



From 'Made in China' to 'Sold in China': The rise of the Chinese urban consumer

EXECUTIVE SUMMARY

November 2006



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Ever since China's process of liberalization began in the 1980s, business executives around the world have dreamed of serving a market of 1.3 billion customers. But while the production side of China's economy has boomed with two decades of 10 percent growth, the consumer side has yet to live up to its promise.¹ Consumption in China has grown at a significantly slower pace than output—consumption as a share of GDP has shrunk from 47 percent in 1995 to 37 percent in 2005. For all of the excitement over China, its total consumer economy today is still barely larger than Italy's despite having over 20 times the population, and its citizens spend on average only \$543 per person per year versus \$11,511 in Italy.

The experience of foreign multinational companies (MNCs) serving China's consumers has likewise been mixed. There have been some notable success stories, for example Western-style supermarkets now reach deep into the Chinese heartland and last year nearly 90 million mobile phones were sold in China, making it the world's largest mobile market. But many companies have been surprised at the competitive intensity of China's markets, found the markets for their—by Chinese standards, premium-priced—products smaller than anticipated, and seen margins squeezed by the costs of sales, marketing, and distribution. As one senior MNC executive put it, the attention China gets in his boardroom is way out of proportion to the reality of his company's current profits in the country.

If there is one overriding message from this report, however, it is that such attention is just what the Chinese consumer market deserves. This report will show that China's economy is on the verge of an important transition in which its consumers will begin to take their place on the world stage.

¹ See Nicholas R. Lardy, "China: Toward a Consumption-Driven Growth Path," Institute for International Economics Policy Briefs in International Economics, no. PB06-6, October 2006.

Over the past year, the McKinsey Global Institute (MGI) has looked closely into the future of China's consumer market. We have assembled a proprietary database of 20 years' of data that links macroeconomic and demographic variables to Chinese incomes and consumption behavior. We have then used that data to econometrically project Chinese income distributions and consumption patterns out to 2025.

Our analysis shows that over the next two decades, the Chinese economy will gradually begin to move away from its historical investment-led growth model, and China's consumers will begin to play a far greater role in their economy's growth. As this re-balancing from investment to consumption occurs, Chinese incomes, which have been lagging GDP growth, will eventually begin to catch up, and, between 2006 and 2015, a massive middle class will emerge. This rising middle class will largely be an urban phenomenon, which we project will spread beyond China's large wealthy coastal cities, to smaller cities further inland, thus significantly changing the geography of China's consumer market.

As the incomes of China's new middle class rise dramatically, so too will their consumption, making China the third-largest consumer market in the world by 2025. A key characteristic of China's new middle class will be that these households will have passed the threshold where necessities such as food and clothing constitute the bulk of their purchases. They will begin to spend a larger proportion of their income on discretionary items, thus significantly changing the pattern of spending in the economy.

We have also found that the spectacular rise of China's urban middle class, and its consequent impact on consumption, is a very robust outcome. It does not depend on major changes in Chinese savings behavior or on particular government policies (although certain policies could accelerate or slow the process), but primarily on economic and demographic forces that are already well-established, and on the continuation of overall economic growth. Even the impact of varying future growth rates tends to alter only the timing of these developments, not whether they happen at all.

CHINA'S ECONOMY WILL RE-BALANCE TOWARD CONSUMPTION

China, like a number of other Asian economies, has aggressively pursued a policy of investment-led growth. It has mobilized the savings of its vast, thrifty population to build its industrial base, particularly in the export sector, and develop its infrastructure. This policy has been very successful in fuelling over two decades

of high growth and, as we will see, significantly improving the incomes of large numbers of citizens.

This investment-led approach, however, has created imbalances in both the Chinese economy and the world economy, ranging from the underdevelopment of China's domestic consumer market, to a heavy reliance on exports for growth, and the consequent imbalances in world trade and currency levels. China's investment share of GDP, at 42 percent in 2005, is among the highest in the world. At some point in its development, China will begin to re-balance. Eventually, two things will occur. First, marginal returns on investment will begin to decline, thus creating a natural brake on investment growth. Prior MGI work shows that this is already beginning to happen in China.² In the first half of the 1990s, China needed \$3.30 of investment to support each dollar of GDP growth; since 2001, it has required \$4.90 to produce one dollar of GDP growth.³ Second, consumers will reach income levels where domestic spending begins to have a larger impact on stimulating economic growth. As we will discuss, incomes in China are fast approaching this point as well.

Furthermore, since December 2004, China's top political leadership has made it an express policy to ensure that a re-balancing towards consumption occurs over time.⁴ The government has been using a combination of monetary and administrative controls to attempt to rein in China's investment growth, as well as taking actions, such as raising the minimum wage, de-regulating the retail market, and creating the "Golden Week" holidays, to encourage consumption growth.

We estimate that over the next two decades, a combination of moderating investment levels and rising incomes will cause China's consumption share of GDP to rise from 37 percent today to 41 percent by 2015, and to 45 percent by 2025 (Exhibit 1). Although this re-balancing would be an important shift from the situation prevailing today, it is important to note that it will merely be returning China to a share of consumption seen in the mid-1990s. It will still leave Chinese

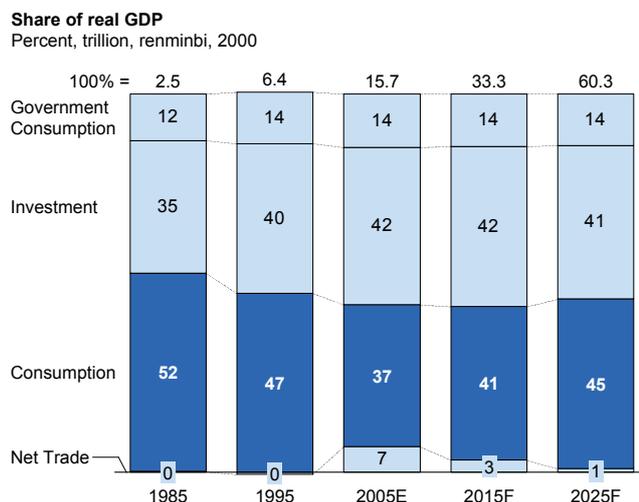
2 See Diana Farrell, Susan Lund, Jaeson Rosenfeld, Fabrice Morin, Niyati Gupta, Ezra Greenberg, "Putting China's Capital to Work: The Value of Financial System Reform," McKinsey Global Institute, 2006, (http://www.mckinsey.com/mgi/publications/china_capital/index.asp).

3 Diana Farrell, Susan Lund, Fabrice Morin, "How Financial System reform could benefit China," The McKinsey Quarterly, 2006 Special Edition: Serving the new Chinese consumer, (http://www.mckinseyquarterly.com/article_page.aspx?ar=1785).

4 As Lardy (2006) notes, the policy was announced at the Central Economic Work Conference in December 2004 and has been reiterated in speeches and remarks by both Premier Wen Jiabao and President Hu Jintao.

Exhibit 1

CONSUMPTION AS A SHARE OF CHINA'S GDP WILL RISE



Source: National Bureau of Statistics of China; MGI China Consumer Demand Model, v2.0

consumption well below current Japanese and US levels at 57 and 71 percent of GDP respectively.

Our scenario for the re-balancing of the Chinese economy assumes a “soft landing” in which China’s investment boom cools while overall GDP growth slows but remains at a healthy level. In our base case, we assume real GDP growth to decline gradually from an annual rate of 9.7 percent over the past two decades, to 7.0 percent over the next two. We will consider other growth scenarios in a later section.

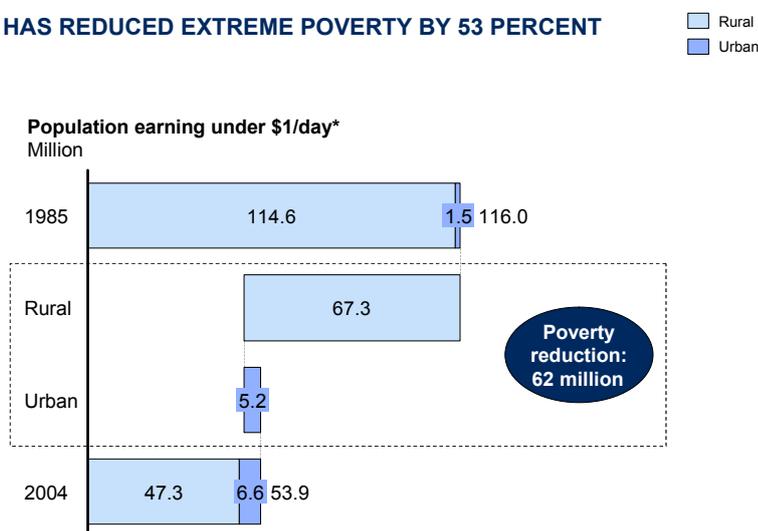
A MASSIVE URBAN MIDDLE CLASS WILL EMERGE

As China’s economy has grown, there has also been a striking increase in Chinese household incomes. We estimate that, since 1985, extreme poverty in China has been cut in half and that 62 million, mostly rural, citizens have been lifted above the \$1 per day income threshold (Exhibit 2).⁵ During this period, China has seen massive rural to urban migration as approximately 250 million people have left the countryside for the cities. Although this has caused a slight rise in the number of urbanites living on less than \$1 per day, for the most part, China’s investment- and export-driven economy has been able to absorb these

⁵ This is in addition to the 125 million that the Chinese government claims to have lifted from poverty between 1978 and 1985 due to rural reforms. While we have used the United Nations’ \$1 per day threshold in our 1985-2004 estimate. The Chinese government uses a poverty line ranging from 100 nominal renminbi per annum in 1978 to 206 renminbi in 1985.

Exhibit 2

CHINA HAS REDUCED EXTREME POVERTY BY 53 PERCENT



* Computed at \$ PPP, 2000
Source: MGI China Consumer Demand Model, v2.0; World Development Indicators

relatively low-skill migrants, shifting them from the agricultural into the manufacturing economy, where both their wages and skill levels have risen. Since 1985, urban real per-capita disposable incomes have more than quadrupled, rising from 2,084 renminbi (\$252) to 8,575 renminbi (\$1,036) per annum in 2005 (Exhibit 3).

Going forward, as the economy re-balances away from investment-led growth, we expect to see Chinese households capture a greater share of total factor income, rising from 59 percent today to 64 percent by 2025. This means that, even as overall economic growth moderates, incomes will continue to rise strongly. In urban areas, total income will continue to rise even faster than overall GDP, climbing 8 percent per annum over the coming two decades. This will be driven by both continued urbanization, as the percentage of people living in urban areas rises from 43 percent today to 59 percent by 2025, as well as rising per capita income as China's cities continue to create higher-value manufacturing and service jobs.

As incomes grow, the shape of the distribution of income in urban China will change too (Exhibit 4). In 1985, 99 percent of the urban population had household disposable income of less than 25,000 renminbi (\$3,019) per year. By 2005, that had dropped by almost half, and will continue to fall as large segments of the population move into the middle class. For the purposes of this report,

Exhibit 3

URBAN INCOMES WILL CONTINUE TO RISE DRAMATICALLY

Total urban household income billion, renminbi, 2000

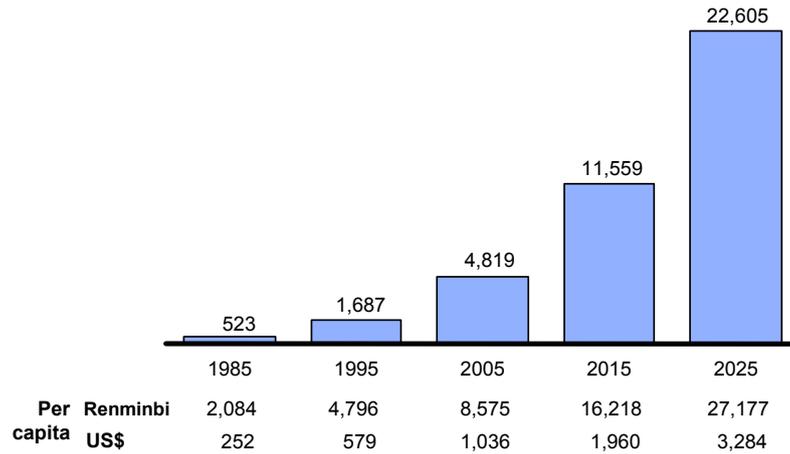
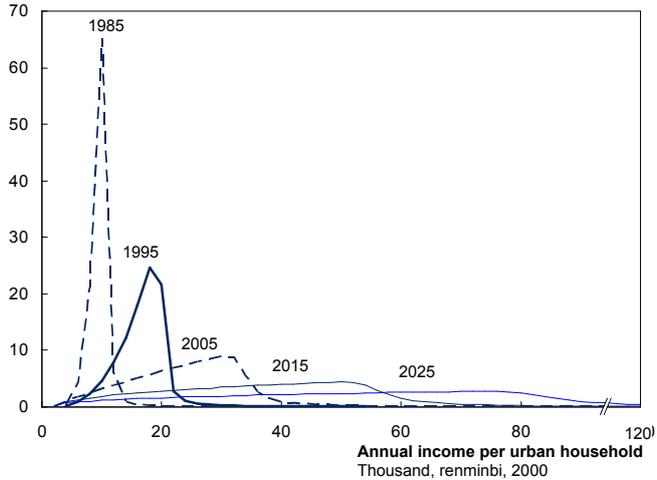


Exhibit 4

CHINA'S URBAN INCOME DISTRIBUTION WILL WIDEN AS ITS MIDDLE CLASS GROWS

Urban household distribution, 1985-2025

Percent of households



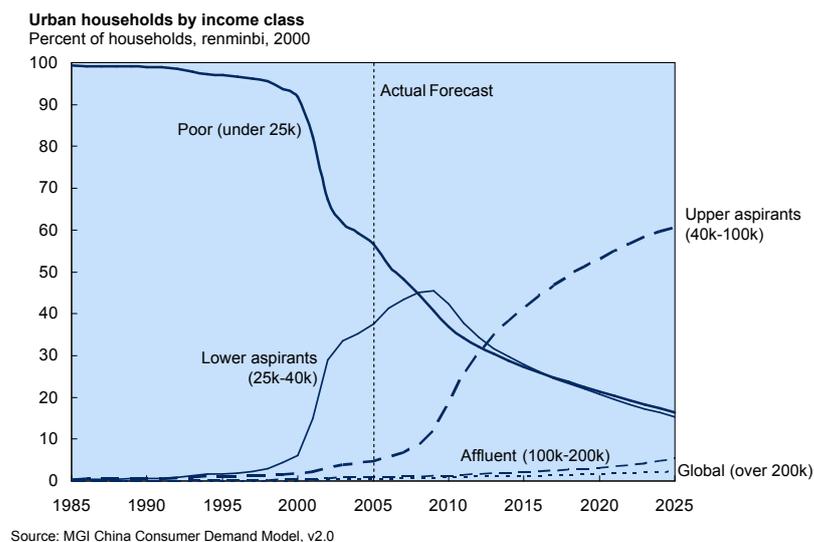
Source: MGI China Consumer Demand Model, v2.0

we define *middle class* as being comprised of two segments: *lower aspirants* earning 25,000 to 40,000 renminbi (\$3,019 to \$4,831) per year, and *upper aspirants* earning 40,000 to 100,000 renminbi (\$4,831 to \$12,077) per year. These amounts may seem modest to Westerners. However, in purchasing power parity terms, lower aspirants earn between \$13,513 to \$21,622, and upper aspirants, \$21,622 to \$54,054—levels of income that purchase a lifestyle that most of the world would recognize as middle class.

We estimate that this urban middle class will grow from 43 percent of the population today, to 69 percent by 2015, and to 76 percent by 2025 or 612 million people-strong (Exhibit 5). As this occurs, the center of gravity in the middle class will shift from the lower aspirants, to a point—around 2015—where upper aspirants will become the largest segment of the population, and then—by around 2020—when they will become the majority. This new middle class will wield enormous spending power. By 2025 real aggregate urban disposable income will reach 22.6 trillion renminbi (\$2.7 trillion), 61 percent of which will be from the upper-aspirant segment alone.

Exhibit 5

UPPER ASPIRANTS WILL BECOME THE LARGEST GROUP IN THE NEXT DECADE



China's urban spending power will also be far less concentrated in the major Tier 1 cities (Beijing, Shanghai, Guangzhou, and Shenzhen) and along the coasts, than it has in the past. China's 37 Tier 2 cities (the top three by population size are Chongqing, Wuhan, and Tianjin), and 620 Tier 3 cities (the top three are Xiangfan, Puning, and Zaoshuang—note that 136 Tier 3 cities have populations of greater than a million) are both growing more quickly than the big four cities and will account for the lion's-share of China's urban income growth.

CHINA WILL BECOME THE WORLD'S THIRD-LARGEST CONSUMER ECONOMY

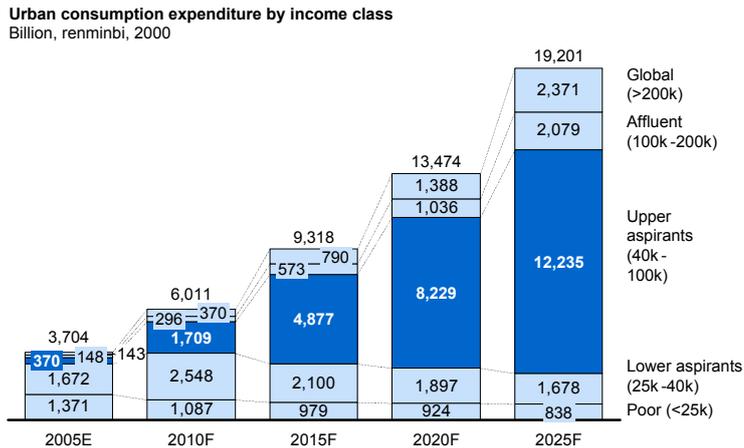
As Chinese urban incomes rise at a rapid rate, so too will the spending of this population. But how much spending rises depends on how much China's frugal citizens put away in savings—overall, Chinese households saved 37 percent of their disposable income in 2005.⁶ Research by McKinsey's China Consumer Center has shown that the primary driver of this high savings rate has been the weakness of the social safety net in China. In essence, people self-insure against unexpected health-care costs, as well as save for their retirement and their children's education. While the Chinese government has made improving the safety net a priority, we assume that only modest progress will be made in the timeframe of our study, and that it will take time for savings behavior to change. Rather, we believe that savings rates will moderate due to demographic factors (the aging of the pre-one child cohort), rising wealth levels, and improvements in the financial sector (e.g. greater availability of insurance products). Urban households already save less than the national average, and we expect their savings rate to decline gradually over the coming two decades.

The combination of rapidly rising incomes and moderating savings rates will lead to a strong surge in spending over the coming two decades. Urban consumer spending will grow more than five-fold in real terms from 3.7 trillion renminbi (\$446 billion) per year in 2005 to 19.2 trillion renminbi (\$2.3 trillion) in 2025 (Exhibit 6). Upper aspirants, who represent only a small fraction of spending today, will be the dominant consumers by 2015.

⁶ This represents a substantial upward revision of earlier estimates of the household savings rate. In the recent release by the NBS, a significant increase in services went to investment rather than consumption. Consequently, this change resulted in a spike in the national savings rate. We re-estimated the share of income and consumption going to households using this revised data and flow-of-funds data, to arrive at a new, higher 2005 estimate of the household savings rate. See also explanation given in Appendix B.

Exhibit 6

URBAN CONSUMPTION WILL INCREASE SHARPLY, MAINLY DRIVEN BY UPPER ASPIRANTS



Source: MGI China Consumer Demand Model, v2.0

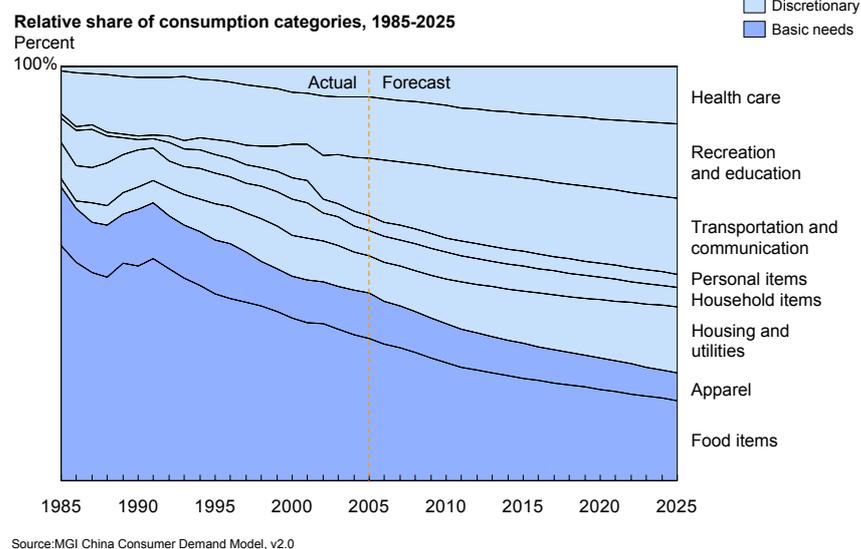
This rise in spending will cause China to surpass Germany in terms of the size of its consumer market by 2015; by 2025, China will become the world's third-largest consumer market, approaching Japan in real dollar terms. Although per-capita spending will remain modest at \$2,302, if we dig under the average we find large numbers of consumers making significant purchases. For example, by 2025 we forecast that there will be eight million global households (disposable income above 200,000 renminbi) with average spending of slightly over 290,000 renminbi per year, and 19 million affluent households (income 100,000 to 200,000 renminbi) with average spending of about 109,000 renminbi per year.

Along with the changing quantity of Chinese spending, the pattern of spending will change dramatically too (Exhibit 7). Since 1990, urban China's share-of-wallet has been shifting steadily away from necessities (which we define as food and clothing) and toward discretionary spending. Today, discretionary items constitute approximately 55 percent of total urban spending, and by 2025 we expect that to rise to 74 percent.

As urban Chinese discretionary spending rises, certain categories will be winners in the share-of-wallet battle, while others will see their shares decline (even if their absolute market sizes continue to rise). Food, which remains China's largest product category throughout the forecast period, will see its relative position decline

Exhibit 7

URBAN CHINA'S RELATIVE SHARES OF CONSUMPTION EXPENDITURE ARE SHIFTING RAPIDLY



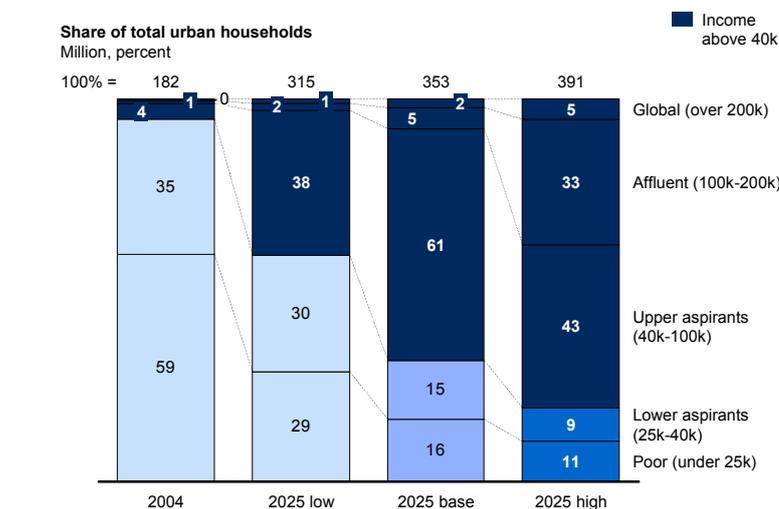
compared with faster-growing categories—despite a 5.5 percent growth rate that is significantly faster than food growth in other world markets. We estimate that transportation and communication will grow at a 10 percent rate, and recreation and education at 9.7 percent as these discretionary categories take up an increasing share of expenditures. Housing and utilities will grow at 11.7 percent as Chinese consumers continue to make investments in improving recently privatized housing stock. The fastest-growing product category will be private health care at 12 percent. Until recently, this has been unaffordable for most Chinese, but it will be a priority for many people as incomes rise.

A QUESTION OF WHEN, NOT IF

The single most important driver of the results summarized above is our assumption of China's overall economic growth rate. As discussed, our base case assumes a "soft landing" whereby China's investment boom gradually cools and growth moderates over time. There are, of course, other possible scenarios, including a "hard landing" in which Chinese growth comes down more rapidly and to a lower level; or what some analysts have called the "no-landing" scenario, in which Chinese growth continues at the levels of the past two decades for another two decades.

Exhibit 8

GROWTH HAS LARGE IMPACT ON TOTAL NUMBER OF HOUSEHOLDS EARNING ABOVE 40,000 RENMINBI A YEAR



In order to test the robustness of our results, we examined income and consumption growth under a hard-landing scenario of 4.2 percent compound annual real GDP growth, and a no-landing scenario of 9.7 percent growth, in addition to our base case of 7.0 percent. In each of the three scenarios, the general character of our results was preserved—urban incomes grow at a pace more rapid than the economy as a whole, a large middle class emerges, and consumption rises significantly, while shifting toward discretionary items. The main difference across the scenarios was the timing of these developments and their magnitude by the end of the forecast period in 2025. One indicator of the timing differences is the point at which the number of upper aspirant households exceeds the number of lower aspirant households; i.e. when the mass of the middle class passes the 40,000 renminbi threshold. In the low case, this happens in 2022; in the base case 2013; and the high case 2011. An indication of the differences in magnitude across the scenarios is the percent of households that reach the 40,000 renminbi upper aspirant threshold by 2025—41 percent in the low case, versus 68 percent in the base case, versus 81 percent in the high case (Exhibit 8).

Urban consumption also grows significantly across all three scenarios, but again with differences in magnitude by 2025. In the low case, consumption grows by a compound annual rate of 5.7 percent, reaching 11.2 trillion renminbi by 2025, compared with 11.5 percent and 32.5 trillion renminbi in the high case. In

all cases, consumption shifts significantly toward discretionary items, reaching 63 percent of share-of-wallet by 2025 in the low case, and 80 percent in the high case.

In addition to GDP growth, we also examined sensitivities to other factors that affect both the level of income as well as its distribution, such as population, growth, the urbanization rate, educational attainment, and wealth effects from savings. While population growth tends to be a relatively predictable factor in economics, there is nonetheless some variability around forecasts, and, given the size of China's population, such differences could potentially matter. For example, if China's population were to be 100 million people, or 7 percent, larger than is forecast by 2025, this would translate into an urban consumption market that is 6.3 percent larger than our base case. Likewise, a 5 percent increase in the urbanization rate from our base case would move the size of the urban market up by 8 percent.

Educational attainment tends to effect the shape of the income distribution, but even a 23 percent change in the level (thus catching up with South Korea) would only marginally change the distribution—e.g. the total income of households at the top-end global-income bracket would only rise by 4 percent. Finally, if real wealth in China were to zoom up from its ratio of 4.2 times GDP today to 6.0 times by 2025 (20 percent higher than our base case and higher than the current US level), there would only be a modest impact on the income distribution—e.g., the total income of households at the top-end global-income bracket would rise by 3.8 percent.

Our conclusion is that, short of an economic downturn far below our low case, a major reversal in China's political or social conditions, or changes in other factors that significantly deviate from our base-case assumptions, over the next two decades China will give birth to a massive middle class and develop into one of the world's major consumer economies.

Readers interested in our detailed findings and analyses are invited to go to the main chapters in the full report. Those interested in forecasts for specific product and service categories should look at Appendix A, and those interested in further details on our modeling approach and data sources are directed to Appendix B.

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As the dream of a market of nearly 270 million middle-class households begins to come true over the coming decades, both business leaders and policy makers will grapple with its implications. MNCs will need to continue to drive their prices and costs down relentlessly to be able to reach and build relationships with consumers who have modest incomes today but will be the middle class of tomorrow. In addition, MNCs will need to extend their geographic reach into the Tier 3 and lower cities where the majority of these consumers live. At the same time, Chinese companies will need to build skills in branding and product innovation in order to follow these customers up-market as their tastes change with rising incomes.

For their part, policy makers will face a delicate balancing act of shifting China's economy from dependence on investment and exports, to one that is increasingly driven by its own domestic consumers, while still keeping growth rates at high levels. Critical decisions will need to be made about government investment in the social safety net to free up consumption, and financial-sector reform will play a key role in helping both China's producers and households reduce their excess savings and spend more.

China's growth into a consumer superpower will be good for China as more of its citizens realize their aspirations for a more comfortable life. It will also be good for the citizens of other countries as China's consumer markets will generate enormous opportunities for companies around the world, creating jobs, expanding trade, and leading to a more balanced role for China in the global economy.