

McKinsey Greater China

The state of the Chinese economy

As China's GDP growth slows, what opportunities can
companies in the country look to?



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In this episode of the *McKinsey on China* podcast, McKinsey senior partners Nick Leung and Jonathan Woetzel, along with senior adviser to McKinsey Gordon Orr, discuss how slowing GDP growth and trade challenges are affecting the Chinese economy.

(For more conversations on the strategy issues that matter, subscribe to the series on iTunes.)

Podcast transcript

Glenn Leibowitz: Hello, and welcome to this episode of the *McKinsey on China* podcast, with me, Glenn Leibowitz. After a lengthy pause, we're very pleased to be back with a new episode. Today, Nick Leung chats with Jonathan Woetzel and Gordon Orr about the state of the Chinese economy. GDP growth is cooling while a trade war heats up with the US. How are these and other trends impacting consumption and investment? And what kind of opportunities are these creating for companies in China today? Jonathan Woetzel is a senior partner who leads the McKinsey Global Institute [MGI] in Asia. Gordon Orr is a former Asia chairman at McKinsey and now is a senior adviser to the firm. Nick Leung is chairman of McKinsey's Greater China practice.

Nick Leung: Hello, welcome back to *McKinsey on China*. After our sabbatical from podcasting, we are back with our regular gurus: Gordon Orr, former Asia chairman and senior adviser to the firm; Jonathan Woetzel, the head of our McKinsey Global Institute; and me, Nick Leung. By popular demand, we are back on the podcasting trail and we hope to give you a few things to listen to in the course of the rest of 2019—which is going to be a big year. That's what we're here to talk about today.

Today's question is: What is the current state of China's economy? We'll try and break this up into, first, a conversation of how we got here, and also what we think might happen next. Of course, having Gordon here, we have the bravest man in terms of China prediction. I'm sure you've all

read his predictions for 2019. We'll cover those in passing, but that won't be the main topic of today. We're going to first talk about how we got here.

Jonathan, why don't you kick us off with the McKinsey Global Institute version of how we got here? Then Gordon and I will ask tough questions.

Jonathan Woetzel: Sure, Nick, and great to be back. So, a little bit depends on where we want to start this, because at some level we can start it way back when in terms of opening up China's economy and market reforms and all that, which sometimes people forget that this is still, relatively speaking, a new thing—an experiment that may not have been written about in books before, it certainly has been written about now, but still as an experiment. There's a lot of innovation, and there's a lot of trying it and seeing whether it works.

But in that context, I think we could start it maybe back in 2008, during a great financial recession. So that had an impact on China and notably it kicked off a round of stimulus that went for about seven or eight years. It also included, from 2008 to 2015 or 2016, a whole set of financial reform and liberalization, including the growth of shadow banking and informal lending and a lot of experiments on the debt side as well.

All of which resulted in nominal credit growth, so double-digit rates, sometimes up to 20 percent.

However, by the late teens, this was starting to show that although there was still a lot of credit going on, there were also signs of a quite significant bubble in as much as the nominal GDP growth was no longer responding in the double-digit ways that it had prior to this. On the other hand, real-estate prices were [responding]. So reading these not-so-subtle tea leaves, regulators, as of 2016, essentially called to halt the financial reforms that resulted in quite a significant drop for the last 24 months in credit availability. So we've had a big downturn in credit.

It takes a lot to stop the Chinese economy, but eventually you get there. We see results of that credit squeeze particularly in the private sector, particularly in smaller enterprises, and particularly in tier-three or tier-four cities now resulting in a slowdown in consumption and a slowdown in growth overall. The economy's largely increasingly dependent on consumption and increasingly on services. So eventually that credit squeeze fed through to the private sector, to employment, to income, and to consumption. That has been the story for past six months, the impact of that tightening and what to do about it.

So we're in a moment where the government is essentially saying, "Well, OK. Maybe we're getting into a cycle. There's a downturn. How does one come out of this again?" Now we have to talk about opening up credit again, but maybe not in such an open-ended way as what was happening in the late teens. For example, the PBOC [People's Bank of China] has recently come out in support of bank liquidity through perpetual issuance, which is intended to allow banks to issue these bonds, to recapitalize and, as a result, lend more, but only under the conditions that the target of lending achieves certain minimum credit standards.

Nick Leung: Jonathan, let me stop you before you shortcut to the forward-looking picture and just reiterate what you said about what you called eight plus two, which is eight years of stimulus followed by two years of attempted deleveraging. Of course, we've seen that in the P2P [peer-to-peer] lending platforms and reductions in shadow banking, et cetera, so the financial markets have certainly played out the way you said.

The fundamental question though, which you just passed over, which was that actually the problem with the stimulus was partly the asset bubbles, also partly that it wasn't delivering the results that it had in the past, right? So each dollar of stimulus was delivering less in actual GDP growth and just more in some of these externalities around asset bubbles, et cetera, right?

Jonathan Woetzel: I think that's fair. The ICOR, or the incremental capital-output ratio—in other words, the amount of bucks that you have to put in to get a certain amount of bang—has been going up quite a lot. To quote one very senior Chinese finance official, essentially, this is because everything is more expensive. Plus, you don't have as much low-hanging fruit. Back in the day, when we first started off the investment, we were sort of urbanizing Shanghai and Beijing. Now you're urbanizing Guangzhou. It's just not the same.

Nick Leung: So basically, like everything else, it got more expensive. Stimulus became more expensive.

Gordon Orr: Let me stand up for Guangzhou. There are many leading-edge data centers and the like transforming the economy down there. But I think what you're both getting at is the problem with any stimulus—is ending a stimulus, all stimulus have to end at some point in time. There's pain that's associated with it, and there's different ways of exiting. In the China way of exiting, pulling back particularly the informal credit channels into the economy, whether it's the shadow banking, peer-to-peer lending, or the like, has really dented not just the confidence, but the ability to operate for some types of players.

Midsized industrial companies got very excited about where their share price had gotten to, and then the owner pledged their shares, went off, and invested that money in new ventures that may pay off at some point in the future but haven't yet; their share price has gone down by half. The banks are saying, "Come on guys, we need some security here." They're in deep trouble.

Nick Leung: That's absolutely one of the things we see, but that's again looking forward.

One of the things I just want to make sure, before we get to the look-forward picture, Gordon, is also to slay one particular falsehood, or fake news perhaps is a better phrase for it, which is that this

is all driven by the Trump trade war. That somehow the correlation between the tariff threats has something to do with the slowdown in China. Of course, this has been much trumpeted across the world, and we don't see it like that.

Gordon Orr: The vast majority of China's economic growth is driven domestically, and driven by growth in consumption of services, driven by growth in expenditures by consumers. Slowdown in the economy, still, by the way, adding absolute economic growth of something like the size of the Australian economy every year, but the slowdown to the current levels is being driven by slower growth in consumer expenditures.

Nick Leung: So the trade dependency of China on US actual trade, what we have now in the tariff regime, is less than 1 percent of GDP. So it can't be that the threat of 1 percent of GDP is driving consumer sentiment in third-tier cities and forcing people not to buy cars. It may be a small influencing factor, but there's clearly a bigger thing going on here in China.

Gordon Orr: It can be an influencing factor, as you say. It's an input to consumer confidence. It's potentially an input to private-sector investment if companies are holding off on making investment decisions on more manufacturing capacity. But as I'm sure we'll get to in a subsequent podcast, the multidimensional nature of the relationship between the US and China goes way beyond trade. I think we're going to get into that; we should talk about it much more in totality.

Nick Leung: Yes. OK, so let's move on quickly.

So in the middle of last year, we saw this quite abrupt, in some cases, dip in consumer spending in some categories, be it cars, a real slowdown in things like cosmetics, so discretionary spending, particularly for large-ticket items. That slowdown continued for the last half of last year, and then there was a much trumpeted lowest-growth quarter in 20 years.

Gordon Orr: But, Nick, if I could, I think this isn't a situation where—I'll pass it over to Jonathan in a second—because you have to focus on the aggregate, not the specific. Yes, there are specific companies that made an enormous deal about how their sales in China were declining, whether it's Apple or Jaguar Land Rover, or a host of other companies that have said specifically, "We didn't hit our global numbers because of China." Then there's the counterpoints of other companies that have absolutely said, "We've exceeded our goals in China, and we've been going strong."

I think there's a tendency to amplify the bad news on specific companies that actually may have made the wrong product choices and made the wrong channel choices and saw the implications of that in China. Whereas, in aggregate, consumer spending, while it didn't rise in double digits last year, still had 8 percent, 9 percent growth in consumption.

Jonathan, I think with MGI you've got a much better handle on the aggregate data, so maybe I'll hand it over to you.

Jonathan Woetzel: I think that Gordon is absolutely right, of course, and I agree with him here that in the aggregate, China is still the world's best consumer story. I think that what's changing a little bit is the nature of that story, and that in the early days this was a very luxury market. The early sort of growth in the premium market was truly astounding. Now it's becoming much more of a middle mass market.

As we cross that line into hundreds of millions of people in the urban middle class moving into their own, it's a very cost-competitive market now. They still want the premium, especially for a global product or a global brand, and there's so much more competition right now. I think that's where some of the foreign companies might've been caught out a little bit, because of the pace, speed, and the catch-up of local competitors, coupled with that increase of mass-market flavor to it.

Nick Leung: My understanding is that we are still in the premiumization trend, so we continue to see that, we continue to see overall growth across the board. So it's just that growth has slowed, but it's growing. You are, however, seeing some very interesting things, like, for example, a segment of trading down consumers.

There was lots of publicity about Pinduoduo last year, the new internet attacker that actually managed to put a dent into the e-commerce duopoly that we have already in China, through essentially a value proposition, which was specifically targeted at people wanting to trade down for more cost-effective purchases. That's actually quite interesting in China. So I think what we're probably seeing is just China's becoming a bit more like the rest of the world in terms of the heterogeneity of consumer choices and consumer incomes, which is natural.

I think this would form a great topic for a future podcast, so let's not go too far down to the consumer because there's a lot going on with the consumer right now, and absolutely we should spend a good segment on that.

But perhaps having now painted what we think the picture is, in terms of the coincidence, not necessarily a direct causation between some of the trade disputes with the rest of the world, and also the overall economy. Big companies, private companies out there feeling the credit squeeze, as you said, Gordon. We are seeing some companies announcing job cuts. Obviously, employment uncertainty in China translates quite quickly into consumer sentiment, but then of course on the other hand, employment can be stimulated through other means, and the government has those means. So how do we see the go-forward picture here? Do we see continued tightening?

My sense is that we are at quite an interesting position now. We're just before the next round of tariffs, potentially, in a couple of weeks. We

have begun to see some of the effects of the credit crunch on some of the private companies. So probably the next six months or so will be an interesting indicator of where we are in this particular story. Jonathan, what do you think?

Jonathan Woetzel: I think, again, it takes a lot to do anything to the Chinese economy, to guide it, to super tank [it], or it's moving at speed. So even if you started the stimulus or restimulus measures now, six, 12 months before you get to see something tangible in terms of the uplift in consumption and income beyond trend line. I'd expect that it's going to get worse before it gets better. This will primarily be visible in the private sector, and sectors that have overcapacity, and where you will see consolidation. Going into a little bit of a question about who consolidates whom, but real estate would be an example, and I'm sure that there will be industrial sectors that likewise format a basis for consolidation. That has knock-on effects. Notably local ones, because industry tends to be very spatially concentrated. So that means that we'll probably see some regional bailouts. Then I think what is a little bit the purpose of starting to recapitalize the banks, and to give them options to increase their lending, so that when the inevitable happens they can step in and pick up the pieces. How they pick up the pieces and who ultimately winds up with those pieces is a very interesting question.

Gordon Orr: I'd be prepared to look forward and say with this credit pressure, particularly on midsize private-sector companies, yes, there will be a considerable round of consolidation. It's quite an interesting window of opportunity for multinationals if you want to be bold in this space, because clearly there's an intent to show increased openness to foreign direct investment in quite a number of sectors.

Nick Leung: So are you leaning forward also on your prediction of the trade resolution in the next two weeks?

Gordon Orr: Let me continue on the thought that I was making, that there's a real window for multinationals that have scale and significance in their sectors in China today to see some of their local competition that's been really aggressive and quite successful over the past few years but now balance-sheet stressed to potentially take them over or to take over a significant chunk of the business. Industrial services may be slightly less in real estate, which is a more complex, local-for-local business going forward.

Nick Leung: But also consumer.

Gordon Orr: But the consumer's going to be benefiting, and we can debate how large the impact is going to be from the income-tax cuts, the subsidies to purchase white goods, potentially the subsidies to purchase cars coming back again. To Jonathan's point, those have been playing through for six to nine months now. If they're going to have an impact, we should be starting to see that going forward.

Nick Leung: So that would argue, Gordon, if I can put a nail on your prediction there, a relatively short cycle is what you see? Apart from the opportunity point, which of course that's very interesting, but in terms of the cycle you probably see something which is not too deep a trough.

Gordon Orr: I certainly don't see anything cataclysmic here, and that the pushes into the banking sector to start to re-extend more credit in a directed fashion to increase spending on infrastructure, things that have already been done on consumer, yes, will see a relatively near-term turning point in the economy.

Nick Leung: Infrastructure, for example, infrastructure went from almost 20 percent down to 4 percent between 2017 and 2018. So obviously that's a bit of a lead indicator, but yes, we're seeing essentially the impact of those types of shifts in investments and credit that you mentioned.

Jonathan Woetzel: I'd add that the single biggest swing factor in the economy, real estate, which is of course way over where it needs to be or should be in the Chinese economy. But because of the unavailability of other savings vehicles, that's what you get, is a lot of middle-class income goes into real-estate purchases, and that's where we'll see the bulk of the impact in terms of swings and roundabouts going forward. So the government has an interest in trying to maintain some level stability, but not overdoing it so that now we have clearly got a rental crisis and a housing crisis in major cities. So it's not having enough space for people to live.

So this time around might be a little different. I see that there's some desire for the government to essentially keep some of that pressure on, so that we don't see overexuberant marketplaces in the very short term. To keep things a little bit tight so that we don't see a kickoff of another speculative spiral again.

Nick Leung: So you've taken the point that I was going to make, which was that I am actually much less positive than you guys for two reasons. First of all, because some of the employment data I think is quite worrying. I see the consumer slowdown essentially being employment linked, and people worried about their employment status. Of course, everyone will end up doing something, but the question is what they do.

As Gordon has pointed out on other occasions, there is an oversupply of tier-one labor and of graduate labor. At least, we're getting to that point, even though the overall labor force isn't increasing. So I think there is a labor issue here, and unemployment may play out.

I also think that if you look at the pattern of this particular administration, it has not prioritized economic growth. I mean, apart from the reaction obviously to the global financial crisis, which was very swift and very significant, but if you

look generally, their priorities seem to be more political and geopolitical than economic. So I'm not convinced that they're going to sail to the rescue and make it a short cycle, and I think we might see something a little longer.

Gordon Orr: To be continued. Nick will be buying us dinner when he's wrong.

Nick Leung: Indeed, which will be, Gordon, according to your view, by the end of the year; we'll see things coming back.

Gordon Orr: I'm looking forward to a fine Christmas dinner, thanks.

Nick Leung is a senior partner in McKinsey's Hong Kong office, **Gordon Orr** is a director emeritus of and a senior adviser to McKinsey, and **Jonathan Woetzel** is a senior partner in the Shanghai office.

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