

McKinsey Global Institute



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# If you've got it, spend it: Unleashing the Chinese consumer



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# If you've got it, spend it: Unleashing the Chinese consumer

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## Preface

China is on course to become the world's third-largest consumer market by 2020. Nevertheless, private consumption constitutes a remarkably low share of China's economy, whose rapid growth in recent years has come on the back of a development model that has rested heavily on industrial investment and exports. Even before the global financial crisis buffeted China and proved its vulnerability to a downturn in its key export markets, the political leadership of the People's Republic had set itself a new aim of rebalancing its economic mix and boosting the consumption share of the economy. If China succeeds in this aim, it would not only boost GDP, jobs, and incomes, but it would also insulate itself from volatility imported from overseas.

As a contribution to the policy debate on China's evolving economic model, the McKinsey Global Institute (MGI) and McKinsey & Company's China practice have analyzed the most important policy levers that could propel China toward the goal of a higher share of consumption in China's economy.

Janamitra Devan, an associate partner based in Shanghai, directed this work. The working team led by Micah Rowland comprised MGI fellows Adam Eichner and Stefano Negri and also included Pia Chock, a consultant from the Shanghai office.

When evaluating the impact of improving the consumer infrastructure, the working team incorporated work done by another McKinsey team, which included Yuval Atsmon, Yougang Chen, Feng Han, Aaron Huang, Kevin Huang, Wenkan Liao, Elaine Lou, Alex Peng, and Lili Rong. We benefited enormously from the expertise and advice of McKinsey colleagues Gordon Orr, Yi Wang and Yehong Zhang in Shanghai, and David Skilling in Singapore.

The working team is also indebted to our MGI China Modeling team colleagues John Gao, Yangmei Hu, Xiujun Lillian Li, and Song Mei for their modeling work, which formed the basis for many of our analyses; and to Vivien Singer of McKinsey's North American Knowledge Center; Janet Bush, senior editor at MGI, for her editorial help; Glenn Leibowitz and Rebeca Robboy for their advice on external communications; and Helen Zhang, MGI Administrator in Shanghai, who also served as our team assistant.

The research was greatly enriched by the advice of external experts. We would like to thank Jonathan Anderson of UBS; Martin Baily of the Brookings Institute; Xiao Geng of Tsinghua University and Brookings; David Dollar, Ardo Hansson, and Louis Kuijs of the Beijing office of the World Bank; and Laura Tyson at the University of California at Berkeley.

This work is part of the fulfillment of MGI's mission to help global leaders understand the forces transforming the global economy, improve company performance, and work for better national and international policies. As with all MGI research, we would like to emphasize that this work is independent and has not been commissioned or sponsored in any way by any business, government, or other institution.

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## Executive summary

There is recognition at the highest political level in China that the economic paradigm that has served the People's Republic so well thus far is no longer fit-for-purpose. China's investment-led model has skewed the economy toward industry and has made corporate investment too cheap, leading to inefficient investment in excess capacity. Reliance on exports has left China exposed to a downturn in its major markets. As the global fallout of the US financial crisis has put new strain on China's current development model, the case for shifting toward a stronger reliance on domestic consumer spending has gathered force.

In March 2007, Chinese Premier Wen Jiabao surprised outside experts at an important annual planning forum by confessing that he feared China's economy suffered from "structural problems" resulting in development that was "unsteady, unbalanced, uncoordinated, and unstable." Indeed, Premier Wen and the rest of China's senior economic leadership recently made the promotion of domestic consumption a critical pillar in the drive to sustain economic growth in the long term—a strategic shift that has potentially profound consequences not only for China but also for the global economy.

In view of this new priority, the McKinsey Global Institute (MGI) undertook to build an understanding of the drivers behind China's low consumption share and to identify potential policy initiatives that could contribute to a rebalancing of China's growth model over the next 15 years. In tandem with a large short-term stimulus package to help the economy weather the current economic crisis, China's government has already embarked on many aspects of this shift, including reforms to health care, education, and the pension system. This report seeks to quantify how this range of other initiatives could, if fully enacted, affect today's low consumption share of GDP.

### **CHINA CAN BOOST CONSUMPTION SHARE OF GDP TO 50 PERCENT BY 2025**

The research demonstrates that it is possible to boost China's consumption share of GDP from 36 percent in 2005 to 45 to 50 percent by 2025, 6 to 11 percentage points above trendline projections of 39 percent (Exhibit E1).<sup>1</sup> By sizing the potential of initiatives in different policy areas to boost China's consumption share, the research suggests some of the priorities that China might set if it is to successfully vault the economy into a new phase in its evolution. It will take a concerted and urgent effort on multiple fronts by both the public and private sectors to overcome the entrenched industrial model that has dominated China's economy in recent decades. But the prize would be an economy that is less vulnerable to ill winds blowing in from overseas, higher levels of efficiency, 15 percent higher average household incomes relative to trend, and a new economic maturity that will stand China in good stead in the long term.

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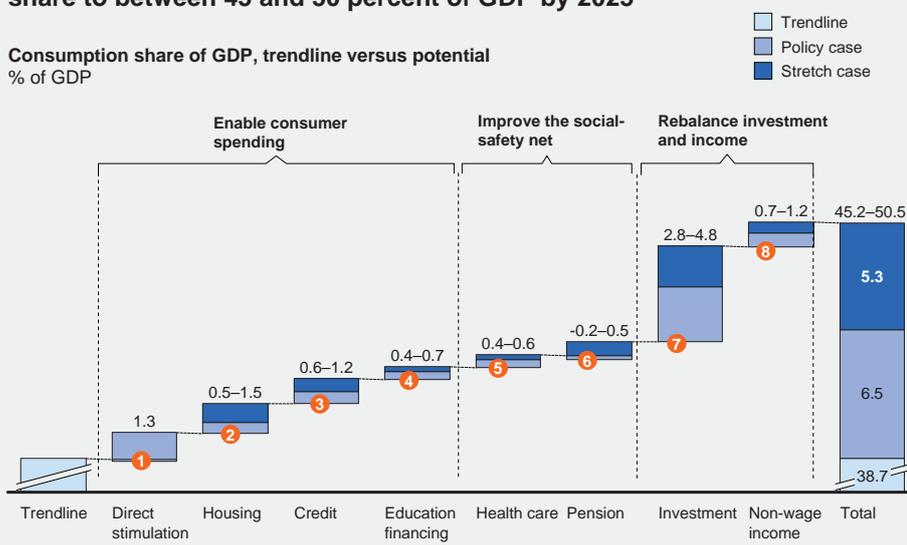
<sup>1</sup> Unless otherwise stated, the word "consumption" here and in the rest of this document refers to private household consumption only.

Private consumption in China today accounts for only a 36 percent share of overall GDP—the lowest percentage of any major economy in the world, reflecting China's reliance thus far on a giant investment machine that crowds out consumption. Even at its low during World War II when consumption dropped in favor of massive industrialization to support the war effort, the US consumption share of GDP never dipped below around the 50 percent mark. Looking at major Asian economies today, Japan's consumption share stands at 55 percent and South Korea's at 48 percent. The shares in two relatively consumption-heavy Western economies—the United States and the United Kingdom—are 71 and 67 percent, respectively. While there is no optimal level for the share of consumption in an economy—some observers might argue that a consumption share of around 70 percent is as unbalanced as China's 36 percent—a share closer to 50 percent would bring China in line with its peers in Asia today.

**Exhibit E1**

**Meeting all top-line policy objectives could raise China's consumption share to between 45 and 50 percent of GDP by 2025**

**Consumption share of GDP, trendline versus potential**  
% of GDP



SOURCE: Global Insight; McKinsey Global Institute China Model; McKinsey Global Institute analysis

According to trendline macroeconomic forecasts and assuming that policy makers were to do nothing to stimulate consumption further on a sustainable basis, China's low consumption share will, at best, moderate upward only slightly over the next 15 years. However, MGI believes China could pursue policies that would boost consumption by 8 trillion to 15 trillion renminbi by 2025 (unless otherwise noted, all figures are listed in real 2000 renminbi terms)—by comparison, the high end of this range is slightly greater than the entire GDP of France today. This would increase consumption's share in China's economy by an incremental 6 to 11 percentage points to between 45 and 50 percent by 2025 on current GDP growth assumptions. On a per capita basis, this would translate into consumption that is 5,500 renminbi to 10,600 renminbi higher (26 to 50 percent) than forecasts based on current trends.

Our analyses estimate the impact of several policies that will likely contribute to a reduction in China's private household savings rate, which surveys today estimate at 25 percent of average per household disposable income. We believe that by 2025, compared with a trendline value of about 17 percent, these policies could reduce household savings rates by between 6 and 12 percentage points, leaving Chinese consumers' savings rates at somewhere between 5 and 11 percent of household disposable income. Although popular dialogue about Chinese consumption

frequently mentions consumer savings rates, we find that even these relatively large changes in savings behavior would result in increases of, at most, 2 to 5 percent in China's consumption share, relative to trendline, less than half of the potential change of 6 to 11 percentage points of additional consumption share possible for China.

Given the relatively small impact of such a significant change in savings rates, our findings suggest that although changes in consumer spending and savings behavior are certainly part of the solution, measures to drive more of China's income to households are at least as important in bridging the gap to a higher consumption share.<sup>2</sup> What is more, many of the policy changes that will be required do not directly relate to consumer behavior but rather aim to encourage more efficient investment and capital allocation, which would ultimately create faster growth in private income. Eventually, these policies are likely to be as big a factor, or bigger, in China's rebalancing as changes in the social-safety net or consumers' spending behavior.

### **HIGHER CONSUMPTION WILL MAKE GROWTH SUSTAINABLE**

The benefits of these policies will extend beyond simply increasing the consumption share in China's economy. Consumption- and service-led economies tend to create more jobs per unit of investment, accompanied by higher wages per dollar invested. China could expect the same impact; by hitting a consumption share in the range of 45 to 50 percent of GDP, China could experience stronger job creation, a boost to average household incomes of 10 to 20 percent, and a strong fillip to domestic firms and entrepreneurs, particularly in the retail and service sectors.

China would also lessen its vulnerability to external shocks, diminish the need to build up foreign reserves, and together with other policies help to ease international tensions that have arisen because of large global trade imbalances, as its trade surplus narrows by 25 to 40 percent by 2025.<sup>3</sup> Moreover, using natural resources such as fossil fuels, water, and land less intensively would mitigate environmental pressures.

If these benefits were not enough, the shift to a consumption-driven economy detailed in this analysis also has the potential to add significantly to China's total economic output relative to trendline forecasts. This results from a combination of higher consumer spending and greater government consumption, both of which, in turn, spur additional job creation and GDP growth. Accounting for these multiplier effects, China's transition could result in a GDP level that is 6.5 trillion to 11.9 trillion renminbi, or 8 to 15 percent, higher than currently projected for 2025 (Exhibit E2). This implies an additional 0.8 to 1.2 percentage points on top of an already rapid GDP compound annual growth rate (CAGR) of 7.7 percent between 2010 and 2025.

From a global perspective, China's share of world consumption would increase to between 11 and 13 percent in 2025, up from 8.9 percent that we project on current economic trends. This would, in turn, mean that China would account for more than 25 percent of consumption growth worldwide over the next 15 years, up from 18 percent on trend.<sup>4</sup>

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2 The study recognizes that there are other measures to increase the share of GDP going to household income, such as minimum-wage policy, the better organization of labor, and so on—measures that have proved effective in other countries. We will consider these areas in future research.

3 MGI projected several macroeconomic scenarios using GDP projections from Global Insight.

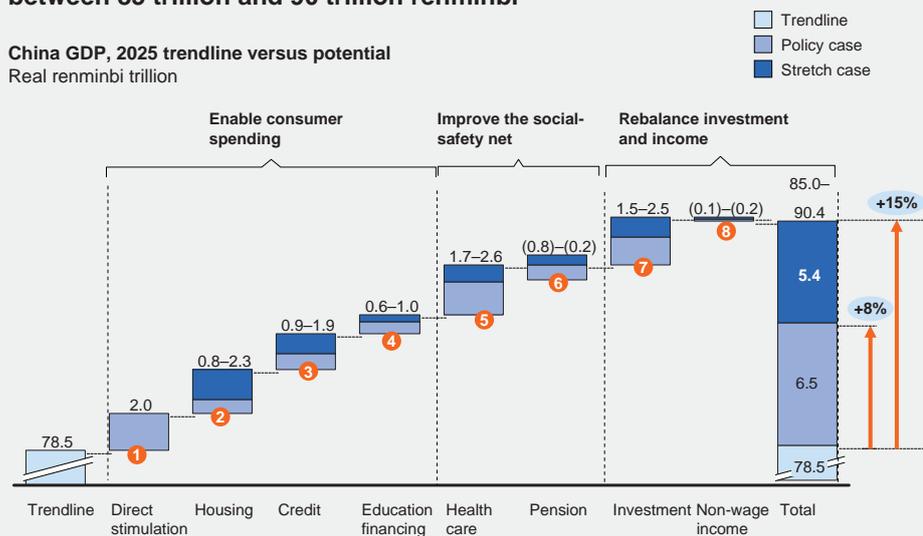
4 This calculation assumes that global real GDP growth tracks trend at 2.9 percent a year between 2008 and 2025.

Securing these domestic and international benefits will necessitate moving toward a new development paradigm—initiating policies on a broad front simultaneously to have a high chance of success. Today's low consumption share is systemic, and China will not be able to tackle this issue without comprehensive reform that includes structural change.

**Exhibit E2**

**These policies could also raise China's 2025 GDP by 8 to 15 percent to between 85 trillion and 90 trillion renminbi**

**China GDP, 2025 trendline versus potential**  
Real renminbi trillion



Note: Numbers may not sum due to rounding.

SOURCE: Global Insight; McKinsey Global Institute China Model; McKinsey Global Institute analysis

**CHINA CAN REBALANCE TOWARD CONSUMPTION**

MGI has identified and quantified a set of three broad groups of policies that could help China raise its consumption over the next 15 years. Our research does not make policy recommendations, so much as attempt to estimate the impact on the economy and on consumption share of pursuing policy objectives.

To reflect different potential degrees of uptake and implementation of these policies by China, this research looks at two scenarios—the policy case and a stretch case—and compares the impact of policies in each with a trendline case based on the current macroeconomic forecasts.

The policy scenario comprises a set of policies and reforms that China is already pursuing and that is likely to affect the consumption share of GDP to some degree—whether or not this is the explicit intention of these policies. In the policy case, China could increase the consumption share up to six percentage points above trendline by 2025 to reach a 45 percent share by 2025 compared with 39 percent in our trendline scenario. If China achieved this shift, it would boost total GDP by approximately 6.5 trillion renminbi and private consumption by approximately 8.0 trillion renminbi—resulting in GDP 8 percent higher than trendline GDP and private consumption 26 percent higher than trendline. Per capita consumption would rise from a projected 21,000 renminbi in 2025 to more than 26,600 renminbi.

Our stretch scenario assumes more aggressive action on each of the issues we outline in this research. In this scenario, China could reach a 50 percent consumption share, boosting GDP by 11.9 trillion renminbi and consumption by 15.2 trillion renminbi—15 percent and 50 percent above trendline, respectively. In this scenario, per capita consumption could reach more than 31,700 renminbi.

### **China can directly enable consumer spending**

This group of policies comprises a range of relatively short-term initiatives focused on creating a more comprehensive “consumption infrastructure” that would make it easier for Chinese citizens to purchase a wider range of products and services than are available to many Chinese today. Some of these changes would require that consumers save less of their disposable incomes, while others would allow them to consume sooner through the use of consumer credit. There are two major policy thrusts for China to consider:

1. **Expanding the availability and improving the quality of products.** Action on this front could add 1.3 percentage points to the consumption share by 2015 and maintain this level through 2025. Today, there is a huge gulf between the retail and consumer experience available in China’s larger and wealthier cities and that in smaller cities and rural areas. Actions might include supporting the development of modern store formats, channels, and distribution networks (e.g., secondhand and leasing markets for cars, online shopping for many categories) and encouraging the continued development of both international and domestic players throughout the consumer industry.
2. **Increasing the availability and uptake of consumer credit.** The availability and use of consumer credit is currently low in China in comparison with other countries, even those within Asia at similar development levels. Measures to increase the availability of credit and to encourage consumers to increase their use of credit as a means of responsibly financing home purchases, education, and a broader set of consumption needs would allow consumers to borrow against future income to make big-ticket purchases that would increase their quality of life today. If pursued wisely, this would contribute to a potential boost in consumption share of 1.5 to 3.4 percentage points and ultimately help generate more wealth for Chinese households in the future.

Together, this group of policies combined has the potential to add between 2.8 and 4.7 percentage points to China’s consumption share by 2025. GDP in 2025 would be higher than trendline projections by 4.2 trillion renminbi to 7.2 trillion renminbi, or between 5.4 and 9.2 percent. Total private consumption spending increases would constitute the bulk of this rise, accounting for between 4.1 trillion renminbi and 7 trillion renminbi in higher expenditure relative to trendline, or about 13.5 to 23.1 percent higher than trendline. On a per capita basis, private consumption spending would increase by between 2,800 renminbi and 4,900 renminbi.

### **An improved social-safety net would boost health-care and retirement spending**

Since the beginning of the reform era, large changes in the funding and delivery of social services such as health care and pensions have undermined both the quantity and quality of benefits provided to Chinese citizens. Improving the social-safety net provided by the government will reduce precautionary over-savings, increase total spending on health care and retirement, and cause discretionary consumer spending to rise. But improving China’s social-safety net is a critical step forward for a number of reasons that go beyond merely boosting consumption. Greater public provision will help guard against the potential for social instability that may result from the inequities engendered by the rapid economic growth and urbanization that China is experiencing today. In addition, higher quality health care and pensions will foster labor-productivity gains over the long term and further improve China’s growth prospects.

Despite the overall significance of these policies and the frequency with which they are cited as a major cause for low consumption, we find that the increased government spending required to expand access to, and improve the quality of, health care and pensions will somewhat limit the total impact on private consumption share of GDP. Even though improved social-safety net coverage has the potential to boost total private and government spending on health care and other categories by between 4 trillion and 11 trillion renminbi annually by 2025, it would add only 0.2 to 1.1 percentage points to China's consumption share. Private consumption would be 480 billion renminbi to 1.9 trillion renminbi, or 1.6 to 6.3 percent, higher than trendline projections, resulting in a boost to annual per capita consumption of between 300 renminbi and 1,300 renminbi. Overall, this would contribute additional GDP totaling between 900 billion renminbi and 2.4 trillion renminbi beyond trendline projections, or about 1.6 to 3.4 percent higher than the trendline 2025 value.

### **Undertaking structural reforms would increase household income**

This group of policies comprises a wide-ranging set of measures affecting the financial system, industrial policy, international trade, and many other aspects of China's political economy. This family of policies would require the largest structural shift of the three discussed in this report and, even if significant changes are made in policy, the full impact on consumption share and the macro structure of the economy may not be felt until far later than the 2025 time horizon we examine. However, our analysis shows that, even by 2025, if China can achieve a significant shift toward service industries and undertake financial-sector reforms that would drive higher growth in non-wage sources of income, it would add between 3.5 and 6.0 percentage points to consumption share.

**Shifting toward services.** China's political leadership recognizes that shifting investment to more efficient and labor- rather than capital-intensive service sectors would have a multiplier effect on employment, economic growth, and consumption. If the government were to target and achieve three percentage point increases in the services share every five years after 2010, as was the goal in the 11th Five Year Plan released in 2005, services would reach 49 percent of GDP in 2025. Such a moderate shift would raise average household income by 9 to 10 percent above 2025 trendline values as employment in services grows more rapidly and productivity gains drive wages up. However, the consumption share of GDP would rise by only 2.8 percentage points because of the increases in investment that would also be required, partially offsetting consumption gains. If China could engineer an even more dramatic shift (imagine, as some commentators have, a move toward South Korea's level of services, at about 55 percent today), it might bring in even higher income gains of up to 20 percent and a correspondingly higher boost in consumption share of up to 4.8 percentage points. Such a shift would require significant investments in human capital and technology in order to improve productivity growth and allow more than 100 million additional workers to move into service sector jobs.

**Improving investment-related sources of household income.** At less than 2 percent of average household income, investment-related sources of income in China are low compared with other countries, and these sources have not been increasing as a share of total income. Today, the real return on financial assets in China is only 0.5 percent, compared with 1.8 percent in South Korea and 3.1 percent in the United States.<sup>5</sup> Although improving returns on household assets over the long-term would require

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5 *Putting China's capital to work: The value of financial system reform*, McKinsey Global Institute, May 2006 ([www.mckinsey.com/mgi](http://www.mckinsey.com/mgi)).

significant changes in China's financial system, much progress is possible simply by giving high-saving households access to a greater array of financial products and services such as mutual funds, fixed-income products, annuities, CDs, and so on. For every additional percentage point of income coming from investment-related sources by 2025, the consumption share should rise by approximately 0.3 to 0.4 percentage points. For example, increases in investment-related sources of income from 1.7 to 3.4 percent of average total household income would add 0.7 percentage points to the consumption share. Increasing investment-related sources of income as a share of the total to 5.1 percent would add 1.2 percentage points to the consumption share.

Three policy areas are particularly promising as China aims to shift toward services and boost incomes:

1. **Encouraging financial-sector liberalization.** China could boost non-wage sources of income by reforming the dividend policy for state-owned enterprises (SOEs) and encouraging the creation of a wider array of financial instruments to enable greater household participation in financial markets. Taken together, action on these fronts would encourage firms to make more judicious investment decisions and allow households to share in the profits generated by those firms, reaping dividends and realizing higher returns on their assets over time. This would help to reallocate capital toward private citizens or service sectors. China is already actively engaged in financial-system reforms, but the reform program is behind schedule and, in any case, China should consider broadening the scope of its plans for banking and capital market liberalization and development as part of its aim of shifting toward a higher consumption share.
2. **Aggressively pursuing greater investment efficiency and consolidation in industry.** There is considerable scope in China to consolidate industries, particularly relatively mature ones such as steel and cement, and thereby boost productivity. Boosting efficiency is also vital. Scarce resources such as water, coal, and land, as well as capital, are often available to industry at below-market rates today. Scaling back the government's direct and indirect subsidies designed to bolster industry's growth—for example, by adjusting tariffs or by encouraging more commercially based lending decisions—could promote higher efficiency in both the investment and consumption of resources. The government may need to institute a system for taxation of resource usage in order to allow corporate cost structures and capital allocation mechanisms to more accurately price in the cost of China's resource intensity.
3. **Supporting the development of SMEs.** The growth of the service sector is likely to hinge on the successful development of small and medium-sized enterprises (SMEs). Today, these companies face a number of barriers to market entry and growth (in common with their counterparts in other developing countries). Reform of business licensing procedures, more supportive labor market policies, and easier credit access are necessary if service-sector SMEs are to increase their share of China's economic activity.

These policies could boost private consumption spending by 3.4 trillion to 6.3 trillion renminbi above trendline, or about a 10 to 20 percent increase. Per household private consumption would rise by between 8,000 and 15,000 renminbi per year, as households capture more of the benefits from China's growth in the form of 10 to 20 percent higher average per household incomes and, relative to the trendline, GDP would be boosted by 1.4 trillion to 2.3 trillion renminbi, or

an increase of 1.8 to 2.9 percent as higher private consumption results in less investment and a smaller trade surplus.

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In chapter 1, we examine China's current development model and growth path and analyze the reasons that the economy would benefit from an increased share of private domestic consumption. In chapter 2, we identify the drivers of China's lagging consumption share, enabling us to describe how China got to be where it is today. In chapter 3, we discuss potential policies—many of which the government is already pursuing to some degree—that would help shift the economy toward a more consumption-oriented growth model, and we assess their potential macroeconomic impact both in China and in the global economy. Chapter 4 offers some brief conclusions and, finally, for readers interested in the detail of our macroeconomic assumptions and our methodological approach, we offer a technical appendix.

