**China’s Choice: Capturing the $5 Trillion Productivity Opportunity**

McKinsey Global Institute, June 2016

Recently, GDP growth in China has slowed, debt has risen, and corporate performance deteriorated. This is supported by McK’s forecasts of the ratio of non-performing loans, which indicate that this ratio could reach up to 15% in the next 3 years. With this backdrop, a shift from investment-led growth model toward a growth model centered on productivity can lead to sustained future growth. In fact, China’s economy is ripe for a productivity revolution since its labor productivity is 15-30% of average in OECD countries.

The report suggests five areas of focus to improve Chinese labor force productivity and unlock sustainable economic growth: (a) serve middle class consumers better, unlocking top line growth; (b) enable new business through digitization; (c) move up value chain through innovation in R&D intensive sectors; (d) lean techniques for more efficient operations; (e) strengthen competitiveness.

**Overview of Current Chinese Economy**

On many metrics, China already looks like an advanced economy. The inflation rate in China is currently 1.4 percent, far below that of developing economies such as India at 5.9 percent inflation rate in 2015. Almost sixty percent of China’s exports are from knowledge-intensive industries, such as electrical machinery and telecommunications equipment, which indicates that the economy has already been diversified and globalized.

The authors of the report believe that most of the Chinese economy can be categorized into five key archetypes, based on the key inputs these industries require. Knowing which archetype characterizes which regions is important for developing the right productivity-led economy.

|  |  |
| --- | --- |
| Capital intensity | Heavy industries such as steelmaking and chemicals, as well as infrastructure sectors |
| R&D intensity | In many industries, the ability to innovate and create new products and variations (or new services) is the key to success |
| Trade intensity | Pharmaceutical and consumer electronics manufacturers operate in global markets and generate value by importing and exporting |
| Marketing intensity | To keep up with shifting tastes, consumer industries spend heavily on advertising, branding, and design |
| Labor intensity | Labor-intensive industries include agriculture, apparel, furniture making, retail, hospitality, and other low-skill manufacturing businesses |

A downside of the investment-led model of the Chinese economy is the distortion it has created in the attractive sectors of the economy from a bottom-line perspective. An example of this is the fact that in China today, the financial sector accounts for >80% of economic profits, whereas this number is close to 20% in the US. This concentration of profits makes China more vulnerable to demand shifts due to lack of diversification and makes the broader economy more vulnerable to asset-related risks.

Looking into the corporate clients of the financial services industry, the study found that 30% of companies have debt to EBITDA multiples > 7x, which foreshadows significant potential defaults in bank loans, and failures for the less regulated shadow-banking industry. A majority of shadow-bank funding is concentrated in high-risk sectors such as mining, metals, and real estate, which are under mounting stress from slowing growth and overcapacity.

In this setting, a productivity-led model can generate additional GDP and income of more than $5 trillion because under the investment approach, weak players are not weeded out organically. Thus, for the next phase of China’s economic growth, businesses need to be allowed to fail, and the workers redeployed to more productive sectors.

**Five opportunities can deliver higher productivity**

1. Better serve middle class consumers
   1. Total Chinese consumption can rise by $6T between 2015 to 2030 driven by continuing urbanization and rising incomes
   2. Consumption has been held back by income inequality and high household savings, but the assumption is that consumers are not finding enough products that fill their expectations
   3. The most attractive demographic group of consumers to capture is young urban workers who are interested in indulgence goods and lifestyle products
2. Digitize to enable new business processes
   1. Manufacturing companies can digitize value chains to create new markets: e.g., retailers can use tech to enable modern-format physical stores and improve efficiency through better supply-chain management
   2. Service companies can modernize how they deliver services: e.g., improve patient care by using data to avoid redundant procedures and bad drug interactions
3. Use digital technologies to improve processes such as management of talent from recruiting to training and retention
   1. Only 57% of universities feel that their curriculum is aligned with industry requirements
   2. Data science can be used to Identify retention and churn drivers for employee base to inform actions
4. Innovate and Move up the value chain
   1. Chinese companies have not yet emerged as global players in sectors requiring extensive R&D like medical equipment manufacturing or pharmaceuticals
   2. In electronics, Chinese manufacturers can expand their global market share by moving up the value chain by manufacturing semiconductors
   3. Chinese industries only have 36 robots / 10K manufacturing workers, only 20% of the US level; average manufacturing worker in China makes 10% of average US manufacturing wage
5. Go Global and Strengthen Competitiveness
   1. Identify core competencies that Chinese companies want to expand through M&A
   2. M&A motivation is changing from natural resources to capabilities

**Transforming institutions and policy to enable this transition**

1. Open more sectors to competition by dropping investment from State-Owned-Enterprises
2. Improve breadth and quality of capital markets
3. Enable corporate restructuring
4. Invest in talent and enhance labor mobility
5. Boost aggregate demand by improving access to credit, lower the cost of consumption and address income inequality
6. Improve public sector effectiveness using technology, and resetting priorities