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What could happen in China in 2015?

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What do you get when you add slower economic growth, greater volatility, and rising competition to more international flights and genuine Chinese innovation? McKinsey director Gordon Orr's annual predictions.

It seemed harder to prepare my "look ahead" this year. On reflection, I believe this is because political and economic leaders in China have clear plans and supporting policies that they are sticking to. You can debate the pace at which actions are being taken, but not really the direction in which the country is traveling. This means a number of the themes I highlighted for this year will remain relevant in 2015:

- Improving productivity and efficiency will remain the key to maintaining profitability for many companies, given lower economic growth (overall and at a sector level) and the impact of producer price deflation on multiple sectors.

- The impact of technology as it eliminates jobs in services and manufacturing will become even greater (but still not in government).

- As a result, the government will keep a sharper focus on net job creation and the quality of those new positions. Companies will hire even more information technologists to keep up in the race to exploit technology better than their competitors.

- The push to lower pollution, and now carbon emissions, will lead to even greater investment in domestic solar and wind farms, boosting the global position of Chinese producers.

- High-speed-rail construction will continue domestically and increasingly abroad, as Chinese companies become the builder of choice for high-speed rail globally.

Beyond these, there are several additional themes that will be important in 2015. I describe them below.

What else may happen in 2015?

China will be the focus of many, many boardroom discussions around the world next year. Unlike most previous years, the topic won't be whether to double down on China—it will be whether to hold or even reduce exposure to a particular sector or the country overall. With China experiencing lower growth, greater competition, and more volatility, it won't only be multinational companies having these conversations. Similar questions will be asked by senior executives of many of China's private-sector leaders, who are looking to sustain their historic growth rates by pivoting to new sectors within China and especially to international markets. Most companies will ultimately decide to stick with their current China strategy, but there will be real choices and trade-offs on the table.

What will be at the center of these conversations? I believe that it will be a debate about Chinese consumers and how they will behave in a slowing economy and, ultimately, the extent to which they will be the driver of economic growth over the next few years. Let me elaborate.

Wages

Next year will likely see the lowest annual income growth in China for at least a decade, with knock-on implications across the economy. Early signs are already there. Government data show urban disposable income rose in single digits year on year in the first nine months of 2014, a hint at the big shift that is under way. The vast majority of the economy has seen double-digit wage growth for the past decade, with the minimum wage in many cities doubling in less than five years. This has created an expectation that this is simply the new normal for income growth. It is not. As a result, workers are pricing themselves out of the market: for example, International Monetary Fund research in China suggests that a 10 percent increase in the minimum wage leads to a 1 percent fall in employment.

The manufacturing sector provides a telling example. Manufacturing wages are up fourfold in dollar terms over the past decade. In recent years, private-sector enterprises have had to agree to annual wage increases three to four percentage points higher than state-owned enterprises in order to narrow the significant pay differential that had developed by 2010. The challenges for low-skill assemblers in Guangdong and Zhejiang are well documented. They are downsizing, as countries from Bangladesh to Kenya gain share. The cost of technology that substitutes for labor in factories has plummeted, displacing more and more workers. Chinese assembly lines today bear no resemblance to those of a decade ago. The best Chinese private companies are as capital intensive as an equivalent factory in the United States. Employers today are under enormous short-term pressure to reduce wage costs amid ongoing weakness in the Purchasing Managers Indexes and persistent deflation in producer prices.

Service industries will also be affected. For example, Chinese airlines use e-ticketing to substitute for desk agents at least as aggressively as any mature-market airline. Telecommunications, financial services, and retail are all being challenged by "people lite" Internet-based business models from new competitors, which have already led them to substantially reduce hiring. In 2015, they will need to quietly cut back further, whether they are in the private sector or a state-owned enterprise—it doesn't matter. In some sectors, such as professional-services industries, entry salaries are actually falling. I believe 2015 will be seen as a tipping point for wages in China.

Jobs

Job seekers next year will realize that the historical attractions of working in state-owned enterprises and government are not coming back—the job for life, opportunities for status, high pay, and other perks are gone for good. Smaller state-owned enterprises are, in many cases, anyway destined for the more commercially demanding world of private ownership. Many larger state-owned enterprises are recruiting less and encouraging departures to improve efficiency. Lower growth means fewer promotion opportunities, and the upcoming regulatory limitations on the multiple of highest and lowest compensation in state-owned enterprises will increase wage compression.

The private sector has become the driver of job creation in China, with official statistics (likely understated) showing an increase of 50 percent or more in private-sector jobs over the past five years. However, many of these jobs are relatively low skill and low paying. In 2015, the service sector's criticality to job creation will be called out even more by the government, with expanded policies to encourage service-sector hiring and additional focus on the quality of jobs created.

In the government sector, the official salaries of teachers, doctors, and civil servants remain low, and opportunities for side arrangements are shrinking. Eventually, the government is going to have to pay its employees more—but I don't see that happening at scale in 2015, despite the growing number of cases of teachers striking for better pay. The number of students taking the central-government entry exam fell this year despite an increase in open positions. There has to be a connection.

The substitution by technology of certain categories of service jobs that have been at the heart of the growing middle class—call centers, shop assistants, bank tellers, insurance agents—will accelerate in 2015. Even those who retain their jobs will wonder if technology will displace them next. Critically, their confidence in their personal economic future will decline.

At the city level, we will start to see signs of the "Detroit-ization" (post-auto) or "Glasgow-ization" (post-shipbuilding) of some Chinese cities. Many cities are heavily dependent on a single industry, not just mining or steel but often a specific single manufactured good—lamps, socks, or automotive wheels. While great in times of fast growth, the reverse is also true. It's not just that real-estate construction is no longer a driver of growth in those cities. Construction, even when it overshot true demand, was always driven off the back of the success of an industry creating jobs and incomes that enabled citizens to buy housing. That success will no longer be there. And with loans to business often guaranteed by other companies in the same industry in the same city, a single default can quickly cascade into other otherwise viable companies. In 2015, we will see the first of many “city transformation” programs as cities go through a Chinese version of restructuring and workout. Hopefully, cities at risk will see what may be coming and will act early to create new economic engines.

It’s all about consumer confidence

As a result, Chinese consumers will feel less financially secure in 2015. Fewer will feel they have a job for life, most will see wages rise more slowly, many of their real-estate investments will decline in value, and lower interest rates will make other investment products look less attractive. Overall, the momentum of their wealth generation will slow dramatically after a decade of remarkable acceleration. And if they have children graduating from college in 2015, they will likely see them struggle to get a good job.

Lower consumer confidence may then translate into lower growth in discretionary spending. Fortunately for many in the middle class, they have already bought their home, car, and other core trappings of middle-class life. Many Chinese consumers could easily postpone further big-ticket-consumption items and, at the same time, cut back on daily consumption spending. Price deflation reduces the perceived opportunity cost of waiting to spend. Already there are signs of this. Recent Nielsen numbers showed only a 3 percent increase in annual purchases of fast-moving consumer goods. More specifically, food and beverage company Tingyi reported a 13 percent decline in turnover in the third quarter of 2014, while beer volume sold by brewing and beverage group SABMiller fell in its most recent reporting period. And remember: very few in the current Chinese middle class were in the middle class the last time there was an economic slowdown. They could well overreact to a small slowdown and turn it into a larger one as a result.

With fewer attractive investment options in China, the opportunity to invest in Hong Kong–listed companies through the Shanghai–Hong Kong stock-exchange connection will look more attractive in 2015. Currently, a lack of awareness about the available stocks and a high minimum investment are holding people back, and the fund flows are way below daily limits. In 2015, that will change.

Where will growth come from?

The result of all of this is that drivers of economic growth will be harder to find in 2015. Increasing consumption has accounted for more than 50 percent of GDP growth for the past couple years. Its share, for reasons laid out above, will likely be smaller next year. Infrastructure investment is directly under government control and will likely remain at current levels and contribute to growth as it did this year. However, property investment—historically, the driver of around 15 percent of GDP—will probably have another weak year. Residential supply has exceeded demand in many cities, and investor interest has diminished as prices have stagnated. While the picture is city specific, significant unsold inventory exists in many cities, and new building is only adding to it. Policy support will have some impact in growing demand, but it would take much lower real interest rates to make a meaningful difference. Could growth be driven by exports? Not since 2007 have net exports contributed more than a percentage point to China's growth. Recovery in the United States has not led to a growth in net exports, and a big boost from demand in Europe in 2015 seems unlikely, even with lower oil prices.

Students reinvent themselves for the jobs of 2015

It will be another year of frustration for students, both those graduating and those still in school considering their prospects. A substantial proportion of new graduates will not find jobs that require a degree. Indeed, many will find what they learned and how they learned at university has done little to prepare them for the 2015 job market in China. Other than for an elite minority, starting salaries will be flat yet again, at levels less than the income level of a full-time taxi driver (student starting salaries have only increased 1 to 2 percent annually over the past five years, one of the few categories in the economy where wages have not risen). The consequences will become increasingly obvious—graduates will be unable to pay off their education debts, let alone save to buy a home or a car or to become meaningful middle-class consumers.

The way forward for most is finding employment in the private sector, services, or small and midsize enterprises, or becoming an individual entrepreneur—none of which average students have been prepared for by their education or their family. Growth in vocational schools is being boosted by many newly graduated students who realize they need to gain more work-relevant skills. Those students still in school will become more vocal in demanding change in what and how they are taught.

Individuals going global

Governments around the world will compete harder to capture a greater share of China's international tourism and outbound-investment boom. The new US ten-year multientry visa sets a bar for other countries to follow. The United Kingdom's guaranteed 24-hour turnaround on visas for premium business travelers sets a bar for speed, although the $1,000-plus price is eye watering. Beyond visas, many countries also offer popular investment paths to a passport or permanent residency. The majority of those using these schemes in most countries are Chinese. In the most popular countries, limited supply is allowing governments to push up the required investment dramatically. We might hear about a $10 million passport this year.

Airlines are also big beneficiaries of this growth in international travel, with a new wave of growth in direct flight connections to key global cities from second- and third-tier Chinese cities (two recent examples are Wuhan to San Francisco and Changsha to Frankfurt). While these routes have been subsidized initially by local Chinese governments, the subsidies won't be needed for long. The big Middle Eastern airlines are also expanding beyond Beijing, Guangzhou, and Shanghai, for example, with Qatar Airways now flying into Hangzhou. Next year will see the launch of dozens more direct flights to non-Asian destinations from second- and third-tier Chinese cities.

Chinese innovation—seriously

Does China innovate? Next year, we will finally stop asking that question and focus on the global impact of the innovation that is clearly taking place. The number of Silicon Valley–based investors visiting China to learn from Internet-enabled business is now remarkable. These folks don't waste their time on sight-seeing trips.

Beyond the Internet, hundreds of midsize companies in the Chinese industrial sector are creating their own version of the German Mittelstand, providing ever-more-serious competition to Fortune 1000 competitors. No longer focused simply on cheap, they deliver great value, listen to what customers want, and develop products in response. Only this month, on a visit to India, I noticed a tipping point. No longer were there complaints about the low quality of Chinese industrial goods; instead, there were compliments about their remarkably high quality. Biotech, pharmaceutical, consumer electronics, medical tech, drones, graphene, and telecommunications equipment are just some of the sectors where aggressive Chinese midsize companies lead the way in their field, often privately owned by a founding chairman or CEO who has a true passion to become a global leader.

Rule of law increases its impact in 2015

A comment you'll hear less in 2015: *I can do this—it's China*. Businesses will more fully recognize that anticorruption initiatives and rule of law with Chinese characteristics are long-term foundational elements of this leadership's platform—they're not optional, and they're not going away. Companies will need to become clear about how recent statements—such as President Xi declaring that the objective of advancing the rule of law is conducive not only to updating state governance but also to deepening reform—apply to them.[1]

We will see the government standardize more of its approaches to decision making on business and regulatory issues, using the precedent of cases heard. For example, reviews of acquisitions should be faster, with clearer conclusions. We will also see the government leveraging

[1] "Xi says China adheres to socialist path in rule of law," Xinhua News Agency, *Global Post*, October 10, 2014, globalpost.com.

technology more to monitor, audit, and impose sanctions on bad behavior, from tax avoidance to overly aggressive entertainment of government officials. Where could anticorruption investigations bite in 2015?

- in an Internet company where a senior executive gets investigated for begging forgiveness, rather than asking permission, once too often
- in local government, where rapid asset sales made it possible for some sales to be made to favored individuals at below-market prices
- in companies that have yet to fully get their sales forces under control

Return of the DVD store

Shops offering pirated DVDs will make a comeback in 2015 as the rule of law extends to what can and cannot be shown online, pushing very popular international series off the Internet. US series including *The Big Bang Theory* and *The Good Wife* have already been blocked, and rules announced in September by the State Administration of Press, Publication, Radio, Film and Television require unapproved shows to be removed from websites by the new year. Perhaps only in China will the selection of available online content be more tightly controlled than the availability of physical content. Or maybe the international providers of virtual private networks will learn to accept payment from UnionPay cards, and demand for their services will skyrocket. Cinemas will likely also benefit, as good-quality online sources for newly released movies have almost entirely disappeared.

A footnote: be careful with national-level statistics from China in 2015. In times of slower growth, they are historically less reliable.

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