

What can we expect in China in 2017?

Strategy January 2017

Provided geopolitical movement doesn't derail his best laid predictions, Gordon Orr sees a year of slowing economic growth, headaches for multinationals, demographic anxiety, and buyer's remorse for soccer tycoons.

My base case for China's outlook this year assumes increased trade friction with the United States, with tariffs raised on specific product categories (such as steel and some agricultural goods), and, while I don't expect across-the-board disruptions, a few high-profile companies will be forced to choose between accommodating the demands of the Chinese or US government.

Of course, if recent statements from US politicians translate into sweeping action on trade, 2017 could develop very differently. Tit-for-tat moves on specific companies and sectors could easily escalate, with many multinationals' global supply chains caught in the middle and consumers around the world facing product shortages and, when products are available, material price increases. China's government could implement sweeping actions to sustain employment, restrict further capital outflows, and stimulate the domestic economy. Market-oriented restructuring and reform would be off the table. Economic nationalism, food and energy security, and social stability would be paramount.

But if globally we continue with something recognizably close to current trade arrangements, how will China fare this year? And, most important for a country that regards economic growth as of paramount importance (the centerpiece of China's 13th five-year plan remains to double GDP and household income in the decade to 2020), can 2016's GDP growth in the ballpark of 6.5 percent be replicated?

Matching 2016's economic growth will be a struggle

Where will China's growth come from this year? It is unlikely to come from exports—even ignoring potential protectionist moves in major export markets, there's nothing that would significantly increase the world's demand for Chinese goods. What about currency depreciation to make exports more competitive? That will be quickly offset by rising wages. Could growth come from consumers? Will they feel good enough to increase spending another

8 to 10 percent this year? They will likely spend a lot less on buying property and fitting it out (because of government action to restrain prices and restrict access to mortgage financing) and less on cars if the current tax break expires. Moreover, real salary increases are likely to be the lowest since the Lehman crisis, and with house prices expected to be flat, there won't be a repeat of last year's wealth effect. The stimulation of e-commerce making goods available in smaller cities for the first time may help, but technology displacing jobs in services, not just manufacturing, certainly won't. In fact, its impact is becoming more and more visible, leading more and more consumers to not only worry about losing their jobs but also actually see them eliminated. The impact of technology on creating jobs in fields such as medical and education services will benefit the privileged few with the skills to take advantage, but it will not offset the near-term job losses.

Will investment-driven growth, in sectors beyond property, take up the slack again? To some extent, absolutely yes. Private-sector corporate investment will accelerate this year, recovering from the low levels of 2016. Lower real interest rates will stimulate investment in productivity-enhancing technologies, such as robots and cloud-based services. And the government hasn't run out of good (or bad) infrastructure projects to spend on—everything from urban transit (such as the \$36 billion project to create a megacity by improving transport links among Beijing, Tianjin, and the neighboring province of Hebei) to intercity rail, water treatment, and 5G projects. Collectively, these projects could deliver several percentage points of growth in a manner similar to a decade ago, but not without debt levels reaching 300 percent of GDP by the end of the year.

All of this still seems unlikely to get China's economy to 6.5 percent growth this year, so look in the second half for constraints on property development to be rolled back. In sum, I see 2017 as a year of running faster and using more effort in traditional ways, to, in the end, travel more slowly.

Watch out if steel prices drop

Last year began with much fanfare over promised government-enforced reductions in coal and steel capacity, and by November the government had declared success. In reality, it would have been embarrassing if the goals had not been reached, considering how modest they were. Taking out the promised 250 million tons of coal capacity was less than the capacity added in the prior year, mostly illegally (and much of this capacity could still reemerge). The more significant impact came as a result of restricting production by limiting the number of days that (mostly state-owned) mines could operate. Coal production fell around 12 percent, but prices are up 80 percent. Great for mine owners, not so great for coal users.

In the steel sector, a reduction of 45 million tons of capacity still left an excess of several hundred million tons. At the time of writing, steel production is actually up for 2016 (as are steel prices) on growing demand from the construction and automotive sectors. The few announcements of industry consolidation have largely been the big merging with the big to

get even bigger. The deals aren't leading to reduced capacity or higher productivity, and unless steel plants are dismantled, there remains the possibility that latent capacity could return to the market.

New goals for capacity reduction will be set and met this year, just as they were in 2016—on paper. A slowdown in construction could see steel demand drop and actual overcapacity grow. Steel prices could fall back quickly, pushing the cash flow of many producers—whose balance sheets last year improved enough to stave off bankruptcy—into the negative again, depressing the confidence of consumers in cities dependent on these industries (especially in parts of northeast and northwest China) and creating a vicious cycle of lower consumer spending leading to declining local-business performance and redundancies. In these cities, property prices will be restrained by lack of demand. Homeowners will also be frustrated by their inability to sell and decreases in their paper wealth. As local governments in these cities raise concerns with Beijing, the pressure on banks to keep funding the insolvent (and for the solvent to merge with the insolvent) will rise. It may not happen this year, but eventually jobs will be lost as many companies are simply too unproductive to compete. But that may only be after billions of dollars have been spent keeping them open for a few more years.

New laws create new risks

China's lawmakers and regulators were active in 2016, with multiple new laws affecting businesses. Ensuring compliance will be a significant headache, especially for multinationals, as what the laws mean in practice will only be defined over time. Take one example: the Anti-Unfair Competition Law, which overlaps with the Anti-Monopoly Law, had significant changes proposed in 2016 to prohibit the "abuse of a relative advantageous position." This is open to a wide interpretation, potentially allowing small retailers and suppliers to pursue claims against larger businesses that they deal with. The law also means employers become liable for bribes and inducements offered by their employees, even if they didn't know bribes were being offered. Multinationals will complain, but these standards are little different from those they are required to follow in many other countries and which are part of corporate ethics commitments.

In November, a new cybersecurity law was published, with implementation due in mid-2017. Requirements on data localization, reporting cyber incidents to the government, the usage and sharing of personal information, and constraints on the publishing of any content online mean almost every multinational operating in China will have to change aspects of its operating model. Maybe companies will need a network architecture that no longer backs up data outside China or a team within IT that simply reports network events to the Ministry, as required. Enterprises that publish content online in China may need to meet new local ownership requirements and understand the review and monitoring obligations that ensure content is deemed acceptable by the government. The law is creating lots of uncertainty and work, and even some larger enterprises will find themselves inadequately prepared and made

The Orr-acle: Gordon's predictions for 2017

1. [Matching 2016's economic growth will be a struggle ...](#) especially if exports and consumer spending are flat.
2. [Watch out if steel prices drop ...](#) which could happen if construction slows and overcapacity spikes.
3. [New laws create new risks ...](#) and more are likely if (when!) a major cybersecurity breach occurs.
4. [Where has the money gone?](#) Despite the government's efforts, currency keeps finding its way overseas.
5. [Where are the children? Their grandparents are lonely.](#) The fertility rate is historically low, stifling economic activity.
6. [Depressed regions become more so ...](#) as urban migration continues, taking economic activity with it.
7. [Will commodities be the next hot asset class?](#) Retail investors and hedge funds are flooding the sector.
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examples of. Rather than simply being deported, last year saw more cases of foreign business executives being detained (most recently Australian casino employees)—and we'll likely see more this year.

China is likely to soon suffer a massive public breach of consumer data. Many corporations are lax with regard to cybersecurity: for example, the China Banking Regulatory Commission recently criticized several banks for allowing their employees to sell personal information without any corporate oversight. Chinese consumers tend to be quite relaxed about how their personal information is shared and used, partly because a large-scale leak has not

yet happened. Yet it's easy to imagine global hackers entering the systems of a bank or an Internet company that handles payments and making the obtained data public. Public opinion could then change very quickly, leading to a heavy-handed government reaction and a major clampdown on how data is protected or sold. The impact on many leading Chinese companies could be that they invest much, much, more in cybersecurity. And some Chinese business leaders may be prosecuted for failing to protect their customer's information sufficiently well.

Where has the money gone?

This year will see a continuation of the great "game of chicken" between those in government trying to manage down China's exchange rate and investors who want to diversify and protect the US dollar value of at least part of their asset base. After a lull through mid-2016, we are back in a situation where the government has created in the mind of investors the expectation of continuous slow depreciation—and now feels it has to act aggressively to stop investors from taking advantage of what they see as a one-way bet.

China's government is constantly looking to shut down leakage points, but is often challenged by its own conflicting objectives. Well over \$100 billion has left China this year for international acquisitions by Chinese businesses, with many acquirers paying over the odds in order to get their money out of the country. This is despite the State Administration of Foreign Exchange frequently declining to approve renminbi conversions for deals in a timely fashion. As a further step, the Ministry of Commerce and the National Development and Reform Commission announced plans in late November to implement stricter controls on any overseas investment above \$10 billion, on state-owned enterprises (SOEs) that invest more than \$1 billion in real estate, and on any companies investing more than \$1 billion in noncore businesses. This makes transactions harder, but not insurmountably harder for private industrial investors as most transactions are below \$10 billion and in their core businesses. Turning off the tap entirely would be totally inconsistent with major government initiatives such as One Belt One Road and China Going Global.

Further restricting the use of credit cards on the estimated 140 million overseas trips made by Chinese travelers in 2015 is possible, but it would annoy these middle-class travelers (a large number of whom are also Party members) and have them looking for another mechanism to spend abroad (travelers checks remain alive and well). As an example, it's been very popular in 2016 to visit Hong Kong, buy single-premium life-insurance policies (with a value of up to \$100 million!) using renminbi, and then use a variety of means to monetize the policy in US dollars. The credit-card squeeze has clamped down on this and, in case that wasn't enough, so has a quiet word with insurers to suggest they don't prioritize these products anymore. In business, the government is investigating over-invoicing as a means of turning local currency into dollars, clamping down on the use of free-trade zones to move money out of China, and investigating transfer-pricing arrangements between the domestic and overseas arms of corporations. Some large and midsize multinationals who have never reported profits in China have recently been asked for up to ten years of transfer-pricing data. Yet in an economy as large and as open to trade and travel as China is today, there will always be new methods emerging.

What else may change in 2017? Every calendar year, Chinese citizens are theoretically allowed to convert the equivalent of \$50,000 from renminbi into foreign currency. Many people did this early in 2016, and I expect many will try to do so again this month to take advantage of the perceived one-way bet. The scale of flows this would create means this allowance is going to be severely restricted in 2017—either it will be officially revoked or simply made infeasible to execute. The “stock connects” that allow Chinese investors (up to a daily quota limit) to invest abroad—currently in Hong Kong, but likely also London this year—will become more popular, as will a “bond connect” if it is launched. Investors have so far held back because of unfamiliarity with the investments on offer, but this year it will be a route for getting capital out of China that, through creative means, can be monetized abroad. Multinationals with surplus cash in China should work out what to do with it domestically, as it’s going to be very hard to get it out of the country in the coming year.

The net result is China’s foreign-exchange reserves will continue to decline despite the trade balance remaining in surplus, perhaps by 20 percent over the course of this year, despite the best efforts of regulators. In the end, regulators are likely to resort to their old tactic of making an example of a few to encourage the many to behave—expect a number of high-profile investigations of wealthy individuals who have rather too visibly taken money abroad.

Where are the children? Their grandparents are lonely

Long-term demographic trends, for the old and the young, will have more visible impact in China this year, creating additional headwinds for growth. China’s official government statistics bureau published data in 2016 from its mini-census that showed China’s total fertility rate—the expected number of children a woman has in her lifetime—had fallen to 1.05. This is one of the world’s lowest rates, and far below the 2.1 needed to sustain current population levels (actually, due to the skew of births of boys, even 2.1 would not be sufficient). Some 11.3 million children were born in China in 2015,¹ down from more than 13 million in 2012, because of a decline in the number of women of child-bearing age, a trend that will continue. This compares with more than 25 million births in India and more than 5 million in Nigeria, a country with less than 20 percent of China’s population. Will China’s relaxation of its one-child policy help? It won’t make a big difference—under the old policy, almost half of all births were second or third children anyway. Moreover, China’s family-planning infrastructure, employing hundreds of thousands, has not disappeared. It continues to pursue and fine those they believe have too many children. The bottom line is that this trend means there will be fewer children for parents to spend money on, to be educated, and to become future consumers. In rural areas, for example, more than 50 percent of schools have already closed because of the impact of the declining birth rate and urban migration.²

Meanwhile, if you people-watch in Shanghai or Nanjing today, you’ll notice a stark difference from 20 years ago. China’s urban population over age 50 now totals 250 million and is growing at 30-percent-plus a year, and over-60s are growing even faster.³ China still sets a retirement

¹ National Bureau of Statistics of China, stats.gov.cn; CEIC Data, ceicdata.com.

² Liang Jianzhang and Huang Wenzheng, “‘Two-child policy’ not enough to halt China’s plunging fertility rates,” Caixin Online, November 3, 2016, caixin.com.

³ For more, see “Urban world: Mapping the economic power of cities,” McKinsey Global Institute, March 2011, on McKinsey.com.

age of 50 for women (55 for civil servants and employees of state enterprises) and 60 for men, so these numbers are a good proxy for the growth rate of retirees, whose income levels typically drop precipitously to less than 50 percent of pre-retirement levels. Even those with significant savings are likely to pull back on consumption to insure against uncertain future costs such as healthcare, and they are more likely to hold on to the property they own than seek to buy more. At the same time, the rural population of over 50s is shrinking, as people in the past 20 years have moved into urban areas to become part of this urban retirement demographic.

Depressed regions become more so

Liaoning earned the dubious honor among Chinese provinces of reporting that its economy shrank in 2016. It is a heavily SOE-dependent region. Of its ten largest companies, three are in basic materials, three in oil and gas, two in automotive, and one in infrastructure—only one is a consumer-facing company. Not one of China's leading Internet companies is based in the province, and private investment fell more than 50 percent year on year in the first half of 2016. The average age of farmers is over 55,⁴ and many graduates from the region's universities leave to get jobs—part of the two million people that left northeast China between 2000 and 2010.⁵ Even the property market that stimulated the local economies of so many cities in 2016 can't turn Liaoning around. Many homes bought only 15 years ago cannot be sold because of their low construction quality and scarcity of buyers. And few have the confidence to buy property in an economy with declining job security and downward pressure on property prices.

Rising coal and steel prices in 2016 may have temporarily hidden similar problems in other parts of the country. Yet the challenges faced by several of Liaoning's largest cities will be seen more clearly this year in cities not just in the northeast but also in the northwest and even the south—in fact, in any Chinese city dependent on a single industry where employment is under pressure. Breaking cities out of this developing cycle of decline has been on the central government's to-do list since 2003. Last year saw multiple initiatives announced by Premier Li Keqiang, calling for the northeast to become a hub of entrepreneurial innovation and tourist-service-based consumption. But without a robust local tax base, with young talent that moves to opportunities elsewhere, and with a rapidly aging population whose skills are best suited to a heavy-industry era, the challenge is almost impossibly hard. This year will see more initiatives announced to fix struggling cities, including money given to bail out their key enterprises and to support their property markets. Despite this, I expect more vocal complaints from local citizens who see little prospect of improvement in the quality of their lives, and some smaller cities may have so exhausted their supply of assets to sell that they de facto become bankrupt.

Will commodities be the next hot asset class?

China's investors will this year hunt for the next hot asset class to put their capital into. After a spectacular year for property valuations in 2016, it's likely to be flat for property prices (certainly that is the government's intention), and the middle class is already very overweight in real estate. Wealth-management products (WMPs), such as off-balance-sheet debt-like products from banks, have become less attractive to investors as nominal returns decline and courts

⁴ Zhengzhou Yang, "Demographic changes in China's farmers: The future of farming in China," *Asian Social Science*; Volume 9, Number 7, 2013, Canadian Center of Science and Education, ccsenet.org.

⁵ Hu Yongqi, "Enhancing Northeast's economy," *China Daily*, October 25, 2016, chinadaily.com.cn.

redefine these investments as equity products (and so, last in line if a bankruptcy occurs). They've also become less appealing to banks, as they are forced to put balance-sheet capital against WMPs. Investors do want to get back into the stock market, but they view it as either a momentum play or one for insiders, hence the growing interest in investing in hedge funds (and the need to regulate them better).

As 2017 begins, commodities look like the next asset class to welcome Chinese investor exuberance. Millions of retail investors and as many as 5,000 hedge funds have entered the sector, and this year will likely see a couple of large hedge funds collapse as they overpromise and underdeliver. Regulators will react by seeking to raise trust in the stock market, launching a number of initiatives to improve corporate governance and potentially taking action in court against directors and auditors who are clearly seen to have failed to deliver on their responsibilities.

Investment management will be one of the bright spots of foreign participation in China's economy. Many majority and fully foreign-owned investment companies are in the final stages of launch. If they build channels and brands effectively, foreign managers should be able to develop trusted relationships with local individual investors with domestic and international investment options. International asset managers already receive a significant share of the growing numbers of mandates from Chinese institutions—such as pension funds and insurance companies—to manage money on their behalf. For the government, the role of these international fund managers is more than just providing returns to investors—it's to professionalize the industry, bring in best practices, develop talent, and make money for themselves while they are at it. As we have seen in many other sectors, local competitors will adapt quickly by building their own international reach and adopting international operating practices.

Finally, this year we'll see much greater investment in Chinese stocks by foreign investors, despite the governance risks just mentioned. With November's opening of the Shenzhen–Hong Kong Stock Connect, foreign investors now have much easier access to many of China's highest-growth companies. Even though many are trading at price-equity ratios of more than 50—if not more than 80—foreign investors will be excited to be able to invest at all and will do so at scale.

The auto industry accelerates into the future

China's auto industry has grown at more than 15 percent annually for a decade. In late 2015, when it looked like demand might stagnate, a tax break was introduced that kept the market expanding at 14 percent in 2016, at the time of writing. Of course, adding more than 20 million new vehicles a year to a fleet of more than 190 million has its downsides, starting with very visible air pollution, congestion seemingly everywhere, and less than one parking space for every two cars in some cities. And for individuals, the cost of owning a car has never been higher, from paying as much as \$15,000 for a license plate (if you are one of the lucky 1 in 20 who wins the lottery for a license) to paying even more for a parking space and insurance. In

cities, owning a car is actually increasingly seen as a costly hassle, and the pressure is on the government to improve the situation. There is some good news. Despite the growth in vehicles, deaths on Chinese roads declined 3 percent annually for the past five years to below 60,000, and reported injuries declined even faster. The average car on the road is today much safer than ten years ago, congestion means that most driving in cities is at a very low speed, and I believe driving is, at the margin, getting better.

The government is focused on a medium-term solution of clean cars, self-driving cars, and shared cars. In each category, it wants China Inc. to seize the opportunity to be the global scale leader. It's more than hypothetical: the government can put in place the entire ecosystem of laws and regulation, build shared infrastructure for charging and more, and provide investment and consumer subsidies to accelerate a drive to scale. There will be a big increase in the amount of money made available to this sector this year, perhaps reaching the level of capital made available to the domestic semiconductor industry and to lots of high-profile pilots involving China's leading companies from the auto and tech sectors. What could go wrong? If the subsidies are skewed to SOEs, if competing tax breaks for buying traditional vehicles remain in place, or if foreign companies are heavily disadvantaged, then we will end up with the same outcome or if as in semiconductors—lots of government spending for very limited return—rather than the outcomes in solar energy or mass public transit, where China Inc. is now a global leader.

Cheers turn to boos in European soccer stadiums

Chinese investors have plunged into European soccer teams, demonstrating support for Xi Jinping's desire for China to improve its national performance in soccer. (On that front, there's not much progress to report—the national team's lowlight was losing to Syria.) This year will see some of those investors start to seriously regret their decision. Not only is there a high likelihood that some of the teams they have acquired will be relegated (therefore, losing access to the large streams of revenue top divisions receive from broadcasters), but I also expect at least one set of fans to turn on the team's new owners, with demonstrations at the games, on social media, to the press, and more.

There is a long tradition, especially in England, of blaming owners for a team's poor performance, for failing to spend enough of their own money to buy the best players and manager, and for extracting money from the club. Just ask Assem Allam (Hull City), the Oystons (Blackpool), Venky's (Blackburn), or even the Glazers (Manchester United) how uncomfortable such a wave of criticism can be. No Chinese entrepreneur has ever faced anything similar at home and will likely react naively when these protests develop. Leading PR firms should be on standby. Some investors will come to realize that while owning a team brings headlines and prestige at the outset, it can be a very volatile, very risky investment, possibly leading to a semi-forced low-price sale. Expect a Chinese investor to cut and run from a soccer investment in 2017.

Investing in adjacent sports businesses (such as Fosun's investment in soccer agents) is often lower risk and provides higher returns. I expect it will not be long before Chinese investors turn

their attention to the UK gambling industry, acquiring some of the main players, seeking to bring some of the key elements of their success back to China (or at least Asia, if regulators balk).



With the caveat that everything is subject to change when it comes to geopolitics, I expect China's government priorities this year to largely be domestic. Ensuring smooth government leadership transitions will take precedence over economic reform perceived as potentially risky. Actions to increase the control of the economy by the Party take precedence over market-based reforms. We will see incremental policy change, largely pushing on the same levers that worked for the government in 2016. But by the second half of 2017, we will see that consumer spending is not growing at the pace needed to deliver the promised GDP growth, leading to a further boost in debt-funded infrastructure spending and property construction and a bumpier second half of the year. □

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