Economy

Rethinking China's Economic Growth Challenges

By John Jullens

In this article, John Jullens discusses why improving domestic firms' capabilities is crucial for maintaining economic growth and development.

Although the world's financial markets seem to be recovering from their worst annual start ever, the outlook for many emerging markets remains bleak. Indeed, the Federal Reserve's recent decision to abandon its goal of raising interest rates four times this year was effectively abandoned in no small measure due to fears that the impact on emerging markets could be severe. Investors are also concerned about longer-term structural challenges, such as the potential impact of the fourth industrial revolution on emerging market jobs. For example, a recent World Bank study estimates that automation may threaten up to about 77% of all jobs in China versus about 57% of jobs in OECD countries and a recent study from The Center for Strategic and International Studies questions whether the BRICS still matter at all.

Not surprisingly, investors are especially concerned about China, not only because of the exceptional volatility of its equity markets, but also because sharply lower Chinese demand for oil and other commodities has caused significant economic and related challenges for commodity-exporting countries, such as Brazil, Russia, and Venezuela. More importantly, China's economic fundamentals are deteriorating steadily, as overcapacity in sectors such as cement, glass, and steel has reached dangerous levels, debt levels are still increasing, and capital flight is on the rise. While a financial implosion remains highly unlikely, it is clear that China is entering a new phase in its economic development and will have to make important structural adjustments to avoid getting ensnared in the dreaded middle-income trap and continue on its journey to eventually become a high-income society.

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The conventional wisdom suggests that China must urgently 're-balance' its economy away from its current dependence on exports and investment towards more private domestic consumption and services. In other words, from a demand-side perspective, a country's GDP consists of public and private domestic consumption, exports for foreign consumption, as well as services and investment. Beijing's challenge is that the Chinese economy has become increasingly reliant on investment alone to achieve its targeted growth rates, especially after the global financial crisis in 2008, which induced policymakers to introduce an extensive investment-led stimulus package to offset the sharp decline in global trade. Predictably, capital efficiency (i.e., the return on those investments) has since declined precipitously while debt levels have continued their inexorable rise.

As a result, China urgently needs to alter the composition of its GDP by increasing the unusually low shares of private domestic consumption and services relative to exports and investment. Unless it makes the structural reforms required to achieve such a rebalancing – generally viewed as a package of extensive market-oriented reforms – China will likely join other once-promising emerging markets, such as Argentina and Brazil, and find itself stuck in the dreaded middle income trap; i.e., capable of sustaining middle income wages indefinitely, but unable to break through this threshold and join the select group of rich countries.

Or so the conventional argument goes. However, while the economic accounting logic may be impeccable, it overlooks the fact that China's domestic consumption and the services sector have actually grown quite rapidly over the last few years. More importantly, the conventional demand-side perspective offers no real insights into exactly how China should rebalance its economy; worse, it actually masks what China needs to do.

China's real challenge lies on the supply side, which views an economy's growth potential as a function of the amount of land available for economic activity, the size and quality of its labour force, capital investment, and some measure of total factor productivity. Seen from a supply-side perspective, it is much easier to understand the true nature of China's economic challenge: arable land is actually shrinking slightly, the size of the labour force has already peaked, and capital efficiency is, of course,

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unacceptably low. This leaves increasing productivity levels as the only viable lever for achieving healthy economic development and growth.

In plain English, China needs to find ways to migrate its industrial base from its current reliance on low-skilled, labour-intensive manufacturing of garments, toys, and similar products to higher value-added activities in services and, for example, medical equipment, cars, and other sectors that are typically already dominated by vastly more experienced and better resourced firms from developed markets. To do so, China will need to develop world-class companies of its own that can compete directly with foreign competitors at home and overseas, and, in turn, support a thriving domestic ecosystem of direct and indirect suppliers, complementary businesses, various types of services, and so on. Needless to say, this is a formidable and time-consuming task that few developing countries have been able to pull off successfully. In fact, South Korea and Taiwan are the only large economies that have been able to do so in the recent past.

So, an important reason that emerging markets struggle to overcome various types of macroeconomic growth traps is that their domestic companies tend to get caught in similar firm-specific growth traps somewhere along their lengthy journey from opportunistic, nascent start-ups to truly world-class companies. In fact, three common growth traps stand out as they lie between each of the major development phases that emerging market companies typically go through on the road to world-class. What makes these traps especially challenging is that they are rooted in strategies and behaviours that made these companies successful before, but are now counter-productive. In other words, the very things that make a company successful during one phase may cause its downfall in the next.

For example, emerging market companies are often initially primarily focused on seizing the moment and getting ahead of the pack by pre-empting local competitors. They pursue top-line growth almost at all costs in an effort to grow top-line revenues and lock in a dominant market share position. In doing so, they often neglect to develop the basic capabilities they will need when the industry matures, such as quality, new product design and engineering, and brand management.

Relatively few emerging market companies are adept

Qingdai based Haier ranked as number one major appliance brand in the world.

Photo Courtesy: www.qingdaonese.com

in managing this inherent contradiction and striking the right balance between capturing early mover advantages on the one hand and laying the foundation for future success on the other hand. As a result, these companies may shine brightly for some time, but then invariably flame out, as the market becomes large enough to attract more experienced foreign players while growth rates and margins decline and competitive intensity increases significantly.

In contrast, successful emerging market companies are often notably internally focused during these early stages of their development. They focus heavily on building strength through adopting quality management techniques and learning from more advanced foreign competitors through some combination of benchmarking, reverse engineering, licensing, contract manufacturing, and other forms of strategic partnerships. As a result of laying a more solid foundation, they eventually start to outgrow their more short-term focused local competitors and often engage in a wave of acquisitions to scale up and consolidate their domestic position.

However, emerging market companies that merely copy competitors' best practices without improving or adapting them to create differentiated value for their customers, may be successful for a while, but will ultimately fail to hold off their strongest competitors, especially, of course, world-class firms from developed countries. While clever copycatting is undoubtedly effective during the initial catch-up phase, and, therefore, itself an important organisational capability, emerging market companies must also learn how to become less short-term operational and more long-term strategic in their approach to the business. This implies a significant shift in firm objectives, strategy, capabilities, decision-making routines, and mind-set that many emerging market companies find difficult to adopt.

Finally, as they get closer to the global productivity frontier, emerging market companies must begin to coalesce their individual capabilities into a coherent system of interlocking, mutually reinforcing capabilities that truly make them distinctive in the marketplace. They will need to increasingly focus primarily on further developing only those capabilities that give them a right to win against other world-class competitors and avoid spreading resources too thin across too many conflicting priorities.

This too represents a significant shift for many emerging market companies, as horizontal diversification and vertical integration may have been important differentiators to overcome various market imperfections, or institutional voids, early on in their home markets. For example, conglomeration may be useful for providing access to investment capital and management know-how not readily available externally, while vertical integration in upstream supply chains and downstream distribution channels is often the only way to achieve required quality and service levels.

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all followed a deliberate process for building world-class capabilities over time. They evolve from acquiring basic production expertise to mastering more sophisticated skills through a process of "chaining" increasingly advanced capabilities over time. They find ways to progress from relying primarily on state protection and country-based comparative advantages, such as low-cost labour, to developing their own firm-specific competitive advantages, and become adept at determining if and when to fill existing capability gaps through external contracting, internal development, or M&A.

It should be clear that emerging market firms often can't do this by themselves, especially in asset-, scale-, or knowledge-intensive industries. The state's role may need to go beyond merely providing public goods and correcting market failures, especially as the economy grows closer to middle income levels and domestic firms are increasingly forced to compete against world-class companies from other countries.

Of course, none of this is meant to suggest a return to the well-intentioned, but self-defeating, import substitution approaches of the past. Instead of protecting domestic firms indefinitely, emerging market governments should focus on administering healthy doses of tough love at the right time. However, that will require much better integration between the three primary disciplines that must inform any comprehensive national development strategy: economics to guide a country from low- to high-income status, political science to design the enabling institutional environment at each stage, and strategic management to create competitive world-class firms over time.

Seen in this context, the solution to China's economic challenges lies only partly in introducing new market-based reforms and liberalising financial markets. Indeed, implementing such reforms too broadly and early could even be counter-productive and lead to excessive financial volatility while wiping out still uncompetitive domestic firms in sectors with high innovation and development spill-over potential. At a minimum, China will need to focus on continuing to grow the services sector, removing constraints on the private sector, redirecting investment toward higher value-added activities, and especially improving the competitiveness of the thousands of SOEs that still make up roughly 40% of its GDP.

Doing so will require another round SOE rationalisation similar to then Premier Zhu Rongji's draconian program in the late 1990s. In addition, management itself must be overhauled, as many SOEs still lack advanced skills in, for example, marketing and strategic planning. In addition, executive incentives should be more clearly focused on improving firm competitiveness instead of meeting local political objectives or advancement in the party hierarchy. Only through active intervention to upgrade its industrial base and improve domestic firms' competitiveness will China be able to avoid the fate that has befallen so many emerging markets and continue on the economic journey it started so auspiciously some thirty years ago. ■

John Jullens is a Principal at PwC Strategy& with more than twenty years of management consulting and industry experience in North America, Europe, and Asia. He is currently the firm's emerging markets leader for the capabilities driven strategy platform and a member of the leadership team of PwC's Growth Markets Centre in Singapore. He blogs at www.johnjullens.com and writes a monthly column for Strategy & Business ("Global Perspective"). In addition, he is a regular contributor to such leading business publications as CEIBS Business Review, China Daily, Financial Times, Forbes, Harvard Business Review, and the Wall Street Journal.