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What can we expect in China in 2020?

With domestic consumption powering economic growth, companies should consider stepping up their activities in 2020.

By Gordon Orr

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Introduction

2019 in China brought together long running challenges, such as uncertainty over US-China tariff levels and ever more intrusive regulation of business in China, with a few unexpected ones as well: the crisis in Hong Kong and the flare up triggered by tweets from an NBA coach, to mention just two. Yet for many businesses, opportunities flourished throughout the year as China's economy grew roughly 6 percent. And in multiple key industries, the government's commitment to global leadership started to pay dividends.

2020 will offer a similar mix of evolving, often worsening, challenges. Growing separation between the US and China in technology sectors seems inevitable. While some companies will evolve to remain relevant in both markets, others will choose to focus on one. In 2020 this separation may become broader, impacting financial markets much more directly. China's economic momentum will continue in 2020 with domestic consumption leading the way, selectively creating opportunities. If China's priority sectors match those of your business, 2020 will be a good year to step up as the taps of government funding remain open for now.

US-China relations

Multiple areas of growing separation between the US and Chinese economies predicted in last year's note were largely realized – investment flows, supply chain, data flows, people flows, technology procurement, standards. In all these areas, further separation will occur in 2020. One example, US government agencies, such as the National Institutes of Health and the Department of Energy, not just the Department of Defense, have been presenting US university administrators with hundreds of case examples where they believe non-US academics, largely Chinese, have failed to disclose parallel funding for their research from overseas governments along with commitments to share their IP discoveries with those governments. Those academics will likely be proactively excluded from US universities; many others will self-select out or simply not come to the US in the first place. Restrictions on investment from China into the US will shift from a focus on larger deals, which have shrunk to almost zero, to direct and indirect (i.e. through funds) investment into technology startups.

I did anticipate a year ago that we would have clarity about tariffs by now, not the ongoing uncertainty that holds back investment plans in supply chain and factories. Looking into 2020, if there is finally agreement it seems likely to be narrow and not likely to be long lasting. Multinationals have suffered least from tariff volatility. They typically send no more than 15 percent of their China production to the US and have multiple factories around the world that they can move production for the US to. Almost none of these factories are or will be in the US. Smaller businesses, often foreign-owned, that focuses solely on exports to the US, have been most hurt.

Factories do continue to move out of China. Manufacturers are also consolidating in China, doubling down on technology in their remaining factories. Indeed, China is rapidly becoming the world center for the Internet of Things in factories. These trends preceded the US tariffs and have only been marginally accelerated by them. More non-Chinese companies than Chinese are shutting down factories in China, but not all move production out of China as they close. A good number outsource their manufacturing to a Chinese owned company producing in China, believing that the Chinese company will be lower cost than the foreign-owned factory, and just as good quality.

New areas of US-China separation will come into focus in 2020. Financial markets will be front and center. The U.S.-China Economic and Security Review Commission's 2019 report to Congress has as its first recommendation to delist Chinese companies on US exchanges that do not meet four criteria. No Chinese company listed in the US meets all four, many won't meet any. This threat covers around 500 companies with a cumulative market capitalization of about US$ 1 trillion (dominated by Alibaba). It was smart of Alibaba to get its secondary listing in Hong Kong in place in November 2019. Companies such as Ping An's fintech subsidiary, OneConnect, which has announced plans to list in New York, may reconsider. After all, less than US$2 billion has been raised by Chinese companies on the NYSE and Nasdaq so far this year, down 74 percent from last year. Some Chinese tech companies may list domestically within China where listings generally achieve higher earnings multiples and Chinese regulators have quietly made it possible for companies using the Variable Interest Entity (VIE) structure to list domestically.

Technology tensions

The US and Chinese governments continue their rush to embrace greater technology separation. 2020 may be a tipping point. On one side the US government excludes Chinese companies from buying US sourced technology components (at least from being able to do so with certainty), from investing in US technology companies, and from supplying their technology products into the US. On the other, the Chinese government has launched an over US$20 billion fund to support Chinese independence in a broad range of manufacturing technologies to go alongside its similar sized fund to support developments in semiconductors.

China's "secure and control" initiative is encouraging government departments and state-owned enterprises to buy technology without US content – perhaps 25 percent of the traditional PC and server market. Chinese manufacturers' share of the server and storage market had already risen from around 30 percent in 2012 to 70-80 percent in 2018. It is set to rise higher. In smartphones, four Chinese brands hold more than 85 percent of the Chinese market and less than 1 percent of the US. China's internet giants, with the exception of TikTok, are absent from the US (TikTok may not retain its presence in the US for long if US legislators sustain their focus on the company); the US giants have long been absent from China.

The pinch point in semiconductors of Taiwanese contract manufacturers who play a key role for both US and Chinese companies will become much more visible in 2020, with greater levels of government to government pressure exerted on the key companies.

One of the few business-focused outcomes from the recent 4th Plenum were plans to establish a "new national system for making breakthroughs in core technologies under socialist market economy conditions." This feels very similar to state-driven industrial policies contained in "Made in China 2025", if not yet with the quantitative targets. In some areas, China is likely to achieve goals quickly, for example, as China still represents nearly a quarter of global manufacturing output; taking leadership in smart factories should be a no brainer. China is turning its cities into large-scale pilots for 5G-enabled smart cities at a pace that will allow China to set de facto standards. Their products will not be accepted in the US, especially not as many will require access to large scale data sets that dwarf those that Chinese companies have been blocked from.

All Chinese and US tariffs could be eliminated tomorrow and only have a marginal impact on these trends. Both governments have embraced growing separation, the only question is how fast and with how much pain is incurred as we proceed.

Global Sports and China

Reactions in China to the social media post by the Houston Rockets general manager are winding down. Initial reaction to the post in China was not surprising; perhaps what was surprising was that it has taken so long for this kind of incident to happen. International criticism of China over Xinjiang and Tibet has occurred for years, but had not triggered an incident, despite sports figures taking public stances on many issues globally.

The incident should make any business that takes sponsorship from Chinese companies pause. Have they done sufficient due diligence on the Chinese company to assess the risk of a player or a fan base launching a campaign against the sponsor? Multinationals with large operations in China should consider the risks of their China sales becoming collateral damage if China's social media nationalists decide to blame a corporate sponsor for remarks made by a team player or coach.

Where might the next incident happen? Soccer. Premier League clubs regularly play preseason games in Mainland China. What would happen in China if European soccer fans waved banners in support of Hong Kong or a player made a remark on a topic deemed sensitive in China? No TV or online coverage of their games, and pressure would be put on their Chinese and non-Chinese sponsors to withdraw their support to the team. What would happen if the impacted team was owned, all or in part, by a Chinese company? (such as Inter Milan by Suning, Wolverhampton Wanderers by Fosun)

While professional sports see enormous commercial potential in China, it largely remains that – potential. Could European soccer leagues survive without Chinese advertisers and broadcast revenues? Yes. The NBA, the same. Some teams may have to.

Consumers in China

Consumer retail spending in the first 10 months of 2019 rose 8 percent year on year, ahead of income growth of roughly 6 percent. Over 10 million new jobs were created. With moderate house price growth and a positive year in domestic stock markets over the last year, the wealth impact on consumer confidence remained positive. More and more consumer purchases are now financed through installment payment schemes, through credit cards and bank debt (now well over US$ 1 trillion). The average Chinese consumer is not yet overleveraged (total household debt stands at only 60 percent of GDP), but the 20-30 age group who borrow most enthusiastically are getting there, pulling forward consumption from future years. These younger age groups also sustain higher current spending by not entering the property ownership market. For many, property prices are now so high it is simply not possible until much later in life. Many realize that renting is a better economic plan. A recent JLL report showed the average price of renting in top Chinese cities was less than half the average mortgage payment. At the individual city level, these trends could finally trigger a material downward adjustment of as much as 30 percent in specific city property prices in 2020.

Multiple consumer sectors suffered significant demand weakness, most notably the automotive sector and smartphones, where a 2020 rebound is unlikely. Yet many service sectors are thriving. Private education providers with quality facilities and faculty are one example, especially those with internationally focused curricula. I recently visited the brand new Whittle School in Shenzhen. With its world class facilities, it will attract students who would otherwise have commuted to schools in Hong Kong. Second tier cities, such as Suzhou, are showing that they can support multiple international schools targeted at mainland students, with Perse School from Cambridge, England adding to those present. Lego announced that it is building the world's largest Legoland theme park in Shanghai at the cost of over US$625 million, locating it alongside Disneyland Shanghai, creating an international theme park cluster. And it has plans for many more.

Healthier eating

China's endless food health and safety scandals along with a growing awareness of personal health (supporting the boom in gyms in China) has led many middle-class Chinese to embrace healthier eating choices. Restaurants are adding more vegetarian options, and plant-protein based meat replacements are gaining traction. In China, which consumes more than 50 percent of pork produced globally and has seen pork prices rise over 100 percent due to disease in the pig population, the need is for pork alternatives, rather than the focus in the US on beef substitutes. As a result, Asian companies such as Green Common from Hong Kong have taken the lead in meeting this demand.

The government is getting more involved, requiring manufacturers to provide additional labelling information. In 2020, the government will require that labels on foods show their glycemic index, a rating of how the carbohydrates impact blood glucose levels. The government is acting in an attempt to impact the explosion in diabetes and obesity across China. If the experience of launching this index in Australia provides guidance, food manufacturers will reformulate their products to reduce their GI rating and will market aggressively on the back of having done so, leading to a boom in consumer demand for lower GI products.

With China's food delivery services providing more than 40 million meal deliveries a day and still growing 35 percent year on year, Meituan and Ele.me have a key role to play in shaping middle class food consumption in China. To meet this demand, they will be promoting healthier options and providing more information to consumers on their choices, whether it is lunch delivered to the office or dinner to the home.

Social Credit System not a big deal for individuals – yet

Government initiatives to create social credit systems attracted a lot of international attention earlier in 2019, which has since died down. In part this was because the system was neither as new nor as all-encompassing as initially described, and in part because Chinese citizens are currently mellow about the entire scheme. Data gathered in the system comes almost entirely from existing databases compiled by many agencies covering financial matters, Party membership, regulatory and legal compliance. As much as 75 percent of this data was already publicly available, perhaps just not online. For many citizens the question was more "what has changed?" Calling out individuals who fail to pay their debts on a public blacklist, making you aware that someone you might be about to do business with has defaulted in the past, seems like a good thing. As with any system, there is potential for misuse, blacklists can get too long, and they may not be objectively created. Evidence from a Jiangsu pilot shows that if government gets too heavy handed, citizens successfully push back.

And of course, there is a part of the social credit system that evaluates and black lists government departments, with more than 20 county level governments already having been blacklisted as "dishonest".

Rebound of EVs

Vehicle manufacturers in China had a tough 2018 and 2019. The overall market fell 8 percent by volume in 2018 and another 3 percent in the year to October 2019. Looking forward, demand faces several headwinds. Anyone spending time in a major city realizes just how unpleasant the experience of owning a car can be with the lack of parking and permanent traffic jams. On top of that, local authorities ration availability and increase the cost of getting a license plate to more than the cost of the car. Ride sharing is extremely cheap and available. It is possible that we have seen the peak of the internal combustion engine vehicle market in China.

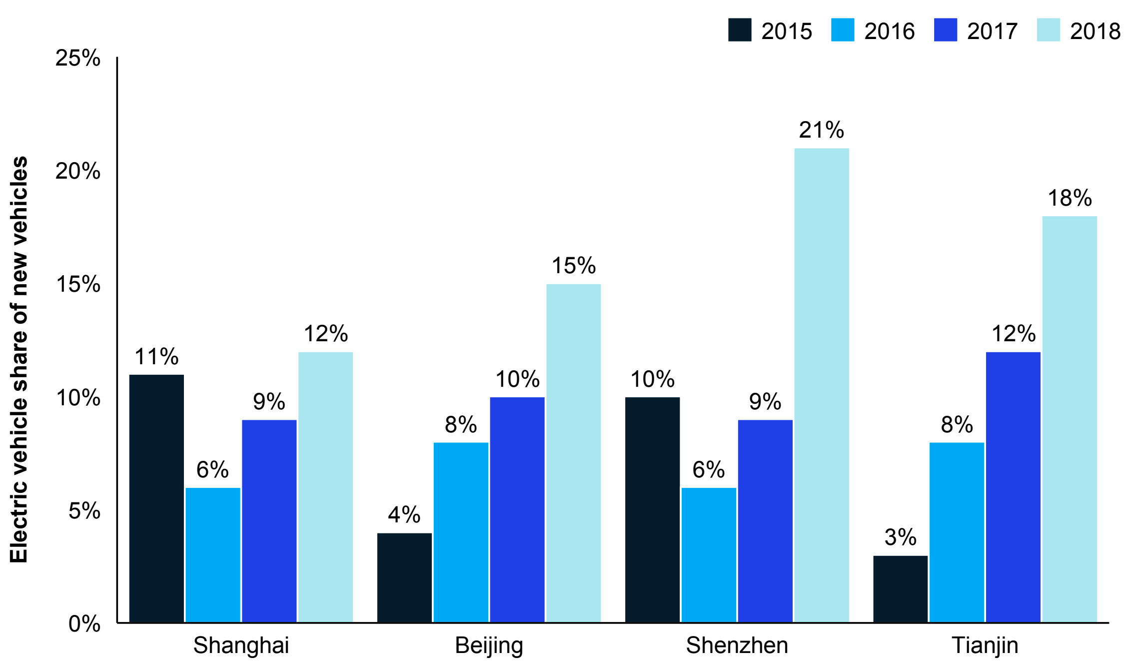
In 2020, as Tesla breaks ground on its 100 percent-owned factory in Shanghai, the industry bright spot will be electric vehicles. Again, local governments play a critical role along with changing consumer tastes. Cities are switching their bus fleets to electric (close to 25 percent of all buses sold in China will likely be electric in 2019, perhaps 35 percent in 2020) and are mandating that taxi fleets shift to electric and reducing the cost of acquiring a license plate for EVs. Cities are rolling out networks of charging stations well ahead of demand. It is common to see car parks where the only spaces are those next to the EV charging stations.

Middle class consumers who are increasingly sensitive to air pollution are investigating EVs and realizing that their range exceeds that which they ever travel in a single car journey. Vehicle OEMs are responding: between 2019 and 2021 more than 200 EV models will launch . EVs represent close to 5 percent of automotive sales in 2019 (up to 20 percent in major cities) and could easily step up to 7 percent in 2020 if central government decides to include EV subsidies in any stimulus program.

China's EV market is already 3-4 times the size of the US market. This multiple will grow, giving market leaders in China the opportunity to become world leaders in developing and manufacturing EVs, their batteries, and charging infrastructure.

Exhibit 1

Electric vehicle share of new vehicles in selected metropolitan areas for 2015-2018



Source: Electric vehicle registration data are from IHS Markit, Norsk Elbiforening, and China Automotive Technology and Research Center

Realizing Parts of the Greater Bay Area (GBA) Initiative

The GBA initiative remains a priority for President Xi Jinping. As the region covers around 15 percent of China's GDP and is the center of innovation for many of China's priority industries, the GBA's success is also important for national economic growth.

The Greater Bay Area will become more concrete (literally) in 2020 as key pieces of its physical infrastructure are built. Bridges, roads, and railways to connect its east and west more closely will start construction. This will bring previously remote areas in the West of the delta much closer to existing economic hubs in the East. Developers will follow quickly to build homes, factories, and business parks in the West. Homes are critically important as this will take pressure off housing prices in Shenzhen, allowing more of China's young talent to migrate into this vibrant hub for work. Factories that relocate to the Western side of the region will still be able to get their goods to Hong Kong or Shenzhen airport within an hour for shipment globally, using the new (and very underused) Hong Kong Zhuhai bridge.

Beyond infrastructure the GBA plan contains hundreds of softer goals, giving cities in the GBA priority sectors to focus on and creating mechanisms for cities that have historically competed aggressively to work more closely together.

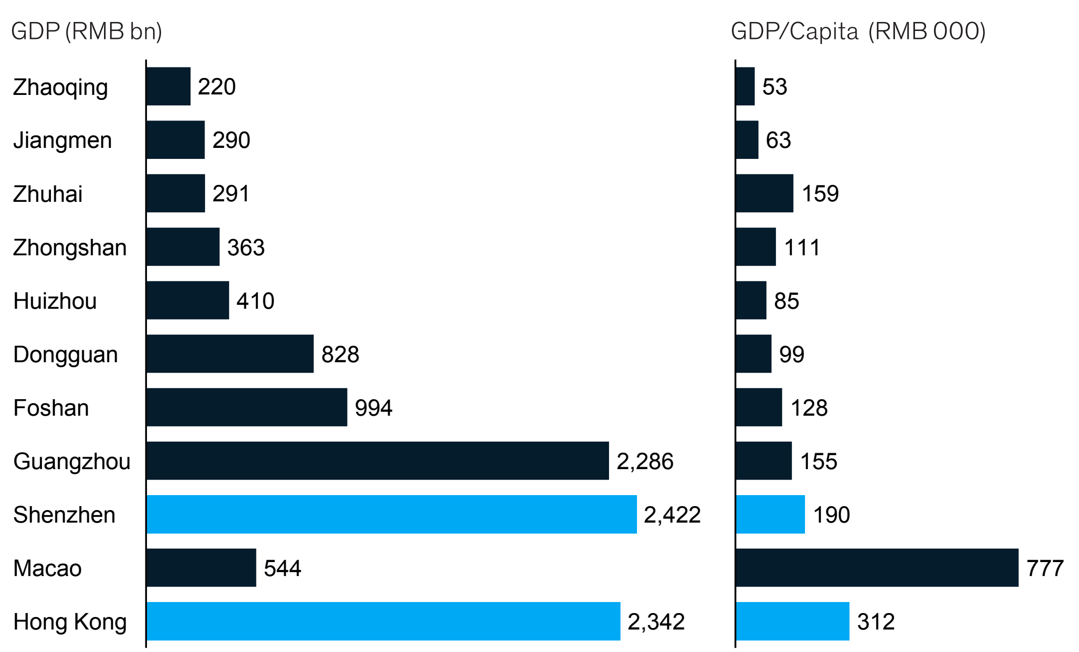
Businesses need strategies for the GBA in 2020 that focus on two things. One – how to take advantage of new regional infrastructure. Two – how to shape still evolving GBA policy to their advantage, rather than reacting once policy is defined.

Policies

Many companies saw 2019 as a year when more and more regulations piled on to them. CEOs who were the legal representative for their company in China got increasingly nervous as legal teams updated them on their personal responsibility under new regulations. Unfortunately for them, 2020 will see more new and evolved regulations targeting all companies operating in China.

Exhibit 2

GBA macro economic performance 2018



Anti-Monopoly

The State Administration of Market Regulation (SAMR) will be more active in 2020 in tackling anti-trust, anti-monopolistic behaviors. Their investigations will have teeth. Fines can be as much as 10 percent of prior year revenue. Inquiries are already underway.

- 15 courier companies are under investigation for their alleged anti-monopolistic practices based on complaints from customers about coordinated price increases and selective willingness to bid for business. Companies should recognize that inquiries will often be triggered by their customers, whether with legitimate complaints or simply a grudge. Ensuring that government affairs teams have a well-established relationship with local SAMR officials is a sensible preparatory step.

- 20 e-commerce enterprises are under investigation for requiring exclusive listings on their sites, which is prohibited by e-commerce law and anti-monopoly law. Sellers on these sites should check their contracts to ensure they are not enabling behaviors that SAMR may find problematic. Businesses will be challenged by SAMR on whether they have sufficient insight and control over behavior by front-line employees to prevent collusion taking place locally. The best Chinese companies' internal control teams deploy up to 100 people on this, and they act against hundreds of often small-scale breaches every year. Multinationals tend to have fewer resources, which may expose them to criticism.

Foreign Investment and National Security Review (NSR)

New foreign investment laws come into effect in January 2020 with elements favorable to foreign companies, solidifying announced market openings and reducing inconsistency in policy enforcement. Policies to support business should in future apply equally to both domestic and foreign enterprises. Foreign enterprises should also have equal access to government procurement and to domestic standards setting processes. There will be no distinction in how policy is applied to different vehicles for foreign investment (WFOE, EJV, CJV). Great intent, follow implementation closely.

Areas of concern exist. The law details how indirect investment by foreigners will be treated, but does not detail the specific structures or ownership levels that will trigger review and registration. This is another area to watch, especially for financial investors.

Perhaps the most important change is the revised national security review of foreign investment. Reviews are required for any foreign investment in national defense security (control not required) and any foreign investment in companies engaged in key industries that are somehow related to national security where the foreign investor has effective control. The second category is more relevant for most enterprises. Industries that fall into its scope range from agriculture to energy, infrastructure, technology, culture and the internet. While 50 percent ownership will certainly be seen as a trigger of effective control, a company could be deemed to have effective control at a much lower equity stake if the foreign investor is seen to be driving management decisions in areas such as strategy and HR.

NDRC coordinates inputs from multiple ministries and other government stakeholders, convening an Inter-Ministerial Joint Committee to make decisions. If they do not reach consensus, decisions are pushed up to the State Council as final decision maker. Businesses should expect high profile decisions to be driven by geopolitics not just economics.

Data Protection

Multi Level Protection Systems or MLPS 2.0 have been front of mind for chief information officers in China for much of 2019 as they prepared for the launch of new data protection standards. Large foreign companies seem more aware and better prepared for these changes that their Chinese peers. All businesses are required to self-assess the data they collect and their protection of this data. Anyone processing data above a certain level of sensitivity must report to their Public Security Bureau. All data breaches or attempted breaches must also be reported. Use of Chinese hardware and China based cloud services is strongly encouraged as part of protection protocols.

Government inspectors from the Public Security Bureau will have unrestricted access to data stored in and passing through corporate servers to ensure that companies have registered themselves and implemented protections appropriately. This oversight of compliance is not theoretical. In Jiangsu province alone, around eight cases per day have been processed and 140 enterprises have been deprived of their business licence over the last two years.

Blockchain

The government is determined not to fall as far behind in regulating emerging blockchain based industries as it did in the early years of the Internet. The strategy of just launching a business and begging forgiveness later will not be tolerated. Regulatory priorities are not to enable unfettered innovation, rather they are to ensure social stability and centralized control. The People's Bank of China (PBOC) recently announced that it had shut down over 170 crypto platforms in 2019. Specific priorities include:

— Ensure Chinese leadership in AI and IoT – an echo of Made in China 2025 priorities.

— Apply blockchain at scale in supply chain and quality control to dramatically reduce cost.

— Enhance food and drug safety – a broad middle-class priority which the government has struggled with for years.

— Accelerate the shift away from physical money, to reduce risk in the financial system and direct money to places that it wants it to go.

— Avoid dependence on the US for any aspect of blockchain technologies.

President Xi's recent speech on blockchain closed with two reminders. One to government officials to get on top of regulating this area, and one to innovators to focus their innovation on approved areas. In 2020, the most visible outcome of the speech will likely be local governments setting up funds to invest in local blockchain businesses.

Business in Mainland China

For many industrial businesses, 2019 has been tough. Profits lower across the board – light and heavy industry, state-owned and private businesses. Labor costs rising while ex-factory prices are not. Access to debt restricted. The gap between high performers and laggards widened further, with leaders raising capital expenditures 20 percent plus over last year as they double down on deploying robotics, IoT, blockchain, and other productivity enablers in their supply chain. Laggards are edging closer to bankruptcy.

There are strong signs that we will see more bankruptcies in 2020. More banks will be allowed to fail beyond the four shuttered so far in 2019. The PBOC declared in its 2019 Financial Stability Report that it had closed 1000 P2P lenders in 2019 and that they evaluate close to 600 smaller banks (13 percent of the total) as “risky”. Their solution will have “Chinese characteristics”: failing banks will almost all be bailed out through merging with one of China’s larger banks.

More property companies will find they are financially extended beyond the level at which black-market lenders will support them. Industry consolidation will be the main solution. Investors will see more dramatic falls in share prices for specific stressed listed companies in the mainland and Hong Kong, along the lines of the 90 percent plus falls at Kasen, ArtGo and Tibet Water in recent weeks. This is a positive, companies that had been clogging up their sectors are finally being cleared out. Business will need to be alert to the financial state of their customers and suppliers.

High growth sectors in 2020 will be clustered in consumer facing services, many internet-enabled. Healthcare, education, travel, and leisure will all remain strong. Sectors where the Chinese government actively encourages investment have been clearly laid out– from semiconductor, to AI and smart cities, to manufacturing IoT, to biotech and advanced materials. Making money in these sectors directly in the short term may be tough, but making money out of supplying to these sectors can be very attractive.

Hong Kong and business

Hong Kong entered a recession driven by the downturn in tourists (nearly 1 million fewer travelers through Hong Kong airport last month with 20 percent fewer arrivals from mainland China) and by locals pulling back on spending. More than 50 conferences and exhibitions have been postponed or moved elsewhere. Popular hotels and restaurants have utilization down below 40 percent, even with 40-60 percent discounts, and are putting staff on unpaid leave. Retailers from clothing to jewelry have sales down as much as 50 percent from last year.

Businesses clustered in industries in and around the financial markets have been less impacted. Financial markets have not closed and IPOs are still happening. But changes are being considered. While they won’t make overnight changes to a successful operating model, many are now starting to think through the what ifs and could act on them in 2020.

For some multinationals, asking the basic question of why a large regional headquarters is in Hong Kong and why it is of the scale that it is can return slightly uncomfortable answers. For a good number, the answer is little more than it has always been like that – a location decision that was made rationally 20 or 30 years ago had not been challenged since then. Plus their senior executives like the low tax rates on offer in Hong Kong.

For China focused businesses, more regional activity could be undertaken in the mainland, without material additional cost. Asean and North Asian businesses may have grown to the scale to justify their own regional hubs. With mainland visitor numbers to Hong Kong looking unlikely to recover soon, luxury brand businesses are questioning just how many outlets they should retain in Hong Kong.

If clients from the mainland now prefer to meet in Shenzhen, it is straightforward to upgrade a Shenzhen office, to accommodate more permanent staff. Shenzhen or other local governments may even offer GBA policy incentives to do so.

Looking forward into 2020, business leaders in Hong Kong face tough organizational challenges such as sustaining a culture in which mainland and local staff work effectively, and persuading Hong Kong staff to continue to take opportunities in the mainland.

Few corporate leaders in Hong Kong are well prepared for these fundamental people challenges. There will likely be public instances where they fall short in 2020.

Closing

2020 is the final year in China's decade long challenge to double its GDP. The government will be able to declare success (potentially with a little support from statistical revisions). US tariffs will continue to have minor impact on Chinese growth. Domestic consumption and investment will remain the key economic drivers, and China will deploy targeted stimuli to maintain momentum.

Many businesses will find 2020 a challenging, stressful year in China – more bankruptcies, more regulation, more unpredictable risks to reputation, and more selective consumer consumption. Yet China will only grow in importance to the majority of global businesses – as a source of global demand, of innovation, of capital, and of newly emerged world class competition. In spite of external pressure to deglobalize, global businesses will evolve their supply chain, their operating model, and even their ownership structure if needed to remain relevant in China.

Gordon Orr is a senior partner emeritus and senior advisor to McKinsey & Company.

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