

# In pursuit of prosperity

November 2018

Why do some emerging economies grow rapidly while others languish? New research highlights the role of public policy, effective government, and globally competitive companies.

**In this episode of the *McKinsey Podcast*,** Simon London speaks with McKinsey Global Institute director Jonathan Woetzel and MGI partner Anu Madgavkar about their recent research on emerging economies that outperform others based on pro-growth agendas and successful companies that help propel them.

## Podcast transcript

**Simon London:** Hello, and welcome to this edition of the *McKinsey Podcast*, with me, Simon London. Why do some countries develop economically while others remain poor? Is economic development determined by geography or demography? Is it even possible without democracy? And what's the role of free-market principles—whatever those might be? To answer these questions, I caught up with the coauthors of a new report from the McKinsey Global Institute entitled *Outperformers: High-growth emerging economies and the companies that propel them*. Jonathan Woetzel is a McKinsey partner based in Shanghai. Anu Madgavkar is a partner based in Mumbai. For this conversation I was lucky enough to intercept them both in New York.

Anu, Jonathan, thanks for being here today.

**Jonathan Woetzel:** It's great to be here. Thank you, Simon.

**Anu Madgavkar:** Great to be here. Thanks.

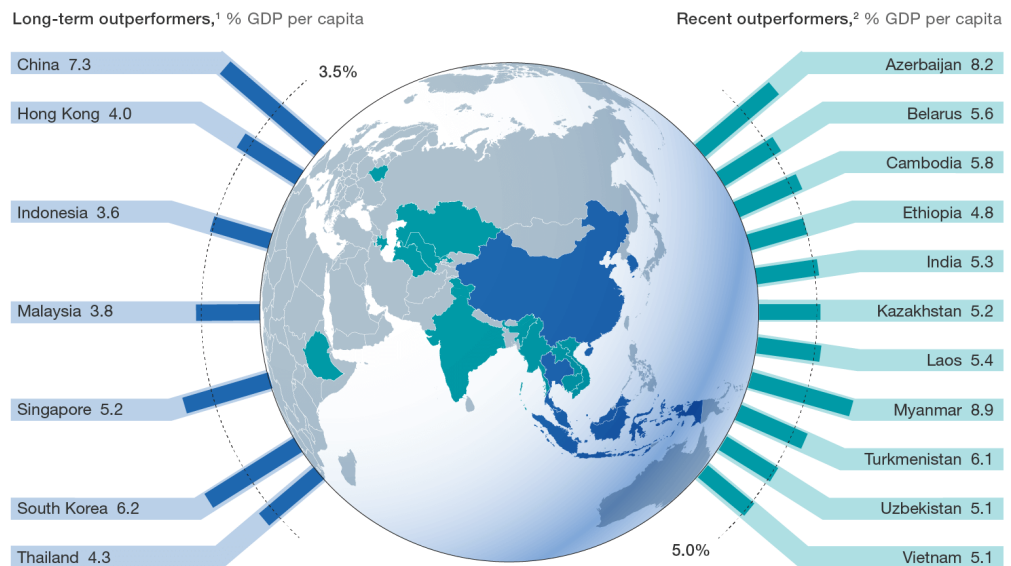
**Simon London:** The obvious first question is, who are the outperformers?

**Anu Madgavkar:** We looked at over 70 emerging economies, and we set a threshold of which economies have delivered sustained per capita GDP growth over long periods of time. Over 50 years this amounted to a set of seven economies, which includes China, South Korea, Hong Kong, Singapore, and then a set of economies in Southeast Asia, which is Malaysia, Indonesia,

and Thailand. These seven did it over 50 years, and then there's another set of 11, which delivered high growth over a shorter period of about 20 years [Exhibit 1].

## Exhibit 1

Seven economies had real annual per capita GDP growth of at least 3.5 percent for 50 years, while 11 other, less-heralded economies grew at least 5.0 percent annually over the past 20 years.



<sup>1</sup>Percentage GDP per capita growth of more than 3.5% annually for 50 years, 1965–2016.

<sup>2</sup>Percentage GDP per capita growth of more than 5.0% annually for 20 years, 1996–2016.

Note: The maps displayed on the MGI website and in MGI reports are for reference only. The boundaries, colors, denominations, and any other information shown on these maps do not imply, on the part of McKinsey, any judgment on the legal status of any territory, or any endorsement or acceptance of such boundaries.

McKinsey&Company | Source: United Nations Conference on Trade and Development; McKinsey Global Institute analysis

**Simon London:** All of those seven are clustered in Asia. They're the names we know, but they're all in Asia. So is there a sense in which geography is destiny? Is that part of the message?

**Anu Madgavkar:** It's interesting to look at the recent outperformers, which is the set of 11 that took off and delivered growth over the last 20 years. Because that's actually a more diversified set. You do have countries in Southeast Asia, like Vietnam and Cambodia. You do have India. And then you have a set of countries which are in Central Asia, which is Kazakhstan, Uzbekistan, and so on. And then one African economy. There is a bit more of regional or geographic diversity in that set. But it probably is true that there are strong advantages of having growth taking off in the form of, let's say, a big anchor economy or an economy that leads in a region. We have seen some of that. But growth has actually been more diversified in the last 20 years.

**Simon London:** And in Asia presumably that's China. China is the big anchor economy. And there is a sense in which some of the other economies have been able to go on the coattails of China, is that right?

**Jonathan Woetzel:** China trade—"China-south" and "China-north"—trade has been the fastest growing piece of global trade. It is an anchor, as you say.

But more broadly, as Anu was saying, I think we do say that there is an approach to growth. There is an approach to outperformance which is common to these East Asian economies. But it is more than that. It goes beyond borders. And it's something that any country can achieve. That's the message: there's an approach and there's an agenda that is open to all.

**Simon London:** Let's double-click on that. Having an anchor economy close by is helpful, but there is a recipe here. There's commonality across countries that achieve growth over the long term. What's the recipe?

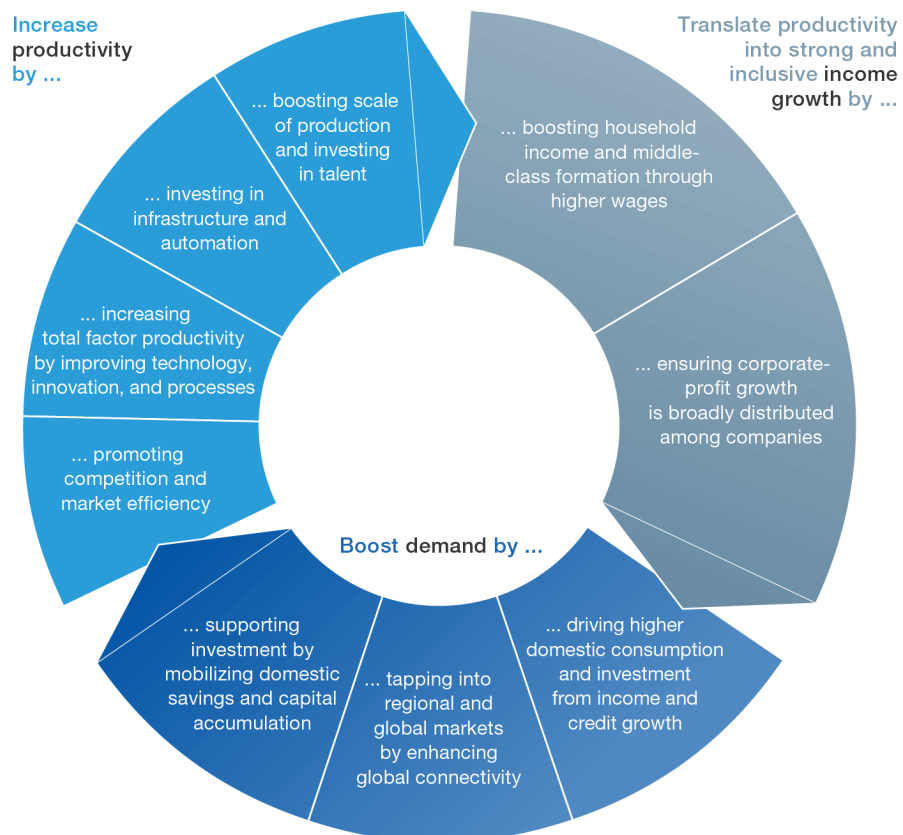
**Jonathan Woetzel:** We think it has two parts. Let's talk about the policy, which I'm hesitant to call policy—but let's say the agenda, the things that we all agree on in an outperforming economy. And essentially the main thing is we agree on growth. And it's quite surprising in some cases that some economies do not agree on growth. So it's apparently not well aligned.

But in a high-performing economy, what we see is an alignment around productivity, income, and demand [Exhibit 2]. These are the three aspects that drive economic growth. Productivity

## Exhibit 2

A pro-growth agenda of productivity, income, and demand propelled the outperforming economies.

How to sustain high GDP per capita growth



to enable better resource-allocation decisions. Income to create return of that productive investment to the people who created it, the workers or the investors and the shareholders. And demand being the reinvestment of that income into new productivity. These things go together: productivity, income, and demand. And that is the first and most important takeaway from why these economies outperform. They agreed on that, and they created policies and mechanisms to support that.

The second thing we note is that large competitive global companies are a hallmark of these outperforming economies. We can argue whether it's causal or correlated. But we can certainly say that these companies have to be there. We need to see large, globally competitive companies emerging to 50 percent, 60 percent revenue as a share of GDP, or 40 percent value added as a share of GDP, in order for us to see an outperforming economy. Those two things: a pro-growth agenda and globally competitive companies.

**Anu Madgavkar:** These two things are not just the common features that we saw across these outperformer economies but also went hand in hand. So just like Jonathan said, it's not clear which was the cause and which was the effect. But there was something like a shared vision that was created around the idea of the importance of growth, the importance of creating a climate in which savings and investment could happen, and that these companies could actually invest, accumulate capital, build productive capacity, and open up to the rest of the economy.

It did take some doing. This is not something that happened automatically or naturally or easily, perhaps, but with a concerted set of actions that actually had policy makers sitting with the private sector charting out what could be done, let's say, to drive up exports in a certain sector or economy-wide. Then they followed a shared agenda around that with the right incentives in place—a fairly concerted set of actions to bring these multiple different actors together.

**Simon London:** I know we don't want to get too deep into policy making. It's up to the countries to decide, clearly, but what are the common levers around something like encouraging a high savings rate within an economy and capital accumulation? What are some of the things that we see consistently across high-growth economies?

**Jonathan Woetzel:** I think you put your finger first of all on a very important one, which is savings rates and the ability to mobilize savings, which implies two things. One is a belief in the value of those savings. That the savings will go to create some future wealth in store. And the second is the security of those savings. Those savings are not something that you have to keep under your mattress at home but you will actually put into a bank account.

The policy first of all is to create the financial system that allows that. So you have to have financial inclusion. You have to have some type of a very broad-based financial network that allows for everybody, farmers to workers to rich and poor, to have security against those deposits.

Then you need to have a way of insuring that what that savings is used for can ultimately create value. The return on that investment, that's where you see the takeoff in manufacturing. The ability to start small-scale manufacturing enterprises, which have access to the marketplace. You see investments of course in real estate. The ability to secure title and see that there's

a medium-term opportunity for you to get this money back so you're willing to put the investment into the savings vehicle.

It boils down to saying, "Yes, we have to have a broad-based financial network. And we have to have the security for the investor." Those two things add up to an incentive to save. Without those we of course see very low savings rates, and those are characteristics of the non-outperformers.

**Anu Madgavkar:** One of the myths I think about emerging economies is that a lot of the investment is led by FDI.

**Simon London:** FDI being foreign direct investment.

**Anu Madgavkar:** Foreign direct investment. And while that is true, FDI has played an important role particularly in bringing new know-how and new technology and linking local companies to global markets. But just in terms of quantum of capital accumulation, it's really domestic savings that dominate across all the cases that we've seen.

There is no substitute in the medium to long term to building the financial institutions, trust, credibility, and financial inclusion and to deepening your domestic savings and investment markets. There really is no substitute for doing that.

**Jonathan Woetzel:** If I could add one other that I think is just incredibly important: the productivity aspect of policy. Productivity sometimes is thought of more as, first of all, an automation and a job-cutting mechanism, and I think that, of course, technological innovation and renovation is an aspect of it. But that's in turn impelled by pro-competition policies.

It's actually the opening of markets and the selective uses of everything from tariffs and quotas and reductions in them to market-availability mechanisms. Saying we allow for this market to be open to private competition, in particular, versus that one to be not yet available.

These levers have been used very purposefully by the outperforming economies to gradually over time open up and deregulate and create a market-based economic benchmark. We call it contested leadership. These markets feature contests for who will be the leading company. Those contests are held on economic grounds saying, "Who can achieve a faster rate of coverage for your telecom network? Who can be more successful in an export market?"

**Simon London:** That was going to be one of my questions about the growth of large companies in these economies. From the outside in, I would say to myself, "Well, of course. These are government selected. They're picking winners. These are protected. They're oligopolies." But actually, the research shows that's not the case, right?

**Anu Madgavkar:** No, that's not the case at all, because per trillion dollars of GDP, so for the size of each of these economies, they have more companies in this \$0.5 billion-plus revenue bracket that we consider large companies.

**Simon London:** So that's our definition, if you'd like, of a large company, just for the sake of argument, is \$0.5 billion of revenue and above.

**Anu Madgavkar:** These outperformers have more such companies. There is more dynamism or churn in terms of who the winners are. We looked at this in terms of saying, “Well, which are the companies that actually perform best in terms of economic profit generation, let’s say ten or 15 years ago?” Of the companies that were leaders at that point, how many of them remained in the top quintile in terms of economic profit generation ten or 15 years later?

What we found is that the rate of dislodging of companies and new companies entering that leadership bracket was much higher in the outperformers compared to the advanced economies, for example.

**Simon London:** So there is this sense of creative destruction in action. And if anything, more creative destruction than you might see among the top echelons.

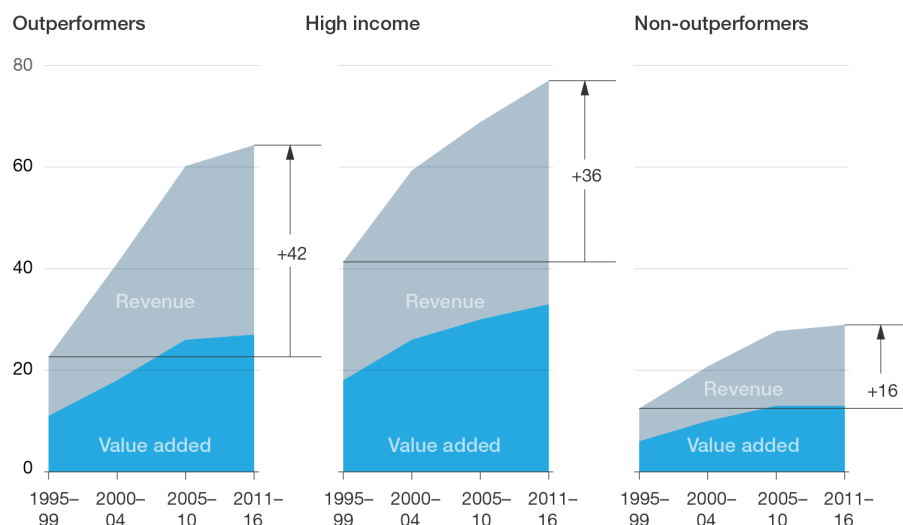
**Jonathan Woetzel:** That’s a great point, Simon. I think that we actually did then look at the firms themselves, to and see whether what we can observe at the firm level—in terms of their management practices and whether that would support this thesis—that there was greater churn and more dynamism.

What we found, interestingly enough, is that yes, in fact, these high-performing emerging economies feature large competitive companies [Exhibit 3], and, relative to their OECD [Organisation for Economic Co-operation and Development] counterparts, they are more

### Exhibit 3

Productive large companies have been key contributors to the growth of outperforming developing economies.

Ratio of large-company revenue to GDP, 1995–2016,<sup>1</sup> % (n = 25 economies; 6,474 companies<sup>2,3</sup>)



<sup>1</sup>Simple average across countries.

<sup>2</sup>Outperformers include China, India, Indonesia, Malaysia, Singapore, South Korea, and Thailand; high-income economies include Canada, France, Germany, Italy, Japan, United Kingdom, and United States; non-outperformers include Argentina, Brazil, Egypt, Mexico, Nigeria, Pakistan, Poland, Philippines, Russia, South Africa, and Turkey; Hong Kong is excluded as an outlier (large-company revenue is equivalent to more than 340% of GDP).

<sup>3</sup>Publicly listed companies with more than \$500 million in revenue in 2016.

Note: Figures may not sum to 100%, because of rounding.

Source: World Bank; McKinsey Corporate Performance Analytics; McKinsey Global Institute analysis

digital. They are growing faster, they are investing faster. They have higher capital productivity. They have higher rates of new product introduction. These are real global contenders. We would contend that this is the birth of the new set of global competitors. If we look down the line in ten, 20 years, the majority of global competitors will be from emerging markets.

**Anu Madgavkar:** What's interesting about them is that they're not just looking at their own markets. They're increasingly looking at the world as the place to play. You have seen very large multinationals coming out of some of these outperformers. And it's not just the outperformer economies. You do see these high-performance, high-growth companies coming up in some of the non-outperforming economies too. There are winners there as well.

It's more a challenge of how can those economies make the effort to scale up many more such companies. But you do have winners. Some really interesting stories. For example, one of the largest bakery brands in the US is a Mexican company that owns I think six out of 12 of the largest bread brands in the US. Or the Korean cosmetics companies which have gone global. There are big global aspirations on the part of many of these companies backed by some of the nimbleness and agility that Jonathan talked about in terms of investment.

**Simon London:** Just to make sure that I understand, part of our argument is that the growth of large companies is something of a development economics lever. And maybe that's been underappreciated until now. Is that broadly what we're saying?

**Jonathan Woetzel:** We can say, first of all, it's certainly a feature. Large corporations we know are important for exports. They are more capable of tapping in historically to that demand. Improvements in the performance of large companies leads to improvements in the performance of small companies. There's a value chain which is associated with it. They pay higher wages so it supports income. And there is more use of R&D, higher levels of our research and technology investments. All of this would say that this is a form of market-based organization, let's say that does drive productivity, increases income, and supports demand. Not every company is as productive and as competitive as the leaders that we've seen in these outperforming economies.

Companies in and of themselves, this may or may not lead you to those results. But the pro-growth agenda, which is again the policy side of the compact, the things that we believe about how an economy should work, combined with these entrepreneurial energies, creates an outperforming economy.

**Simon London:** Are we essentially saying here that a free-market set of policies, throwing the economy open to global competition, letting big companies fend for themselves, is that the recipe that we see at work or is it actually something a little more subtle?

**Anu Madgavkar:** The governments in many of these outperformer economies have played a very active role, so I'm not sure we should characterize it as a purely laissez-faire or free-market

type of approach. There has been a large amount of effort put into figuring out what aspects of global experience are relevant for the country at that point in time.

While all these economies and policy makers did try to get the best thinking from the world, there was equally a strong desire to shape that and adapt that to the conditions which were prevalent. Going back to the earlier point around savings—there was a fairly big role played by governments to almost do forced savings, which is to create conditions in which capital was available relatively cheaply to companies.

This may not have happened had it been a completely free-market system. That's just one example where policies were adapted and developed which were consistent with the stage of development of the economy at that point in time.

**Jonathan Woetzel:** I think it's fair to say that many of these economies are still in the relatively early stages of their development. They're moving from agriculture into industrialization. In that process, many times there's been market failure. There simply hasn't been private capital available to invest.

And so government has taken up the slack in terms of fixed assets and infrastructure investments, economic-development zones, and to some extent the actual development of what initially are state enterprises. Over time then privatizing or corporatizing them, as the case may be.

As Anu says, there's a very active government role here. The productivity, the income, and the demand. But that said, I think the philosophy is clear. All these economies have embraced, if you will, market principles, in not only the operation of the market but even in how government itself operates. And government itself embraces this idea of contested leadership.

**Simon London:** Yes. And I guess from a political economy angle, there's something here about government effectiveness. So, Anu, do you want to say a little bit more about the importance of that?

**Anu Madgavkar:** I think it's fair to say first of all that government effectiveness had less to do with or little to do with the form of government. We did find a whole spectrum of different forms of government, and that wasn't a big differentiator between the outperformers and the other economies that hadn't actually achieved high growth. Among the outperformers, you do have single-party forms of government, like China or Vietnam. You do have democratic governments. And then you have India, which is a very diverse, very vibrant, and some might say noisy democracy. So you have all these flavors.

It didn't have to do with a recipe of how governments come into power or how they conduct themselves but more how they think about economic growth and development. That is the focus of the research. We did not specifically look at questions of political effectiveness and human rights. We focus much more on understanding government effectiveness in terms of economic policies. Certainly, the form of government did not seem to be a differentiator there.



**Simon London:** So as far as we can tell, it's not true that only democracies can succeed. But by the same token there's no reason to believe that a noisy democracy such as India cannot succeed.

**Anu Madgavkar:** That was one of the very interesting findings that came out of this.

**Jonathan Woetzel:** I think that's the key point: that it's the trajectory that matters. It's the rate of improvement. You start where you start. So some of our more recent economies are post-Civil War economies, so high levels of distrust and not much infrastructure.

But the fact that they have improved the quality of their governance or their transparency and that levels of corruption have been reduced, the ease of doing business has increased, and that in turn has been a hallmark we think of as creating the trust that enables demand. That's a direct tie to the savings rate again.

**Simon London:** I thought one of the very interesting findings in the report that jumped out at me is the survey of senior managers in these various economies. And in your average developing economy, a senior manager will spend more than 10 percent of their time working on government or regulatory issues. In our outperformers, it's only 5 percent. So that actually is a microexample of why this matters. It can bog down an economy.

**Anu Madgavkar:** It is frankly work in process for all economies, including the outperformers. There's absolutely no room for complacency. Capital will flow where the enabling environment to deploy it productively exists. And this is as much a competition as anything else. I would say that even for the outperformers, particularly for some of the recent outperformers where ease of doing business is still a journey, that little factoid or microexample should serve to spur even more reform in that area.

**Simon London:** So let's talk about trade. We hear a lot about globalization stalling, or in some cases, moving in reverse. Clearly trade has been a very important lever for our long-term outperformers. The question is, will it be a big lever for outperformers in the future?

**Anu Madgavkar:** If you look back at the last seven to eight years, it's fair to say that at an aggregate level, so if you think about top-line, total trade, there seems to be this deceleration. It's flat. It's plateauing. People are concerned about deglobalization. But if you unpeel that onion a bit, there are two trends that are notable. Not all forms of trade are declining or flattening. Trade in services is rising. All sorts of data flows and information flows, which indirectly enable trade in services, are skyrocketing. If you strip away the pure commodity piece of goods trade, the rest is demonstrating healthy growth as well.

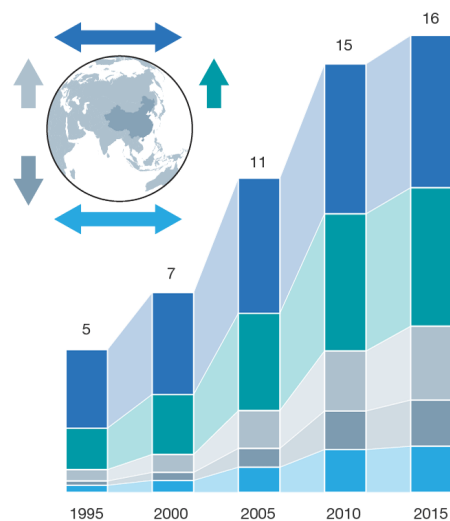
The second piece is to look at trade connections not necessarily with the advanced economies, or the OECD countries, but also among emerging economies, which we call south-south trade—though not all of these are in the Southern Hemisphere—but south-south trade is shorthand. If you look at cumulative trade within the emerging economies, that went up from

something like 8 percent of global trade to 20 percent of global trade in the span of [about 20] years [Exhibit 4]. So there is rising growth there.

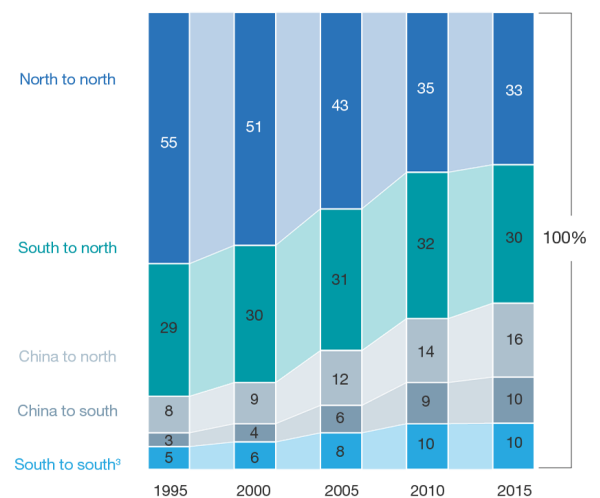
#### Exhibit 4

The share of goods trade among emerging markets (South to south and China to south) has increased from 8 percent in 1995 to 20 percent in 2016.

Total goods trade by development status,<sup>1</sup> \$ trillion<sup>2</sup>



Share of total goods trade by development status, %



<sup>1</sup>Global imports of goods; north and south defined as developed and emerging markets, respectively.

<sup>2</sup>In current dollars.

<sup>3</sup>South-to-south trade is shorthand for trade among emerging economies even if they are not in the Southern Hemisphere.

Note: Figures may not sum to 100%, because of rounding.

McKinsey&Company | Source: United Nations Conference on Trade and Development; McKinsey Global Institute analysis

There are these big economies like China, which have created value chains and are sourcing more from the rest of the emerging economies and potentially importing for domestic consumption as well. We've seen labor-intensive exports from countries like Bangladesh, Cambodia, Vietnam, Uzbekistan, rising at the rate of 20 to 30 percent, directed toward China. So in some ways there is the opportunity for China to become a new engine of consumption, which in turn creates more opportunities for south-south trade.

**Simon London:** Another thing that struck me in the research is that there's not a lot in there, that I read anyway, around education. I would've thought that government investment in human capital and the labor force would be a big policy lever for development. Do you want to speak to that a little bit?

**Anu Madgavkar:** I think relative to the role that capital and technology and productivity growth have played, the role of quantity of labor to start with has been much smaller. There is another myth that says emerging economies grow fundamentally because they have lots of people and populations are growing.

**Simon London:** Well, there's a demographic dividend, effectively.

**Anu Madgavkar:** That was certainly not the case. It was by far the productivity growth that dominated. That said, what we did find is that as you look at a host of different indicators, the amount that government spends on educating its workforce did show up as reasonably important.

But, again, because we start at different levels and because some of these economies actually aren't that urbanized and don't have high levels of education, what we did find is that successful companies—and sometimes whole sectors—have figured out how to take the labor supply that exists and upskill it to make it relevant and productive in the context of what you're doing.

India's IT sector is a good example. We did have a lot of tertiary-educated people entering the sector. But companies then figured out that to make them really employable and really productive, they did need to spend time and money upskilling them. They figured out that solution.

**Jonathan Woetzel:** To build on what Anu was saying, the labor markets themselves, the flexibility and the inclusivity and the mobility that you have, that's really what differentiates these outperforming economies' labor results, their income results from the non-outperformers.

It's how well they include and they allow for everybody—the farthest-flung peasant to the inner-city worker—to get access to a value chain, an industry, a competitive sector, which then builds their skills. That flexibility and essentially allowing for the geographic mobility but also the cross-industry mobility.

The growth of new companies, the dynamism of the value chain, the opportunity for SMEs [small and medium-size enterprises] to spring up and to create more employment opportunities, that's the kind of education that really matters. The expenditures themselves, we didn't see a high correlation there.

**Simon London:** Look into the future. If you think about the next generation of outperformers: Who are they? Where should we look?

**Jonathan Woetzel:** First of all, they're a far-flung lot [Exhibit 5]. We believe that we will see the growth of the outperforming economies spread to every continent and that they are both large and small. There won't be a straightforward correlation based on geography or size. Rather, it will again be driven by the policy agenda, the pro-growth agenda, and the emergence of these globally competitive companies in emerging markets. I can give away a few names but—

**Simon London:** Do. Give away a few names.

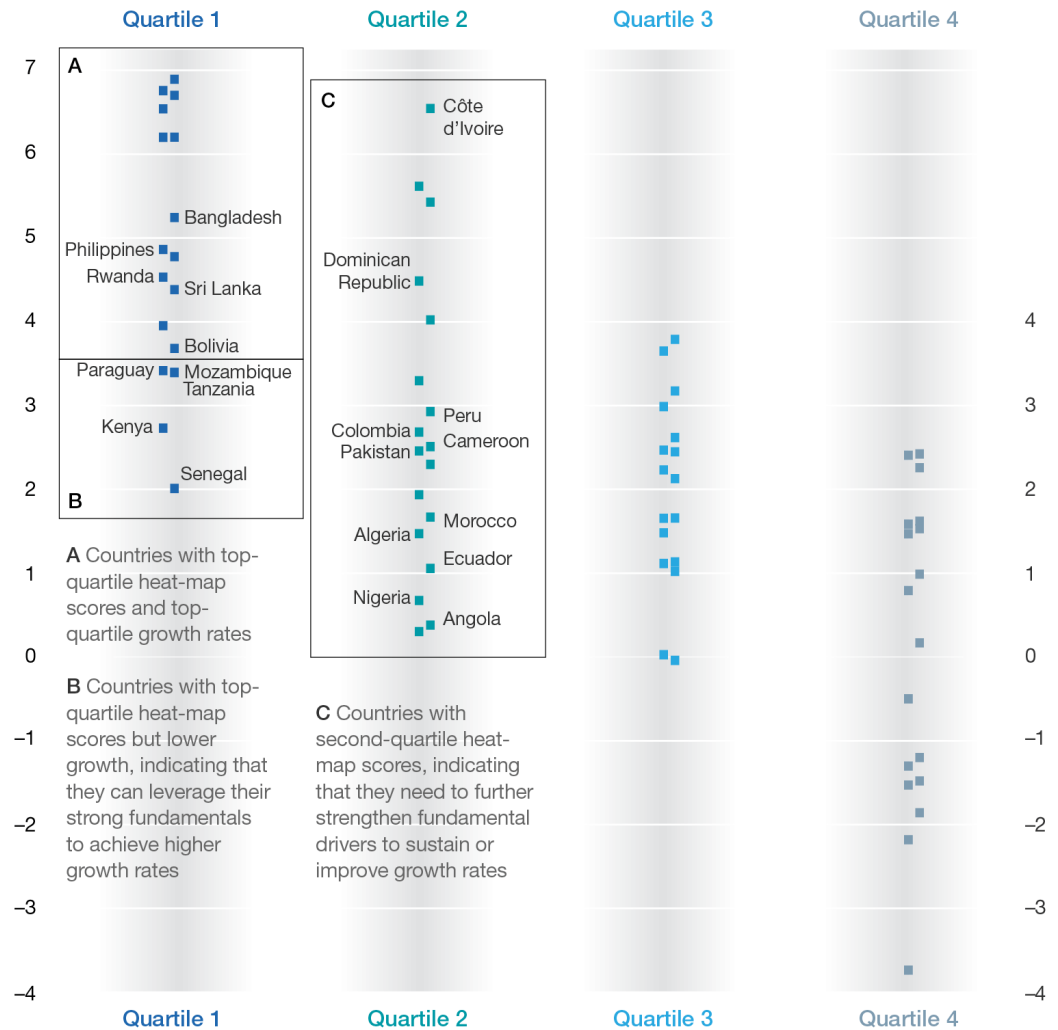
**Jonathan Woetzel:** It's all in the report, but in Africa, Rwanda stands out as being an example of a small country which has delivered the GDP per capita growth—but also recently has a very robust set of institutions or I should say a robust agenda against these growth policies.

In Latin America we see Bolivia starting to show recent outperformance. The right policies and agenda in place. With any of these types of predictions, of course, it's just that. It's just

## Exhibit 5

Countries that achieved high GDP per capita growth and strong momentum since 2011 have the potential to join the next wave of outperformers.

GDP per capita by heat-map-score quartile, % CAGR<sup>1</sup> 2011–16



Note: Heat-map score is based on each country's performance across the 13 drivers of growth. Results are normalized for each indicator and summed with a weight based on the indicator's simple correlation to GDP per capita growth. Quartiles represent where the total country score falls. Overall correlation between heat-map scores and GDP per capita growth is 0.8.

McKinsey&Company | Source: McKinsey Global Institute analysis

a prediction. What we base it on essentially is the recent GDP per capita growth and an assessment of the elements of their policy agenda. Those are what we see as the potential for the next wave of outperformers.

**Simon London:** Fantastic. Well, I think we're out of time for today. But, Anu and Jonathan, thanks so much.

**Jonathan Woetzel:** Thank you very much.

**Anu Madgavkar:** Thank you.

**Simon London:** And thanks, as always, to you, our listeners. To download the report, *Outperformers: High-growth emerging economies and the companies that propel them*, and to learn more about the McKinsey Global Institute, please visit [McKinsey.com](https://www.mckinsey.com). □

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