

China's MegaTrends:

(3) Rise of the middle-class – the birth of a consumer society

The Great Spenders

yueguangzu in Putonghua (1) literally translated as the 'moonlight clan' does not make any sense. It is actually a Chinese pun referring to a new young generation who spend to the hilt every month. They are the product of the One Child Policy and have grown up being doted upon by two parents and four grandparents (the so-called 4-2-1 phenomenon). In recent years, the rapid rise in household income has pushed them to the forefront of a burgeoning consumer society.

Statistics show that the rate of consumption growth far outpaces the growth of per capita disposable income of urban residents. According to a research article *Overview of China's Retail Sector* published in *China Distribution and Trading* (2), the per capita retail sales of consumer goods was only RMB 184.5 in 1979. The figure grew by 1822% to RMB 3,547 in 2003. Two consumption booms were identified: the first from 1983 to 1988 with an average annual growth rate of 21%; the second from 1993 to 1996 with an annual growth rate of 26%. Both periods were characterized by the popularization and the upgrading of household durable goods especially electrical appliances.

Changing consumer patterns

In October 2009, the National Bureau of Statistics stated that China's retail sales increased by 16.2% year-on-year to RMB1.172 trillion (\$171.6 billion). The consumption pattern has long broadened to embrace new apartments, interior decoration, automobiles, laptop computers, flat-screen TVs, iPods, jewelry, culture and entertainment, to quote just a few examples. According to a research conducted by the Horizon Research Group (3), amongst middle and high-income urban residents, 16.5% switch to a new mobile phone within one year and 26.1% change their MP3s within two years. The group from 30 to 40 years of age accounts for 37%, the largest proportion of high-income city dwellers, followed by the group aged 40-50, representing 31.3%. For the young in education, their annual pocket money is on average RMB 2,300, according to an investigation in 2006 by the Research Institute of Sociology under the Shanghai Academy of Social Science. According to another investigation in the high-income cities of Beijing, Tianjin and Shanghai, 85% of families admitted that their children's monthly consumption costs as much as one-third of family income (4)

A report by the China Internet Network Information Centre (5) points out that about a quarter of China's internet population of 338 million (6) shops online. The number of online shoppers rose to 87.88 million despite the economic crisis, an increase of nearly 14 million within six months. Cosmetics and mobile phones feature prominently. Also becoming popular

are healthcare products including nutrition supplements and exercise equipment and services. Amongst urban residents, 86.1% named health as their top priority.

As urbanization is rapidly spreading to the countryside (7), the potential of the rural population (70% of China's total) becoming more avid consumers cannot be under-estimated. The Ministry of Commerce (MOFCOM) has estimated that every yuan spent by farmers will increase two yuan of consumer demand in the national economy.

The luxury end of the market is witnessing dramatic growth in recent years. The President of LVMH Yves Carcelle has remarked that China will become the world's largest luxury market. Sales of Louis Vuitton goods have been soaring by about 50% annually. Statistics provided by GEMS Ltd, a consultancy, has revealed that China has become the largest consumer of platinum jewelry with annual sales reaching 1.4 -1.5 million ounces, or 44% of the world's total (8).

The Rising Consumption Class

Following a survey in 2005, the National Bureau of Statistics concluded that an annual household income of RMB 60,000 to 500,000 defines what may be called the middle-class. Under this definition, about 20% of the population falls into this category. A report by BNP Prime Peregrine concludes that better days are still to come for China's luxury market. When middle-class families reach 100 million by 2012 with average assets of RMB 600,000, China's consumption rate may rocket to 71% by 2020, about the same level of developed countries today (9).

The 2009 Hurun Report on China's wealthiest people highlights Beijing as having 143,000 multimillionaires and 8,800 billionaires. Shanghai has 116,000 multimillionaires and 7,000 billionaires. In a research note in September 2009, the Boston Consulting Group estimates that China is set to become the world's largest luxury market 'in the next 5 to 7 years' (10).

A McKinsey research article (11) shows that because of rising concerns with health and safety, particularly edibles, most Chinese shoppers, 63 % in 2008, enter a store with a shortlist of favorite brands. Although this percentage represents a drop from 73 % in 2007 due to growing price sensitivity and in-store promotions, it still displays a high level of brand loyalty. Amongst the country's high earners, people making more than RMB 5,000 (\$730) a month, their share of private consumption, now 15 %, is expected to rise to more than 50% by 2015. These high earners are prepared to pay a premium for better products in more than 60 % across many product categories.

In a survey conducted over a two-week period ending 9 March 2009, a report by FT China Confidential (12) reveals that despite the global financial crisis, Chinese consumers in the middle and upper income groups (earning between RMB 40,000 and 120,000 a year and above) remain fairly bullish, with 46% to 51% intending to increase spending in 2009. Top on their list

of preferred purchases include personal computers, mobile phones, private cars (especially government-subsidized 'green' cars), digital cameras, educational courses, and tourism, in that order. Currently, these two groups of discretionary spenders account for 36% of total consumer spending. By 2015, this proportion is expected to increase to 44%.

Consumption trends

The FT report highlights three consumption trends. The first is that second and third-tier cities are gaining ground compared with those in the more established Yangtze and Pearl River Deltas which have been dominant over the last 30 years. The second is that young adult spenders are coming to the fore. The third is that Chinese brands in some key product categories including private cars are experiencing a surge in popularity.

Similarly, a report published in October 2009 by Bates 141, an Asian marketing communications network and part of WPP, finds significant consumption potential in China's many booming county-level cities. The report was based on a survey of people aged 16 to 35 (13) in eight such cities over the past two years. There are more than 4,000 third- and fourth-tier cities in China. According to figures recently released by the National Bureau of Statistics, the retail sales of consumer goods at and below county level totaled 3.48 trillion yuan (\$497 billion) in 2008 compared with 1.84 trillion yuan in 2004.

Unique Chinese consumer behavior

An earlier McKinsey comparative study in June 2007 (14) found that Chinese consumers spend 9.8 hours a week shopping in stores, compared with an average of 7.2 hours a week for BRIC countries (Brazil, Russia, India and China) as a group and just 3.6 hours a week in the US. Only 50 % of Chinese consumers see themselves as a loyal customer of at least one store, compared with 59 % for the BRIC average, and 67 % in France. Only 30 % of Chinese spend more than 50 % of their money in any one retail category at their main store, compared with 80 per cent of consumers in the US. Although Chinese consumers are price conscious, they are prepared to pay a premium for quality and freshness. 52 % of the respondents believe that cheap means poor quality, compared with just 16 per cent in the US. As a result, just 12 % of Chinese consumers bought the cheapest food regardless of quality, while 24 per cent of French consumers did so.

Coming inflexion points

Taking stock of the value of China's emerging middle class, a study in The McKinsey Quarterly (15) indicates that the cohort in the annual household income bracket of RMB 100,001 to 200,000 is expected to jump from 0.6% of the total in 2005 to 36.4% by 2025. Adjusted for purchasing power parity, a household income of RMB 100,000 is roughly equivalent to that of \$40,000 in the US.

The study anticipates two main surges of consumer power. The first surge is forecast to happen in 2010 when the proportion of the lower middle class with annual household income of RMB 25,001 to 40,000 is expected to be more than that of the poorer households below this

income level. The second is expected to occur in 2020, when the size of the upper middle class with annual household income of RMB 40,001 to 100,000 is expected to exceed that of the lower middle class.

In 2006, 77.3 % of households lived with less than RMB 25,001 a year. By 2015, this proportion will drop to 9.7%. Instead, 79.2% will consist of the lower and upper middle classes. The remaining 11% will be the mass affluent with an annual household income of RMB 100,001 to 200,000 and the global affluent with an annual household income level over RMB 200,000. By that time, China will become one of the leading consumer markets in the world, with an annual turnover of RMB 20 trillion, about the size of Japan's consumer market today.

Why more spending amongst savers?

Today China's households save a quarter of their income. Although China is expected to improve her social safety net gradually, the urban saving rate is expected to decline only moderately and remain at a fairly high level, above 20%, over the next two decades. However, as incomes rise, so will spending patterns change. The outcome will be a rise in total urban consumption by 8.7% annually and by 6.1% annually in per capita consumption.

Over the period 2004-2025, the McKinsey study estimates that the biggest rise in spending would be in housing and utilities with a compound growth rate of 11.8% p.a. Healthcare consumption is expected to grow at 11.6% p.a., recreation and education at 9.5% p.a., and transportation (such as private cars) and communication (for example, personal computers and mobile phones) at 9.3% p.a. Though expenditure on food is expected to increase moderately at a compound rate of 6.7% p.a., China's huge population means that this will remain the largest expansion in absolute terms, making China the fastest growing food market in the world.

According to the McKinsey June 2007 study referred to earlier (16), the Chinese market was worth US\$800 billion in retail sales in 2006, behind only the US and Japan, and was bigger than the rest of Asia combined. It was already the fastest-growing retail market in the world, expected to be worth US\$1.3 trillion annually within five years.

The rise of the Chinese consumer is supported by an earlier survey (17) undertaken by a Credit Suisse team in eight major cities in 2005, using its proprietary research database. Assuming a rising consumption-to-GDP ratio and gradual real exchange rate appreciation, China is expected to quadruple her share of global consumption spending and displace the US consumer as the engine of consumer growth in the world economy by 2014.

Consumer behavior by sectors

The survey highlighted a host of interesting consumer behaviour in various sectors.

For example, debit and credit card ownership is inversely correlated with age. The ownership of debit cards was slightly more than double and of credit cards three times more in the 20-29 age group than in the 50-59 age group.

Only 7% of car owners finance their cars. 15% and 41% of private car owners are likely to replace their cars or buy another for their household within the next three years.

The beer market is the largest in the world at 256 million hectoliters. The branding is highly regional. Foreign brands have only a 10% market share. Similarly, international imported spirits account for less than 1% of the total market but have very high profit margins in high-end bars and restaurants.

With a 5% household penetration rate, China already accounts for 14% of personal computers worldwide, compared with 37% in the US. Only 35% of respondents are prepared to pay a premium for foreign brands of personal computers. Foreign brands, however, account for the major share of the mobile phone market. Amongst the surveyed cities, mobile phone penetration rate has reached 81% with handset owners intending to replace their handsets in 1.4 years on average.

85% now buy food in hypermarkets, compared with 58% three years ago. Total restaurant frequency is 4.6 times per month, but only 1.2 times per month for Western fast food, compared with 4 times per week in the US fast food market. YUM Brands (KFC) is far bigger than McDonalds and has higher unit volume and profit margins than their international and US averages.

As for household and personal care products, 51% perceive quality as most important. Procter & Gamble has the largest absolute presence with over 50% market share in some categories, such as shampoo and hair care, while Colgate accounts for 80% of oral care sales.

Total spend on luxury goods is RMB 12,518 over the past three years. This is expected to grow to RMB 8,026 per year. The penetration rate of European luxury brands is still low with no clear brand leadership. Local products are often mistaken for luxury.

54% of males smoke but only 4% of females. Smokers spend on average RMB 181.5 on cigarettes each month, 20 times the US consumption, accounting for 31% of the global volume. Foreign brands, however, accounts for only 3% of the market.

In the past, international air travel was mainly driven by business and in-bound traffic. Now 13% of the respondents are likely to take an overseas holiday in the following year. The top travel destinations are Europe (30%) and South East Asia (25%). 47% prefer Chinese airlines compared with 26% for foreign carriers. There is, however, a strong brand recognition of European airlines. A surprising find is that of 23% of holiday goers intend to take a cruise (mainly to South East Asia) compared with 1.5% for the UK, 0.5% for Germany, and 3% for the US.

The Chinese wealthy

An important sector of China's booming consumer market is the wealthy. The number of wealthy households reached 1.6 million in 2008 and is expected to grow to more than 4.4 million by 2015, behind only the United States, Japan, and the United Kingdom in sheer size (adjusted for purchasing-power parity). Even with the current economic slowdown, the number of wealthy

households in China is likely to grow at 16 % for the next five to seven years. In developed markets, this group grows largely in line with GDP.

A more recent study by McKinsey in July 2009 (18) analyses the consumer behavior of 1,750 wealthy Chinese consumers in 16 cities in households earning more than \$36,500 annually. This is equivalent to the spending power of a US household making \$100,000 a year. China's four richest cities—Shanghai, Beijing, Guangzhou, and Shenzhen—account for about 30 % of all wealthy consumers. The top ten cities are home to some 50 % of them, compared with 25 % in the US. But this concentration is giving way to the much faster growth of the wealthy (mostly entrepreneurs) in the second-tier or even third-tier cities. From 2008 –2015, their growth in Tier-1 cities (19) is expected to be 25%, in Tier-2 cities 32% and in Tier-3 cities 43%.

The study identifies in China's *nouveau riche* very different consumer behavior from their counterparts in other countries. One clear distinguishing feature is their youth. 80 % are under 45 years of age, compared with 30 % in the US and 19 % in Japan. In addition, they value the functional benefits of any particular purchase (the quality, material, design, or craftsmanship, for instance) more than their counterparts elsewhere. The emotional benefits count, but a little less. 52 % trust foreign brands, compared with only 11 % amongst China's mainstream consumers. They are more amenable to new technology and consumer credit. 77% watch a lot of television and spend a good deal more time surfing the internet. They are more socially active and more likely to find it difficult to maintain a satisfactory work–life balance. They spend 17 % of their household income dining out and 10 % on leisure and entertainment, including sports and health spas. Rather surprisingly, wealthy consumers living in the four largest cities display more conservative attitudes toward saving and family than their counterparts in smaller cities. Depending on their income levels, degree of sophistication and penchant for showiness, they display very diverse consumer characteristics.

Reality check

The above descriptions of China's burgeoning consumer society must not be exaggerated. Above all, it is easy to get carried away by seeking what may turn out to be fool's gold.

The retail sector, for example, is full of trap doors for the uninitiated. Total retail sales reached RMB 1.13 trillion (\$166 billion), according to the National Bureau of Statistics in December 2009. The growth was 15.8% in November, 2009 despite the global financial crisis, 5% less than a year earlier (20). However, this is still miniscule in global terms, less than a tenth of US non-car retail sales. About half of this consists of subsistence purchases in rural areas and small towns and cities, served by a fragmented maze of individual home retailers. Moreover, the whole market is highly fragmented. Apart from the still nascent hypermarket sector where Carrefour and Wal-Mart have a strong position, most of the nation's 30 biggest retailers are local. Yet they accounted for only 16.5 % of the national market in 2006, compared to figures of 37 % and 31 % in the US and South Korea respectively. Transportation is inefficient: logistics costs in China are 20 % of GDP, compared to 8% in the US (21).

Imperatives of a Consumer Economy

In fact, a McKinsey report in August 2009 confirms that domestic consumption accounts for only 37% of China's GDP, the lowest of such ratios amongst the world's major economies except Saudi Arabia. Indeed, China's savings rate is 15 % above the GDP-weighted average for Asia as a region (22). The same report suggests that a larger consumer economy would lead to greater efficiency of allocating capital and resources, more job creation, and more equitable distribution of benefits. It would even help the economy grow more rapidly. Above all, China has learnt from the global financial crisis the vulnerability of her economy to external shocks. Expanding domestic consumer spending has now become a national priority (23).

Moreover, as a result of China's huge stimulus package in response to the financial crisis, gross fixed capital formation accounted for 70% of China's growth in 2008 and close to 90% of China's growth in the first half of 2009. The incremental capital output ratio or marginal productivity of such capital investments is deteriorating rapidly and the capital investment-led growth is unlikely to be sustainable (24).

Structural barriers

China's very high savings rate is both behavioral and structural, according to the August 2009 McKinsey report (25). However, the study estimates that a fully fledged program to expand China's health and retirement benefits alone would only add one percentage point to its 2025 base-case GDP projection on the strength of the existing investment-led development model.

The other more formidable structural barriers are, firstly, an inadequate supply of suitable products available to over half of China's population. They live in rural areas where retail establishments account only for 18 % of consumption, compared with 50 % amongst urbanites. Secondly, consumer debt only accounts for 3% of China's GDP, well below other large developing countries, such as Brazil (12 %), or Russia (7 %). Mortgages take up 90% of bank lending to consumers. Only the more affluent urbanites can obtain mortgages, which cover just 23 % of the value of new homes in China, compared with 65 % in the United States.

The number one barrier, however, is the need to save for a university education for one's offspring. Nine in ten Chinese households hope to send their children to college. On average, the cost of a university education is nearly half the disposable income of a typical Chinese family.

The McKinsey study calculates that making products more affordable and more easily available in rural areas, expanded access to consumer credit, and helping with the cost of university education could raise consumption's 2025 share of GDP by 2.8 to 4.7 percentage points.

Conclusion

A young and dynamic consumer society has been borne in China and growing fast, along with the rise of a better educated middle class. This will have a massive influence on the types of goods and services China sells to and imports from the world and the quality and nature of China's international businesses. It is also set to broaden and deepen China's interaction with the world's civil and intellectual society and value systems. An interesting question will be to what

extent China's social and political systems will evolve in this dynamic process. This will be the subject of a later chapter.

- (1) *Yueguang* is Chinese for 'moonlight' but is also a Chinese vernacular acronym of *yue* ('moon' or 'month' or 'monthly') and *guang* ('light' or as a homonym for 'empty' in the sense of an 'emptied wallet').
- (2) *Overview of China's Retail Sector*, China Distribution and Trading, Li & Fung Research Centre, Issue 19, November 2004
- (3) Referred to in *Spending Spree* by Lan Xinzhen in *Beijing Review*, 26 April, 2007, page 30
- (4) *Growing Expenses*, Special Report, *China Today*, June 2006, page 17 -18
- (5) *Beijing Review*, 26 April, 2007, page 31
- (6) See section under Internet in my Chapter on Rapid Mobility
- (7) See my Chapter on Massive Urbanization
- (8) Will '07 Open Wallets?, *Beijing Review*, 4 January, 2007, page 33
- (9) *Growing Expenses*, Special Report, *China Today*, June 2006, page 23
- (10) *China's Luxury Market in a Post-Land-Rush Era* by Matt Anestis, Jean-Marc Bellaiche, Hubert Hsu, Michelle Eirinberg Kluz, Yan Lou and Vincent Lui, The Boston Consulting Group, September 2009
- (11) *What is new with the Chinese Consumer*, by Ian St-Maurice, Claudia Süßmuth-Dyckerhoff, and Hsinhsin Tsai, *McKinsey Quarterly*, October 2008
- (12) *China Confidential*, a *Financial Times* publication, 2 April, 2009
- (13) The growing number of younger and upwardly mobile Chinese spenders is a leading example of a global trend of the so-called *A Generation* with rising consumer Aspirations. Aged between 30 and 40, their per capita income is rising fast and their numbers are forecast to hit one billion within the next two decades. The resultant global demand explosion is expected to occur when large numbers of people - particularly in China - hit the "magic" annual per capita income of \$3,000.
- (14) *The Consumer Trap*, 2 June 2007, by Wai-Chan Chan, a partner and Anne Tse, an associate principal in McKinsey & Company's Hong Kong office
- (15) *The Value of China's Emerging Middle Class*, by Dianna Farrell, Ulrich A. Gersch, and Elizabeth Stephenson in *McKinsey Quarterly* 2006 Special Edition, pages 60 – 69.
- (16) See Note (14) above
- (17) Jonathan Garner, *The Rise of the Chinese Consumer – Theory and Evidence*, John Wiley and Sons, 2005
- (18) *Understanding China's Wealthy*, *McKinsey Quarterly*, July 2009
- (19) Chinese cities are grouped into tiers according to level of total consumption and potential future growth. Source: 2008 McKinsey survey of wealthy Chinese consumers; McKinsey Global Institute
- (20) *People's Daily Online*, 11 December 2009
- (21) *Retailer's Fool's Gold*, by Arthur Kroeber, managing editor, *China Economic Quarterly*, 16 July, 2007
- (22) For comparison, such ratios are Mexico (73%), Chile (71%), US (71%), South Africa (68%), United Kingdom (67%), Brazil (65%), Russia (62%), Poland (61%), Canada (60%), France (58%), India (57%), Japan (55%), Germany (54%), Taiwan (54%), Thailand (54%), Hong Kong (53%), Malaysia (52%), South Korea (48%), Singapore (40%). Source: *A Consumer Paradigm for China*, *McKinsey Quarterly*, August 2009, McKinsey Global Institute, Exhibit 2
- (23) "Our focus in countering the crisis is to expand domestic demand, especially consumer demand," President Hu Jiantao said in his address at the Asia-Pacific Economic Co-operation forum in Singapore on 13 November 2009
- (24) *China's Investment Boom: The Great Leap into the Unknown*, a research note by Pivot Capital Management, 2009
- (25) *A Consumer Paradigm for China*, *McKinsey Quarterly*, August 2009, McKinsey Global Institute

