



China Brief

The state of the economy

Nick Leung, chairman, McKinsey Greater China

Welcome to the first edition of China Brief. In this series, linked to our monthly podcast, *McKinsey on China*, our China-based partners share the latest insights from this dynamic market.

Pundits have been buzzing in recent months about the slowdown of China's economic juggernaut. There is evident cooling of GDP growth, especially since the middle of last year, and sales of cars and smartphones have been dropping steeply. Some high-profile companies are flashing warnings of plunging sales and some even of job cuts.

Yet, despite the doom and gloom, China continues to rack up one of the most enviable growth rates in the world, adding the equivalent of "another Australia" each year. Consumers continue to trade up to more expensive premium goods and some companies are registering record sales. So the gloom is not uniform. What do the facts tell us about what to expect in 2019? In this first edition of China Brief, we take a quick look at some of the key drivers shaping China's economy today.

1. Growth is slowing—but China is still adding the equivalent of Australia every year

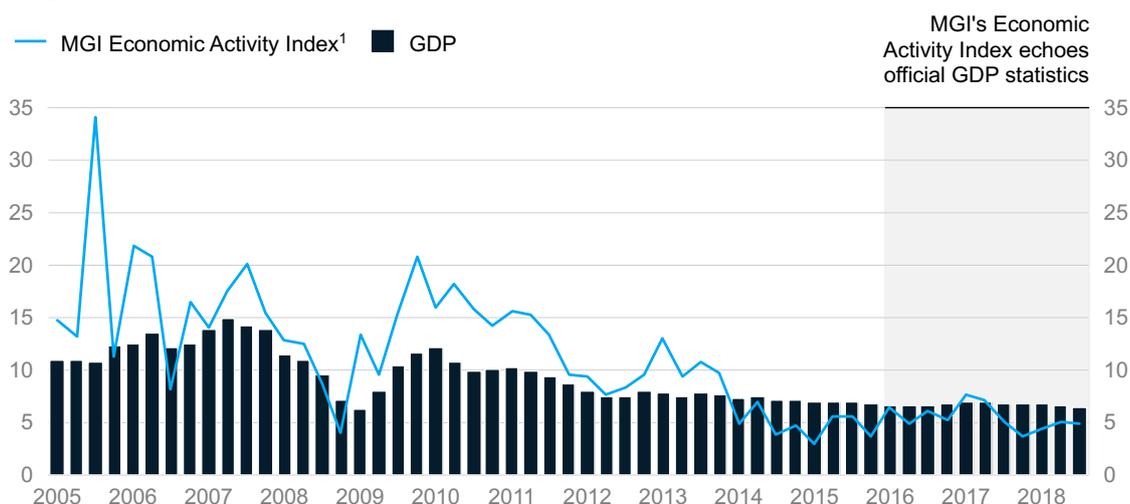
Economic activity weakened in 2018: official statistics placed real GDP growth at 6.6 percent in 2018, the lowest rate since 1990. While some observers may challenge the precision of the official numbers, this much is true: the Chinese economy is slowing. The McKinsey Global Institute's Economic Activity Index, which tracks the performance of the Chinese economy by looking at a basket of 57 different indicators ranging from retail and property sales to electricity consumption, echoes the dipping trend line in China's official GDP numbers (Exhibit 1).

The Economic Activity Index takes a broad set of factors into account and has fluctuated more than raw GDP over the last decade, rising higher than GDP in the double-digit period from 2005–08, and then again from 2010–13. The Index has been lower than GDP for the last four years, and currently hovers at levels similar to 2015–16, when there were similar fears of a hard landing for China's high growth economy.

Exhibit 1

China's GDP has been cooling.

Real growth rate, year on year, quarterly, %



¹Based on 57 indicators that measure economic activity.
Source: CEIC; McKinsey analysis

The economy is expected to continue to soften in 2019, with consensus forecasts expecting GDP growth to land somewhere between 6.0 and 6.2 percent this year.

Yes, China's economic engine is cooling down, yet it continues to rack up one of the fastest rates of economic growth in the world. Given its enormous scale, this translates into substantial additions in absolute terms: this year, China will add the equivalent of the entire Australian economy to its GDP.

For many companies, the real question is whether they can adapt quickly enough to slower growth, or whether their strategies, balance sheets, and operations require higher growth to thrive, or even survive. For entrepreneurs who took growth rates and share-price valuations for granted, and who, for instance, pledged recently listed shares to secure funding for visionary projects, the slowdown risks tipping this precarious balance into a real corporate disruption.

2. The consumer story is still strong, but also changing

The raft of negative news from multinational and domestic companies in China that have seen their sales drop in recent months has triggered a wave of concern over the strength of China's consumer engine. Despite the headlines of plunging sales by Apple and other multinational companies in recent months, China continues to be the world's best consumer story.

According to consensus forecasts, Chinese consumption is expected to grow by about \$6 trillion

from today through 2030. This enormous sum is equivalent to the combined consumption growth expected in the United States and Western Europe over the same period, double that of India, and ASEAN economies together.

China's economic rebalancing toward consumption and services continued; they contributed about 76 percent and 60 percent of GDP growth, respectively. Growth in retail sales edged lower to 9.0 percent in 2018 from 10.2 percent in 2017, reflecting weaker auto sales. Real per capita disposable income was 6.5 percent in 2018, in line with GDP growth, and China created 13.6 million new urban jobs in 2018, exceeding the 11 million target.

Beneath the slowdown lie changes in the patterns of consumption. Sharper drops in sales of individual companies, or even of sales in categories like autos or cosmetics, do not tell the whole story. Online sales, for instance, grew at a strong 24 percent. For the first time in China, we also see a new segment of customers trading down. The success of Pinduoduo, a lower segment discounter appealing to customers explicitly trading down—and which has disrupted China's e-commerce duopoly (an attacker of the attackers)—indicates a maturing and changing market.

First-tier city consumption remains very robust, while lower-tier cities soften: Could this simply reflect the larger "wealth buffer," higher real-estate values, and affluence bolstering the confidence of wealthy consumers yet to feel the slowdown already apparent lower down the income scale? The next few months will tell.

3. The credit crunch is real

The last ten years of stimulus and deleveraging is a story of “eight-plus-two.” Eight years of government stimulus after the global financial crisis, followed by a couple years of conscious deleveraging and credit reduction.

The crisis kicked off a round of stimulus and financial liberalization measures that lasted for the next seven to eight years. This led to the rapid growth of shadow banking and informal lending and spawned a range of experiments in debt issuance. China’s debt-to-GDP ratio soared from 120 percent in 2007 to 253 percent in Q2 2018 (higher than the ratios in Germany and the United States).

However, recently the efficacy of government stimulus has been waning. Each renminbi of economic stimulus that the government pumped into the economy delivered less in actual GDP growth than in the past. The rise in ICOR, the Incremental Capital-Output Ratio—the amount of money the government needs to put in to yield a unit of growth—meant that economic stimulus was, in other words, getting more expensive.

Years of priming the credit pump also created asset bubbles in the economy sustained through excess liquidity. Real estate prices have continued their upward climb even as nominal GDP growth has now settled into single-digit territory.

Since 2016, regulators have acknowledged these challenges and emphasized deleveraging. The government’s crackdown on shadow banking and P2P lending, including arrests of executives, is having an additional dampening effect on the flow of credit. This has led to a significant drop in credit availability over the past 24 months. Growth in outstanding credit fell from 13 percent in 2017 to 7 percent in 2018, below nominal GDP growth of 9.7 percent. This reflects a marked contraction in shadow banking financing that grew by 13 percent in 2017, but declined by 7 percent in 2018 (Exhibit 2).

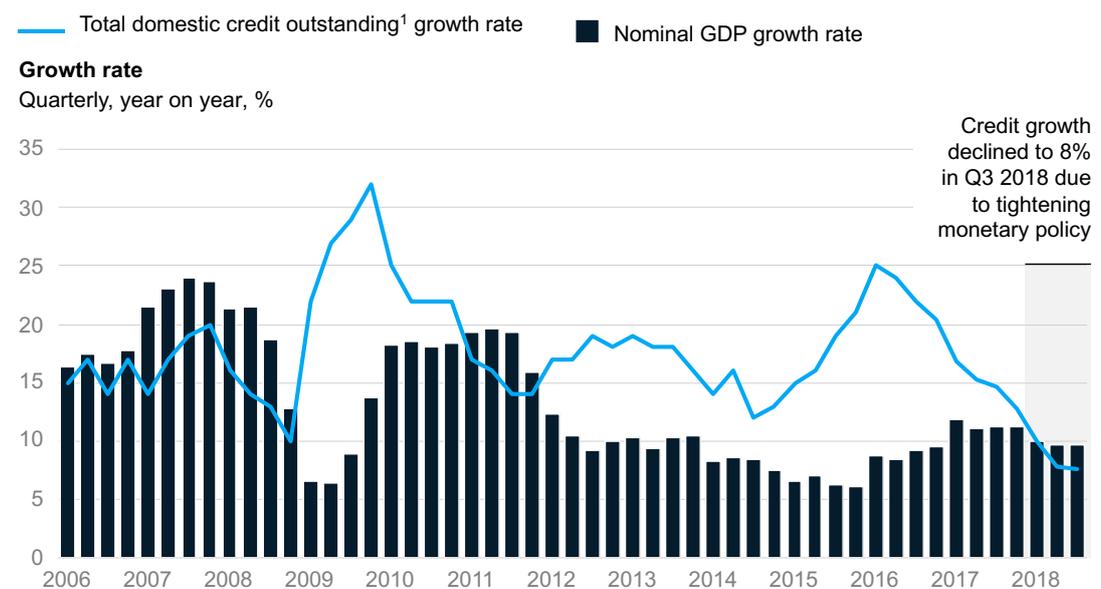
It takes a lot to slow the Chinese economy, but the impact of the credit squeeze has started to be felt, particularly among smaller enterprises in the private sector, and among companies in tier three and four cities. And, since the Chinese economy is increasingly dependent on consumption and services, a squeeze on companies ultimately ripples through to incomes, consumption, and overall growth.

A lot of recent news reports have led many to believe that the trade spat between the US and China is leading to the current economic slowdown; politicians have also used this as a convenient explanation. But China’s GDP is far less dependent on trade today than what some would have us believe. In fact, China’s net trade surplus was only 1.7 percent of GDP in 2017, down from 8 percent in

Exhibit 2

China is experiencing a credit squeeze.

Total outstanding credit and GDP growth



¹Includes total claims of depository institutions on the nondepository domestic economy, bankers’ acceptances, entrusted loans and trust loans. Source: McKinsey China debt database; CEIC; Emerging Advisors Group

2008. The effect may be more indirect, impacting consumer confidence and causing private sector companies to hold off on making decisions to invest in more manufacturing capacity.

Regulators are now figuring out ways to reopen the credit spigots, but they are moving more cautiously, and are applying levers in a more targeted way than they did during the eight years of credit expansion. For example, the PBOC (People's Bank of China) has recently announced measures to boost bank liquidity through perpetual bond issuance. This is intended to allow banks to issue bonds and recapitalize, and lend more, but under the condition that the target of lending achieves certain minimum credit standards.

Ultimately, China will have to chart a course between providing more stimulus (with the resulting bubbles and externalities), pushing through structural reforms of the state-owned sector (which may be politically sensitive), or accepting slower overall growth rates. These policy choices may be influenced as much by political and geopolitical factors as economic considerations. The next few months will be indicative of which course we are on, as well as whether we are in a longer or shorter period of economic slowdown.

4. Acquisition opportunities are opening up for fast movers.

The government's squeeze on credit put pressure on private sector liquidity, and the number of bond defaults by private firms rose from 42 in 2017 to 147 in 2018. With the intense credit pressure being applied particularly to mid-size private sector companies, we expect there could be a considerable round of consolidation on the horizon.

In the prior periods of credit tightening, industry consolidation favored the state-owned enterprises over their less-well-funded private competitors. Today a deeper capital market and the massive growth of private capital in China might change this dynamic somewhat. The question for many private companies remains how much of their "powder" is still dry, or have they leveraged themselves up, pegging their balance sheets to unsustainably higher growth rates and valuation assumptions.

This, combined with a potentially increased openness to foreign direct investment across several sectors being discussed in broader trade-related negotiations, could create a window of opportunity for multinationals, with scale and significance in China, and the willingness to make bold moves, to acquire domestic competitors caught in the credit squeeze.

Ironically, just as headlines about China become less exuberant, now might be precisely the time to more purposefully step up presence and engagement.

Nick Leung is chairman of McKinsey Greater China. To listen to a podcast conversation on this topic with Gordon Orr, former Asia chairman of McKinsey, and Jonathan Woetzel, senior partner and Asia director of the McKinsey Global Institute, please visit our website at mckinseychina.com/podcast.

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