The Economist Corporate Network

IN SEARCH OF THE "SECRET SAUCE"

The quest to fire up productivity in Asia

A summary paper sponsored by

In search of the "secret sauce"

The Economist Corporate Network staged a meeting of senior business leaders in Asia Pacific in July 2013. Given a backdrop of rising costs and competition in the region, the meeting focused on how to improve productivity. This report is a summary of the ideas discussed at the event.

THE PRODUCTIVITY BACKDROP IN ASIA

"Productivity isn't everything, but in the long run it is almost everything," said Paul Krugman, a Nobel prize-winning economist, in 1994. "A country's ability to improve its standard of living over time depends almost entirely on its ability to raise its output per worker."

Productivity is a simple concept. It is the ratio of inputs to output. In an economy, the inputs are people, land and capital, while the output is GDP. By combining the inputs in new ways through ideas and technology, the amount of output can be increased for the same level of input. For workers, improving the output per worker means rising wages. For companies, it means increasing profits.

History has backed Mr Krugman's thesis. Countries that have managed to improve productivity levels have prospered. In Asia, since the 1950s, economies such as Singapore, Hong Kong, Taiwan and South Korea have made great leaps in productivity and thereby income levels. Today they rank among the richest countries in the world on a per capita basis.

But not all countries succeed in raising productivity at the same rate. In Asia, nations such as Malaysia and Thailand are sometimes said to be stuck in a "middle income trap". (See Chart 1.) Such countries start off as low-income economies but rapidly rise to middle-income status, usually by opening up their borders to trade and foreign investment, and encouraging the growth of low-cost manufacturing industries. As investment and technology and ideas flow into the country, so productivity improves sharply, output per worker grows and wages rise. However, the second part of the journey—moving from middle-income to high-income—is much more challenging.

For this second part of the journey, countries need to invest in the things that support continuing productivity improvements—such as education and research, the rule of law, transparency, free and fair competition, and efficient capital markets. When countries find their development journey stagnating as they reach middle-income status, the reasons are often to do with under-investing in the things that support continued growth in productivity. Without improving productivity, countries find that they lose competitiveness relative to their peers.

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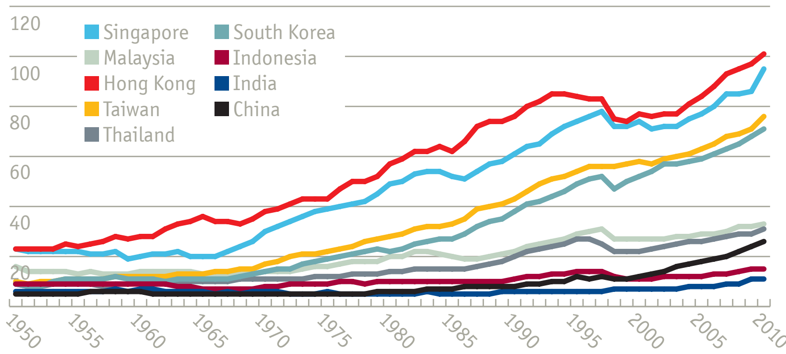
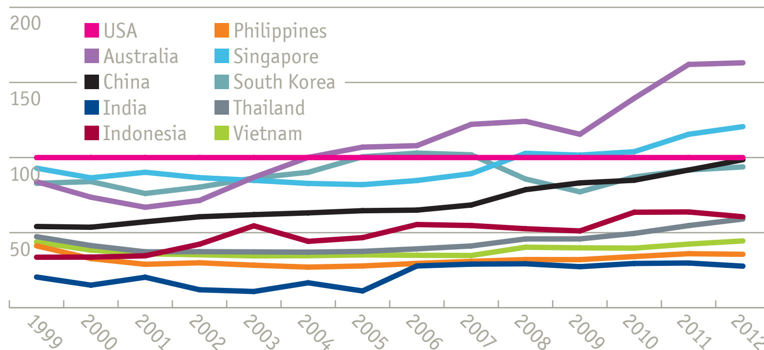
Chart 1:
Per capita GDP relative to USA, using PPP (USA = 100)



Source: Economist Intelligence Unit, using data from the Maddison Project Database

Chart 2:
Unit labour costs (the labour cost of producing one unit of economic output, or GDP, indexed to USA = 100)



Source: Economist Intelligence Unit

What is true for an economy is also true for a company. If productivity stagnates, companies find themselves losing competitiveness, and growth grinds to a halt. The pressure is ever-present to raise output per worker (or per unit of capital). Companies can do so either by thinking up new products and services (thereby increasing the firm's output), or by devising cheaper ways to produce the same output (ie, reducing the firm's inputs).

THE PRODUCTIVITY CHALLENGE IN ASIA

In Asia, the task is especially pressing because costs in the region are rising sharply. Wages, for example, are soaring in much of the region. In China, nominal average wages per worker increased by a spectacular 278% between 2003 and 2012. Average earnings per worker in China are now higher than in many other emerging markets, such as Mexico (two times higher) or India (seven times higher).

At the same time, China's productivity has improved at a far slower rate than the growth in wages. As a result, Chinese unit labour costs have been inching up steadily. In 2000, China's unit labour costs were about 60% that of America's, and it made sense for many companies to locate their manufacturing operations in China to take advantage of the lower labour costs. Today, however, China has lost some of its low-cost advantage as unit labour costs have risen to equal that of America's. (See Chart 2.) Wages remain much higher in the US, but productivity is also higher. The same story is evident in many other parts of Asia too.

It isn't only labour costs that have swelled in Asia. Property prices—especially in commercial hubs such as Singapore, Jakarta, Shanghai, Manila and Hong Kong—have skyrocketed. Other business costs, such as regulatory costs, have also increased significantly. Previously, regulations around workplace safety and health or the environment were less stringently enforced in Asia. This is changing as governments focus more on implementation of these regulations, forcing companies to invest more in compliance.

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Equally important for companies are the "hidden" costs of doing business in Asia. In the World Bank's *Doing Business 2013* report, a number of Asian countries still rank relatively poorly in terms of the ease of doing business. These include the Philippines (ranked 138th place out of 185 countries), Indonesia (128th), Vietnam (99th). Even China, a country that has made great progress in cutting red tape for businesses in recent years, is ranked in the 91st spot. Common tasks such as starting a business, dealing with construction permits, getting electricity, accessing credit, paying taxes, and enforcing contracts can often be inefficient and costly for businesses operating in these countries.

Moreover, reforms can be challenging, and will take time. China's new political team, led by president Xi Jinping, has vowed to streamline government approvals and reduce the number of administrative procedures by at least a third. However, these efforts are likely to face resistance from bureaucrats because the process of granting approvals presents them with valuable rent-seeking opportunities.

One participant at the Economist Corporate Network meeting, a managing partner at an international law firm, noted that corruption is another hidden cost that cannot be ignored by companies operating in Asia. In many countries—including India, China, Indonesia, the Philippines, and Malaysia—corruption is a pervasive and systematic problem. In recent years, governments have ramped up their efforts to reduce corruption, but with varying degrees of success. In some cases, government efforts to reduce corruption have, paradoxically, burdened companies with even greater costs, as they are required to comply with official investigations and have to pay extra fees for legal counsel and advisors.

THE RISE OF THE ROBOTS?

One response from companies to the tide of rising costs in Asia is to increase automation. One regional president of a manufacturing group argued that huge potential exists in Asia to deploy robots in place of workers across a whole range of processes. A decade ago, low wages in Asia meant that automation was not worth the expense. He found, for example, that it was cheaper to hire a room full of workers to do the work of a packaging machine. This is no longer the case.

But automation isn't a panacea, even in manufacturing. Production lines that churn out hundreds of thousands of the same goods lend themselves to greater use of machines, but the production of specialised goods with a high degree of variability and customisation are harder to automate. Often such goods require a high degree of worker intervention. The managing director of a high-tech engineering group in China noted: "The challenge for us now is to find qualified workers to get involved in the

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manufacturing process. Productivity is important, but we need humans to pay attention to detail and quality. It is still labour-intensive work for us."

The group CFO of an automotive parts maker in India, identified further barriers to automation. Given India's currently unfavourable environment of high-inflation and weak economic growth, he argued that many manufacturing companies are reluctant to invest too much in automation as they worry about generating overcapacity. "Because of the macroeconomics, most of the industry is operating on a semi-automatic basis," he said. "Although full automation would be more productive it also calls for much greater fixed capital investment. In the current climate that is just too risky."

SALES PRODUCTIVITY FAILS

Moreover, while automation can significantly help to raise productivity levels in factories and in a company's back-end operations, it is less effective for improving productivity of the front line sales and service staff. The regional CEO of a global bank said, "A big challenge for us—and other service industries especially in the hospitality sector—is to improve the productivity of front-line staff without compromising on the quality of the service. Given that client interaction and customised service are a big part of the client experience, it is difficult to automate these front-line processes while maintaining the same level of customer satisfaction."

For the financial services sector, increasing use of technologies such as internet banking platforms, automatic teller machines and mobile payments are helping to cut down the need for face-to-face client interaction. "However, the extent and frequency to which these technologies are used is as much determined by the customers' willingness to adopt them and change their behaviour as the industry's efforts to develop these platforms," said the regional CEO. "For example, corporate clients are often concerned about regulation and security issues and still prefer to go through a banking officer to complete their trade transactions."

MAY I HELP YOU?

Improving productivity in Asia's services sector is critical, as a number of economies in the region—the Philippines, India, Australia, Singapore, Hong Kong and New Zealand—are more service-focused than industry-focused. Right across the region, the services sector has been raising its share of both economic output and employment. Countries such as China and Thailand are making the shift from a manufacturing-led to a services-led economy. Indeed, China is often referred to as the factory of the world, but its services sector now matches its manufacturing sector's contribution to the economy, with the services industry expanding more rapidly.

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However, compared to OECD countries, Asia's productivity in its services sector leaves much to be desired. According to a study by the Peterson Institute for International Economics, labour productivity in the services sector of nearly all the Asian countries—including Malaysia, Thailand, India, the Philippines, Indonesia, China, Vietnam and Indonesia—is less than 20% that of the OECD. (The exceptions are Hong Kong, Singapore, Taiwan and South Korea.) It will take many years for these countries to reach even half of the OECD's current labour services productivity.

Compounding the problem is that services productivity levels in a number of Asian countries have barely improved over the past decade. For example, while South Korea's productivity level is already 40% that of OECD, labour productivity growth has been growing by only around 1% a year. For Thailand, labour services productivity has been stagnant. In some economies with relatively large services sectors such as the Philippines and Sri Lanka, labour productivity growth rates have only averaged about 2% to 3% a year.

In fact, some companies have reported that productivity in Asia's services sector is so low that businesses are struggling to make a profit. The regional managing director of a US computing firm said, "In the US, we spend 80 to 90 cents on sales and marketing to earn $1 of revenue for the business. In Asia, we need to spend $3 on sales and marketing to earn $1 of revenue. In other words, we are very far from breaking even in Asia. We are overinvesting in our sales and marketing teams here, and yet we don't get the same quality of output. This is because there is an acute shortage of talent and experienced sales staff in Asia, even in cities like Singapore, Hong Kong, Shanghai or Mumbai. Good sales staff are in high demand, so we have to pay a premium wage to these staff even if they're less qualified than their U.S. counterparts. We then need to spend a huge amount of time and money training them and equipping them with the right skills. Compared to our US team, the costs are significantly higher, and yet the output is much lower."

In certain cases, less qualified sales staff in Asia are paid even more generously than their more experienced counterparts overseas. The regional managing director of a US research group said that the top positions in its Asian offices are paid more compared to anywhere else in the world, including the US or Europe. The country managing director for China of a Swedish company added that key managerial positions in the company's China office earned salaries that were 20% higher than their counterparts in the firm's Swedish headquarters.

PIPELINE TO THE FUTURE

Given the headaches companies face in finding experienced and qualified staff, many are making a conscious effort to identify a younger generation of talent within their

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organisations, and to train them for key positions in the future. Doing so requires that companies take a long-term view of how many workers they will need in the years ahead, what skills they must have, and what roles they will play.

“Over the past few years, we have shifted our business model to recruit more junior people, and invest heavily in their professional development,” said the regional managing director of the US research group. “We hope to retain talent by increasing their salaries from a junior level. They become very well paid relatively quickly, but they also become highly productive. We have ramped up our internal training programmes, and helped our staff develop skills that we believe will be critical for our business in the future. For example, we are sending our junior staff to Shanghai to learn Mandarin, as we plan to expand our business in China and anticipate our major workforce gap in the coming decade to be Mandarin-speaking staff.”

Of course, such measures don’t stop competitors from poaching these staff with offers of generous pay rises. However, while training programmes may end up helping the competition, they are also likely to produce loyal staff who are comfortable deploying their skills in a familiar environment for which the skills were designed.

In any case, said one manager at an accounting group, “Sure, we lose some of the people that we train. But what else can we do? If we don’t invest in productivity and skills we won’t succeed.”

PRACTICAL IDEAS

Among the ideas for productivity improvement discussed at the meeting:

- In the face of rapidly rising wages in Asia, many manufacturers are increasing automation, and moving away from labour-intensive production models to more capital-intensive systems.
- In the services sector, companies are trying to automate customer interaction by deploying more internet-based self-service tools for consumers, more automated communication interfaces, and new business models around technologies such as self-service banking kiosks.
- Many firms note that their internal processes, even for trivial tasks such as travel authorisations and expense claims, are time-consuming and inefficient. Automating internal processes frees up staff time that can be spent on more productive activities.
- One of the most obvious ways to raise productivity is to increase the skills of a company’s workforce. Many firms say they have made big commitments to

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education and training in Asia in a bid to raise output per worker.

- Another HR-related idea is to do long-range jobs planning. Many companies complain of skills shortages in the job market. Only by thinking about what skills a company will need in the years ahead, and then devising appropriate recruitment, retention and training programmes will companies address these shortages and thereby raise the firm’s future productivity.
- Companies are improving the productivity of their sales forces by rethinking their management of both existing customers and potential customers. It is often the case than 80% of revenues come from 20% of a firm’s clientele. Yet, companies often spend an equal amount of time servicing all clients. Some firms are reorganising their sales team to spend the majority of their time on the biggest clients, and reducing customer service for smaller clients.
- Just as important, some firms say that tracking how salespeople use their time reveals that huge amounts of it are wasted. A time management exercise like this can be the catalyst for changing behaviour and raising sales productivity. Such surveys often reveal that salespeople spend a large chunk of time on administrative tasks. By taking these tasks away from salespeople, they have more time to sell.
- Another way to encourage workers to improve their productivity is to link pay increases to performance. For many companies in the past, salary increases were automatic and not tied to productivity. Salary differentials between employees were often based on the length of their tenure and their seniority, rather than how good their performance was. However, many companies are now starting to link pay to performance as a way to motivate and provide an incentive to workers to continually improve their productivity. The challenge for companies then is in managing employees’ expectations and to help them understand that their wages cannot rise continually without corresponding improvements in their performance.
- Productivity isn’t only about labour, it is also about managing capital efficiently. One of the greatest areas of potential improvement is in working capital management, especially inventories. At present, many firms have a standard inventory promise for all clients, such as delivery of an order within two hours. However, meeting such a promise requires keeping huge amounts of inventory on hand, which is an inefficient use of capital. Instead, some firms say they are adjusting their inventory and service delivery promise depending on the client. A high-priority client might expect delivery in one day, while a low-priority client might get one week, unless they are willing to pay more.

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