will require new business models and resource shifts on such a scale that the multinationals themselves will be transformed. Hence the end of corporate imperialism. The cultural and economic realities of the major emerging markets, combined with their sheer size, will demand radically different approaches to strategy and organization.

In describing markets such as China, India, Brazil, and Indonesia, the operative word is *emerging*. No one, least of all the authors, is suggesting that such huge opportunities come without huge risks. In fact, all of the three defining shifts of the new economy—in the economics of information, in the relative value of knowledge, and in the globalization of trade—combine to create uncertainty, to destabilize existing strategies and industry structures. Decision making in the face of uncertainty has always been the major challenge of strategy. The next two articles are about the information and the tools needed to think strategically in the new economy.

Traditional approaches to strategic planning lead executives to view uncertainty in a binary way, according to McKinsey's Hugh Courtney, Jane Kirkland, and Patrick Viguerie in "Strategy under Uncertainty." They assume that the world is either certain, and therefore open to precise cash flow predictions about the future, or uncertain, and completely unpredictable. Either extreme can lead to bad decisions and missed opportunities.

Even the most uncertain environments contain a good deal of strategically relevant information. "Strategy under Uncertainty" offers a framework for sifting through that information. Most strategic decisions, the authors argue, fall into one of four discrete levels of uncertainty. The kind of analysis companies rely on and the strategic postures they choose must be tailored to the level of uncertainty they face.

Options thinking is one of the most promising and potentially powerful of the new tools for decision making under uncertainty. Traditional corporate finance, with its reliance on net present value (NPV) calculations, offers only two possible actions: invest or don't invest. But decision making in the real world is more textured. As soon as we start executing a strategy, we begin learning—about business conditions, competitors' actions, technical developments—and we need to respond flexibly to what we learn.

Options thinking addresses the issues an active manager will care about: not only whether to invest or not, but when to invest, and what to do in the meantime. In financial terms, then, a business strategy is much more like a series of options than it is like a series of static cash flows. That insight underlies Timothy A. Luehrman's "Strategy as a Portfolio of Real Options." Luehrman has written a series of articles for the *Harvard Business Review* on valuation.

The discounted cash flow approach used almost universally to estimate the value of a strategy locks managers into a static and a passive mind-set. It is built on the assumption that a company will follow a predetermined plan, regardless of how events unfold. Options, on the other hand, reflect the more active role managers play in adjusting their decisions as they learn. By aligning the financial model for valuation with the nature of the uncertainties managers face, options deliver the extra insight to help executives think strategically on their feet.

For a generation of professionally trained business leaders, net present value has been more than a financial tool. In essence, it embodied a whole managerial mind-set. "Strategy as a Portfolio of Real Options" also heralds a new way of thinking. As Luehrman describes it, the options approach is more than a technical tool for finance specialists; it is a way of conceptualizing business problems that encourages active and flexible management of future opportunities.

Part II: Leadership and Organization

Trust has always been important in organizations, but in the new economy—where value creation depends increasingly on ideas and innovation—it is essential. "Fair Process: Managing in the Knowledge Economy" by INSEAD's W. Chan Kim and Renée Mauborgne describes a management tool for companies struggling to make the transition from a production-based to a knowledge-based economy.

Unlike the traditional factors of production—land, labor, and capital—knowledge is a resource locked in the human mind. Creating and sharing knowledge are intangible activities that can be neither supervised nor forced on people. They happen only when people cooperate willingly. Traditional management science has an arsenal of tools to promote efficiency and consistency by controlling behavior and compelling people to comply with management dictates—tools for allocating resources, creating economic incentives and rewards, monitoring and measuring performance, and manipulating organizational structures to set lines of authority.

These conventional levers still have a role to play, but they have little to do with engendering trust, which encourages the exchange of ideas, which, in turn, promotes innovation. Kim and Mauborgne note that individuals are most likely to trust and cooperate freely with systems—whether they themselves win or lose by those systems—when *fair process* is observed. Not to be confused with consensus building or empowerment, fair process is a way to approach decision making that follows three principles: engage people in the decisions that affect them; explain the thinking underlying decisions once they have been taken; and set clear expectations about the new rules of the game.

"When people are trusted," writes Henry Mintzberg, "they do not have to be empowered." Knowledge workers need to be trusted, and leading them is more about inspiring than supervising. In "Covert Leadership: Notes on Managing Professionals," Mintzberg, who teaches at McGill and INSEAD, observes that in a good deal of knowledge work, the profession itself, not the manager, supplies much of the structure, coordination, and control.

Leaders in professional organizations often face a special challenge—leading among ostensible equals. Thus they must learn to manage under a set of constraints that leave them neither in absolute control of others nor completely powerless, but functioning somewhere in between. Mintzberg urges a greater appreciation in all managerial work of what he calls covert leadership: not leadership actions in and of themselves—motivating, coaching, directing—but rather unobtrusive actions that infuse all the other things managers do, that inspire others. He describes such leadership as managing by doing, which he warns can be done only by someone with an intimate understanding of what is being managed.

Both "Fair Process" and "Covert Leadership" have to do with how individuals within organizations are treated, especially by their managers. In "The Dawn of the E-Lance Economy," Thomas W. Malone and Robert J. Laubacher of MIT question whether individuals will continue to work within organizations as we know them today.

While the authors acknowledge that an economy consisting of electronically connected freelancers is a radical concept, they note that in many ways it is already upon us. We see it in the emergence of virtual companies, in the rise of outsourcing and telecommuting, and in the proliferation of freelance and temporary workers. Even within large organizations, we see it in the increasing importance of ad hoc project teams, in the rise of "intrapreneurs," and in the formation of independent business units.

At the heart of the "e-lance" economy is the idea that by changing the way work is done, electronic networks may lead to a new kind of economy centered on the individual. Consider the development of Linux software. A temporary community of self-managed individuals came together, connected by the Internet, to engage in a common task. Their job complete, the network disbanded.

Malone and Laubacher discuss the organizational implications of networks and connectivity, picking up where Evans and Wurster leave off in "Strategy and the New Economics of Information." When it is cheaper to conduct transactions internally, within the bounds of a corporation, organizations grow larger. But when it is cheaper to conduct them externally, in the open market, organizations stay small or shrink. Such new coordination technologies as powerful personal computers and broad electronic networks enable us to return to the preindustrial model of tiny autonomous businesses conducting transactions with one another in the market. The one crucial difference is that electronic networks allow small companies to tap into the global reservoirs of information, expertise, and financing that used to be available only to large companies.

Malone and Laubacher say we need a new mind-set for thinking about the transformation of management that these new organizational models imply. When we see a flock of birds in formation, they write, we assume the bird in front is the leader, somehow determining the organization of all the other birds. In fact, biologists tell us, the bird in front is no more important than any other. Each is simply flying by a set of rules, and they are all essential to the pattern they are forming.

In "The Post-Capitalist Executive," a *Harvard Business Review* interview by T George Harris, Peter F. Drucker certainly heeds the call for a new mind-set for thinking about the relationship between individuals and organizations. Drucker began writing about the knowledge worker more than 30 years ago, and he has been consistently provocative and insightful about the transformation of industrial economies into knowledge economies.

To build achieving organizations today, Drucker says, you must replace rank and power with responsibility and mutual understanding. Drucker explains with characteristic directness and sense just what that means. Contrary to popular thinking, the answer is neither "participation" nor "empowerment." Instead, the key is self-awareness, the difficult and demanding discipline of thinking about who you are and what you do best. While self-awareness has always been important, Drucker notes, in the knowledge economy it is essential for survival.

Not long ago, most people were either farmers, factory workers, tradesmen, or domestic servants; it was easy to know what others did at work. This is no longer true. As knowledge work has become more specialized, the burden has shifted to individuals not only to define what their own contribution to the organization will be, but also to take responsibility for telling others around them what their priorities are. "When you don't communicate," Drucker writes, "you don't get to do the things you are good at."

Values are an important part of self-management and self-awareness. While ethics are universal, values are matters of deep belief about which honest people, and organizations, can disagree. As Drucker has previously stated, to work in an organization whose value system is unacceptable or incompatible with one's own condemns a person both to frustration and to poor performance.

Moving from the personal to the universal, Part II ends with "Values in Tension: Ethics Away from Home" by Thomas Donaldson. Even the best-informed, best-intentioned executives must rethink their assumptions about business practice in foreign settings. Donaldson, who teaches business ethics at Wharton, offers a set of guiding principles to help executives answer the questions, When is different just different, and When is different wrong? He doesn't shrink from the especially thorny (and common) problem of what to do when a host country's ethical standards are lower than the home country's.

Part III: Ideas at Work

Part III begins with "The Power of Virtual Integration: An Interview with Dell Computer's Michael Dell." When Michael Dell dropped out of school to start his company in 1984, he might not have been able to tell you what the term "value chain" meant, but he certainly grasped the basic economics. His simple business insight was that he could bypass the dealer channel through which personal computers were then sold. Instead, he would sell directly to customers and build customized products to order. In one swoop, Dell eliminated the reseller's markup and the costs and risks associated with carrying large inventories of finished goods. The formula became known as the direct business model, and it gave Dell a substantial cost advantage.

Dell's product line has expanded over the years. In addition to desktop personal computers, the company now sells a broader range of hardware—laptops, servers, and workstations. But make no mistake, Dell sells physical *things*, manufactured goods that must be assembled and transported and delivered and serviced. It sounds a lot like the old, tangible economy.

Is Dell, then, stuck in the past of material goods and physical flows? Or is it the quintessential new economy company, creating wealth through ideas and information, and doing so with incredible speed and flexibility? In fact, Dell is both.

Companies have always thrived by offering customers superior value, giving them more for less. For the most part, they offer better value by shrinking the time and the resources consumed in meeting customers' needs. (Recall that the adage "Time is money" appeared in 1748, in Ben Franklin's *Advice to a Young Tradesman.*) The basic economics of business haven't changed, but like many other companies today, Dell is harnessing the tools of the knowledge economy—

information and technology—to bring new levels of efficiency and productivity to the old world of tangible goods.

Dell stays nimble by focusing on only a few elements of the value chain and letting its suppliers worry about the rest. It has found ways to work across organizational boundaries with suppliers and with customers that Michael Dell calls "virtual integration," a term which suggests his company is getting the best of both worlds: the coordination of vertical integration plus the flexibility of a virtual organization.

Dell's strategy has been remarkably consistent over the company's 15-year life, a fact that contradicts the shibboleth of the new economy that the world simply moves too fast for strategy to matter. Hypercompetition and turbulence, the argument goes, will obsolete any strategy as soon as it is articulated. Tell that to Michael Dell. Under his leadership, continuity in strategy has driven ongoing innovation in execution, and it has created great wealth for shareholders.

As Dell has grown, it has rapidly recut its customer base into successively finer segments—and it has changed the structure of its own organization in order to map onto those new customer segments. This flexible approach to organization keeps the company close to its customers and holds businesses to a manageable size.

Halfway around the globe, Victor Fung, chairman of a large Hong Kong–based export trading company, shares Michael Dell's obsession with serving customers, with speed and flexibility. His company, Li & Fung, was founded in China 90 years ago by his grandfather. Today, however, it is anything but a staid family enterprise. Part of a new breed of focused Asian multinationals, Li & Fung has been an innovator in the development of supply chain management.

On behalf of its customers, primarily American and European retailers, Li & Fung works with an ever-expanding network of thousands of suppliers—mostly in emerging markets—sourcing clothing and other consumer goods ranging from toys to fashion accessories to luggage. The goal is to deliver a new type of value added, the best products on a global scale. Instead of asking which country does the best job overall, Li & Fung dissects the manufacturing value chain and looks at each step for the solution best tailored to the customers' needs. Thus, in effect, Li & Fung creates a customized value chain for every customer order.

The result, as the title of my interview with him suggests, is "Fast, Global, and Entrepreneurial: Supply Chain Management Hong Kong Style." Supply chain management—buying the right things and shortening delivery cycles—is critical for any time-sensitive product. What