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

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.

1. Raise productivity by:
   1. Serve middle class consumers better, unlocking top line growth
   2. Enable new business through digitization
   3. Move up value chain through innovation in R&D intensive sectors
   4. Lean techniques for more efficient operations
   5. Strengthen competitiveness by making it easy for foreign companies to do business

**Chapter 1: Investment Led growth has served china well, but is running out of steam**

1. On many metrics, China already looks like an advanced economy
   1. inflation rate is 1.4 percent, far below that of developing economies such as India at 5.9 percent inflation rate in 2015
   2. ~60% of China’s exports are from knowledge-intensive industries, such as electrical machinery and telecommunications equipment
2. Chinese economy has diversified and globalized
   1. Industry archetypes
      1. Capital intensity: Heavy industries such as steelmaking and chemicals, as well as infrastructure sectors
      2. R&D intensity: In many industries, the ability to innovate and create new products and variations (or new services) is the key to success
      3. Trade intensity: Pharmaceutical and consumer electronics manufacturers operate in global markets and generate value by importing and exporting
      4. Marketing intensity: To keep up with shifting tastes, consumer industries spend heavily on advertising, branding, and design
      5. Labor intensity: Labor-intensive industries include agriculture, apparel, furniture making, retail, hospitality, and other low-skill manufacturing businesses
   2. Knowing which archetype characterizes which regions is important for developing the right productivity-led economy
3. Investment Led Model has led to distortion in economy
   1. Financial sector accounts for >80% of economic profits
   2. This could make China more vulnerable to demand shifts due to lack of diversification
4. Asset-side risks: Potential defaults in bank loans and failures in shadow banking
   1. 30% of companies have debt to EBITDA multiples > 7x
   2. 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
5. A productivity-led model can generate additional GDP and income of more than $5 trillion
   1. Under the investment approach, weak players are not weeded out organically
   2. To make this happen, businesses need to be allowed to fail, and the workers redeployed

**Chapter 2: 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
      1. 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
      1. 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. Identify retention and churn drivers for employee base to inform actions that improve the situation
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
      1. Average manufacturing worker in China makes 10% of average US manufacturing wage
      2. High cost of automation equipment is primary barrier, but mechanization can unlock more productivity
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

**Chapter 3: Transforming Institutions to Enable the 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