

Meeting China's productivity challenge

August 2016

The country's investment model for growth is losing steam. Shifting to a productivity-led model could add more than \$5 trillion to its economy — if China can make the transition.

For decades, China's economy has been driven by investment and the continual stream of workers from rural to urban areas. But it's time for the country to move beyond a "if you build it, they will come" philosophy to focus on how investments translate to real economic productivity and growth. In this episode of the *McKinsey Podcast*, McKinsey Global Institute director Jonathan Woetzel and McKinsey senior partner Kevin Sneader talk with McKinsey's Cecilia Ma Zecha about how China has the opportunity and the ability to boost growth over the next 15 years by making productivity more inclusive and less focused on the financial sector.

Podcast transcript

Cecilia Ma Zecha: Hello, and welcome to this edition of the *McKinsey Podcast*. My name is Cecilia Ma Zecha. I'm an editor with McKinsey Publishing, based in Singapore. China's economy has been powered by investment, and it's been hugely successful. But China is now experiencing growing pains. The investment model is losing steam. Growth has slowed, debt has risen, and return on invested capital has fallen. The economy is distorted. More than 80 percent of economic profit comes from the financial sector.

Could China's economy be facing a hard landing? McKinsey Global Institute's latest report on China's economy says there are risks, but China can face such challenges. In fact, China has a choice, and it can choose to shift gears, decisively, to an economy centered on productivity instead of investment. MGI estimates that this approach could add \$5.6 trillion to GDP, and \$5.1 trillion in household income. Here to tell us more is MGI director Jonathan Woetzel and McKinsey's chairman in Asia, Kevin Sneader.

Jonathan, let me start with you. What are the trade-offs, to begin with, between an economic growth model that is driven by investment and one that is centered on productivity?

Jonathan Woetzel: The history of China's economic growth in the past couple of decades has been all about investments. It's been about savings, which have translated into

investments in infrastructure and urbanization which, in turn, have created opportunities for literally hundreds of millions of Chinese people to become more productive.

That said, it's been very much a story of, if you will, quantity over quality. So that's simply that the strategy in China was all about simply showing up. Literally building something and then people would come there, and almost anything they would do would be more productive than what they were doing before.

Today, infrastructure stock, as a share of GDP, is over 70 percent, which is roughly the world average. Now it's less about showing up and making those investments than, *What are we doing with those investments? And how good a job are we doing in making those investments? And how do these investments translate into real economic productivity, quality growth?* That's the transition. It's from quantity to quality, and from, *How much of it are you doing?* to, *How well are you doing it?*

Cecilia Ma Zecha: Kevin, why do you think it's urgent for China to make that transition now?

Kevin Sneader: There are several reasons to urge a more rapid move from what Jonathan has described as "showing up," to actually being productive. And the reason for this, I think, stems from both an opportunity and a challenge. The opportunity is that there really is a potential here for China to take the next step in terms of consumption and actually create an economy that has a more inclusive nature to it and has the potential to allow members of the Chinese economy to participate in a way that some have not.

Let me put some numbers behind this. What is quite striking today is that the rate of growth has seen 600 million people raised out of poverty. That's what Jonathan said when he talked about quantity. It has seen an economy that has sustained double-digit growth for almost 25 years. All of that has translated into huge progress on many dimensions.

But here's the challenge. There are some clouds that really, now, cannot be ignored. If you look at nonperforming loans, the official number says somewhere around 1.7 percent. An estimate today is probably that number is 7 percent. One could get to a place in a few years' time where that number is 15 percent. At 15 percent, while we do not doubt that China could afford, given the scale and nature of its financial assets, to maintain the health and well-being of the financial sector, you would face a liquidity crunch that would have significant implications for many Chinese financial institutions.

That's a matter of real concern. Secondly, the reality is that, as urbanization inevitably slows—and it's been worth 2–3 percent a year in terms of incremental growth in urbanization—as that rate slows to 1 percent, the big driver of a lot of the economic growth that has happened, namely, taking people from a rural environment and putting them in an urban environment, that starts to slow. As that slows, the economic opportunity could slow too. Then, perhaps, the third most urgent reason why it's time for this change to occur is that, in some regards, the inequality within the Chinese society has been getting much sharper.

You now find that that top 20 percent of people who have household income in the top 20 percent, they are, in effect, controlling somewhere between over half of all the economic growth. They're gaining from that growth disproportionately.

Jonathan Woetzel: As Kevin highlights, the economic liabilities that have been accruing, by lending to enterprises, which are no longer earning a return on capital, those are real. They will have to be dealt with. There's no scenario where that doesn't happen.

The only question, really, is how much growth will the rest of the economy, the productive economy deliver? How will we direct capital to the rest of the economy? We know that 50 percent of commercial bank lending is still going to capital-intensive, heavy industries dominated largely by state enterprises, which are not, in fact, earning a return on capital. How that changes over time, and how quickly that changes, is the central question.

Cecilia Ma Zecha: How are Chinese business and government doing right now with productivity, in general?

Jonathan Woetzel: We see a vast disparity between the performance of the top quartile of the firms and the long tail, the bottom 50 percent, and on a much broader span of performance than we would in a North American or any competitive OECD [Organisation for Economic Co-operation and Development] economy. That reflects this fundamental transition in that it's been about showing up. It hasn't been about performance.

So we have a really broad range of performance here. That's the big challenge for China, is how does it help narrow that span of performance? If you bring up the bottom tail, or simply allow the top performers to grow and expand, and deliver products and services to Chinese consumers at a more competitive cost.

Kevin Sneader: To build on Jonathan's point, Chinese productivity, on average, is 15–30 percent of the OECD average. And as Jonathan says, within that headline, there are enormous differences. I work with Chinese clients who are every bit as productive as their Western counterparts. In fact, if you look at some of the high-tech manufacturing, you can absolutely see Chinese firms who are productive in the same sense that you would see it in the West.

The difference is that range is enormous. For example, in retail, where I spend a lot of time working—whereas in the West, the role of B2B, in terms of the e-commerce engines, using that to control supply chains, making sure that goods are tracked throughout the chain, there's a big distance between what happens here, in China, and what happens in the West. Therefore, the productivity gap there is particularly large. That is the challenge. How does this productivity gap, which is acute in a number of industries, and offset, in part, by labor, but the problem is, labor costs have been rising dramatically.

The Chinese competitiveness, in terms of the labor-cost equation versus the productivity equation, is not what it needs to be. You can see in a number of sectors where that is resulting in China's share dropping. There's the opportunity. If China can get just that

bit more productive, then you actually would start to see that equation look a lot more balanced than it is right now.

The reason why it's important to answer the question you had about the trade-off is China has shown itself rather adept at handling significant transformations in the past. We are in danger of underestimating the ability of this actually to react to the environment which now exists.

If we think about it in consumer terms, there were two million households who had disposable income, let's say, ahead of 20,000 US dollars, back in the year 2000. That number today is 115 or 116 million households, and you can see that number rising to well over 300 million in the event of material-productivity gains being delivered. That matters, because I think that talks to the transition, which needs to happen, toward a consumption economy. One where goods and services play more of a role domestically than has been the case in the past.

If that happens, then you can be much more optimistic about the country being able to handle the scale of transition that it now needs to do. It's also worth remembering that it's not that long ago that SOEs [state-owned enterprises] were 50 percent-plus of all employment. And today, they are, what, 15 percent? A much smaller number.

Cecilia Ma Zecha: Is there business confidence that China will make the right choice?

Jonathan Woetzel: There is a high degree of confidence, if for no other reason than this is an optimistic place. There's a track record of success. In some ways, most people look at China and they say, "Well, you know, they've done the hard part, which was double digit growth for 25 years." There are very few economies, if any, that could actually state that. That, plus the reservoir of savings, of capacity to intervene, from both companies and government, that's very high.

The pace of the change, and the rapidity of the change, that one is very much up for grabs. There is a sort of very near-term question about how will China manage what is a relatively low-growth global environment?

If there's one thing that's on the mind of the Chinese government, it is how to be resilient in the event of a new OECD recession.

Kevin Sneader: I think that's right. What I'm very struck by, as I travel domestically here in China and overseas, is that overseas business leaders are a lot more worried about China than Chinese business leaders are worried about China. The reason for that is, for many Chinese business leaders, there remains a real sense of opportunity, because they can see the transition taking place.

In particular, if you're in the consumer sector, for example, you can see a number of trends actually working in your favor, whether it's the premium-ization of products, the continued development of income amongst those moving into the consuming classes, and you

therefore see that opportunity. When you're overseas and you're looking at China, you hear the headlines and you get a lot more nervous.

That's a disparity if anything is growing. But domestic Chinese businesses and their leadership, or businesses in China, they remain quietly confident because they've already been through a lot. Quite frankly, they remember from where they came. If you remember from where they came only a matter of years ago, you can see why they see reason to believe and be the optimists that many of them are.

Jonathan Woetzel: We underappreciated exactly how entrepreneurial Chinese society is. There have been more entrepreneurs in China than anywhere else on the planet for the last decade. We're in the era of the Carnegies and Mellons and Rockefellers and Rothschilds, for that matter. Dynasties are being created now.

Kevin Sneader: The other reality is Chinese companies have a number of areas where they still need to hone the skills needed for success. A simple area: branding. If you look at China, despite the enormous growth of its consumer-goods sector, it only has two brands in the top 100. That talks to a skill gap on the creativity side which still needs to be closed in the area of consumer goods.

More generally, there's still work to be done in the R&D area when it comes to science-based breakthroughs. China still does not pull its weight in areas like pharmaceuticals. Now again, there are an awful lot of entrepreneurs working on both those topics. I've certainly spent quite a bit of time with Chinese business leaders on the subject of branding, and trust me, they will crack it. It's just a matter of when, not if.

Cecilia Ma Zecha: The report highlights five opportunities to raise productivity: better serve the middle class, using digital technologies, and improving business operations, and so forth. Can you talk a little bit more about them, Jonathan?

Jonathan Woetzel: These opportunities are, first of all, they're all getting attention by the folks that are in China. We drew those five by looking at that top quartile of companies, the ones that are the outperformers. These are the things that they are doing. They're globalizing, they're digitizing, they're focusing on the middle-class consumer. And they are trying to move up the value chain. These are the habits of the successful companies.

As to which ones will really move the needle, I'm actually probably where Kevin is in terms of the value-chain opportunity. If we just look at what is the opportunity for branding, and for higher productivity of products and services. China earns half the margin in pharma of what its OECD counterparts do, Chinese companies do. That, or, for that matter, in semiconductors. If they or any other sort of innovation-intensive industries, there's just a massive opportunity for Chinese companies to capture the fruits of their labor, if you will, or of their talent.

Anything that can be done to raise services productivity will have a huge multiplier effect. In the case of China, the ability to bring a better product or service via the web to the Chinese to consumer pays off. Or it pays off dramatically, as we've seen

in the growth of the Chinese Internet companies.

Kevin Sneider: The digitization that's happening in China is happening at a remarkable pace. If you recall that today, not the future, today, the Chinese market for online commerce is larger than the market in the United States by quite some distance, by about 80 percent. The gap is enormous. As that continues, the learning and experience that Chinese companies are building will lead to sustained innovation. It already is.

The innovation that's happened around the whole payments industry in China is far superior to that which has happened in other parts of the world. At the same time, there are areas where China lags on the digital side. If you look at the amount that China invests in digitizing its supply chain, it's roughly half that of Western companies. Well, that's a major opportunity for productivity gains.

If that investment can translate into better management of infrastructure and supply, then that should boost economic returns quite significantly. That does require investment, and it does require complementing the huge focus on the consumer side of the digital experience with an equal focus on the supply side and the business elements of it. Once that focus happens, we'll see enormous gains, because China's proven to be very, very good at process-based innovation, and less good at other types, and that's what's required here.

Jonathan Woetzel: I agree, and I would add some numbers: the SMEs [small and medium-size enterprises] in China may be only at 10–15 percent of any kind of web enablement. Compared to 40 percent, 50 percent, 60 percent in OECD countries. So that, in and of itself, is just a massive opportunity. As those SMEs come online, as they will through integrated supply-chain management by larger downstream OEMs or by customer-relationship-management programs to reach the middle class. It will just speed up the pace of Chinese business.

This is something that will happen. It's a massive opportunity for productivity growth. It's also a massive opportunity for demand growth. We also see that in many ways, that there are products and services just simply not reaching the customer right now. With enablement through digitization, that can happen, and that will translate into income, into demand, and ultimately, into employment as well.

Kevin Sneider: Let's also not forget that one of the five that we highlighted was Chinese companies going global. While China has dramatically ratcheted up its investment overseas, I think it's growing at 25 percent per annum over the past decade; the reality is we're still in the early stages of that phenomenon.

What's happening now is it's a shift from acquisitions, and resource-heavy areas, into technology and services. And as China's acquisitions overseas shift into technologies and services, well, so too will the capabilities associated with them build. And those capabilities will be very relevant back here in China, just as they are overseas.

Cecilia Ma Zecha: Hearing you talk about the pace of digitization in China being very

fast, what are the risks, and how should China address them? For one, helping displaced workers shift into different jobs and industries.

Jonathan Woetzel: China is in a relatively fortunate place because it's catching all of this at a fairly early stage of development. We're still only halfway through the urbanization journey, so we still have a lot of folks who simply don't have any legacy, and so they're not hanging onto anything. They come into the city, and they just look for what they can get.

Now in the past, those folks would have gone to the job site, the construction site, and they'd say, you know, "Give me a pick and a shovel, and I'll do something." Those jobs aren't there anymore. Where do they go? Well, they go to become an express-delivery guy on a scooter serving an e-commerce company. In many ways, China's taking this entire agricultural population and leapfrogging them right into a postindustrial-services economy.

That's the massive transition. Of course, some folks won't be able to make it, and that is a risk. So the risk is about how does one enable this workforce for a 21st-century economy coming out of a 19th-century one. There is a mobility challenge, there's a training challenge, there's an income-inequality challenge.

Kevin Sneader: One other, you can call an advantage or maybe it's just a reality, which is the Chinese working-age population is shrinking. China's population of the working age has peaked, two years ago, and will decline 0.5 percent per annum over the next 20 or so years. It's not necessarily a good thing, but it does actually help when it comes to the issue we're discussing of how do you handle this displacement of workers.

The reality is, China has a shrinking labor force, which makes the need for skilled employees even higher. The combination of the facts that Jonathan described, plus the reality of what's happening demographically, means that China probably has more reason to be able to do this successfully than one might think.

Cecilia Ma Zecha: Finally, China's transition will provide a new set of opportunities for businesses that are operating in China and competing companies around the world. What's your advice for CEOs to navigate this transition?

Jonathan Woetzel: The first piece of advice is please come to China. There's more to be learned. China's a full-body experience. The context is all-important in interpreting the numbers. There's a high level of risk in trying to develop one's China thinking from outside the country.

Kevin Sneader: The other simple observation I would make about the importance of understanding what's really happening on the ground in China, by being here, is don't fall victim to simple headlines. Some seem to believe that China's "economic miracle," as it's called, has been based purely on cheap labor and actually has very little to do with technology.

There are some numbers that can talk to that, so I've had people tell me, "Well, China

doesn't have very many robots in its factories." That's one way of looking at it, or you can say that China accounts for about 25 percent of all demand of robots today, let alone what's going to happen in the future. If anything, it's going to ratchet up as this transition occurs, as the need to do things differently. Couple that with a very entrepreneurial class of business leaders, the private sector in China is very vibrant. When you're here, you sense the pace and the way with which messages such as the ones we've been discussing today get translated into action very quickly.

That's the consequence for everyone looking at China, which is don't underestimate the rate of change, the capacity of this market to make the shift, and the way in which business leaders will see that and translate it into very tangible and real opportunities. I really hope that companies listening to this overseas take that as a sense of, "OK, we need to get closer to what's happening," and view this as part of a broader set of changes, which are positive.

Jonathan Woetzel: People generally get that China is a big story at this point. They don't always get that China is a fast story. It's a bit hard to see. It's like being on a train. You know it's going there, but you don't realize exactly how fast you're passing the landscape until you either get off the train, or the train hits you. Most people need to look at how quickly events are changing in their industry, how quickly Chinese competitors are entering, and how quickly the Chinese market is becoming the market. Then, step back and say, "So, where do we fit?"

Cecilia Ma Zecha: Jonathan and Kevin, thank you for your insights today. And thank you for listening to this podcast. If you want to find out more about our knowledge and insights on China, head over to [McKinsey.com](https://www.mckinsey.com). [□](#)

Kevin Sneader is a senior partner in McKinsey's Hong Kong office, and **Jonathan Woetzel** is a director of the McKinsey Global Institute. **Cecilia Ma Zecha** is the head of digital communications for Asia and is based in the Singapore office.