



China - New Environment New Expectations

December 3, 2008

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Preface

3

The continuing deterioration of global economic conditions has many observers wondering what is in store for China. How will China's financial and non-financial sectors cope in 2009? What are the most important economic and financial factors we should continue to monitor? What risks and opportunities does the current environment portend for companies in China? In this report, George Nast, a partner in our Shanghai Office, Janamitra Devan, a Senior fellow with the McKinsey Global Institute, Santiago Campero, a Fellow with the same institute and I provide our perspective on China's short-term macro-economic outlook and discuss its possible implications for companies. Given the unprecedented uncertainty in the global economic environment, this document represents our current, but evolving perspective.

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Since the global financial crisis took a turn for the worse in September of this year, pundits and commentators have pointed to China as a potential savior. With an 11 percent GDP growth rate as recently as 2007, and almost \$2 trillion in foreign exchange reserves, China potentially has the heft to help lift the world out of the current malaise. The reality, however, is that China now faces its own domestically-driven slowdown and is also exposed to the effects of the global crisis. Longer-term growth prospects are still strong, driven by urbanization and productivity trends that in our view remain largely unaffected by current economic conditions.

Consensus forecasts call for China's growth to slow to 8.2 percent in 2009¹ [Exhibit 1]. Given sharper slowdowns in other regions, China's contribution to global GDP growth is likely to almost double, growing from 17 to 27 percent. The composition of China's growth will shift significantly from investment and export-led growth in 2007 to government expenditure-led growth in 2009.

Exhibit 1

Consensus forecasts call for China to grow at 8.2% in 2009 and contribute over a quarter of global GDP growth



* Based on IMF forecast using real effective exchange rate (forecast released on Nov 6, 2008)
Source: Global Insights; IMF; EU Commission; analyst reports; McKinsey Global Institute analysis

¹ Ranging from the IMF's 8.5 percent forecast of November 10, 2008 to the World Bank's 7.5 percent forecast of November 25, 2008

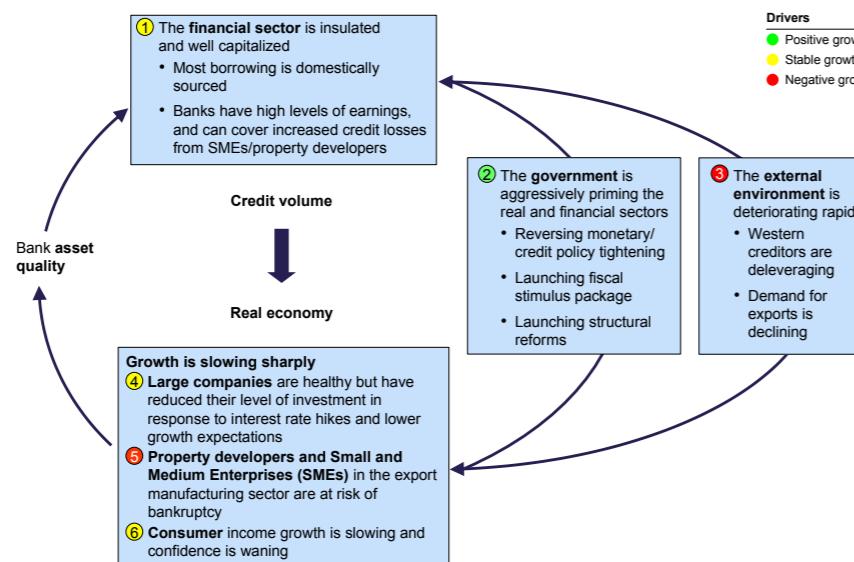
The slowdown in external demand, softening of domestic demand, and slowdown in investment would, if unmitigated, call for a hard landing scenario in China next year (i.e., GDP growth potentially less than 6 percent). However, the monetary and fiscal measures taken by the government are likely to fill the gap necessary for China to achieve its target growth rate of 8 percent.

The key downside risk to the economy is a deflationary cycle caused by a lack of external demand, a continued drop in commodity prices, and domestic overcapacity. If expectations of continued decline in prices become entrenched, consumers and businesses could postpone their spending and provoke a self-reinforcing deflationary cycle. However, although some modest short term deflation may occur next year, we view the prospect of a prolonged deflationary cycle as unlikely. There are many productive investment opportunities for both the government and the private sector in construction and beyond. This limits the risk of unproductive stimulus (i.e., “bridges to nowhere”) or a prolonged business investment slowdown.

On the positive side, China can count on a relatively insulated financial system as well as a financially strong government committed to sustaining growth of its economy [Exhibit 2]. The real economy is largely healthy and corporate profits have been at record levels over the last few years (15 percent average

Exhibit 2

The outlook for China's economy in the short-term is driven by the interaction of key strengths and vulnerabilities



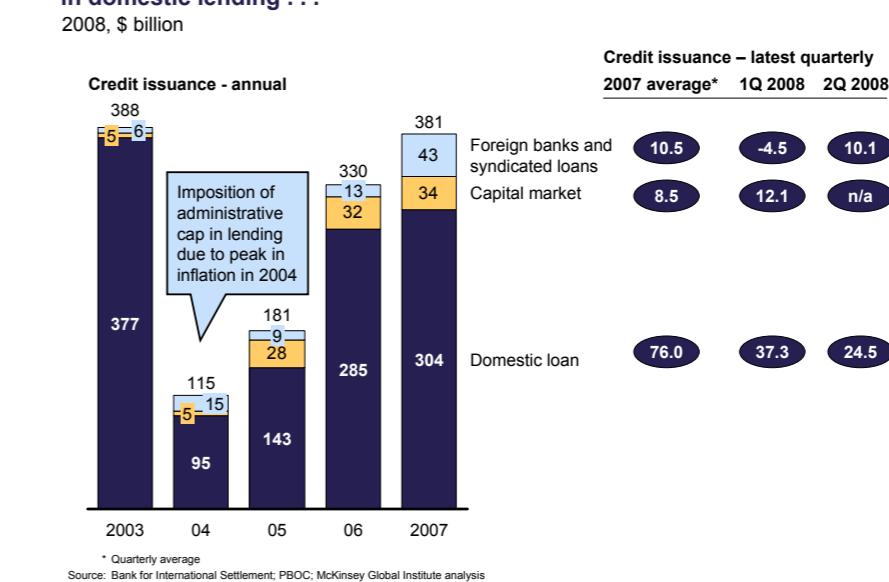
ROE for large Chinese corporations from 2004 to 2007) even as the pace of private investment growth slowed (large corporate capex growth slowed from a CAGR of 20 percent in 2005-07 to 11 percent in 2008 yoy). The two largest vulnerabilities the economy faces are in the export manufacturing and property development sectors, which are likely to see a continued spike in bankruptcies.

THE FINANCIAL SECTOR IS STABLE

China's financial sector is insulated, profitable and, given the recent reversal in monetary tightening, poised to support strong credit growth. Chinese credit markets consist mostly of domestic bank lending to businesses [Exhibit 3]. Foreign credit makes up less than 10 percent of the total and thus can be

Exhibit 3

Most recent trends in credit issuance (Q1 and Q2 '08) indicate a slowdown in domestic lending . . .

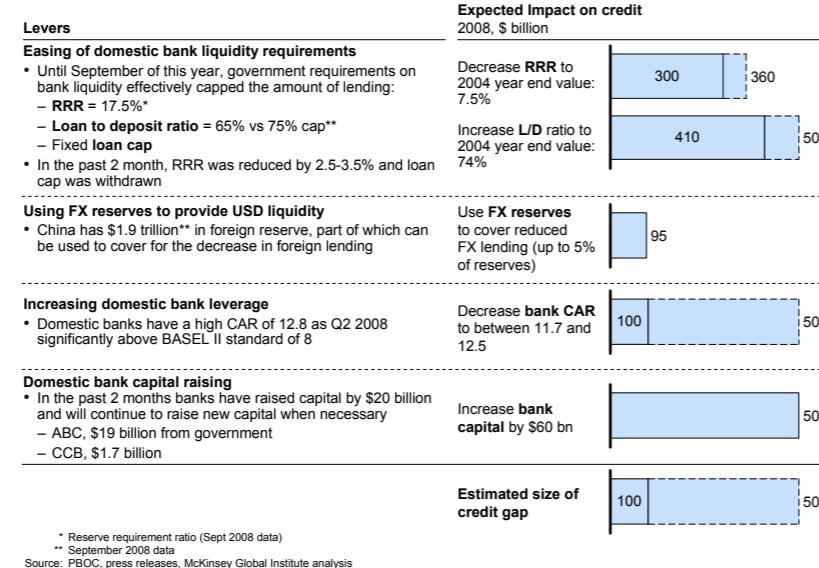


covered through increased domestic lending. Domestic bank credit losses are likely to rise due to vulnerability in the export manufacturing sector, and persistent failures in risk management in the property development sector. We estimate that the effects of a reduction in foreign lending, capital market issuance, and increase in domestic bank credit losses could lead to a gap in credit growth of between \$100 and \$500 billion over the next two years relative to the level of credit growth required to maintain an 8 percent GDP growth rate.

However, the government is already taking aggressive steps to increase bank lending through interest rate policy and provision of additional liquidity through the elimination of loan caps and lowering of reserve requirements [Exhibit

Exhibit 4

China has many levers to cover a potential credit gap; therefore, do not expect a slowdown in credit supply growth



4]. In essence, the authorities are relieving a self-induced credit crunch. Moreover, even under a worse case scenario where credit growth falls \$500 billion short of what is needed, Chinese banks need to either raise \$60 billion of new capital or lower their Capital Adequacy Ratio (CAR) from 12.8 percent to between 11.7 and 12.5 percent to be able to fill the lending gap – all manageable. While the overall volume of credit growth is sustainable, demand and distribution is more problematic. China's Small and Medium Enterprises (SME), in particular, may face a tight credit environment, as banks may have incentives to direct most of their lending to more creditworthy corporations and State-owned Enterprises (SOE). The old problem of Chinese banks being unwilling to lend to unfamiliar and risky private companies and SMEs will be particularly acute in the next two years.

THE GOVERNMENT IS PUMP-PRIMING THE ECONOMY

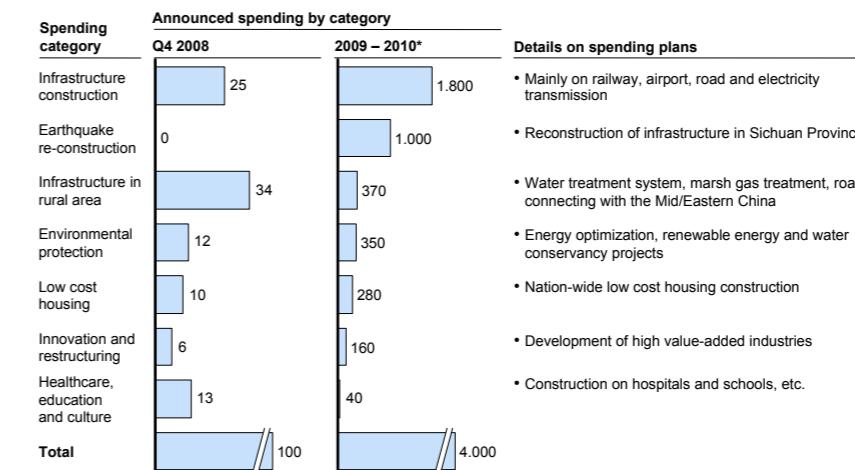
Beyond monetary policy, the government is coming to the aid with expansionary fiscal policy. The Chinese government recently announced an approximately \$590 billion (4 trillion renminbi) stimulus package to signal the authorities' commitment to sustaining growth. However, the actual impact of this package will depend on how much of it is actually new spending and how effectively it is used. We estimate the impact of the package on GDP to be between 1 and 2 percent depending on the extent of the slowdown over the next few quarters. This corresponds to between \$75 and \$150 billion of actual new expenditure (0.5-1 trillion renminbi). In response to the central government's commitments, local governments announced massive packages, totaling \$2.6 trillion (18 trillion renminbi). Although skepticism on the actual size of programs remains, the announcement is intended to signal that local governments stand behind the central government in their commitment to sustain growth.

Infrastructure (in particular rural infrastructure, railways, housing, roads and airports) is expected to be the focus of the spending, although social welfare spending would also increase [Exhibit 5]. Spending on social welfare, although essential to refocus the economy towards domestic consumption over the

Exhibit 5

The package is mainly focused on rural, communications and social infrastructure as well as housing

RMB billion



medium-term, has a lower short term multiplier effect. The effectiveness of the stimulus will also depend on the timing (it is notoriously difficult to change consumer sentiment once it becomes entrenched) as well as the government's ability to implement policy directives at the local level and minimize corruption.

The stimulus package is likely to benefit the transportation, infrastructure, logistics, energy and materials sectors most due to massive investment on railways, roads and construction. Healthcare and pharmaceuticals will also benefit due to the expected increase in social welfare spending. Companies in these sectors should expect an uptick in demand from the implementation of the package.

LARGE CHINESE COMPANIES ARE HEALTHY ...

The liquidity and solvency positions of Chinese corporations across all sectors are for the most part healthy [Exhibit 6]. Profits of SOEs reached a record level of \$240 billion in 2007. In 2008, the level of profitability moderated due to higher raw materials and funding costs. Tightening credit also led companies in several sectors to slow the pace of investment growth [Exhibit 7]. Expect this

Exhibit 6

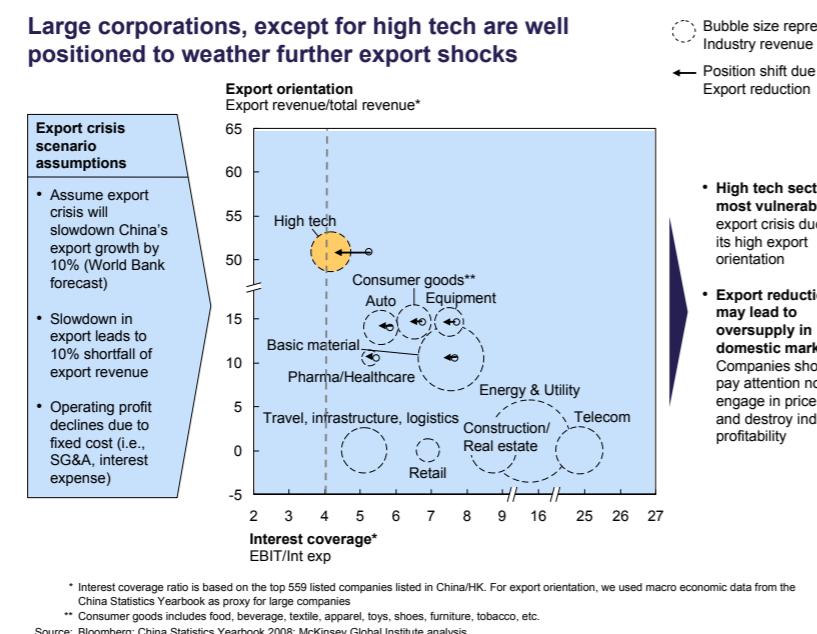
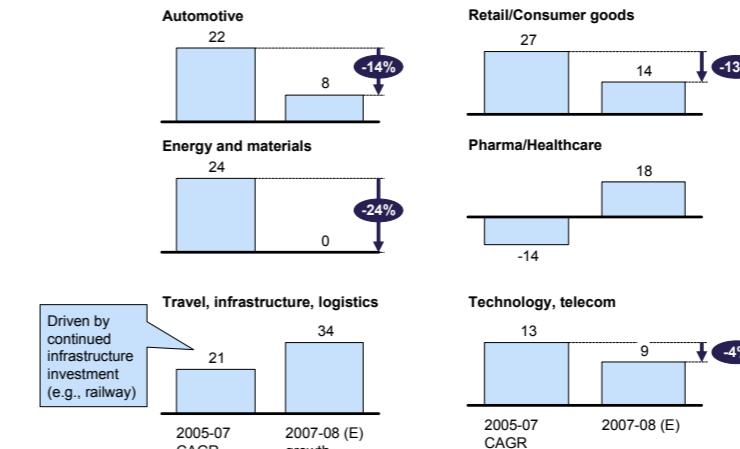


Exhibit 7

Investment growth has slowed significantly in 2008 due to tightening credit and lower growth expectations

Real Capex growth*, percent, Top 559 companies listed in China/HK, 2008**



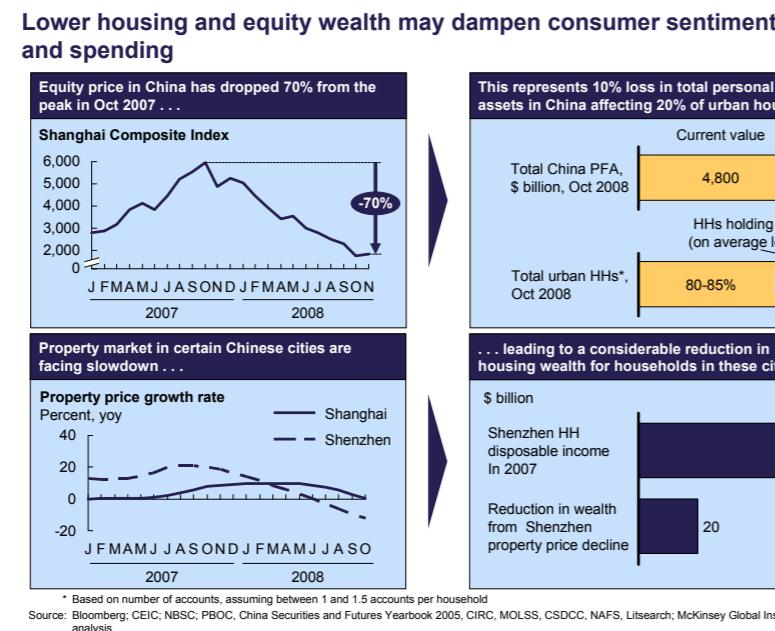
slowdown to continue driven by lower growth expectations both domestically and abroad. Additionally, the slowdown in investment could lead to bottlenecks in transport in particular if a recovery takes place sooner than expected. However, the potential inflationary pressure of such bottlenecks would actually be a positive factor to counteract any deflationary trend that might set in.

... BUT THE CONSUMER IS SUFFERING

Consumer income growth is slowing and confidence is waning. The key drivers of consumption (i.e., household income and propensity to consume) indicate a slowdown in consumption growth in the short term. Growth in real urban disposable income per capita slowed from 13 percent in 2007 to 7 percent in 2008 Q1-Q3 yoy, and is expected to continue to slow in line with lower GDP growth. The slowdown in overall activity is also reflected in the labor market where unemployment has spiked as reported by Chinese officials ("Demand for workers in 84 cities across China has fallen by 5.5 percent, the first quarterly drop in many years" – Zhang Xiaojian, vice-minister of social security). We expect the employment situation in the manufacturing sector to further deteriorate in the short term as the full effects of the export shock are felt.

Urban household wealth has also been diminished by the collapse of the stock market and the downturn in property markets in certain cities (e.g., the Shenzhen average home price is down about 10 percent this year [Exhibit 8]).

Exhibit 8



For instance, we estimate the decline in the Chinese stock market has reduced personal financial assets of Chinese households by 10 percent from 2007 to 2008 year-to-date. The decline in wealth is also reflected in consumer confidence which has dipped to a four-year low. The effects of lower confidence are most likely to be felt on big ticket luxury goods, which had been growing rapidly in China. For example, in the last four years, car sales have been growing at a compound annual growth rate of 33 percent, compared to overall retail sales, which have grown 20 percent during this period.

THE EXTERNAL ENVIRONMENT IS DETERIORATING RAPIDLY

In 2001, during the “tech wreck” recession, Chinese export growth declined by 20 percentage points, affecting all categories of Chinese exports. The reduction in external demand is likely to be significantly more severe this time as the expected slowdown in global GDP is expected to be larger [Exhibit 9]. In 2001, world GDP grew at 2.5 percent in real terms; the forecast for next year

Exhibit 9

Chinese total exports have so far held up, however, expect a significant slowdown in export growth over the coming year

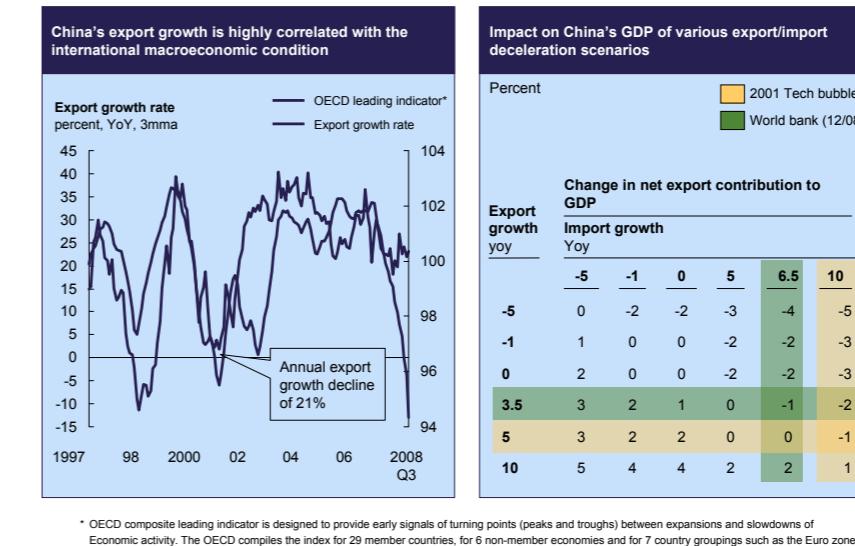
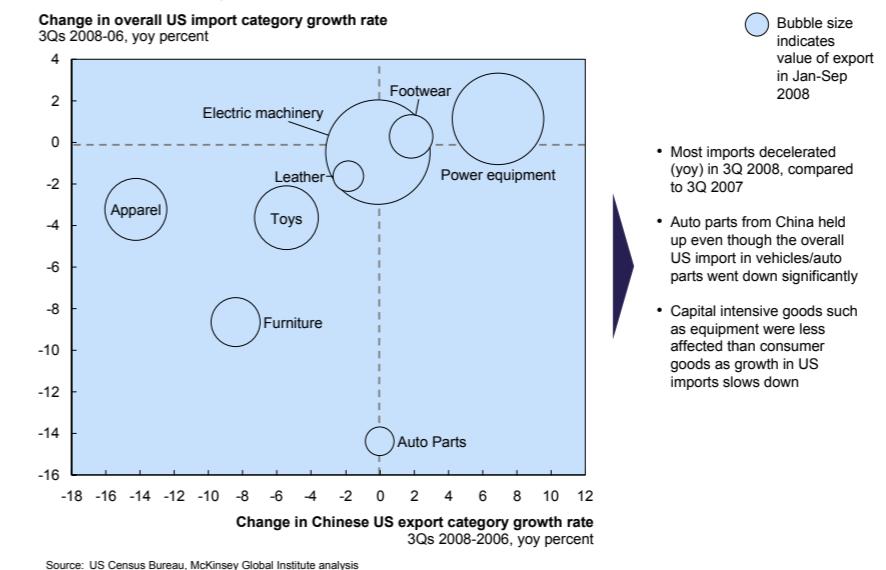


Exhibit 10

Most exports to the US have already decelerated: apparel, furniture, and toys have been hit the most in the last 3 months

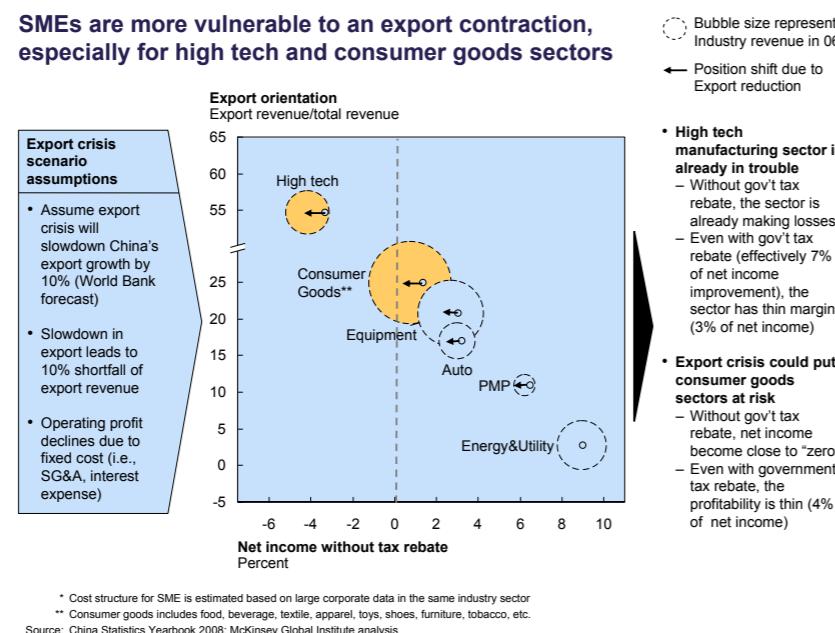


from the IMF (World Economic Outlook Nov 2008) calls for global growth of 2.2 percent. The fact that Chinese exports are now more regionally diversified than in 2000 provides only limited comfort as very few regions are maintaining export demand growth. In the past 3 months, growth of Chinese exports to the US slowed sharply in categories such as toys, furniture, and apparel [Exhibit 10]. Although these categories seem to be taking the biggest hits, other large export categories (e.g., machinery, auto parts) may also face a slowdown in the next few months. As a reference, no major export category maintained the pre-crisis level of growth in 2001. In addition, although Chinese businesses are less reliant on trade finance than businesses elsewhere, the reduction in trade finance liquidity can exacerbate the export shock in the very near term. This is likely to be true especially for SMEs.

BANKRUPTCIES ARE ON THE RISE

Property developers, particularly smaller ones, and SMEs in the export manufacturing sectors are at risk of bankruptcy [Exhibit 11]. SMEs in manufacturing, particularly in the high tech and consumer sectors, are marginally profitable today and highly vulnerable to an export demand shock.

Exhibit 11



Even after considering the government's tax rebates, we estimate that a reduction in revenue of 10 percent from falling export demand will reduce margins for high tech and consumer SMEs to between 3 and 4 percent on average. Property sales are down and inventories are rising, leading to widespread expectations of rising defaults among property developers. As an example, an analysis of five major Chinese property developers² shows that even if these developers are able to refinance their short term loans, they will not have sufficient cash to cover land premium payments.

IMPLICATIONS OF THE MACRO OUTLOOK

Maintaining prudent business management and moving quickly to secure emerging opportunities should be the focus of businesses' China agenda. Possible actions in the current environment include:

- Take the opportunity to attain a new level of performance reflecting the harsher climate both domestically and internationally. Companies have opportunities to optimize their operating performance (i.e., manufacturing, supply chain, purchasing, back office, etc.). Success in driving performance improvement now will determine how well a company positions itself for the recovery
- Conserve cash and raise financing in the short term. The days of highly leveraged working capital finance is over. Where possible, look for export insurance and government finance support programs, and also lean on suppliers and buyers to extend terms
- Use cash to secure market leadership. Many Chinese companies have large cash reserves that can be used to acquire smaller players in distress and consolidate the industry. They can also look beyond China and acquire depressed assets in the West that allow them to address key gaps in technology, talent, and global presence. Opportunities to take positions in other Asian economies should not be ruled out
- Prepare to address supply chain risks due to vulnerabilities in the SME sector. Many SMEs in the technology and manufacturing sectors are already underwater; the situation will only worsen with further export shocks
- Recognize shifts in consumer behavior as a result of the crisis (e.g., preference for value), and adjust customer value propositions accordingly

² DBS Vickers Securities, China Banking Sector Outlook, September 24, 2008

For financial institutions, this may be a unique opportunity to capture market share in the intermediation process, but managing credit risk will also be important. Possible actions for financial institutions to undertake include:

- Capture benefits of re-intermediation from reduction in foreign funding and capital markets borrowing. Seize lending opportunities, particularly with safer large cap companies and raise pricing where possible. Strengthen risk management to build capability to expand lending within the current environment
- Launch deposit gathering initiatives, particularly for smaller network banks (target corporate funds, launch retail deposit campaigns). For all banks, be particularly aggressive in gathering US dollar deposits
- Address rising NPLs: Conduct immediate lending portfolio triage to identify loans to export oriented, dollar or trade finance funded companies, and develop strategies to deal with high-risk cases. Carefully monitor rising delinquencies and sudden draw-downs and consider selective loan sell-downs
- Take advantage of financing opportunities related to the government stimulus package. Part of the stated focus of the government stimulus package is to “seed” private investment by partially funding private investment projects
- Selectively pick-up available talent to enter new businesses. Target specific talent from weak or acquired foreign institutions to enter new businesses, particularly in wholesale banking

* * *

China is certainly not immune from global events, but it is in a comparatively strong position due to the insulation of its financial institutions, the solvency of its large companies, and the significant intervention the government is undertaking. These strengths will likely help China avoid the kind of severe downturn we are likely to see in other regions and make it an even more important source of growth for businesses in the coming years.

Greater China Office
November 2008
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