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What could happen in China in 2014?

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The year ahead could see companies focus on driving productivity, CIOs becoming a hot commodity, shopping malls going bankrupt, and European soccer clubs finally investing in Chinese ones. McKinsey director Gordon Orr makes his annual predictions.

1. Two phrases will be important for 2014: 'productivity growth' and 'technological disruption'

China's labor costs continue to rise by more than 10 percent a year, land costs are pricing offices out of city centers, the cost of energy and water is growing so much that they may be rationed in some geographies, and the cost of capital is higher, especially for state-owned enterprises. Basically, all major input costs are growing, while intense competition and, often, overcapacity make it incredibly hard to pass price increases onto customers. China's solution? Higher productivity. Companies will adopt global best practices from wherever they can be found, which explains why recent international field trips of Chinese executives have taken on a much more serious, substantive tone.

This productivity focus will extend beyond manufacturing. In agriculture, the pace at which larger farms emerge should accelerate, spurring mechanization and more efficient irrigation and giving farmers the ability to finance the purchase of higher-quality seeds. Services will also be affected: for companies where labor is now the fastest-growing cost, a sustained edge in productivity may make all the difference. And in industry after industry, companies will feel the disruptive impact of technology, which will help them generate more from less and potentially spawn entirely new business models. Consider China's banking sector, where bricks-and-mortar scale has been a critical differentiator for the past two decades. If private bank start-ups were allowed, could we see a digital-only model, offering comprehensive services without high physical costs? Will Chinese consumers be willing to bank online? Absolutely—if their willingness to shop online is any guide.

2. CIOs become a hot commodity

There is a paradox when it comes to technology in China. On the one hand, the country excels in consumer-oriented tech services and products, and it boasts the world's largest e-commerce market and a very vibrant Internet and social-media ecosystem. On the other hand, it has been a laggard in applying business technology in an effective way. As one of our surveys[1] recently showed, Chinese companies widely regard the IT function as strong at helping to run the business, not at helping it to grow. Indeed, simply trying to find the CIO in many Chinese state-owned enterprises is akin to hunting for a needle in a haystack.

Yet the CIOs' day is coming. The productivity imperative is making technology a top-team priority for the first time in many enterprises. Everything is on the table: digitizing existing processes and eliminating labor, reaching consumers directly through the Internet, transforming the supply chain, reinventing the business model. The problem is that China sorely lacks the business-savvy, technology-capable talent to lead this effort. Strong CIOs should expect large compensation increases—they are the key executives in everything from aligning IT and business strategies to building stronger internal IT teams and adopting new technologies, such as cloud computing or big data.

3. The government focuses on jobs, not growth

Expect the Chinese government's rhetoric and focus to shift from economic growth to job creation. The paradox of rising input costs (including wages), the productivity push, and technological disruption is that they collectively undermine job growth, at the very time China needs more jobs. Millions and millions of them. While few companies are shifting manufacturing operations out of the country, they are putting incremental production capacity elsewhere and investing heavily in automation.

For example, Foxconn usually hires the bulk of its workers for a given 12-month span just after the Chinese New Year. Yet at the beginning of last year, the company announced that it wouldn't hire any entry-level workers, as automation and better employee retention had reduced its needs. Although upswings in the company's hiring still occur (as with last year's iPhone 5S and 5C release), the gradual rollout of robots will probably reduce demand for factory workers going forward. In short, many manufacturers—both multinational and Chinese—are producing more with less.

So as technology enables massive disruptions in service industries and sales forces, what happens to millions of retail jobs when sales move online? To millions of insurance sales agents? Millions of bank clerks? Even business-to-business sales folks may find themselves partially disintermediated

[1] See Driek Desmet, Kevin Wei Wang, and Chenan Xia, "A strategic role for China's CIOs," June 2013, mckinsey.com.

by technology, and rising numbers of graduates will have fewer and fewer jobs that meet their expectations. They will not be happy about this and may not be passive. Finally, while state-owned enterprises will feel pressure to improve their performance, to use capital more efficiently, and to deal with market forces, they are likely, at the same time, to face pressure to hire and retain staff they may not really need. The government and the leaders of these enterprises have long argued that such jobs are among the most secure. They will find it very hard to declare them expendable.

4. There will be more M&A in logistics

As everyone pushes for greater productivity, logistics is a rich source of potential gains. State-owned enterprises dominate in capital expenditure–intensive logistics, such as shipping, ports, toll roads, rail, and airports; small mom-and-pop entrepreneurs are the norm in segments such as road transportation. This sector costs businesses in China way more than it should. With upward of $500 billion in annual revenues, logistics is an industry ripe for massive infusions of capital, operational best practices, and consolidation. Driven by the pressure to increase productivity, that's already happening at a rapid pace in areas such as express delivery, warehousing, and cold chain. Private and foreign participation is increasingly encouraged in many parts of the sector, and its competitive intensity is likely to rise.

5. Crumbling buildings get much-needed attention

While China's flagship buildings are architectural wonders built to the highest global standards of quality and energy efficiency, they are unfortunately the exception, not the rule. Much of the residential and office construction in China over the past 30 years used low-quality methods, as well as materials that are aging badly. Some cities are reaching a tipping point: clusters of buildings barely 20 years old are visibly decaying. Many will need to be renovated thoroughly, others to be knocked down and rebuilt. Who will pay for this? What will happen if residential buildings filled with private owners who sank their life savings into an apartment now find it declining in value and, perhaps, unsellable? Alongside a wave of reconstruction, prepare for a wave of local protests against developers and, in some cases, local governments too.

6. The country doubles down on high-speed rail

When China inaugurated its high-speed rail lines, seven years ago, many observers declared them another infrastructure boondoggle that would never be used at capacity. How wrong they were: daily ridership soared from 250,000 in 2007 to 1.3 million last year, fuelled partly by aggressive ticket prices. Demand was simply underestimated. Now that trains run as often as every 15 minutes on the Shanghai–Nanjing line, business and retail clusters are merging and people are making weekly day-trips rather than monthly two-day visits. The turnaround of ideas is faster; market visibility is better; and many people come to Shanghai for the day to browse and shop.

There are already more than 9,000 kilometers (5,592 miles) of operational lines—and that's set to double by 2015. If the "market decides" framing of China's Third Plenum applies here, much of the investment should switch from building brand-new lines to increasing capacity on routes that are already proven successes.

7. Solar industry survivors flourish

Many solar stocks, while nowhere near their all-time highs, more than tripled in value in 2013. For the entire industry, and specifically for Chinese players, it was a year of much-needed relief. By November, ten of the Chinese solar-panel manufacturers that lost money in 2012 reported third-quarter profits, driven by demand from Japan in the wake of the Fukushima disaster. (Japan's installed capacity quadrupled, from 1.7 gigawatts in 2012 to more than 6 gigawatts by the end of 2013.) Domestic demand also picked up as the State Grid Corporation of China allowed some small-scale distributed solar-power plants to be connected to the grid, while a State Council subsidy program even prompted panel manufacturers to invest in building and operating solar farms—an initiative that will ramp up further.

This year is likely to see even stronger demand. Aided by international organizations, including the World Bank, an increasing number of developing countries (such as India) regard scaling up distributed power as a way of improving access to electricity. In addition, solar-energy prices continue to fall rapidly, driven down by technological innovations and a focus on operational efficiency. While I'm on green topics, I'll point out that the coming months are also likely to see another effort to create a real Chinese electric-vehicle market. The push will be centered on the launch of the first vehicle from Shenzhen BYD Daimler New Technology.

8. Mall developers go bankrupt—especially state-owned ones

Shopping malls are losing ground to the online marketplace. While overall retail sales are growing, e-retail sales jumped by 50 percent in 2013. Although the rate of growth may slow in 2014, it will be significant. Yet developers have already announced plans to increase China's shopping-mall capacity by 50 percent during the next three years. For an industry that generates a significant portion of its returns from a percentage of the sales of retailers in its malls, this looks rash indeed. If clothing and electronics stores are pulling back on the number of outlets, what will fill these malls? Certainly, more restaurants, cinemas, health clinics, and dental and optical providers. But banks and financial-service advisers are moving online, as are tutorial and other education services.

I expect malls in weaker locations to suffer disproportionately. These are often owned by smaller developers that can't afford better locations or by city-sponsored state-owned developers that are expanding into new cities. The weak will get weaker, and while they may be able to consolidate, it's more likely they will go out of business.

9. The Shanghai Free Trade Zone will be fairly quiet

In early October, there was much speculation about the size of the opportunity after the State Council issued the Overall Plan for the China (Shanghai) Pilot Free Trade Zone (FTZ), and the Shanghai municipality issued its “negative list” of restricted and prohibited projects just a few days later at the end of September. For the FTZ, the only change so far appears to be that companies allowed to invest in it will not have to go through an approval process. As for the negative list, while there’s a possibility that Shanghai will ease the limitations, for the moment the list very much matches the categories for restricted and prohibited projects in the government’s fifth Catalog of Industries for Guiding Foreign Investment. This ambiguous situation gives the authorities, as usual, full freedom to maintain the status quo or to pursue bolder liberalization in the FTZ in 2014 if they see a need for a stimulus of some kind. On balance, I’d say this is relatively unlikely to happen.

10. European soccer teams invest in the Chinese Super League

I know, I know—I’m making exactly the same prediction I did a year ago. True, Chinese football has battled both corruption and a lack of long-term vision. It’s also true that the Chinese Super League still trails Spain’s La Liga and the English Premier League in television ratings. That’s in spite of roping in stars such as Nicolas Anelka and Didier Drogba (who both returned to Europe this year) and even David Beckham (as an “ambassador”).

At least this year some things started to improve. After all, Guangzhou Evergrande just won Asia’s premier club competition—the AFC Champions League—a year after hiring Italy’s seasoned coach Marcelo Lippi. This international success could be temporary, but there is a shared sense in China that something has to change because there is so much underleveraged potential. Maybe Rupert Murdoch’s decision to invest in the Indian football league will precipitate more openness among Chinese football administrators? Perhaps the catalyst will be the news that the Qatari investors in Manchester City also invested in a New York City soccer franchise? An era of cross-border synergies from the development and branding of sister soccer teams is coming closer.

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Finally, something that’s less a prediction than a request. Can we declare the end of the “BRICs”? When the acronym came into common use, a decade ago, the BRIC countries—Brazil, Russia, India, and China—contributed roughly 20 percent of global economic growth. Although China was already the heavyweight, it did not yet dominate: in 2004, the country contributed

13 percent of global growth in gross domestic product, while Brazil, Russia, and India combined contributed 9 percent, with similar growth rates. Compare that with the experience of the past two years. China accounted for 26 percent of global economic growth in 2012 and for 29 percent in 2013. The collective share of Brazil, Russia, and India has shrunk to just 7 percent. It's time to let BRIC sink.

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