

# Reaching higher productivity growth in France and Germany

## Executive Summary



McKinsey  
Global  
Institute

with assistance from our Advisory Committee

Olivier Blanchard, Chairman  
Martin Baily  
Hans Gersbach  
Monika Schnitzer  
Jean Tirole

October 2002

©2002 McKinsey & Company, Inc.

All rights reserved. No part of this book may be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopying, recording, or by any information storage and retrieval system, without prior permission in writing from McKinsey & Company.

# Executive summary

*Reaching higher productivity growth is vital to France and Germany's future standard of living. Fortunately, it is fully within their grasp. Our sector analyses indicate clearly that the key is business and technology innovations made possible by appropriate regulation that spur high competitive intensity at the sector level.*

*Plainly, France and Germany must set themselves the goal of faster productivity growth. The engine of the vehicle with which they can reach this destination is innovation – now turbo-charged by the power of IT. But the top speeds attainable today are in many cases limited by the bad road conditions of the current regulatory environment. By improving regulations, policymakers can lay out an "economichighway" that allows the companies with the most horsepower to succeed and, in doing so, drive the entire economy forward faster. If policymakers are responsible for providing the highway, business leaders are in the driver's seat: in a competitive environment they will speed up, striving to close the gap to best practice operations and reach efficient scale. With a broad perspective on productivity, they may even be able to identify innovative concepts that change their traditional business systems altogether, and reorganize the structure of their value chain.*

## **The Destination: Stronger productivity performance in France and Germany**

France and Germany's labor productivity moved promisingly close to that of the US for five decades following World War II. In the mid-1990s, however, the trend reversed: Productivity in the US grew at a faster rate than in France and Germany, and the gap started to widen again. In 2000, the gap in labor productivity, as compared with the US, is estimated to have been 5 percent in France and 15 percent in Germany. Weakening productivity performance should worry us. Given the current and projected demographic challenges, future living standards will increasingly depend on high productivity growth.

To develop effective solutions for dealing with these challenges, policymakers and business leaders in France and Germany need to base their decisions on a complete and nuanced understanding of the barriers to and drivers of higher productivity growth. This level of understanding has not yet been attained. One of the drivers focused on in public debate is the lower level of involvement in the production and use of IT. This is often considered the main cause of lower productivity growth rates in France and Germany. There is indeed some truth to the assertion that productivity growth in France and Germany did not benefit as much from the IT manufacturing sectors as it did in the US.

However, this effect explains only approximately one-third of the difference in productivity growth between France and Germany on the one hand and the US on the other hand since the mid-1990s. The lower level of IT spending in France and Germany, however, does not serve as a convincing, let alone, complete explanation of the remaining two-thirds of the gap in productivity growth. Firstly, it does not explain why France and Germany are spending less on IT and, secondly, a recent MGI study showed that higher spending on IT alone does not automatically lead to higher productivity growth.<sup>1</sup>

Productivity is shaped in companies and sectors – not at the aggregate level. To contribute to a better understanding of the true drivers of and barriers to higher productivity growth, we performed an extensive in-depth analysis of the labor productivity performance of six sectors in France, Germany, and the US: telecommunications, retail banking, retail trade, utilities, road freight, and automotive. These sectors are not assumed to be "representative" of the entire economy of France or Germany. Rather, they were specifically chosen as they provide a suitable basis for gaining insight into the drivers of and barriers to productivity growth.

### **The Vehicle: Innovation is the engine – but constrained by inappropriate regulation**

From these sector cases it becomes quite evident that development and diffusion of innovative products, services, and processes are the most sustainable sources of productivity improvement. Although we also identified some significant productivity improvements as a result of industry consolidation or the simple reduction of excess labor capacities, these forms of productivity improvement have only limited potential: once an industry has reached its optimum level of concentration and excess capacities are removed, business and technology innovations are the only source of productivity growth.

IT plays a critical role in this context: many of the innovations of the 1990s were supported by or, in some cases, made possible only through the application of IT. Prominent examples include the digital technology in mobile telephony or back-office automation in retail banking, both of which boosted productivity growth in their corresponding sector. We identified sizable differences across countries as regards the degree of innovation diffusion and the extent to which these innovations were leveraged through scale. However, we did not find that the different propensity or ability to invest in IT was a main cause for these cross-country differences. Scrutiny of four sectors revealed that the differences in the diffusion and leverage of innovations were primarily caused by inappropriate regulation and lack of shareholder pressure – both of which led to insufficient competitive intensity – and, to a lesser extent,

---

<sup>1</sup> See: "Productivity Growth 1995–2000, Understanding the Contribution of Information Technology Relative to other Factors"; McKinsey Global Institute; Washington D.C.; October 2001.

by differences in the nature of demand and lower income levels in France and Germany – rather than by differences in the propensity to invest in IT:

¶ *Inappropriate regulation and lack of shareholder pressure* prevented companies in almost all of the sectors we analyzed from either diffusing innovative products, services or processes, or from building up scale to maximize the benefits from these innovations. In road freight, for example, price regulation and market access restrictions curtailed the level of competition in France and Germany. This, in turn, discouraged consolidation and kept the industry fragmented in both countries. As a result, IT-based network optimization tools, which were instrumental in improving productivity performance in the US, were not introduced on a broad scale. Other sectors, such as the US mobile communication industry and the German retail banking sector also revealed a sub-optimal level of industry concentration that was the result of regulatory shortcomings. In both cases, companies were not able to leverage scale and maximize the benefit of innovative products, services or processes.

¶ *Differences in the nature of demand and lower income levels* affected productivity in the analyzed sectors in two distinct ways:

- People consumed more of the same goods, which enabled industries with a fixed network infrastructure – e.g., telecommunications, utilities, and retail banking – to better utilize their network capacity.
- People consumed goods of high value added per hour worked, e.g., goods that benefit from brand premiums or luxury goods – such as SUVs in US automotive.

In summary, insufficient competitive intensity, restrictive regulations, and lower aggregate income levels have created an environment in France and Germany that has not facilitated the rapid diffusion of innovative products, services, and processes. With the emergence of IT as a key enabler of many important innovations, the negative impact of this environment on productivity growth is likely to have become an increasing constraint at the aggregate level during the late 1990s.

## **The Road: Policymakers need to lay out the "economic highway"**

Policymakers are responsible for laying the groundwork for a competitive market environment and paving the economic highway. The good news is that they have already started to do so. Efforts to increase competitive intensity by providing a better regulatory environment in the course of the 1990s have been rewarded. The positive impact of removing regulatory restrictions confirms the power of competition to stimulate productivity growth. Examples for this are the relaxation of capacity restrictions and the elimination of fixed price lists in road freight, the liberalization of the fixed-line business in telecommunications, or the gradual removal of import quotas for Japanese cars. These regulatory improvements were often accompanied by privatization programs. Increased pressure from the capital markets encouraged former state-owned companies to improve their productivity in order to succeed in the new competitive environment.

The bad news is that, despite all these regulatory improvements, there are still numerous barriers to competition in France and Germany – and to a lesser extent also in the US. If France and Germany are to significantly improve their productivity in the longer term, policymakers need to review regulations that either restrict market access for new or foreign competitors or create an uneven playing field in terms of competition on quality or price. We have identified such barriers primarily in four sectors: utilities, retail trade, retail banking, and automotive.

Ensuring competitive intensity is particularly tricky in network-based sectors with very high fixed costs, for example, in utilities and telecommunications. In these sectors, smart regulatory solutions are required. Policymakers need to develop a regulatory framework that enables fair and transparent third-party access to the network, and provides companies with incentives to improve their operational performance. In addition, competitive intensity needs to be monitored in these sectors.

Any form of productivity improvement – including regulatory reforms – leads to structural changes. Employment levels may be reduced in one sector, and increased in another. Policymakers need to enhance these structural changes and speed up the transformation process in order to ensure that the productivity improvements lead to economic growth and employment, as occurred in the US in the course of the 1990s. They can do so by facilitating the redeployment of workers and providing a fostering environment in which innovative sectors can grow.

## **In the Drivers' Seat: Business leaders need to master productivity growth**

Business leaders are in the driver's seat of the vehicle that can take Germany and France to higher productivity growth – but they have to shift into higher gear.

The key levers for productivity growth – and thus also for sustainable profitability – are the development and diffusion of innovative products, services, and processes. Furthermore, some sectors still have some potential for reaching optimal size and attaining economies of scale through consolidation:

- ¶ *Innovation* – Development and diffusion of innovative products, services, and processes provide further potential for productivity improvements. We expect, for example, further diffusion of IT-enabled tools for network optimization in the European road freight industry, and the introduction of best-practice processes in the French and German automotive sectors.
- ¶ *Consolidation* – There is still ample opportunity for improving productivity by reaching efficient scale. Examples here include the German retail trade and retail banking sectors as well as the US mobile communication industry.

Business leaders also need to ensure that they have a sufficiently broad perspective on productivity. This will put them in a position to recognize and exploit opportunities arising from product and process innovation along the entire value chain: either in the form of vertical collaboration or through horizontal specialization. Examples of these trends include the intensive collaboration between suppliers and retailers in the US and the establishment of specialized service businesses that provide transaction processing for a number of banks in France and Germany.

\*\*\*