What’s in store for China in 2013?

The year ahead could be a time of significant change for everything from banks, retailers, and infrastructure projects to pork prices, soccer, and “compulsory” vacation time.

Gordon Orr
How might China surprise us in 2013? Read the ten predictions of Gordon Orr, a McKinsey director based in Shanghai, and tell us what you would add.

1. **Banks underperform**
Mainland banks have undergone a remarkable financial recovery over the past decade, thanks to the sector’s initial recapitalization and China’s rapid economic growth. As the economy slows, however, two issues are of immediate concern: the scale of nonperforming loans left behind after the 2009 economic stimulus and the volume of wealth-management products recently snapped up by retail investors in search of decent returns. The latter may come back to haunt Chinese banks in the same way that structured products plagued Western ones in the early stages of the global financial crisis.

This year could mark the start of a more fundamental transformation that will last several years. Most banks, after all, realize they need to find a different economic and business model, given growth rates that comfortably exceed returns on equity and unsustainable rates of capital consumption. In view of current trends, banks must find 1.3 trillion renminbi ($208 billion) in additional capital over the coming five years.

The challenge, which many banks are ill-equipped to manage, will be to shift from customer-acquisition and “growth at all costs” strategies to more differentiated ones focused on profits. The winners will be institutions that serve the customer well and improve their operational capabilities—among other things, by taking a more robust approach to risk. Complying with decisions of the China Banking Regulatory Commission, for example, must become a much more strategic exercise in future.

2. **Pork or chicken prices rise 100 percent**
China’s domestic food supply has been strained for years. The country consumes 50 percent of all pork globally, and rising demand for protein, especially pork, is pushing the system beyond its limits. In July 2011, pork prices surged 57 percent for a number of reasons, including the steady exit of swine farmers from the market beginning in 2010 and an outbreak of disease among pigs in late 2010 and early 2011. That could easily happen again, and on a much larger scale, because of failures in farms or in the extremely rudimentary cold supply chain. Imports could not increase on a scale sufficient to fill the gap. The psychological scars from recent food-safety scandals could lead to panic hoarding of substitute products and drive up their prices, too. Although a better food chain will develop over time, this may take several years.

3. **Local protests intensify—and succeed more often**
In June 2007, local protesters successfully forced the authorities to withdraw plans to build a chemical plant in Xiamen. Since then, a growing number of planned incineration and chemical projects have been withdrawn, postponed, or modified following protests, whose number doubled in the second half of 2012. A “not in my backyard” mentality is
becoming common. Since there is no formal process for legitimizing proposed investments in a community, people are willing to protest noisily for an extended period, harnessing the power of social media. They realize that the government has little choice but to intervene with force or to compromise or back down.

In 2013, local protests against both new construction of polluting facilities and the operation of existing ones are likely to intensify. The fear of further damage to health and the environment will increasingly trump the desire for economic growth. Local governments will back down more often.

4. China spends more on infrastructure
Beijing’s airport welcomed more than 80 million passengers last year, and China has the world’s largest network of toll roads and high-speed trains, as well as six of the ten busiest container ports. Yet the high cost of logistics is just one indicator that China needs to build a much more extensive transport infrastructure. Many in government not only recognize this reality but also believe profoundly that it is better to build sooner rather than later.

China lags furthest behind other nations in the number of airports with paved runways: the world’s most populous country has 452 airports, Brazil 713 and the United States 5,194. Forty-four Chinese cities with more than a million people still have no mass-transit system other than buses. The supply chain for agricultural products remains rudimentary.

Most significantly, much of the urban population in all but the top-tier cities lacks modern accommodations, and the rehousing of China’s existing urban residents is considerably less than half complete. The scale of the construction task is all the greater, since many of the residential buildings China put up in the 1980s were of relatively poor quality and will reach the end of their useful lives much sooner than might have been expected at the time.

Manufacturing investment will be strong this year. Capital-intensive Chinese manufacturing continues to earn good returns, and investment in technology across all sectors is boosting productivity, although this is perhaps not such good news for employment.

Infrastructure spending will continue to drive economic growth in 2013, and the vast majority of it will be put to good use. Yet the capital efficiency of many projects lags behind that of global leaders.

5. Online competition bankrupts a major main-street retailer
Online competition has yet to put major retailers in China out of business. Historically, economic growth has been sufficient to support all players, but that is about to change. In third- and fourth-tier Chinese cities, where modern retailing still isn’t well established, online retailers have the biggest edge in product range and prices. But thanks to low-cost
distribution and very small markups on consumer-electronics products such as mobile phones, China’s e-retailers are increasingly penetrating “time poor” middle-income households in all cities. The appeal of these players lies not just in low prices but also in convenient home delivery, a trusted payment system, and the ability to return goods quickly and without administrative barriers. Physical retailers are moving online as fast as they can, but for most of them this is a very different business model and one that requires execution skills and a sophisticated online presence they currently lack.

The scale of the Alibaba companies—with $150 billion-plus 2012 sales, up by more than 60 percent—is overwhelming. This year will represent a tipping point for growth in the share of online sales of clothes and electronics. Many Chinese physical retailers, as owners of their own real estate and part of broader conglomerates, may be able to hide their underperformance for a while. But further exits from China by multinationals (following the path of Home Depot, Mattel, and OBI) seem likely.

6. Even the middle classes hedge their bets
It has long been common knowledge that many of the offspring of China’s leaders study outside the country. More and more upwardly mobile people are now following suit. In the past four years, the number of Chinese students applying to boarding schools in the United Kingdom and the United States appears to have tripled; many of these institutions could fill their classes entirely with students from mainland China. Parents are not motivated only by a desire to give their children an alternative to the rote learning that still characterizes much of Chinese education; they are also creating additional options for their children should there be a discontinuity in China.

Private-business owners have an opportunity to give themselves such options by making international investments and acquisitions outside China. With permanent residence on offer in countries such as Australia, Canada, and Singapore in return for an investment of up to a few million dollars, many are taking advantage. Vancouver, in particular, has had a new influx of the kind it experienced from Hong Kong in 1997. Individuals may have fewer options for diversifying their asset base outside the country, but buying real estate is one of them: by some reckonings, the Chinese are now the second-largest acquirers of luxury property in London. Like other forms of “groupthink,” this wave will probably get a lot larger before it subsides.

7. European soccer teams invest in the Chinese Super League
The government-owned Chinese Super League of soccer became a lot more glamorous last year when the star player Didier Drogba joined Nicolas Anelka at Shanghai Shenhua, an ambitious but underperforming team. Yet the Chinese Super League will never fulfill its potential until fans have confidence that the games are clean and that coaches and players are improving. In many other (generally Olympic) sports, China has imported the best coaches and operating models. But not in soccer.
A new leadership intends to privatize the Chinese Super League and welcome international investment as part of an ongoing program of reform. This will allow team owners to develop and retain the full range of revenue streams at a modern sports club’s disposal. International teams from many European countries will invest in leading Chinese teams and rotate players between Europe and China.

8. Investment in overseas agriculture is the “next big thing”
In China, a trend that starts as a trickle often becomes an overnight flood. Outbound investment in commodities and premium agricultural products, for instance, will reach a tipping point in 2013: China has shifted rapidly from a trade balance on agricultural goods to a deficit that’s currently around $40 billion and growing at 50 percent a year. This transformation reflects increased demand in China for basic cereals to feed its expanding livestock populations and a slow-to-restructure domestic industry that can’t supply the need. China is now the second-largest importer of rice and barley and a top-ten buyer of corn. Chinese companies lease hundreds of thousands of hectares from Argentina to Kazakhstan to grow soybeans.

Outbound investors also eye a growing opportunity for premium fruits and vegetables of the kind sorely lacking in China. I don’t mean only state-owned enterprises spending their spare cash. Many private Chinese entrepreneurs, who have been wildly successful in areas from real estate to technology, have identified the food chain as their next big thing. Investing outside rather than inside China is attractive not only for the reasons already mentioned but also to diversify assets geographically and to avoid the high prices paid recently for assets in the domestic food chain. In the last few months, for example, the Shanghai Zhongfu Group diversified from real estate in Shanghai by investing around $728 million in a sugar-cane project in Western Australia. And at a major conference in Beijing in December, Chinese private-equity firms met with senior executives of US food companies and representatives of US state agricultural bureaus to discuss ways of increasing China’s investment in US agriculture.

9. A third-tier city goes bankrupt
Chinese cities still depend on land sales—in many cases, for 30 percent of gross revenue and, in some, for more than 50 percent. However, the supply of attractively located land for sale to developers is not inexhaustible. Some cities, especially those located in areas where manufacturing is in decline, now find that land values are on the slide. The financing vehicles these cities have been using to build projects will no longer work. Recent cases of trust companies bailing out troubled local real-estate concerns represent warning signals that municipalities are in difficulty. Without a bailout from the central government, they will no longer be able to meet their bills. Continuing to roll over loans to state-owned enterprises just pushes the problem a short way into the future.
10. National holiday weeks are abolished (please)
Perhaps this is more a hope than an expectation. Fifteen years ago, when the current structure of mandated vacation weeks was put in place, China’s economy was very different. There was a real belief that, without mandated vacations, most workers would never get a holiday or have an opportunity to spend the income they were saving. Yes, many hundreds of millions did travel during the Chinese New Year period, but far fewer people had migrated from their home towns to new urban environments than have done so today, and far fewer could afford to travel. In this respect, China was not that different from those European countries that mandated vacation weeks in the 1970s.

Today, these compulsory holiday weeks merely serve to saturate and overload the country’s infrastructure—if anything, reducing the amount of money that people spend on travel and related services as more and more choose to stay at home. The growing middle classes can schedule their own vacations when they want to much more readily than they could in the past. Formerly, large numbers of state-owned and private-sector enterprises did not meet the legal requirements for vacations. But in the age of social media, even factory workers can now name and shame offending employers.

Mandated vacation weeks will either gradually decline into irrelevance—starting in first-tier cities—or, better still, they will be formally abolished as an idea that has outlived its purpose.

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