



**SOLD IN  
CHINA**

**TRANSITIONING TO  
A CONSUMER-LED ECONOMY**

LOUISE KEELY AND BRIAN ANDERSON





名甲 旗艦店  
2332 0188  
www.supernail.com.hk

卓悅 BONJOUR

毛\$15

足健  
3488 3628 2/F

4D APPAREL COLLECTION  
timberland.com.hk  
旺角花園街83號舖  
旺角西洋菜街42號舖  
環華中心先施百貨



16 November  
Happy Valley Racecourse  
11月16日

心靈成長發展中心  
http://lifeempowerment.org

高登 中西大藥房  
K.B. DISPENSARY  
118 CORDON WATSON ST.

永隆銀行(香港)有限公司  
2811 1155  
人民幣找換  
2020 YEE EXCHANGE

innisfree

保安課程  
(QAS優質保安證書)  
平安咭 電工A牌  
密閉咭 貨櫃咭  
劇車牌 風煤牌  
23011162  
卓悅大廈6樓  
彌敦道701號 (快餐街口)

裝婚紗  
Kenny Thai  
TEL: +852 9552 9983  
+86 1471 4309955

essie  
Only \$60  
起up  
Zoya  
Socks  
Socks  
Socks

網上行  
登記站  
電話

永

LANE

網上行

登記站

電話





### **About The Demand Institute**

The Demand Institute illuminates how consumer demand is evolving around the world. We help government and business leaders align investments to where consumer demand is headed across industries, countries and markets. A non-advocacy, non-profit organization and a division of The Conference Board, The Demand Institute holds 501(c)(3) tax-exempt status in the United States and is jointly operated by The Conference Board and Nielsen. For more information, please visit [demandinstitute.org](http://demandinstitute.org).

### **About The Conference Board**

The Conference Board is a global, independent business membership and research association working in the public interest. Our mission is unique: To provide the world's leading organizations with the practical knowledge they need to improve their performance and better serve society. The Conference Board is a non-advocacy, not-for-profit entity holding 501(c)(3) tax-exempt status in the United States. For more information, visit [conference-board.org](http://conference-board.org).

### **About Nielsen**

Nielsen N.V. (NYSE: NLSN) is a global performance management company that provides a comprehensive understanding of what consumers Watch and Buy. Nielsen's Watch segment provides media and advertising clients with Total Audience measurement services across all devices where content – video, audio and text – is consumed. The Buy segment offers consumer packaged goods manufacturers and retailers the industry's only global view of retail performance measurement. By integrating information from its Watch and Buy segments and other data sources, Nielsen provides its clients with both world-class measurement as well as analytics that help improve performance. Nielsen, an S&P 500 company, has operations in over 100 countries that cover more than 90 percent of the world's population. For more information, visit [www.nielsen.com](http://www.nielsen.com).

# ACKNOWLEDGEMENTS

The Demand Institute is entirely accountable for the information, ideas, and projections in this report. The report does not necessarily reflect the views of the numerous people from other organizations who generously gave their time and expertise to help shape it.

The authors would like to thank the board members of The Demand Institute, Mark Leiter, John Lewis, Jonathan Spector, and Bart van Ark, for their sponsorship and intensive involvement in the work of The Demand Institute, including this report. We appreciate the input we received from them and other colleagues at The Conference Board and Nielsen, including Ethan Cramer-Flood, Janet Hao, David Hoffman, Gad Levanon, Ataman Ozyildirim, Andrew Polk, Oliver Rust, Wendy Wang, Lynn Xu, and Yan Xuan.

We would like to extend special thanks to Ben Cheng for his tremendous work with the data and modeling that were critical inputs into this report. Our editors, Joanne Mason, Saul Rosenberg, and Karen Schenkenfelder, helped us to articulate our findings clearly and accessibly. We would also like to thank the team at Publisiez, and their help with communicating our findings.

# CONTENTS

KEY MESSAGES	6
EXECUTIVE SUMMARY	7
1. REVERSING A LONG TREND	11
2. SCALE OF THE OPPORTUNITY FOR CONSUMER-FACING BUSINESSES	12
3. LOOKING AHEAD – METRICS TO MONITOR	12
4. LOOKING AHEAD – ACTIONS TO TAKE	19
APPENDIX – RESEARCH METHODOLOGY	25

# KEY MESSAGES

Economic growth in China has been strong for the last several decades, driven by a focus on investments and exports. It is now beginning to slow. As with many developing economies, a transition to consumption-led growth is now deemed essential for continued, robust economic expansion.

Consumption's share of real GDP has been falling for six decades, from 76% in 1952 to 28% in 2011. That fall will soon flatten out. Without a substantial intervention, however, we believe consumption's share of China's economy is unlikely to rise substantially before 2025.

Changing this trajectory represents a significant opportunity. If consumption's share of real GDP rose from 28% to 46% of GDP in China in the course of a decade—an optimistic but not impossible scenario, given our research—it would generate an incremental 90 trillion yuan between 2015 and 2025 (\$15 trillion at current exchange rates).

Government and business leaders have a critical role to play in encouraging consumption-led growth. Government policy must provide the initial impetus, but business can nurture emerging demand when it sees it. Initiatives that businesses can take to support and reinforce government include but are not limited to the following:

1. Cultivating the consumer culture
2. Making it easier for consumers to access goods and services
3. Innovating to satisfy the demands of different consumer segments
4. Offering more financial services to support consumption

## **Sold in China: Transitioning to a consumer-led economy**

---

### **Louise Keely**

President, The Demand Institute  
Senior Vice President, Nielsen

### **Brian Anderson**

Manager, The Demand Institute

# EXECUTIVE SUMMARY

China has been a key source of growth for multinational companies for the last two decades. Between 1999 and 2011, as the economy surged, real consumer spending rose by more than 50% in total. Recently, GDP growth has slowed, raising the question of whether companies need to scale back their projections of consumption's growth. However, it may receive an additional boost from the government's stated intention to direct the economy away from its dependence on investments and exports and toward domestic consumer spending—a transition most economists agree is essential to support China's continued strong growth.

How long that transition might take, however, is far from clear. Consumption as a share of real GDP has fallen for more than five decades, from 76% in 1952 to 28% in 2011.<sup>1</sup> It is one of the lowest figures in all markets.

In comparison, consumption as a share of GDP stands at 76% in the United States, the highest level among mature markets, and 52% in India, a level typical in emerging markets. While it is normal for consumption's share of GDP to fall as part of industrial development, the extent of the fall in China is unique.

Success in shifting China's trajectory would have wide ramifications. The lives of millions of Chinese consumers and the fortunes of many global businesses would be transformed. Given the sheer size of the Chinese economy, a successful transition could also underpin the health of the global economy.

It is against this backdrop that we have spent the last year examining the road ahead for China. We have made this investment with two objectives. The first is to help businesses gauge the pace of the transition and its impact on consumer spending, so that they can respond accordingly. The second is to describe what business can do to accelerate the transition.

Today, there are signs that the decline in consumption's share of GDP may have abated, but it has certainly not yet been reversed. Indeed, we conclude that it is likely to remain roughly flat at around 28% of GDP between 2015 and 2025. We base this conclusion on an examination of the economic development of 167 countries between 1950 and 2011. In most countries whose underlying economic characteristics were similar to China's today, consumption's share of output remained flat for a significant period once it stopped falling.

Our view also takes into account the unique challenge China faces in reversing such a long, steep decline. This decline has been due to a fall in both of the components that underlie consumption: household income's share of GDP and consumption's share of household income. These parallel downward trends are distinctive to China's history. Elsewhere, countries have had only one of these factors to reverse.

Our analysis also examines the outlook for consumer spending. We modeled two different scenarios. One looks at consumer spending if China's progress toward consumer-led growth is negligible in the next decade. The other sizes potential consumer spending if the Chinese economy transitions to consumer-led growth more quickly.

---

<sup>1</sup> Penn World Table v8.0, <http://www.rug.nl/research/ggdc/data/pwt/>. Consumption's share of GDP is stated in real, purchasing-power-parity-adjusted terms. The Penn World Table's data allows for cross-country analysis. Conversion to nominal shares yields figures similar to those reported by China's National Bureau of Statistics.

### **Scenario 1: Consumption's share flattens.**

The first scenario demonstrates that absolute consumption will rise as the economy grows, even if consumption's share of that output stays flat. Assuming, as previously described, that consumption's contribution to the economy remains constant at roughly 28% between 2015 and 2025, total consumer spending during the period would amount to around 330 trillion yuan in nominal terms. That represents a 60% increase in China's consumer spending over the decade.

**Scenario 2: A typical reversal.** The second scenario estimates consumer spending if consumption's share of GDP were to reach 46% by 2025. This is the share typically achieved by countries that have reversed a decline in consumption's share of GDP within a 10-year time frame. As such, it can be seen as the upper limit of a range of possible outcomes for China. Under this scenario, annual consumer spending rises by as much as 126% between 2015 and 2025 to total 420 trillion yuan in nominal terms during the period.

The difference between the two scenarios is a total of 90 trillion yuan over the period. And although current indications suggest China is on track to proceed down the path laid out in Scenario 1, new government policy could move it in a different direction. It is therefore important for businesses to be able to gauge the extent to which policy will affect consumption, so that they are ready to grasp the opportunity. This can be done by tracking certain key indicators. Some track whether consumers are willing to save less of their income and spend more. Others track household income as a share of GDP. We describe a total of 13 important indicators to watch, including the corporate savings rate and household tax policy—both of which can indicate how much net wages are likely to rise relative to GDP growth—as

well as consumer confidence and the strength of social safety nets, which should influence household savings habits.

As to the second aim of the report—what business can do to help drive the transition to a consumption-led economy—while government policy must provide the initial impetus, business can nurture emerging demand when it sees it. The report highlights four areas where it can look for opportunities to do so:

- **Consumer culture.** The hurdles to consumer-led growth in China are not purely economic. Companies in many industries will need to work hard to communicate the benefits of their goods and services in order to build demand and loyalty. For example, growth in insurance products will require significant consumer education, as history demonstrates that consumers are slow to adopt insurance as a means of protecting assets. Educating consumers will be particularly important in an era when consumers' brand preferences are still shifting rapidly.
- **Access to products and services.** Despite the huge leaps China has made in creating distribution and retail channels, many product categories remain unavailable outside the largest and most affluent cities. E-commerce has made some inroads in addressing this gap, yet there is still much that companies can do to stimulate demand by efficiently distributing their goods and services through both physical and digital channels.
- **Innovation.** If consumers are to become a dominant growth driver for the economy, multinational corporations will need to tailor their products to Chinese



demand. At some level, this has always been true of the Chinese market. But as consumerism spreads from the largest cities to lower-income regions, companies will have to accelerate the pace at which they tailor offerings to different income levels, regional tastes and levels of consumer sophistication.

- **Financial services.** Chinese consumers enjoy a relatively limited set of the investment and borrowing options that underpin consumer spending in major economic centers. Increased access to such services—whether it is an outcome of companies offering more products (e.g., automotive financing, online investment management) or establishing credit rating systems or both—will encourage and support changes in consumer behavior.

Over the past several decades, China's vibrant, growing economy has secured its position as one of the most important players on the global stage. Maintaining that momentum over the next several decades will require a "rebalancing" from infrastructure investments and exports toward a consumer-led economy. In other words, China will need to turn "Made in China" to "Sold in China." We believe this is within reach. As long as business leaders remain alert to government cues, we could see a continuation of arguably the greatest consumer-spending expansion in history.



## 1. REVERSING A LONG TREND

Consumer spending in China rose more than 50% in real terms between 1999 and 2011 as the economy surged, providing a key source of growth for many multinational companies. China's current economic growth has slowed. But it still supports strong growth in consumption and may soon receive an additional boost from the government's intention to direct the economy away from dependence on investments and exports and toward domestic consumer spending. Most economists agree that such a transition—which depends on household income rising as a share of GDP and on persuading China's famously cautious consumers to spend a greater proportion of that income—is essential to support China's continued economic expansion. It is a transition that would have wide ramifications. It would transform the lives of millions of Chinese and the fortunes of many global businesses. It might well also underpin the health of the entire global economy.

How long such a transition might take, however, is far from clear. Relative to the size of its economy, consumption in China is low. In 2011, the latest year for which comparative data is available, it represented 28% of real GDP, compared with 76% in the United States, 67% in Brazil, 60% in Japan, 59% in Germany, and 52% in India.

Consumption's low share of GDP reflects China's past emphasis on investment- and export-led growth, an emphasis typical of emerging economies. Yet this focus has been particularly pronounced in China. Consumption's share of GDP fell 29 percentage points from 76% to 47% between 1952 and 1999. Between 1999 and 2011, it fell a further 19 percentage points even as GDP surged (Figure 1). This represents one of the

longest and largest declines in consumption relative to GDP of any economy on record (Figure 2).

Because the economy has grown so strongly in recent decades, the impact of this decline is sometimes overlooked. We estimate that had consumption as a share of GDP stayed constant between 1999 and 2011, it would have grown by more than 150% over the period, compared with actual growth of just over 50%. This amounts to nearly \$11 trillion of "lost consumption" over the entire period—a clear indication of the extent to which a transition to consumption-led growth could shape the fortunes of businesses in China.

We believe that the decline in consumption as a share of GDP is likely to halt soon, if it has not done so already. We expect it then to hover at around 28% until 2025, and not to rise significantly. We base this conclusion on an examination of the economic development of 167 countries between 1950 and 2011, described in the appendix. Countries whose underlying economic characteristics were similar to China's generally saw consumption remain flat relative to GDP for a considerable period after it stopped falling.

China might find it more difficult than other countries to reverse the decline, however. That is because the steep drop from 1999 onward was due to falls in both components of consumption: household income's share of GDP and consumption's share of household income. This simultaneous decline appears to be unique to China, and both components will have to be reversed to drive strong, consumer-led growth. A range of levers is available to policy makers and business leaders to achieve this, but the task remains complex.



## 2. SCALE OF THE OPPORTUNITY FOR CONSUMER-FACING BUSINESSES

Whether or not China makes a transition to consumption-led growth, annual consumer spending will continue to rise if the economy carries on growing. To understand the additional impact a transition to a consumption-led economy could have on consumer spending, we modeled two scenarios. Both are based on a forecast by The Conference Board's China Center that economic growth will slow from about 7% in 2014 to about 4% by 2019, where it would remain until 2025.<sup>2</sup>

### **Scenario 1. Consumption's share flattens.**

The first scenario assumes consumption's share of GDP will remain constant at roughly 28% between 2015 and 2025. Under this scenario, total consumer spending between 2015 and 2025 reaches around 330 trillion yuan in nominal terms, and annual consumer spending rises by 60% over the period. Both consumption and non-consumption components of GDP (investment, government spending, and net exports) grow at an annualized rate of 4.9%.

**Scenario 2. A typical reversal.** The second scenario assumes consumption's share of GDP reaches 46% by 2025. This corresponds to the rise in share typically achieved by countries that have made the transition from investment-led growth to consumption-led growth within a 10-year time frame. It therefore can be seen as the upper limit of a range of possible outcomes for China. Under this scenario, annual consumer spending rises by as much as 126% between 2015 and 2025, to reach a total of 420 trillion yuan in nominal terms. Consumption grows at an annualized rate of 8.5%, while the other components of GDP grow at a combined rate of about 2%.

There is a difference in consumer spending of 27% between these two scenarios—a difference worth a full 90 trillion yuan (\$15 trillion).

Government policy has a clear influence in deciding where within this range consumption will fall. For example, in Taiwan, recent consumption-led growth was enabled by labor policy and, specifically, a rise in unionization that helped raise household income's share of GDP. In Japan, it was led by a decline in the household savings rate, brought about by rising urbanization (associated with a lower household savings rate) and the growth of state-supported technology industries. The electronics industry in particular is believed to have encouraged a consumer culture.

In China's command economy, the role of government policy will be even more important. But as we will argue, business also has a role to play.

## 3. LOOKING AHEAD: METRICS TO MONITOR

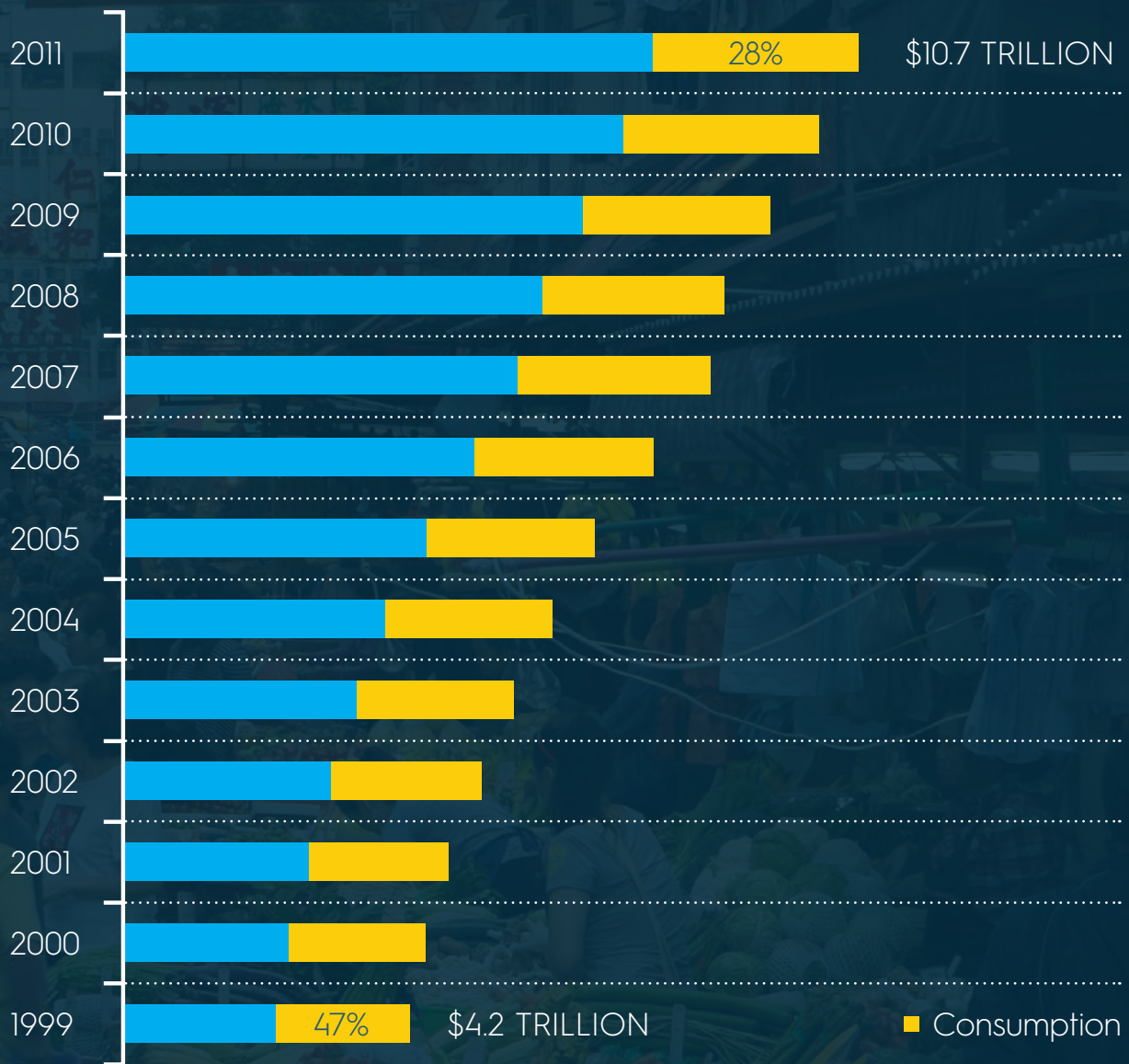
Although the government's 2010 five-year plan acknowledged the need to strengthen consumer demand, many of the policies that supported the old growth strategy remain in place, which is presumably why consumption as a share of GDP remains low compared with other countries at similar levels of development. The next five-year plan has yet to be released, although early indications are that it will emphasize support for consumer-facing industries including education, low-income housing, travel and leisure, sports, information technologies, green industries, and "healthy aging"—this last being in part a way of managing health care costs.

---

<sup>2</sup> David Hoffman and Andrew Polk, *The Long Soft Fall in Chinese Growth* (The Conference Board's China Center, October 2014).

# CHINA'S INVESTMENT-LED GROWTH IN GDP

CHINA REAL GDP\* AND SHARE OF CONSUMPTION





# CHINA'S DECLINE IN C/GDP IS LONGEST SINCE 1950

THE TEN LONGEST CONTINUOUS DECLINES IN C/GDP SINCE 1950

COUNTRY	LENGTH OF DECLINE			RATE OF DECLINE		
	DECLINE START YEAR	DECLINE END YEAR	LENGTH OF DECLINE (YEARS)	INITIAL C/GDP (%)	FINAL C/GDP (%)	PERCENT DECLINE (%)
CHINA	1952*	2011*	59	76	28	63
PANAMA	1957	2011*	54	99	47	53
BANGLADESH	1952*	2011*	52	103	71	32
SINGAPORE	1960*	2011*	58	92	33	64
IRELAND	1950*	2001*	51	89	45	50
ARGENTINA	1950*	2001	51	77	67	13
SWEDEN	1950*	2000	50	69	49	28
THAILAND	1950*	1998	48	69	44	36
DENMARK	1950*	1998	48	69	54	21
MALAYSIA	1955*	2002	47	69	43	38



Note\*: First (or last) year of available data; decline may extend further back in time (or longer into future)

Source: The Demand Institute, Penn World Table version 8.0







Such a focus would support domestic demand. Yet businesses will need to monitor developments carefully, as policies are not always clear. Back in 2012, for example, President Hu Jintao announced an official goal of doubling real per capita income by 2020—but noted GDP should also double, implying consumption's share of GDP would remain the same. And some policies designed to persuade householders to relax their saving have resulted in lower incomes, making it hard for people to spend more. For example, in 2011 requirements were introduced for employers to help fund costs of the social safety net by contributing money to the government on behalf of employees. In some cases, the burden on the employer approached half of the employee's salary. This led employers to look for alternative, nonfinancial forms of compensation, leaving workers with less money in their pockets.

In other areas, progress is slow. At the end of 2014, for example, Vice Premier Ma Kai said health care coverage—which would encourage people to save less—was almost universal and that the vast majority of adults had joined the state's pension system. Yet some commentators believe coverage, particularly for the elderly and migrant workers, is inadequate. In addition, it is well known that the state pension system is underfunded, although the government is trying to rectify this.

In such a complex environment, it is important that businesses gauge the change under way. This will help them assess the scale of the opportunity and equip them to move quickly when the time is right. Several leading indicators can help. Some track whether household income as a share of GDP will rise. Others track whether householders are willing to spend more of that income. These are summarized in Figure 3, and categorized by whether the indicator is chiefly the result of government or corporate action, or that of consumer shifts.

The metrics that indicate whether household income as a share of GDP is likely to rise include the following:

- **Corporate savings rate.** A decline in corporate savings indicates that wages and therefore household income will rise.
- **Household tax rates.** Changes in household tax policy would directly affect household disposable income.
- **Total factor productivity.** Rising total factor productivity means inputs including labor are more productive. Labor will typically command higher wages as a result.
- **Service sector's share of GDP and a move to higher value-added manufacturing.** An expanding service sector and a move to higher value-added manufacturing will require a more highly skilled labor force, which also implies that wages will rise.
- **Urbanization rate.** Higher rates of urbanization mean that rural, agricultural workers are moving to cities to take advantage of higher-wage labor markets. This, too, raises household incomes.
- **The education of the working-age population.** Improvements in education and job-related training will lead to higher labor productivity, and thus higher wages for existing workers and more opportunity for new entrants to the labor market.

Recent trends indicated by these measures are mixed. The service sector's share of GDP has risen. Urbanization has boomed, and education is expanding. However, recent data indicate that total factor productivity has contracted, indicating less efficient use of production inputs, and the corporate savings rate does not yet show a clear downward trend.

Turning to the future, businesses should look for policy adjustments that affect all these measures. Policy actions, rather than consumer shifts, are most likely to have substantial impact on household income's share of GDP. Among those, declines in the corporate savings rate and household tax rates would be most important, because these should lead most directly to a greater share of output going to household income.

The following metrics will help determine whether households are willing to spend a larger share of their income:

- **Urbanization rate and internet access.** Consumers in cities and those with online information about and access to more varied consumption options tend to have lower savings rates.
- **Age distribution.** As the working portion of the adult population becomes smaller and the retired portion larger, savings rates typically fall, because workers are net savers, while retirees are net borrowers.
- **Birth rates.** Everywhere, families with children tend to save less and spend more. China's recent loosening of its one-child policy should raise the birth rate, which will lead to more spending. Parents with children tend to spend more, both to care for the children and because they feel less need to save for retirement when they have more children to support them.
- **Consumer confidence.** Increasing consumer confidence leads consumers to be more comfortable spending more and saving less.
- **Real interest rates.** Higher real interest rates for households' savings and investment would enable them to

accumulate wealth more quickly toward a particular savings goal, freeing income for consumption. This link is particular to China, as real interest rates have been negative until recently. In most other economies, rising interest rates would encourage savings and lead to lower consumption.

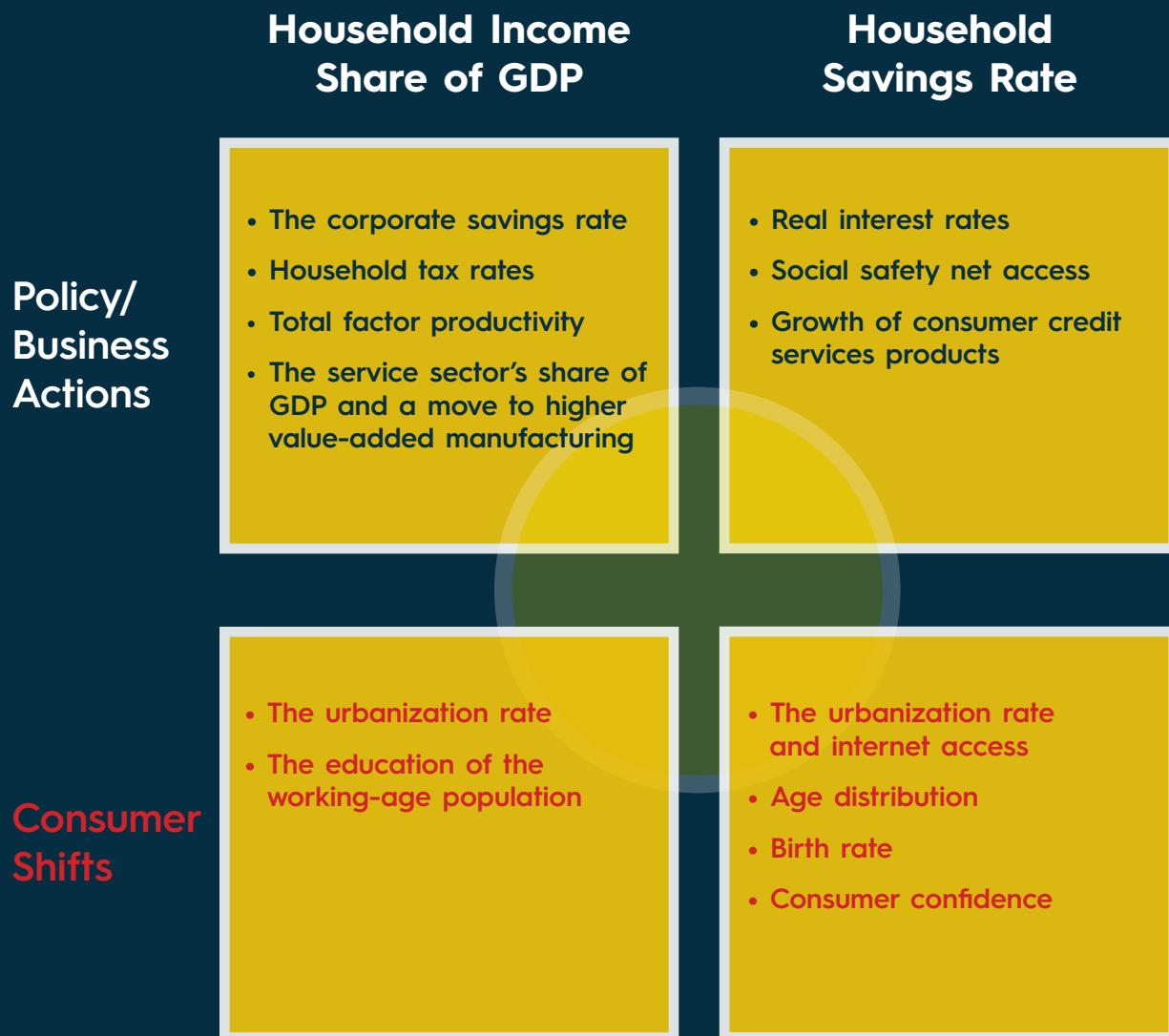
- **Access to a social safety net.** Increased penetration and usage of social-safety-net programs, including public pensions, health care systems, and unemployment and disability benefits, will enable households to reduce private savings made in anticipation of health needs, retirement, and loss of wage income.
- **Growth of consumer credit services products.** The rising popularity of new products such as credit cards, mortgages, and auto loans all signal the growth of a consumer culture, and hence reduced savings rates.

China's performance on a number of these metrics are often put forward as explanations for why the Chinese household savings rate is high in China, especially those related to the aging population and low birth rate, to household interest rates, and to a social safety net. Recent movement in these metrics is not encouraging. Birth rates and real interest rates remain very low compared with those of other countries. Access to public pensions, health care systems, and unemployment and disability benefits has grown strongly, according to official data, but these services have not yet had the intended impact on savings rates. Meanwhile, although the population of China will age in the medium term, and the number of retired people will rise in the next decade, demographic forecasts indicate that the working-age population will increase before it starts to decline. In addition, in China, where children are traditionally expected to care



# INDICATORS OF CHANGES IN C/GDP COMPONENTS

---



for parents, workers will prepare for that responsibility. So we may not see a significant decline in the savings rate in the short term. Consumer confidence has been volatile in recent years, but overall there has been a slight upward trend since 2011. The brightest spots are consumer credit services and growth in urbanization and internet access. Consumer credit services are expanding quickly, albeit from a relatively small base. We also view continued growth in access to modern consumer markets—both physically in China’s larger cities and online—as holding great promise as drivers of greater household willingness to spend.

## 4. LOOKING AHEAD: ACTIONS TO TAKE

Policy decisions will drive the initial impetus for a transition to a consumption-led economy. But it is up to business to nurture the demand that policy unleashes, aligning goods and services with consumers’ shifting preferences.

We highlight four areas in which business leaders should look for opportunities to help drive the transition to a consumption-led economy.

### Cultivating a new consumer class

The hurdles to consumer-led growth in China are not merely economic. Some are the effect of cultural norms, such as a reluctance to borrow to finance large purchases. To overcome this reluctance, companies need to work hard to communicate the benefits of their goods and services. Chinese people are eager to participate in a consumer economy, but companies will need to help them feel more comfortable about spending.

Good communication is behind the success of many products popular today but once unfamiliar to consumers. One recent example of effective communication is Apple’s wildly successful launch of the iPad in 2010. Many tablet computers were available in the 1980s, but not one was successful. It was only when advances in digital communication technologies made it possible for Apple to market the iPad as a device for media consumption—rather than as a replacement for laptops—that it was able to demonstrate to consumers how and why they should be using it. Shortly after its launch, the iPad became the product nobody knew they needed but from then on could not live without. Wearables are the next frontier, and a challenge for manufacturers will be how to educate consumers to use these devices both as a replacement for other devices and as a way to perform new tasks where no option exists today.

One segment of the Chinese market in which communication could generate a big payoff is property insurance. As the number of millionaires has exploded, so have purchases of expensive items such as cars, jewelry, and artwork. Last year, at a Sotheby’s auction in New York, a Chinese collector purchased a van Gogh painting for \$62 million, thought to be the highest price paid abroad by a Chinese collector for Western art. At about the same time, at a Christie’s auction in Hong Kong, a Chinese collector paid \$45 million for a Ming dynasty wall hanging. These are just two of the most visible examples of growth in Chinese purchases of art and other nonfinancial assets. According to Lloyd’s, however, the penetration of property insurance in China remains very low: between 2004 and 2011, only 1.4% of property losses were insured. Regulatory challenges and lack of insurance products are partly responsible for this low figure, but a major cause is the extreme caution felt by many Chinese about

buying unfamiliar products. Education about property insurance and its benefits will be necessary if significantly more is to be sold.

Consumer-facing businesses looking to enter the Chinese market should therefore embrace the challenges that come with educating new consumers. One advantage of the market is the high level of mobile penetration and consumers' willingness to learn about new products online. Almost half of the population already has Internet access. The opportunity to engage with consumers is greater than ever before. For foreign firms, the imperative is, too, because many domestic brands are now taking hold.

## Ensuring consumer access to products and services

Despite the huge leaps China has already made toward a consumer society, many categories of product remain unavailable outside the largest and most affluent cities, due to a dearth of modern trade channels and distribution networks.

The rapid spread of e-commerce is helping to overcome this problem, enabling companies to reach a larger population. Indeed, e-commerce in China is outstripping e-commerce in Western markets in terms of market share and speed of delivery, although there is still scope for more efficient shipping and distribution in all channels, and for moving from traditional to modern trade.

Post Mart, a chain of stores run jointly by the state-owned China Post and the international firm China Horizon Investment Group, has shown what is possible in terms of filling gaps in infrastructure by expanding retail access to rural areas through the postal system's distribution and retail network. In Brazil, Microsoft and Google offer another example of how infrastructure problems

can be addressed. The uncharted nature of Brazil's city slums, where an estimated 11 million people live, once made the delivery of online purchases or local retail distribution to these areas almost impossible. Microsoft and Google have since entered into partnerships with local community groups to map the slums, which will help companies reach these consumers, many of whom have access to mobile phones and whose incomes are rising. In China, slums are not prevalent. Because of the hukou system, however, many people live in informal housing in a city that is not their registered residence. Much needs to be done to understand and serve the demand of these consumers.

Improvements to the payments infrastructure also will enable access to new products and services, because many people in China still lack bank accounts and credit cards. M-Pesa in Kenya famously developed a business model to address this problem by replacing traditional banks with wireless carriers. In China, WeChat and Sina Weibo have used their social-media platforms to enable peer-to-peer and consumer retail payments. These are just two of many examples of payments innovations in China; in fact, Chinese domestic and international businesses are leading the way globally in consumer payments.

## Innovating to satisfy demand across different income, regional and age groups

For cultural, demographic and other reasons, products that are successful in developed markets are not always successful in China. If consumers are to be a dominant source of growth, multinational corporations will need to tailor their products to Chinese demand. And in a country with a population of nearly 1.4 billion spread over a huge area, there will be no such thing as one size fits all.



Take smartphones. Smartphone penetration is heading toward 50% in China. But in the past couple of years, it has become clear that Chinese consumers prefer smartphones with larger screens. This meant that Apple's iPhone was not the runaway success in China many had predicted, until Apple released the larger-screen iPhone 6 in 2014. The investment paid off. Apple's early 2015 earnings announcement declared record iPhone sales and year-on-year growth in China of more than 70%.

At the other end of the market, where companies battle for volume sales of lower-priced phones, Xiaomi takes the lead. Xiaomi's is a story of a local company that filled a gap Western smartphone companies missed. Its business model differs from that of manufacturers such as Apple and Samsung. It sells phones at close to cost through online channels, selling apps as add-ons to produce a stream of high-margin revenue. By late 2014, Xiaomi was the fifth-largest smartphone manufacturer in the world and is entering other emerging markets.

Personal transportation is a second industry in which it has been crucial to understand differences in demand between China and mature markets, and manufacturers that have done so have experienced tremendous growth. Audi, for example, focused on an extended-wheelbase version of its sedans to cater to the luxury market, and it now sells more luxury cars than any other manufacturer in China. Ford is developing Lincoln models that have more luxury in the backseat than the driver's seat, because many Chinese who can afford it prefer to be driven. As a result, these manufacturers have captured growth at the top of the Chinese market.

At the other end of the market are electric bikes—a low-cost way to get around quickly. A decade ago, there was no market for them.

Today, an estimated 200 million Chinese use them, and the number is rising. Driving much of this growth are the antipollution regulations in car-congested cities. Chinese manufacturers have been so successful that they now dominate the electric-bicycle market not only in China but globally.

The market for alcoholic beverages offers a third example of specific Chinese preferences. Traditionally, except for grain-based spirits drunk by older men in private or on business occasions, the Chinese have been less likely than people in many other cultures to drink alcohol routinely. This is changing. Wine is finding a market with women, who view it as a healthier and more aspirational drink than traditional spirits, and who are drinking more as their economic power and societal roles change. As a result, wine, starting from the smallest base, is the fastest-growing segment of the alcohol market, and spirits are the slowest growing. Lower-alcohol drinks, such as beer and wine coolers, are gaining popularity with younger adults, who are newer to alcohol.

In countless other market segments, multinational and domestic corporations stand to benefit by developing a thorough understanding of the specific preferences of Chinese consumers. The regulatory environment provides relatively few obstacles to understanding their likes, and companies can take advantage of modern capabilities to measure behavior and to communicate with consumers digitally.

## Offering more financial services to support consumption

Financial services are a critical underpinning of consumer spending in all economies. In a robust market, consumers have plenty of services to help them save, invest, or borrow.

But Chinese consumers still have a relatively limited set of investment and borrowing options.

Car financing is a significant untapped opportunity: fewer than 20% of new-car purchases are currently financed, compared with half of sales in Germany and 80% in the United States. Long-term car leasing and used-car financing also represent substantial opportunities. Chinese consumers have demonstrated strong demand for the latest models of different consumer products. The desire to trade in cars for new models, or to upgrade to a smarter model by buying a used rather than a new car, is likely to support the growth of car financing.

Insurance products also can promote consumer demand: paying steadily for health, life, and disability insurance, for instance, frees consumers from having to save in anticipation of major costs. The policies can also provide an annuity or serve as a vehicle for inheritance. The market for life insurance offers vast potential. Spending on it can be perceived as a form of saving and is thus likely to find favor with Chinese households. Current penetration of life insurance is estimated at just 2%. New products and business models to serve Chinese needs and shopping behaviors will help spread these products. For example, the Sino-U.S. United MetLife Insurance Company, catering to Chinese consumers' heavy use of digital technologies, recently announced an entirely digital platform for the purchase of life insurance products and services.

Sesame Credit Management Group, started by Alibaba founder Jack Ma, provides another example. Its new product may remove an obstacle to the expansion of consumer credit in China: the absence of credit history among consumers and of rating systems to assess credit risk. Sesame Credit Management

Group will use Alibaba's data to build a history of consumers' financial activity based on their online purchase behavior, including their record of paying utility and cell phone bills, so that their creditworthiness can be assessed. JD.com, another Chinese e-commerce giant, recently announced a similar initiative. This new class of credit ratings will be an important resource for Chinese consumers looking to take out a loan or to open a credit card account, enabling vastly increased spending. Multinational corporations looking to provide consumer credit services in China also will benefit from this and similar innovations, if they are able to adapt their business models to incorporate them.

\* \* \* \* \*

The transition to a consumption-driven economy will be complex and its timing hard to judge. Our view is that the level of consumption relative to GDP is likely to remain roughly flat at around 28% for the coming decade and not to rise substantially.

Energetic policy changes could, however, drive a speedier transition, as could the way businesses respond. Businesses should therefore monitor the speed of change, so that they can drive and shape the transition by addressing the needs and desires of China's consumers. If they do, they will continue to benefit from one of the greatest consumer-spending expansions in history.





天就

神樓佛具 名香

新時肉食公司

鴻運

海味 鮮產

和興臘家

九記肉

隆昌大





# APPENDIX – RESEARCH METHODOLOGY

The Demand Institute's research concludes that consumption's share of GDP in the Chinese economy will likely remain flat over the next decade. This conclusion is based on analysis of the experience of 167 economies between 1950 and 2011 from the Penn World Table v8.0.

The analysis used statistical tools to examine each country's economy and identify what we call regimes—that is, extended periods of time during which consumption's share of GDP was flat, decreased or increased. We then examined transition patterns, seeking to ascertain how common it is to move from a regime where consumption's share is decreasing to one where it increases, for example, or one where it remains flat before decreasing. There are nine different types of transitions, as shown in Figure A. Two consecutive periods when consumption's share of GDP is increasing or decreasing but the pace of change differs are counted as different regimes and hence constitute a transition. Thus, China's economy has transitioned from a regime of slower, more volatile decline in 1952-1998 to one of steeper and steadier decline in 1999-2011 (the last year for which data are available).

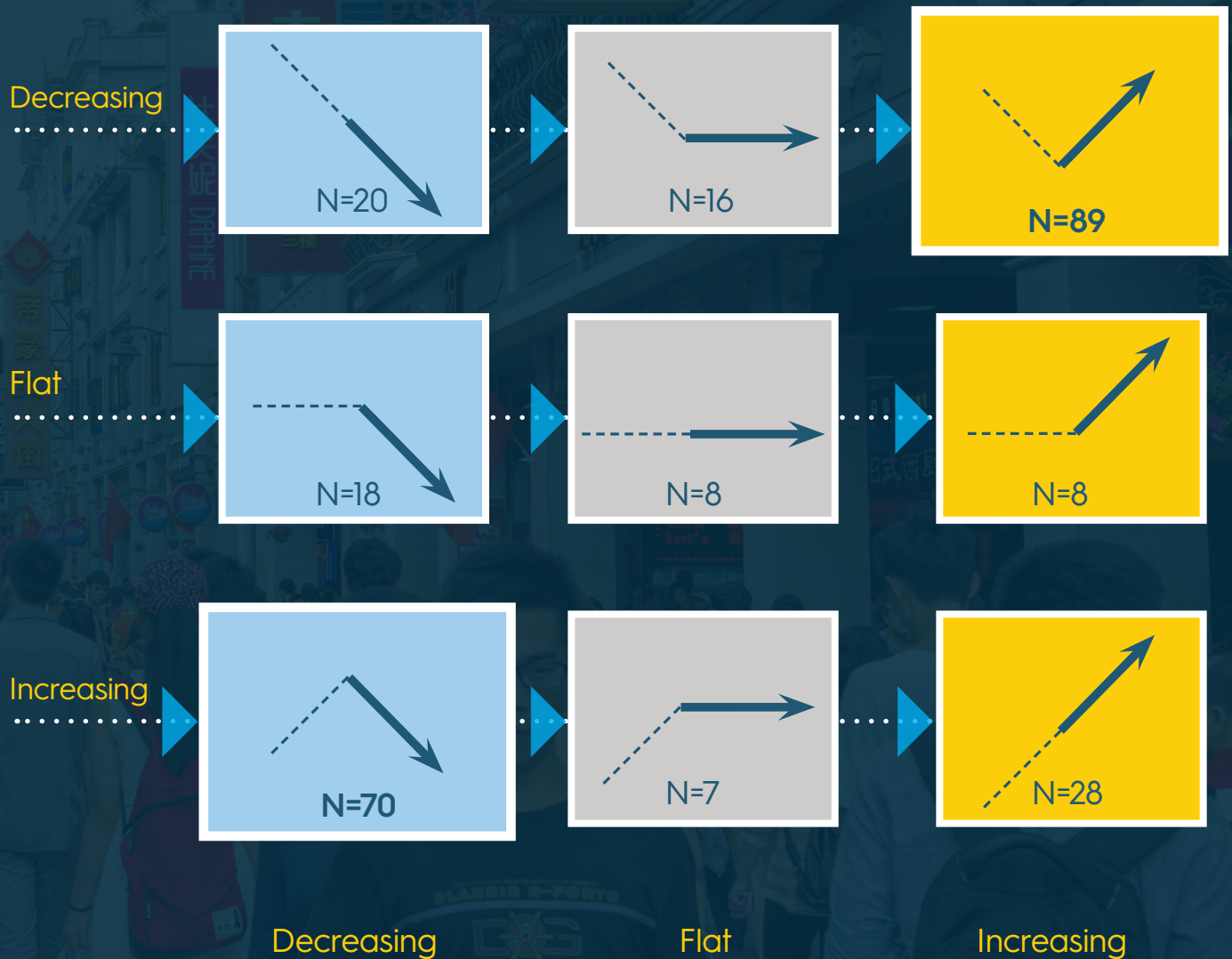






# GLOBAL TRANSITION FRAMEWORK

C/GDP, NUMBER OF COUNTRIES FOR EACH REGIME TREND  
AND TRANSITION SCENARIO



Analysis of these transitions suggests the future path of China's economy. A solid majority of transitions in the database—159 out of a total of 264—are reversals, where an increasing share of consumption relative to GDP switches to a decreasing share, or vice versa. (The greater number of transitions relative to the number of countries is accounted for by the fact that some countries made more than one transition during the time frame.) Of the transitions that began with a decreasing regime (125), the vast majority (89) moved into an increasing one. Only 16 went from a declining to a flat regime.

At the very least, this finding suggests that a further extended period of falling consumption relative to GDP is unlikely in China. Indeed, this measure might at first glance seem likely to rise next. However, the path that any single country takes is ultimately decided by the specific economic conditions that prevail. To further our understanding of which regime China might next follow, we compared features of its economy today with those that prevailed in countries where consumption's share of GDP fell before transitioning to a flat or increasing regime.

China's sharp decline in consumption's share of GDP in recent years has been accompanied by high growth in per capita GDP, increases in investment as a share of GDP, growth in total factor productivity (until very recently), and large increases in capital intensity. All are indications of an economy being led by investment and an increase in higher-value-added manufacturing. These are characteristics most commonly found in regimes where consumption's share of GDP transitioned to a flat regime after declining. This supports the view that China will make a similar transition.

There is further evidence. Countries that transition from a declining to a flat regime continue to see positive growth in per capita

GDP once the transition is made, but at lower rates. These conditions are consistent with forecasts of slowing future growth in China. In addition, a declining-to-flat transition is most closely associated with countries with a middle-level per capita income, and where the ratio of capital to labor inputs is growing strongly. Again, this is consistent with current economic conditions in China.

## Timing

The analysis shows that the median length of a decreasing regime that ultimately transitions into a flat one is 19 years. China has been in its current regime for 15 years, suggesting a transition is imminent. China's consumption held steady at 28% of GDP in 2010 and 2011. This does not confirm a long-term trend, but it does offer further support for our view that consumption's share of GDP in China is on the cusp of a transition from declining consumption as a share of GDP to a period when it remains flat.

The analysis also indicates how long the next regime might last. According to our analysis, a flat regime that follows a decreasing one typically lasts 16 years. Thus, if China follows this trajectory, we should expect consumption's share of GDP to remain flat at least until 2025 and possibly for a few years beyond.

## Regime reversal

Finally, the analysis considered the extent to which consumption's share of GDP might grow following a period of decline. This was a means of scoping an upper limit for the potential impact on consumer spending, were conditions in China to change as a result of policy reforms and subsequent business actions, supporting a transition to a regime where consumption's share of GDP would grow substantially rather than stay roughly

flat. The analysis showed an increasing relationship between the magnitude of a decline and the subsequent increase in the 89 transitions that followed this path. Moreover, a rising regime following a declining one typically lasted 13 years. On this basis, if China were to transition from a declining to an increasing regime in a way similar to that of other markets, we would expect consumption's share of the economy to grow steadily to 46% of GDP by 2025.

Further detail about the research is available on request.













**SOLD IN CHINA:**  
TRANSITIONING TO  
A CONSUMER-LED ECONOMY

LOUISE KEELY AND BRIAN ANDERSON