

Forecasting China

Gordon Orr

McKinsey's Gordon Orr has been publishing predictions about China for nearly five years. Join him for a review of the good guesses, major misses, and lessons he's learned from both.

I started writing lists of what might happen in China seven or eight years ago. At first, they were just for me—a way of organizing my own thinking in early January for the 12 months ahead. Then I began to post some of the more interesting ideas on the blog I write for McKinsey colleagues.

Four years ago, when my publishing colleagues suggested I share my predictions externally—first in English, then in English and Chinese—the stakes rose significantly. This development not only brought the forecasts to the attention of thousands of users on a McKinsey site but also made it possible for social and traditional media to amplify the message to hundreds of thousands of people (and, in the case of one notorious forecast, to several million of them). Better data, more coherence, greater sensitivity to the possible implications of what I was saying, and thorough editing were needed. In the annual forecasts, I have tried to strike a balance among the following:

- Developments that I'm convinced will really happen and have a material impact on the country but aren't being highlighted as much as I think they should. They range from small changes that illustrate a broader point—sometimes even a real discontinuity—to large changes of national significance.

- Things that might or might not happen, but whose impact would be very material if they did and are worth thinking about anyway for what they tell us about China today.
- Things that are highly unlikely to happen but would be fun if they did. Exploring them has allowed me to share interesting and perhaps unexpected things I learned about China.

For 20 years, it has been my privilege to make China my home and to immerse myself in the transformation of its business, its economy, and its society. I live and work in China but I am not of China. I hope that gives me both optimism about what can be achieved there, often rapidly, and objectivity enough to see the flaws alongside the successes and to recognize when foundations are solid and when they are cracked.

The themes I write about come implicitly and explicitly from my interactions with many people. I have seen four, five, even six generations of country heads of multinational companies come and go. I have been able to work with the executives of many multibillion-dollar Chinese companies as they have moved from middle management to the top of their organizations. And I have seen many of the talented Chinese nationals we recruit for McKinsey grow into partners and, in some instances, move beyond the firm to lead some of the most exciting enterprises in China today.

How did the forecasts do?

Here are some of the highlights and lowlights of my forecasts over the past four years.

2009

The forecasts for 2009 were perhaps the most provocative—and specific—and included one that subsequently went viral and was read by millions. In my comments on the substandard quality of Chinese construction, I had suggested that a major tower block would fall over. So when fire destroyed a tower in the new China Central Television (CCTV) complex in Beijing a few months later, and a newly completed housing tower block in Shanghai collapsed for lack of

proper foundations, China's social media claimed I had magical foresight.

Slightly less presciently, I forecast that Mexico would expand significantly as a production base for Chinese manufacturers. South Korean producers already had a large presence there, and the early signs suggested that cost and demand pressures were driving the growth of multiple manufacturing hubs. Foxconn and Haier did acquire factories in Mexico, and recently Lenovo announced that it will be assembling PCs in the United States. But Chinese manufacturers did not act as boldly to diversify their production geographically as I had expected. The advantages of staying close to their existing supplier base and avoiding complexity far from home proved more compelling.

I had thought that following Huawei's failed 2008 attempt to buy the US network-equipment manufacturer 3Com, another iconic US technology company might be the object of Chinese attention in 2009. Since the Lenovo acquisition of IBM's PC business unit in 2005, however, no Chinese company has succeeded in buying a US technology business of any size, not even those that have fallen on hard times. Many observers have noted the changing political climate: if the Lenovo acquisition had been proposed a few years later, it would probably have been turned down. Fear of rejection remains a powerful deterrent to larger-scale Chinese acquisitions in the United States—so much so that the American Chamber of Commerce in China is currently planning an initiative to help Chinese companies invest in the United States.

Competition in the telecom sector, meanwhile, has declined to a whimper even without the continued consolidation I forecast at the start of 2009. Government-orchestrated share shifts enabled

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through policy and regulatory pronouncements have prevented the weaker operators, with their large legacy fixed-network assets, from getting into serious financial distress.

Although China has not made quite the leap I predicted in electric cars, its commitment to developing the world's leading electric-vehicle (EV) industry has been substantial. That commitment includes billions of dollars in subsidies and huge incentives for potential buyers, as well as directives to government purchasers to buy electric. The original Program to Promote the Automotive Industry, in 2009, set a target of 500,000 new-energy (EV, hybrid, and other) vehicles by 2011. The actual volume turned out to be 15,000, of which 10,000 are EVs.

To date in China, as elsewhere in the world, consumers have largely rejected EVs, and EV technology has failed to live up to the commitments of Chinese companies. The share price of BYD, one of the businesses I highlighted, has fallen by more than 65 percent since the euphoria that followed Warren Buffet's investment. The timing of my forecast was spectacularly wrong. But the need for electric vehicles is still pressing—if anything, more so given the intense pollution in Beijing earlier this year. Chinese companies recognize how challenging it will be to develop the technology, particularly batteries, and are reaching out globally. Wanxiang's recent purchase of A123 Systems is a case in point. There will be a second wave for EVs in China, but probably not on a major scale until after 2017.

I was at least partly justified, at the start of 2009, in looking forward to warmer cross-strait relations between the mainland and Taiwan. Mainland banks have invested modestly there, although the first representative branch didn't open until 2010. By the end of 2012, four mainland banks—Bank of China, Bank of Communications, China Construction Bank, and China Merchants Bank—had a branch or office in Taipei.

2010

As a result of a couple of transactions I was supporting over the Christmas and New Year period, I wasn't able to make that year's forecast in time for publication.

2011

The list of forecasts was shorter in 2011 than in other years. I thought inflation would be a problem, and, sure enough, it rose by more than 5 percent (against 3.3 percent in 2010 and -0.7 percent in 2009). The jump in food prices was of particular concern to government officials. To this day, the food chain remains highly strained, vulnerable to harvests disrupted by weather or outbreaks of disease. Imports of agricultural products also took off in 2011, encouraging financial investors to find opportunities in the sector.

I predicted a rise in minimum wages as well, albeit with the caveat that productivity gains would outstrip labor costs. With the push to boost economic growth through consumption, minimum wages did increase, by as much as 20 percent annually in many cities. Companies struggled to achieve matching productivity gains, though. For the first time, many multinationals experienced a China with middling, even high, labor costs and significant rigidities when it came to hiring and firing workers. The country now has a much clearer understanding of the trade-off between hiring factory workers and making capital investments—and especially of the risks of hiring expensive white-collar staff with, at best, average productivity levels.

As I expected, 2011 was a bumper year for outbound acquisitions by Chinese companies, which committed more than \$50 billion to deals. A majority of the largest were in the energy sector, notably Sinopec's purchase, for \$4.8 billion, of a 30 percent stake in Petrogal Brasil (petroleum and natural gas); China Three Gorges Corporation's \$3.5 billion strategic partnership with Energias de Portugal, an electric utility; and China Investment Corporation's decision to invest \$4.3 billion for a 30 percent stake in the exploration and production division of GDF Suez (natural gas). Chinese companies also acquired rights to exploit oil and gas fields in Australia and in the United States, and there were several sizable mining acquisitions. In other sectors, Lenovo bought NEC's personal-computer business and a 37 percent stake in Medion, a German consumer-electronics manufacturer. Chinese investment in international port operations also grew.

My poorest forecast was probably that China's government would meaningfully reduce its stake in state-owned enterprises, particularly in the industrial companies overseen by the State-owned Assets Supervision and Administration Commission (SASAC). Instead, the status quo well and truly held. Indeed, since 2010 the market share of state-owned enterprises has grown in numerous sectors.

2012

I had some easy wins in 2012. For example, compensation again predictably rose across the board, as did minimum wages (by 13 percent in Shanghai and even more in many other cities). White-collar salaries rose still further—so much that it might be cheaper to employ a researcher in Munich than in Shanghai. In one Chinese company's R&D organization, the average compensation cost rose to \$70,000.

Accounting scandals in Chinese companies grew in number and scale through 2012 and continued in 2013, at a pace faster than I had anticipated and across a broader range of industries. Even an illustrative list is long: Boshiwa, China MediaExpress, Daqing Dairy, Focus Media, Longtop, Sino-Forest, Zoomlion, and, more recently, Zhengzhou Siwei Mechanical & Electrical Manufacturing (a subsidiary of ERA Mining Machinery). This is an important issue, and not only for shareholders. A number of multinationals have walked away from acquisition negotiations because they were worried that problems might be lurking, and not because they found anything (see “Due diligence in China: Art, science, and self-defense,” on mckinsey.com).

Chinese companies also became bolder with their acquisitions in 2012, particularly in agriculture and in basic materials. Larger deals were still most common in energy. They included Sinopec's minority stakes in five of Devon Energy's US shale-oil and -gas fields (for \$2.44 billion); China Guangdong Nuclear Power Holding's 57 percent stake in the uranium-focused Australian company Extract Resources (acquired for \$1.3 billion); and Sany Heavy Industry's \$700 million purchase of the German concrete-pump manufacturer Putzmeister.

I was right that the Chinese automotive market would slow down—as it turned out, from 32 percent growth in 2010 to 9 percent in 2012.

The impact was greater on domestically owned producers (which grew by just 5 percent) than on the major joint ventures between local companies and multinationals (sales were up by 11 percent in 2012). OEMs at the very high end of the market grew more than 20 percent, notwithstanding the economic slowdown and the clampdown on conspicuous consumption.

Hospital reforms also went ahead as anticipated. Hospitals may now be 100 percent foreign owned, though the reluctance of medical staff to leave the state sector constrains private-sector growth.

At the start of 2012, I was bullish about green investment. It proved to be a great year for solar installations in China and a terrible year to manufacture solar equipment there. China installed about 5 gigawatts (5,000 megawatts) of solar capacity in 2012, double the more than 2.5 GW achieved in 2011, itself four times the 2010 figure. The country is now the world's number-two end market for solar, thanks in large part to increased support from the Chinese government.

Solar-module manufacturers, on the other hand, faced lower selling prices, weakening demand in Europe, industry overcapacity, and rising trade barriers. China's manufacturing capacity in 2012 was about 40 to 45 GW, against global demand of about 30 GW. Chinese solar panels are selling for 60 cents per watt-peak¹ (Wp)—at or below manufacturing cost—compared with \$1/Wp a year ago, \$1.60/Wp in 2011, and \$4/Wp in 2008. Most manufacturers depend on borrowing from Chinese banks to survive, and consolidation is overdue. However, as too often happens in China, when demand growth slows, local government steps in with support.

China escaped any disease-driven discontinuity in 2012 but has done little to reduce the potential for the further food inflation I expected. Structurally, China's trade deficit in agricultural products continues to grow, reaching \$56 billion in 2012. Given tight global markets in many agricultural products, inflationary pressures have been building, but across-the-board inflation did not materialize in 2012; indeed the pig price cycle was at a disinflationary point in 2012. I could have seen that more clearly.

¹Watt-peak (Wp) is a measure of the nominal power output of a solar panel under laboratory-testing conditions.



A pig farmer feeds grass to her pigs in Jiaxing, a city in China's eastern Zhejiang Province. China's trade deficit in agricultural products continues to grow, reaching \$56 billion in 2012.

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My suggestion that private-equity and venture-capital funds might go “walkabout” perhaps proved too alarmist. But although there was no high-profile instance of a private-equity manager diverting funds, I believe this development is only a matter of time. At a personal level, I saw the owner of my son's school in Shanghai divert school fees to another project. No money remained for salaries, housing, or insurance—or to renew the visas of non-Chinese teachers. It was only thanks to the staff's loyalty that the school kept going until the end of the year.

2013

Much less than halfway through the year (as I write this article), it's too early to tell how my list for 2013 will fare. I've predicted, among other things, a rough time for banks, a doubling of pork or chicken prices, the bankruptcy of a brick-and-mortar retailer, and investment by European soccer teams in the Chinese Super League. The

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banks are indeed increasingly concerned that their wealth-management products are becoming a liability, and German retailer MediaMarkt has highlighted the challenges in retailing with its announcement that it is leaving the China market (following the closure by Best Buy of its branded stores in 2011). We will need to wait until the end of the soccer season in Europe to see if its teams will invest in China.

What I have learned

New Year forecasting is a widely practiced business art in most areas of the world, but in China it carries particular risks and rewards. Here are a few reflections to help leaders trying to plan ahead in this fast-changing land:

- As long as you are directionally correct, growth in China will make your predictions right at some point, and often very quickly. Having a sense for the pace of change is critical.
- Don't rely too heavily on government statistics. In the past, at least, the government struggled to gather quality data, and what data it had were often heavily massaged.
- Trying to forecast exactly when discontinuities will happen is a fool's game. But identifying what types of discontinuities could occur—and having a plan to deal with them if they do—is a basic corporate responsibility.
- Volatility is a central feature of the Chinese economy. Consumers and businesses still overreact to signals to spend, to invest, and to cut back, so there will be unexpected jumps in demand—and setbacks. Don't forecast in straight lines.

- Economics is still economics in China. If something looks odd, it probably is. Find out why before you forecast (or invest).
- It is more important for forecasting to be interesting—thereby encouraging debate, scenario planning, and a flexible mind-set—than comprehensive.

As for my own modest efforts, I've learned to live with the fact that public forecasts never disappear; people still circulate the old ones online. So I'm developing a thick skin, while trying to balance my role as provocateur with my desire to avoid saying something today that will embarrass me in years to come. ○

Gordon Orr is a director in McKinsey's Shanghai office. For more on his 2013 predictions, see "What's in store for China in 2013?," on mckinsey.com.