Business Standard

Pathways to obsolescence

Chinese manufacturing and Indian software face similar trajectories and risks

Subir Gokarn | New Delhi April 21, 2013 Last Updated at 21:48 IST

If C Northcote Parkinson had formulated a law of obsolescence, it would probably read like this: "The greater the efficiency achieved by an organisation in performing its core tasks, the more rapid will be its descent into obsolescence." But since neither he nor anyone else I know of did, I will stake my claim on it.

The conceptual foundations of this proposition are quite simple. Organisations succeed and grow because they figure out how to do a few things very well. These things - products or services, with all the attendant processes - then expectedly tend to crowd out everything else they do. People move up the ladder because they have been associated with successful activities. Over a period of time, the top leadership comprises exclusively people who have all come up in exactly this fashion. The focus of the organisation on these activities and the reward and recognition systems tied to them gradually leads to the disappearance of everybody who has other interests or perspectives, particularly from the top leadership.

Every product and service has a natural life cycle and, consequently, so do business models and strategies. This is what drives obsolescence. Organisations of the kind described above lose the ability to anticipate and respond to the end of the life cycle, because they are full of people with huge vested interests in the current model. As a result, when the life cycle ends, their knowledge and skills developed while perfecting the process stop being competitive advantages and, very often, can become a liability because they are not easily transferred to the beginning of a new product life cycle. Obsolescence is the outcome.

Of course, organisations adapt. The management literature is full of case studies of successful transformations - companies that moved from the end of one life cycle to the beginning of the next. This literature also attempts to identify the core characteristics of organisations that achieve this. But it suffers hugely from what is called "survivor bias". It does not, because it often cannot, look at organisations that failed to make the transition. My guess would be that there are far more cases of failed transitions than of successful ones.

Be that as it may, it may be useful to look at two of the most successful strategic trajectories in the past three decades against this backdrop of pathways to obsolescence. The first is the Chinese manufacturing sector. Clearly, it achieved phenomenal success in combining low-cost labour, large scale and quality infrastructure to dominate global markets in an ever-increasing range of products over three decades. Other policies, including, importantly, exchange rate management, contributed, but the persistent focus on cost efficiency was really at the heart of the success.

However, while this combination of factors was so important in achieving cost efficiency, it de-emphasised some key requirements for life cycle transitions. Significantly, there are virtually no recognisable Chinese brands in any of the industries in which they are so cost-competitive. Japanese and Korean brands, for example, have retained or gained global market share by manufacturing in China. US retail chains source from China, but sell under their own brand labels - iPads, iPhones ... the list goes on and on. And yet, there isn't a single identifiable

Chinese name in it. Two critical inputs into the success of Chinese manufacturing - technology and marketing - have been provided by non-Chinese organisations.

In effect, if any of the Chinese factors that contributed to China's competitiveness disappears, its lack of control over those two critical factors may well be its undoing. One of these factors, low labour costs, is clearly under threat. Demographic trends suggest a rapid decline in the supply of workers, pushing wages up. Recent developments suggest that the transition is well under way. It will take a while to play out, but the more strategically oriented companies currently sourcing from China are presumably looking at other possible locations. There are three possible outcomes as this process unfolds. One, production relocates away from China. Two, labour-displacing technology - robotics, for example - spreads, making previously high-cost locations attractive again. Three, China retains its position, but costs increase, with consequences for global demand patterns.

The second success story is Indian software. Recent announcements of quarterly results by IT companies have raised concerns about the sustainability of the so far enormously successful model. Some see these as largely company-specific problems, a view supported by the diversity of performance. But are there deeper, sector-wide forces at work?

The success of the Indian software model is based on virtually the same factors as the Chinese manufacturing model. Low labour costs, effective aggregation into large units and the telecom boom all contributed to the development of a strong offshore delivery model. Great efficiencies have been generated by this model for a couple of decades. However, just as in the Chinese case, some critical inputs remain out of the control of the Indian software industry. Intellectual property is still predominantly in the hands of non-Indian companies. And demand for Indian services is predominantly from outside the country.

Given these conditions, the trajectory of Indian software looks quite similar to that of Chinese manufacturing. Rising relative labour costs could take activity elsewhere; technological developments may make the sector location-neutral or the world has to learn to live with a higher-cost model, with implications for global demand.

So is this a portent of obsolescence for both Chinese manufacturing and Indian software? Well, yes and no. Yes, because in both cases, the models that were so successful for two or three decades are clearly showing signs of stress. An inability on the part of the players involved to adapt their structures and strategies to climb on to the next life cycle will obviously reinforce the moves towards obsolescence. And if this inability manifests, its seeds will have been sown by the very success of the prevailing model, because everyone who is in a decision-making role is closely associated with that success.

No, because history suggests that successful transformations, even if they have been relatively few, can be achieved. In both these cases, the key components of the transformation are easy to see - gaining control over technology, intellectual property and over markets. But achieving these requires adopting new organisational structures and business strategies, which in turn requires different thinking, if not different people. At this point, both Chinese manufacturing and Indian software could go either way.

The writer is former Deputy Governor of the Reserve Bank of India. These views are personal