

What can we expect in China in 2021?

While China enters the new year economically stronger than any major economy in the world, fulfilling high expectations will pose a tough challenge for the country's leaders.

by Gordon Orr



China enters 2021 economically stronger relative to major economies than anytime since 2009. This apparent strength creates extremely high expectations for China to deliver on its forecast economic recovery, on its rollout of vaccines in China and beyond, and on stabilizing its geopolitical relationships. In a year when avoiding major risks and sources of instability remain paramount, China's leaders will find it harder to keep the economy on track than anticipated.

Overall

Economic growth expectations for 2021 of 8 percent-plus (in real renminbi terms) are pricing in perfection. Achieving it could pose a challenge. Most critical is the need to accelerate still sluggish consumer spending. The recent pivot in government policy to demand stimulation reflects growing concern in Beijing that consumers are not stepping up their spending as needed. China's export strength in 2020 has resulted from global demand for personal protective equipment (PPE), a global shift to online purchasing, and Chinese manufacturers stepping up to fill gaps left by manufacturers locked down in other markets.

In 2021, with the roll-out of vaccines, manufacturers ex-China will fully recover. Additionally, the secular trend to move manufacturing (especially destined for the US) out of China will restart, and China based manufacturers will feel the full impact of the renminbi's appreciation. Domestically, infrastructure spending has not yielded the desired results. The continued flirtation with bankruptcy of several of China's leading property developers highlights fragility in this sector. Expect aggressive action to lower tax and other burdens on individuals. Concerns about growth will also push Beijing towards opening up further to foreign capital and business participation within China. Negative lists will shorten further and more licenses will be issued from basic materials to financial services.

Geographically, China's economic center of gravity continued its long-term shift southwards in 2020, as Tianjin fell out of the 10 ten cities by GDP, leaving only Beijing from the north on the list. Beyond the usual clusters of the Pearl River and Yangtze River Deltas, President Xi continues to push for the development of the Hainan Free Trade Port (HFTP), with preferential policies for industries from aviation to health and internet services, beyond traditional support to tourism sectors.

If China does achieve 8 percent growth in 2021 with domestic inflation of 1-2 percent and currency appreciation of 3-5 percent, then the size of China's economy relative to the US could exceed 75 percent in 2021 (using IMF forecasts).

Consumers

The COVID-19 economic shock, though short, was traumatic for many lower income Chinese consumers. China's younger generations had not experienced anything close to a recession prior to COVID-19 in 2020. The virus has forced them to think harder about spending, saving, and trade-offs in purchasing behavior. While aggregate savings have grown this year—McKinsey reported the country's household deposit balance increased by 8 percent over the first quarter to reach 87.8 trillion RMB—this was concentrated in high income households. These consumers said they planned to increase sources of income through wealth management, investments, and mutual funds. But these richer consumers at least still have savings. Many at lower income levels found their modest savings entirely wiped out by the COVID-19 lockdown. Unsurprisingly they have been both unable and unwilling to jump back to prior spending levels—and probably won't until they are convinced that a vaccine has eliminated the risk of recurrence.

The virus has also led consumers to seek better quality and healthier options: More than 70 percent of respondents in the McKinsey COVID-19 consumer survey will continue to spend more time and money purchasing safe and eco-friendly products, while three-quarters want to eat more healthily after the

crisis. But not all spending has shifted to “virtuous” products: High-end malls in China have seen their sales grow 25-35 percent compared with 2019 as the wealthiest consumers, unable to travel, spent much more within China than before.

When Chinese consumers do spend, they are increasingly focused on strong local brands. WPP in its Brand Z report showed a 30 percent increase in the value of the top 100 Chinese brands in 2020, almost all associated with their growing domestic success. Likewise, China Skinny research highlights the phenomenal success of local brands such as Yatsen in beauty.

Of course, prior trends will continue. Chinese consumers will be more digital than ever before, with the major online battles in 2021 waged over who gets to deliver fresh groceries to the home and who provides the digital health care solutions that exploded in popularity during 2020.

Industry Sectors

The most attractive sectors for investment in 2021 will be shaped both by recovering consumer demand and by government priorities set out in the 14th five-year plan, due to be unveiled during the annual parliament session in early 2021. The high-level outlines of the plan are clear: Risk mitigation and stability, greater state involvement in business, focus on industries of the future (with a special emphasis on semiconductors), accelerating growth through consumption, and sustainable growth.

Cross-border trade flows will be impacted by priorities for both inbound and outbound goods. For priority inbound sectors, China wishes in the short-term to ensure that it retains maximum access to global suppliers, and in the medium-term, build up world class domestic capabilities.

Beyond semiconductors, particular priorities are agriculture tech (AgTech) and biotech. AgTech is not simply about providing a greater proportion of China’s food supply domestically. It is also about ensuring that food is grown from seeds where the intellectual property (IP) is developed and owned in China.

Traditional energy supplies—oil, gas, and the key minerals used in NEV batteries—remain priorities for ensuring stability. Even under the latest plans, renewables will only provide 25 percent of China’s energy by 2030, much of the remainder will still need to be imported. In semiconductors, mainland China buys more than one quarter of all manufacturing equipment sold today (versus less than 3 percent in Europe) to go along with the billions of dollars being invested in semiconductor research and start-ups. That proportion could rise above 30 percent in 2021.

Priority outbound sectors are largely emerging industries, where China already feels confident in its potential to be world class, and in which it seeks to ensure maximum access to markets beyond China. China’s asks in the Comprehensive Agreement on Investment are very much focused on this. In this category are sectors such as new energy vehicles, green tech, and smart tech. Smart tech covers many subcategories, often 5G-enabled, from smart cities to smart factories and industrial IoT. In these sectors, China will seek to export not only hardware as usual, but also software, and critically, the standards on which the Chinese products are based. Chinese-produced NEV exports will range from Tesla’s made-in-China for sale in Europe vehicles and Tesla’s emerging China-owned competitors such as Nio, Xpeng, and LiAuto, to sub-US\$10,000 entry level EVs, to EV buses from BYD.

Should the EU-China investment agreement be ratified, European companies should receive preferential market access in a number of these sectors in China, and Chinese companies will be permitted to push forward on their green energy and NEV investment strategies into the EU. The impact will not be as material and swift as the opening up of the financial sector to majority foreign-owned players was in 2020, and the text has not yet been finalized, but openings are promised in new energy vehicles, cloud services, financial services and health.

Online grocery shopping will likely be one of the most contested and contentious consumer facing sectors in China in 2021, highlighting both the

further digitization of the Chinese consumer and more aggressive intervention by Chinese regulators. Community grocery buying, where one person organizes grocery purchase and delivery for the following day for a community of typically 30 of their neighbors, is seen as the next major showdown between China's internet giants (including Meituan, where I sit on the board).

As with many online to offline business models, economies of scale at the city level are key to success. While being so popular with consumers that it could reach close to 20 percent of grocery sales by 2022, the sudden emergence of grocery ecommerce will receive push back because of the disruption to traditional channels—distributors and local retailers (hundreds of thousands of mom-and-pop outlets). Regulators might consider using their new anti-monopoly powers to ensure an orderly evolution of the market.

Regulation

2021 will be a year of intense regulatory action in China. In multiple areas, regulators are on the front foot with a common intent to centralize and standardize regulations (eliminating provincial variations in how regulations are applied) and to better protect individuals and small businesses from predatory behaviors by larger businesses. These policies are targeted at all businesses and of course foreign businesses will come under scrutiny as a result. Key areas include:

- Anti-trust enforcement by the State Administration for Market Regulation (SAMR) could likely target discriminatory pricing, forced exclusivity, below cost pricing and acquisitions to pre-empt competition. Larger internet companies will find ways to adapt but some will see their margins impacted.
- The corporate social credit system could become more effective at joining the dots to highlight corporate bad actors as the system more effectively consolidates data already held on corporations across multiple (largely local) databases.
- Undercapitalized players in the financial sector will probably find they need to add billions of dollars in new capital requirements to sustain their existing business model and operators using a provincial license to operate nationwide will find that path no longer open. Sales of bank wealth management products will be restricted by new regulations on distribution, with third party platforms removing many such products already in January.
- New rules on personal data protection pile on top of existing cybersecurity and national security requirements. Consumers are increasingly concerned about data privacy and protection and the government is catching up. More explicit opt ins for collecting data, restrictions on selling data to third parties, government approvals for taking data cross border and even higher requirements on protecting minors' data will apply. Sensitive data still walks out the door of corporation. Companies will be expected to have policies to prevent this. Breaches or failures to comply must be self-reported or corporations will face additional liabilities.
- Technology exporters will likely need to navigate China's new export control law, largely modelled on what China has seen applied by the US. Details of the law were laid out in December; many existing technology exporters are likely to find that they need additional licenses to export in the future.
- Taking lessons from governments around the world, Beijing has rolled out a national security screening process as part of the approval process for foreign acquisition of companies based in China.

Hong Kong

Entering 2021, Hong Kong remains China's international financial center, and through the narrow lens of that sector, had a surprisingly successful 2020. IPOs continued throughout the year, demonstrating that much of the sector's activity can flourish even when arrivals at the airport fall to less than 1 percent of normal levels.

One milestone came when the Hang Seng Index adjusted the companies it includes to take out Swire Pacific (a member since the index was launched 51 years ago) and bring in Meituan, listed only two years ago. (I am a board member of both companies). Weighted by value, mainland companies now make up over 60 percent of the index. With the pressure to delist Chinese companies from the US only growing, underlying momentum supporting the financial market in 2021 remains strong.

With Hong Kong now on Wave 4 of the virus, there seems little likelihood that international business travel will return at any scale into Hong Kong until the second half of 2021. As a result, many business decisions remain on hold—whether to adjust the scale of operations in Hong Kong, or to move activity into mainland China or elsewhere in Asia. When the border with mainland China reopens, expect a step-up in investment from mainland China in Hong Kong, of mainland companies expanding their operations in Hong Kong, and of mainland talent moving to Hong Kong. These secular trends have been on hold for 18 months now—in part due to the wave of civil unrest that gripped the city before the outbreak of COVID-19—but will see a snap back in 2021.

Beyond China

China will likely continue with its multilateral engagement strategy, building off the successes of the Regional Economic Comprehensive Partnership (RCEP) and the China–EU Comprehensive Agreement on Investment from 2020. RCEP's gradual tariff reductions and rules of origin for manufactured goods will deepen flows of goods

between China and the 14 other member economies that in combination represent 30 percent of global GDP, even if it does little on services.

In 2021, China may also deepen its commitments to standards setting institutions such as the International Standards Organization (ISO), the International Telecommunications Union (ITU), the International Electrotechnical Commission (IEC) and more, encouraging its companies and researchers to promote China developed standards. In multilateral bodies shaping global climate change policies and global COVID-19 vaccine distribution, China will seek to position itself as a more significant (in terms of offers made) and more reliable partner.

Belt and Road Initiatives (BRI) will probably continue at scale, with billions of dollars going into completing the backlog of agreed projects. 2021 will also see new variants of BRI emerge, for example:

- Green energy BRI—Fewer coal and more solar projects, more green finance for projects.
- Smart or Digital BRI—More telecom than road infrastructure, more smart city projects, more smart car projects.
- Healthy BRI—Covering everything from vaccines to hospitals and digital health solutions.

Chinese companies have low expectations for material change in their ability to do business in and with the United States in 2021. They optimistically hope for stability simply to be able to better plan and make investment and sourcing decisions with certainty, and to be able to close partnerships with US companies at least in China, if not in the US. 2020 will prove to have been the last wave of Chinese companies listing in the US. 2021 will see a mix of forced delistings and companies choosing to relist in Hong Kong or on mainland exchanges, even if they have only been listed in the US for a year or so.

Gradual supply chain reconfigurations will continue. As global trade normalizes, China's share of global manufactured goods exports will fall back from the all-time high it reached in 2020 on the

back of demand for PPE, and will return to the gradual trend downwards as manufacturers add incremental new capacity closer to scale markets around the world. As part of this trend, expect to see many more Chinese companies opening factories not just in Vietnam and India, but also across Africa, in Mexico, Brazil, Turkey, and Poland. For example, almost all Chinese smartphone producers now manufacture in India for India.

Companies that manufacture in China for China, whether Chinese or multinational, will largely continue to do so. For most, domestic demand consumes the significant majority of their output. These companies will engage in the growing wave of manufacturing upgrades in China—increasingly the global hub for what the future “smart factory” will look like. Companies that needed to shift production to avoid US tariffs have done so.

China and Environmental, Social, and Corporate Governance (ESG)

Even before the government's commitments for China to become “carbon neutral” by 2060, Chinese businesses had been starting to take ESG concerns more seriously. Consumer, investor, and regulator demands were too strong to ignore. For Chinese companies listed in Hong Kong, disclosure requirements by the Stock Exchange of Hong Kong Exchange (HKEX) become higher each year and force companies to gather and review at board level data that they likely have never looked at before. Questions from not just

ESG funds but almost all fund managers on ESG put management on the spot during quarterly reporting calls. Gaining a higher ranking in ESG ratings schemes from MSCI and Dow Jones is becoming something that company leadership wants to say it is ahead of its peers on. Even on mainland exchanges, one quarter of companies issued ESG reports in 2019, likely over a third did so in 2020, and domestic ESG rating schemes such as the one by Ping An and the China Economic Information Service (CEIS) have launched.

Ahead of the 26th UN Climate Change Conference (COP26) meeting in November 2021, it is likely that Chinese regulators could take the opportunity to issue new ESG policies with tougher mandated disclosures. Clearly there is a wide range of performance on ESG among Chinese companies, with “G” having the furthest to go, but at least on “E”, 2021 will see significant progress.

Closing

July 23, 2021 is the 100th anniversary of the founding of the Chinese Communist Party in China—coincidentally also the date of the rescheduled opening ceremony for the Tokyo Olympics. Hundreds of events are planned across China, from movies to parades and political speeches, to celebrate this anniversary. Ensuring all goes smoothly in the run up to the anniversary is a key objective. Domestically that requires stability—social, economic, and political—above all else. While pursuing sector specific priorities in 2021, don't lose sight of this overarching requirement.

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The views expressed in this article represent those of the author.