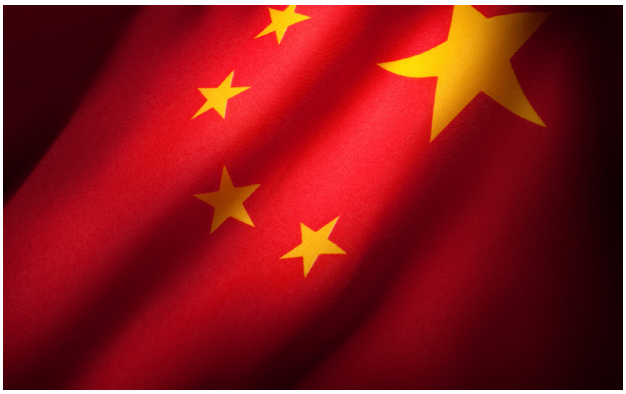
McKinsey Insights China



What's next for China?

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What's next for China?

Introduction

The economic backdrop to the 18th national congress of the Chinese Communist Party may not have been all sunshine. But the continuing robust growth of the world's second biggest and most dynamic large economy should have provided cheer for Party members as they gathered in Beijing to appoint the next generation of China's leadership. And while the new leadership's stance on some issues may be widely debated, there already appears to be a consensus that the country must navigate to a slower but more sustainable growth path marked by greater productivity and consumer input—and there are early signs it is moving in that direction.

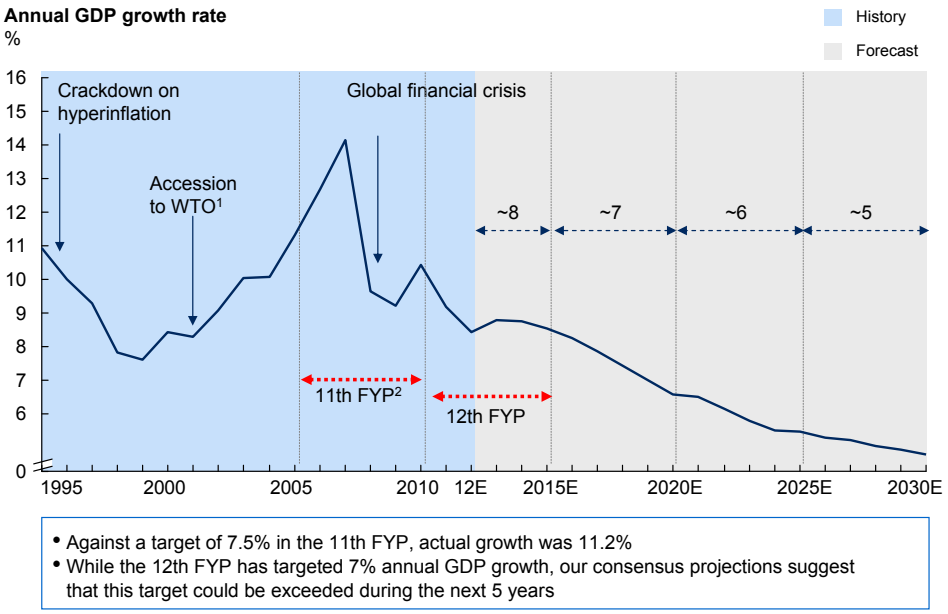
In this paper we provide insights for Chinese and international business leaders into how the profile of China's economy is likely to change on this evolutionary path, how this will play out in the country's cities, which are key drivers of growth, and what are some implications for their businesses.

Our macroeconomic perspective on China is that the country will maintain growth momentum by transitioning from an investment-led economy into a consumption-driven and service-driven economy by 2030. As China's economy makes this transition and continues to expand, the consensus of GDP projections that we have compiled suggests that the economy's growth rate will be, however, slower than in the last decade (Exhibit 1).

Progress in China, however, is never in a straight line, as the exhibit amply demonstrates. Periods of consumer-oriented policy are likely to be followed by periodic reversions to investment-led growth, as indeed appears to be happening in the fourth quarter of 2012. Policy makers will teeter between making short-term infusions of cash to support stability and embracing the risks of funding entrepreneurs and consumers to prompt growth.

Markers of China's progress toward the goal of a more economically developed society will be higher productivity of its workers and higher productivity and greater efficiency on the part of government. These trends will result in more and better-paid employment and a greater share of national income in the hands of consumers—the key determinant of China's future economic profile. This is the scenario that the experts and international executives whom we regularly survey[1] have identified as the most likely for China. We have studied a number of

Exhibit 1 China's GDP growth is likely to slow—but could grow faster than announced targets.



1 World Trade Organization.
2 Five-year plan.

Source: McKinsey Global Economics Intelligence; McKinsey Insights China macroeconomic model update (April 2012)

1 The outlook presented in this paper combines insights from McKinsey's Insights China and Global Economics Intelligence (GEI). GEI conducts regular polls of a group of senior global executives on their view of the outlook for the global economy and invites them to select from a range of scenarios the one they regard as most likely to unfold. The scenario is then used as the baseline for projections made by McKinsey's Insights China research service line, which includes a macroeconomic database for China. Employing the database in conjunction with the selected scenario makes it possible to build the projections presented in this paper.

other scenarios, but we are not covering them in this paper because they are not backed by this consensus of opinion.

Just as in other emerging economies that have moved through an investment-led phase, consumption in China rises as income levels rise. High levels of investment turn into consumption over time—roads are built for travelers, buildings for residents. At the same time, we expect policy initiatives led by the Chinese government to reinforce the trends toward higher productivity and greater income. These initiatives could include shifting toward services and advanced industry sectors (in particular, seeking leading positions in industries for which China will be a major market), encouraging the accelerated rise of smaller cities in a cluster-based pattern, and boosting efficiency in agriculture and in energy production and energy use. Our projections also suggest that as labor costs rise and the population ages there will be pressure on low-value-added export-oriented sectors and labor-intensive sectors. As a result, these sectors' share of the economy could decline.

For businesses, there are clear opportunities to capture through differentiated approaches to the growing cities' markets, while allocating their resources in an optimized way to the emerging hub-and-spoke city clusters. The increasingly affluent population of Chinese consumers presents huge market potential, but China's demographic trends will create a more demanding labor landscape in terms of remuneration and employee requirements, and businesses need a comprehensive understanding of the country's economic environment. Successful innovation in China is similarly likely to depend on deploying this deeper perspective. Companies that take the time to build an understanding of this key market will reap the rewards.

What is needed for a consumption-driven economy?

A new chapter is opening in China's development. The country is starting to turn the corner to becoming an economy where private consumption will replace investment as the major driver of GDP growth and eventually constitute the largest share of GDP.

Our projections suggest that within the next five years, the consumer's contribution to GDP growth will stop its long-term decline and begin to grow and gradually accelerate. In contrast, investment's share of GDP growth will continue to decline from the peak it reached in the global financial crisis and its immediate aftermath from 2008 to 2011. Trade will also see its net contribution to GDP growth decline from the peak it reached in 2008—although exports will continue to be an important driver of economic activity, particularly in coastal provinces (Exhibit 2).

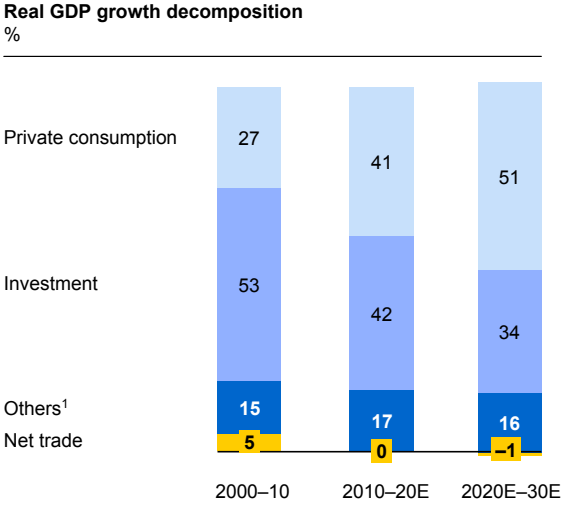
The acceleration of growth in private consumption will result in it becoming the largest contributor to GDP growth by around 2020, our projections suggest. These changes in the dynamics of GDP growth will lead to changes in the overall composition of China's GDP: by around 2025, private consumption could overtake investment as the largest component of GDP (Exhibit 3). We do not identify a specific point at which the share of GDP growth from consumption will outpace that of investment.

By evolving in this way, China will be following the same pattern of peaking followed by a decline of investment that has been seen in the economic development of other Asian countries, including Japan and South Korea.

Household income growth as a driver

This evolution marks a major shift from the investment-led growth model that China has been implementing since 1990. Over the past two decades, the growth in China's GDP has been largely powered by investment by government and the corporate sector—primarily state-owned enterprises that retained or reinvested their relatively high returns on

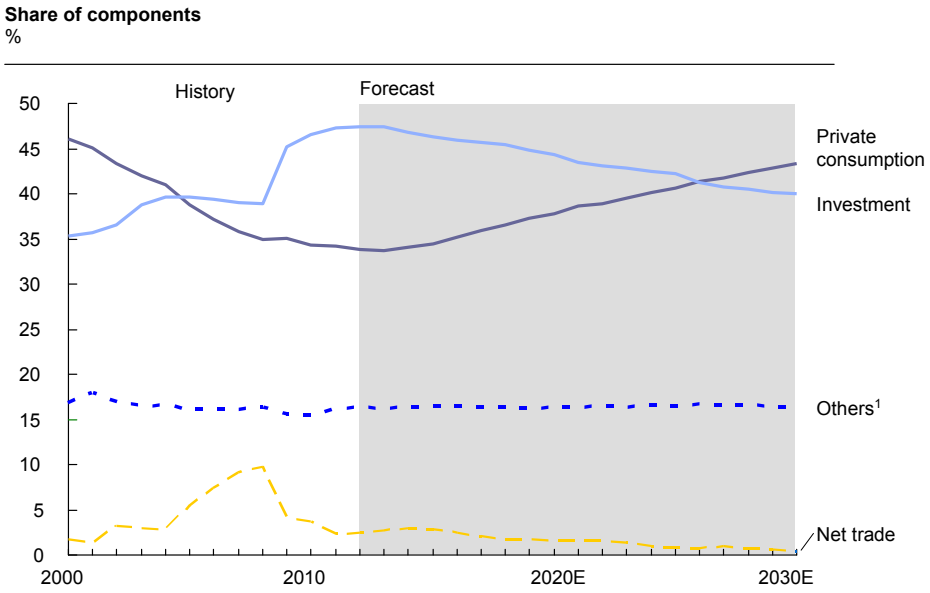
Exhibit 2 Consumption is expected to overtake investment as the largest contributor to China's GDP growth.



1 Others include government consumption and inventory.

Source: Global Insights; McKinsey Insights China macroeconomic model update (2012)

Exhibit 3 Consumption's share of China's GDP is expected to gradually increase.



1 Others include government consumption and inventory.

Source: Global Insights; McKinsey Insights China macroeconomic model update (2012)

investment. This investment has increased at such a fast rate that although household income has risen consistently over the period since 1990, as a percentage of GDP, it has fallen from 70 percent in 1990 to 57 percent in 2011. However, our projections suggest the household income share of GDP could start to rebound.

We see three drivers for this acceleration in household income growth. First, wages are likely to rise due to government policies and structural changes in the labor market. Second, financial reforms are likely to stimulate additional employment growth and thus income generation. Third, opening up wider areas of the economy to private enterprise could encourage more productivity growth, lower costs, and allow greater income to accrue to households.

1. Wage levels. Policy makers have set a clear target that per capita disposable income should rise at least as fast as GDP in the 12th five-year plan. The main steps are focused on increasing minimum wages and the reference wage. Four-fifths of China's administrative districts took action in the first half of 2012: 16 provinces raised the minimum wage by an average of 19.7 percent, and 12 others raised the government reference wage by an average of 14 percent. Supply and demand dynamics are pushing in the same direction as government policy: as we will discuss in more detail later in this paper, China's labor pool is shrinking due to demographics and a reduced flow of migrant labor from rural areas, and this is exerting upward pressure on wages.

2. Financial reforms. Steps by the government to open financial markets and increase competition in the economy could also help expand private-sector activity that in turn could boost employment and accelerate household-income growth.

Interest-rate deregulation could be the first such step. This is arguably the key lever for renewing expansion of China's economy, as it would increase competition among banks, broaden the pool of enterprises that receive credit, bring in more players (including foreign capital), and help reduce loan-and-deposit interest-rate differentials. Higher deposit rates would raise household incomes, while loan rates would fall for borrowers.

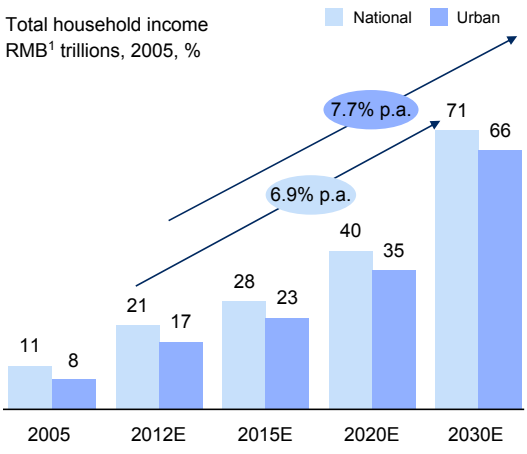
The lack of competition in the financial sector currently restrains private enterprises—especially small and midsize enterprises (SMEs) and service-sector enterprises with few tangible assets—from getting bank credit. Introducing market-based incentives for banks could help private

enterprises obtain financing more easily from small or foreign banks or from nonbank financial institutions. The combined impact of having more financial players and more market-driven regulation could make financing transactions easier and more efficient, and the resulting higher level of economic activity could increase returns that would in turn boost incomes.

3. Stimulating competition. Other rules block investment in certain sectors. The government could encourage competition there by opening them up to private capital, which would help to boost productivity and resource optimization. The government is already making progress in opening up resource-focused areas such as mining, electricity transmission and distribution, and water to more competition. It is also starting to encourage greater competition in telecommunications, health care, and rail- and air-transportation services. Under consideration are steps to encourage greater competition in the ownership and management of China's infrastructure, including roads, railroads, bridges, city water pipelines, and city power-distribution networks. Opening up closed and monopoly markets to greater competition will help shift a greater share of total earnings away from corporate entities, especially state-owned enterprises, and to households instead as prices come down and productivity improves.

Exhibit 4 Household income could outpace GDP growth through 2030.

Real GDP growth, China: 6.5%, 2012–30



1 Renminbi.

Source: Global Insights; World Bank; McKinsey Insights China macroeconomic model update (April 2012)

Should all these drivers play out as expected, income per household would more than double by 2030, according to our projections. This means that household income growth will narrowly outpace GDP growth in the 2012 to 2030 period: our projections show urban household income growth at 7.7 percent per annum across the period, national household income growth at 6.9 percent per annum, and GDP growth at 6.5 percent per annum (Exhibit 4).

Consumption to move into higher gear. Our projections suggest that household consumption will rise faster than household income over the same period. China's household savings rate is expected to decline from 42 percent of income to 36 percent in 2020 and 29 percent in 2030, again following a similar pattern to that seen in the economic development of other Asian economies.

Growing consumer confidence based on income growth is expected to be the most important factor that will drive consumption ahead of income. Once household income reaches a certain level and is backed up by rising confidence in sustained growth, Chinese citizens would be more willing to increase consumption instead of simply saving. Other factors will reinforce this greater propensity to spend—once a certain income level is in reach. First, government subsidies to social security are expected to triple by 2015, strengthening China's social safety net. Second, an increase in local-government-provided housing supply and stricter regulation of property prices could make it less essential for Chinese citizens to save at such high rates. Third, urbanization and modernization could be expected to encourage China's population to spend more, in particular on discretionary goods. Last, an appreciating renminbi could provide stronger purchasing power for acquiring imported goods, again promoting consumption.

We project China's urban consumption to grow at 9 percent per annum between 2012 and 2030, and overall national private consumption to grow at 8 percent per annum. In our estimate, consumption per household will increase nearly threefold, from 39,000 renminbi for urban households and 30,000 renminbi for the national average in 2012 to 112,000 renminbi for urban households and 92,000 renminbi for the national average in 2030.

A shift in the structure of China's economy

Just as household income and consumption will displace investment as the key driver of China's growth, so the service sector of the economy is expected to expand to match and then overtake the scale of the industrial sector. Development of the service sector is not only a natural progression as societies

move up the income ladder but is also a considered policy of the Chinese government, intended to create employment.

Since 1990, China's heavy industry sector's share of nominal GDP has risen 10 percentage points, from 25 to 35 percent, while the service sector has grown more slowly, from 39 to 44 percent; meanwhile, agriculture's share has shrunk. This evolution reflected the investment-led growth model that encouraged mass urbanization and infrastructure building. Services, in contrast, were not supported by government policies, received lower investment, and generated lower returns.

In the 2000s, services did see some acceleration in growth with the expansion of the real-estate and financial-services industries that supported urbanization. This expansion is set to continue and indeed to accelerate beyond these industries.

Changing the growth model. China's leadership recognizes that while its growth models to date have delivered success in many dimensions of the economy, the investment-led model it has deployed in the past two decades has left the country with problems in a number of areas. These include—most importantly—a slowing of employment growth, but also the wasteful use of natural resources, environmental degradation, high levels of monopoly and inefficiency where state-owned enterprises have managed resource-oriented sectors, and a lack of growth in private enterprises, especially at the SME level.

The slowing of employment growth is the top challenge, and one that is likely to get worse as China's economic growth model shifts. China has passed a turning point where its progress on productivity improvements—albeit from a low base—has now become as important as physical investments in contributing to GDP growth; with that, the challenge to create jobs has become pressing (Exhibit 5).

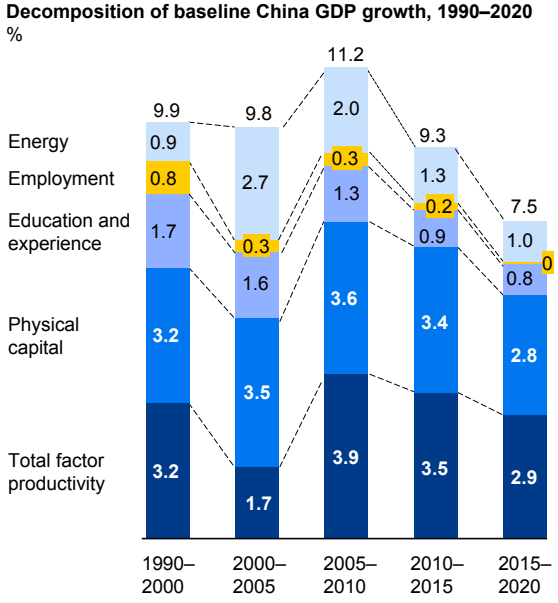
First, the slowing of mass urbanization and related infrastructure building and property construction—major sources of employment—are having a knock-on effect on other low-value-added and labor-intensive industry sectors such as mining. Job demand is likely to decline in these types of industries.

Second, a transformation of important export-dependent manufacturing industries such as apparel and consumer electronics—industries that have enjoyed a massive boom since China joined the World Trade Organization in 2001—can be expected. The growth in these industries has supported a large number of SMEs. However, due to capital-labor dynamics that will encourage greater investment in mechanization rather than additional manpower, this sector is not expected to generate a further large net increase in new jobs. In addition, these industries have depended on demand from markets outside China and therefore make its economy vulnerable to downturns elsewhere in the world, as seen during the 2008 and 2009 financial crisis. The Chinese government wants to shift them to a focus on the domestic market, if not reduce their weight in the economy.

Third, important changes to deliver higher productivity are under way in the agriculture sector, currently accounting for around 9 percent of China's economy. This is likely to reduce rural employment. Initiatives to centralize and mechanize production—objectives include capturing a 10 percent increase in crop yield through mechanization—and land reform to consolidate small holdings could reduce farm employment. If these changes proceed, they could potentially lead to additional migration over and above the current annual exodus of 10 million to 15 million rural residents.

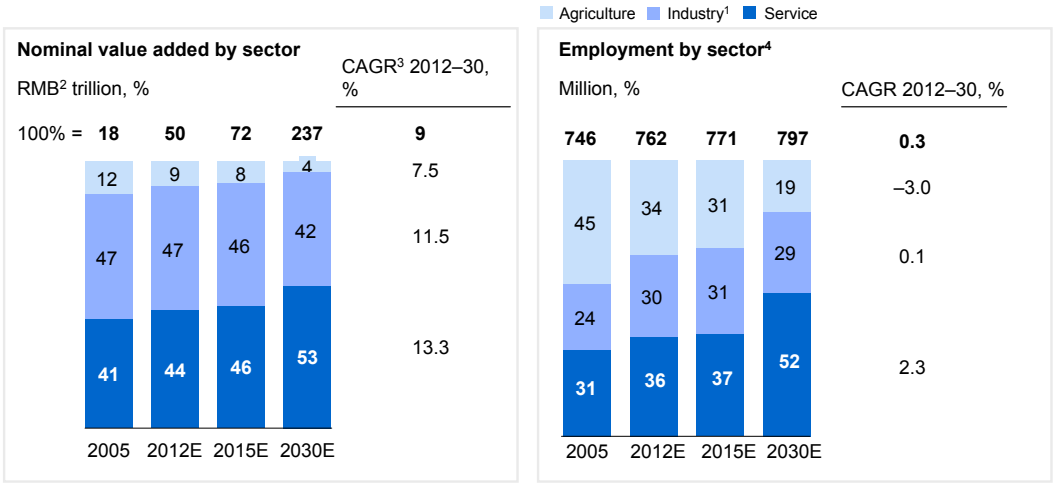
The Chinese government has said it intends to make major changes in the country's industrial structure to address these challenges over the next five years. It aims to promote modern agriculture, to optimize the structure of its major industries, and, most important, to develop the service sector into a much larger segment of the economy in revenues and employment.

Exhibit 5 Productivity has overtaken investment as a contributor to China's growth.



Source: McKinsey Global Economics Intelligence; McKinsey Global Growth Model v3.5

Exhibit 6 The service sector's share could expand and become the key driver for employment growth over the long term.



1 Industry includes mining, manufacturing, electricity/gas distribution stations/water production and supply, and construction.
2 Renminbi.
3 Compound annual growth rate.
4 Assumption of productivity growth from "China 2030: Building a modern, harmonious, and creative high-income society," World Bank, February 2012.

Source: CEIC Data Company; World Bank; McKinsey Insights China macroeconomic model update (April 2012)

Our projections suggest that within the next five years, the Chinese economy will be split equally between services and industry, with agriculture's GDP contribution moving down marginally, to 8 percent (Exhibit 6).

Initiatives will include encouraging private and foreign capital to enter service industries, providing business premises and fiscal and financing support, strengthening intellectual-property protection, and improving data gathering on aspects of the economy relevant to the service sector. In business-related services such as finance, logistics, and IT, the government wants to drive innovation. In consumer- and household-related services such as retail, real estate, and legal services, drivers will include standardization of processes and service-level quality improvement.

Our projections show that these trends could lead to major shifts. By 2030, services would represent 53 percent of GDP compared with industry's 42 percent share. With regard to employment, by 2030, the service sector's share could rise to 52 percent from its 2012 level of 36 percent. Agriculture's share could fall from 34 to 19 percent. Industry's share of employment, meanwhile, would remain relatively steady, from 30 percent in 2012 to 29 percent in 2030.

The changing Chinese city

Nowhere are these broad trends in China's economy likely to manifest themselves more dramatically than in its cities. The urban landscape thus provides a lens to see how these dynamics and changes could play out. Our projections suggest that the profile of China's cities will be very different in 20 years.

Peaking of urban labor growth

First, while China will see continuing urbanization over the next two decades, the urban labor pool will stop growing by the end of the period. This is due to the aging of the population: from 2012 to 2030, the 0-to-14-year-old population cohort will see a decline of 1.2 percent per year, while the over-65 cohort will grow at 3.9 percent per year. Thus there will be fewer people available for the future labor force, and the likely result is that the nonworking population will account for a larger share of the total.

This demographic shift will affect migration from the countryside to the cities: while migration will continue on a large scale, it will be at a slower rate compared with previous years. From 2000 to 2010, the bulk of the growth in the urban labor force came from migration of rural workers to cities, accounting for 80 percent of the growth in labor-force expansion. But in the next decade, with the change in the population's age profile, there is likely to be a

reduced supply of working-age rural migrants available to move to cities.

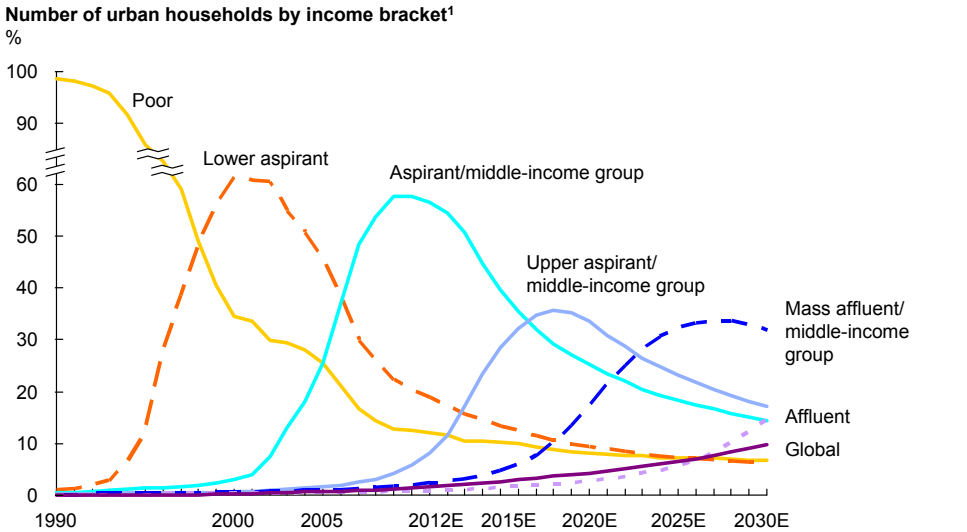
Large-scale migration is especially likely to decline to the southern coastal cities, which have traditionally been home to export-oriented industries. Instead, rural workers in inland provinces are now more likely to want to work in cities close to their hometown. One reason is that workers in the emerging manufacturing bases of Henan, Hubei, and Sichuan provinces are seeing incomes grow more rapidly than in the past. In addition, as total employment opportunities expand in inland cities, rural inhabitants in these regions may prefer to stay close to home, retaining the residence privileges of living in their rural home areas but working in urban areas.

Wealthier, more productive city dwellers

The urban population, meanwhile, will become increasingly wealthy. The tighter supply of workers could lead to further wage inflation in coastal cities. Already, manufacturing-labor costs in the Pearl River Delta rose 11 percent during 2011 and wage rates at factories in Guangzhou and Dongguan have increased 10 percent in the past year. The upward trajectory in wages is being supported by improving productivity. This has put China in the leading position when it comes to productivity growth compared with other countries—albeit from a low base. In the future, productivity gains could be captured in the service sector, as well as in China's expanding high-end manufacturing sector. These developments will in turn require initiatives to improve education and training—both hallmarks of a blossoming urban society.

Besides its higher income, the urban population will also benefit from the social-safety-net improvements, and it is likely to spend more, as discussed earlier in this article. By 2030, consumption growth will be dominated by rapidly growing middle- and higher-income urban population groups. Our projections suggest that the number of urban households in these categories will rise from 71 percent in 2012 to 87 percent in 2030. Within those groups, the wealthiest households will grow to account for a proportionately larger share of consumption—accounting for one-quarter of urban households by 2030 but fully half of total urban consumption at that date. The result will be a shift of spending toward discretionary categories, including personal items, recreation, education and cultural expenditures, and transportation and communication spending (Exhibit 7 and Exhibit 8).

Exhibit 7 Future growth will be driven by the expanding middle-income group.

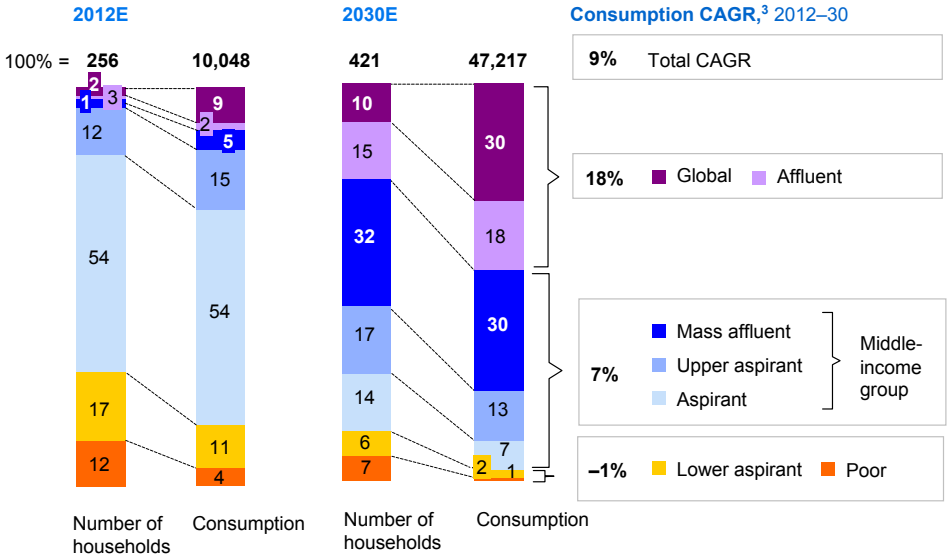


1 Per household per year disposable income in 2005 real renminbi (RMB). Brackets are defined by household annual income as follows: global, >RMB 227,000; affluent, RMB 171,000–RMB 227,000; mass affluent, RMB 114,000–RMB 171,000; upper aspirant, RMB 79,000–RMB 114,000; aspirant, RMB 45,000–RMB 79,000; lower aspirant, RMB 28,000–RMB 45,000; poor, <RMB 28,000.

Source: McKinsey Insights China macroeconomic model update (April 2012)

Exhibit 8 The richest quarter of urban households could account for half of all urban consumption.

Consumption of urban households by income bracket[1]
Million households, RMB[2] billions, 2005



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2 Renminbi.
3 Compound annual growth rate.

Source: McKinsey Insights China macroeconomic model update (April 2012)

In the countryside, the market will grow even as employment shrinks. For those who remain, the Chinese government is instituting policies that aim to narrow the gap between urban and rural incomes by lowering rural taxes, increasing consumption subsidies, and putting in place measures to enhance the rural social-security net and improve rural living conditions. In addition, the rural population is seeing its income rise faster than in the past due to increasing agricultural product prices and productivity: in 2011, the former rose 16 percent and the latter 23 percent.

Pressure on resources

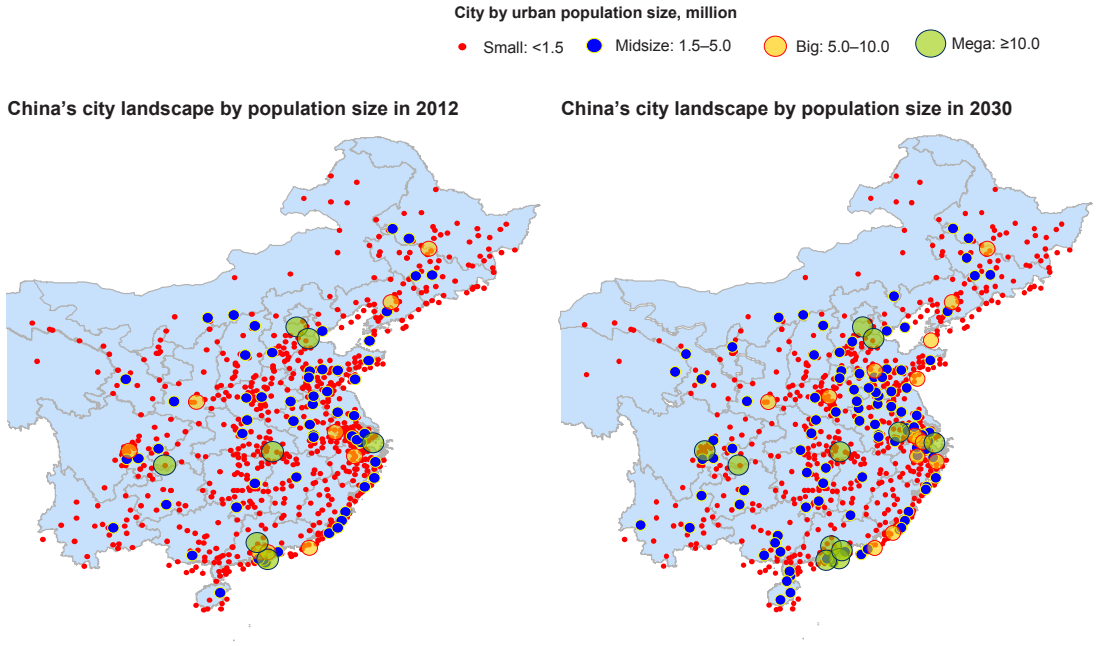
The larger and richer urban population will, however, also put a strain on energy and food supplies. On the demand side, the increasingly prosperous population could be expected to spend its wealth on eating more and to consume more electric power. On the supply side, the working-age agricultural population is declining, as described above, while at the same time available agricultural land is being lost to urbanization—whether through actually building residences or factories or through urbanization-related encroachments such as roads or railroads.

Initiatives are under way to address these challenges. As referenced above, the government is attempting to boost agricultural productivity and protect farm land. To meet energy demand growth, the government is seeking to develop all available alternatives to oil, which China has to import in large quantities. These include promoting increased production and use of natural gas, building up the electric-vehicle fleet, and expanding renewable-energy sources. To help manage the need for oil imports, efforts are under way to acquire overseas energy assets and to reduce dependency on any single energy supplier.

Smaller cities will drive China's growth

To think of China as a single economy is to make a similar mistake as thinking of Europe as a single country: the quality and pace of urban development is likely to vary sharply across China. Cities are at different stages of

Exhibit 9 Expansion of smaller cities is projected to account for the largest share of urban GDP growth through 2030.



Source: McKinsey Insights China macroeconomic model update (April 2012)

development, and the development paths they will follow are likely to vary and reflect strengths specific to each city.

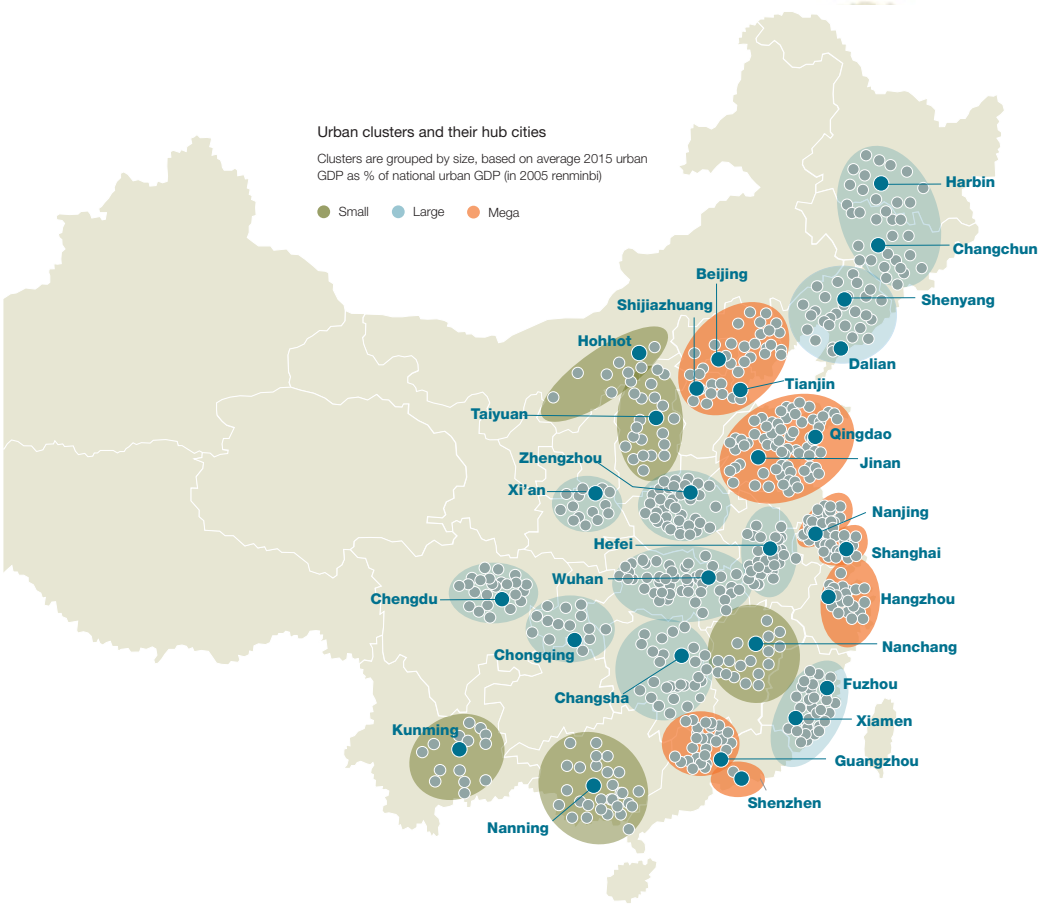
Our projections suggest that growth will be fastest outside China's megacities. In the next two decades, the dozens of smaller cities with current urban populations of less than 1.5 million will make the largest contribution to growth. A large number of these cities—now at earlier stages of development than the larger cities and so with more growth potential—will expand to become cities with populations in the 1.5 million to 5 million range. This group will represent the single largest growth cohort and contribute 40 percent of total China urban GDP growth through 2030. Cities that currently have a population in the 1.5 million to 5 million range will contribute about 25 percent of GDP growth over the same period, while cities with populations that are already above 5 million will contribute about 35 percent (Exhibit 9).

The small cities will form hub-and-spoke-type clusters around the megacity or big-city hubs that are already in existence: we have identified 22 such emerging economic clusters, each the size of a midsize European country. For example, the GDP of the Shandong cluster (around Jinan and Qingdao) will by 2020 be similar to the size of Taiwan's today, while the GDP of the central cluster—cities around Zhengzhou in the center of China—will be similar to Denmark's (Exhibit 10).

Cities will compete based on their comparative advantages in terms of productivity or population growth. For example, cities that are rich in natural resources and have an abundant labor supply but historically low productivity have typically developed "traditional" industry sectors such as mining, textile manufacture, or energy production. Those sectors have developed extensively over the past three decades since China's economy started to open up. Production processes in these industries tend to be mature and standardized, and as a result, simply increasing input (for example, additional labor supply) leads to growth.

Zhengzhou, capital of Henan, one of China's most populous provinces, is an example of this development model.

Exhibit 10 Urban growth is expected to build on the existing 22 hub-and-spoke city clusters.



Source: McKinsey Insights China macroeconomic model update (April 2012)

Zhengzhou has abundant supply of labor but has only a relatively short history of industrialization and lacks a highly skilled labor force. Reflecting the city's value proposition, Foxconn, the world's largest consumer-electronics contract manufacturer, opened a factory to do assembly work there in 2011. These cities can continue to enhance their attractiveness by upgrading their labor quality and location benefits.

In contrast, cities that already have a well-developed industrial base could expand in more advanced industries such as civilian aerospace and semiconductor manufacturing, which are more capital and technology intensive than labor intensive. Similarly, they could build up service industries such as banking and logistics that require more sophisticated skills and do not depend on labor-supply volume. The key to growth in such sectors is productivity improvement, typically driven by adoption of new technology or investment in training and education.

A number of cities already exemplify these growth models. Pharmaceutical companies in Shijiazhuang are continuously investing in R&D, and the city has become one of China's most advanced pharmaceutical-production centers. Tianjin has targeted its new Binhai district for growth as a financial and logistics center serving not only the Tianjin urban cluster but also China's northern regions. Suzhou, an early bird of China's industrial development, is now expanding its finance-services and logistics sectors, which are closely integrated with nearby Shanghai's global-finance and logistics centers, while promoting its historical and natural heritage to become the region's most popular tourist destination.

Some cities are in a position to deploy both growth models simultaneously. Xi'an, the largest city in northwestern China, is a representative example. Xi'an is the nearest major city destination for migrant workers from the five provinces in China's northwest, and labor costs there are cheaper than in the central and coastal regions. Xi'an also has access to

important natural-resource deposits in its immediate region, such as coal. In addition, Xi'an is one of China's R&D centers, with a number of leading universities and research centers. These endowments position the city to pursue a dual-driver development path.

Technology is a wild card in this scenario, in particular, the impact of the Internet and online business models. Low-labor-cost cities can compete for new Internet-business investment (for example, order fulfillment, call centers, and data processing) and leapfrog the traditional industry phases. Depending on how fast China develops its e-commerce capabilities, this could further accelerate growth, particularly in midsize cities that take a focused approach to win this business. Hangzhou, a city of over six million inhabitants close to Shanghai and a long-renowned destination for its historic pagodas and natural beauty, is now also recognized on another score—as "China's e-commerce capital." There are more than 60,000 employees in Hangzhou working in Internet and e-commerce companies such as Alibaba and Panshi. Hangzhou's e-commerce employment ranks it China's third largest center in this field, behind Beijing and Shanghai. Home to more than one-third of China's e-commerce and Internet companies and generating two-thirds of its total e-commerce revenue, the Internet has already become a new growth engine for Hangzhou.

What are the implications for business?

In a word, the implications are huge. Right now, China's GDP is about $6 trillion; by 2020, we think it could be $11 trillion. That is nearly the equivalent of an additional two Germanys.

Higher income, lower savings, and broader prosperity add up to more purchasing power. In short, many more people are going to buy more and more products. Companies have an enormous, literally unprecedented, opportunity. Here are six actions that companies can take to adjust their business focus and strategy toward China's market.

1. Design city-specific solutions

As noted above, the six megacities, each with populations of ten million, are currently China's most prosperous, but over the next two decades, the smaller cities will constitute the single largest growth cohort and will underpin long-term growth. In addition, cities in the western regions will grow faster, supported by government policies. By 2025, there will be another four cities joining this ten-million cohort, two of which are in western China—Chengdu and Chongqing.

Companies must recognize the heterogeneity of the line-up of Chinese cities and adapt their offerings accordingly to the needs of these populations. Vectors of differentiation include differences in population (urban versus rural), age, and household income. These differences have a direct effect on many significant consumer attitudes and preferences. Consider the variation of chocolate-purchasing habits between Shanghai and nearby Hangzhou: our research shows that citizens of Shanghai base their chocolate-buying decisions overwhelmingly on value for money, whereas price is less important to citizens of Hangzhou than being able to obtain their preferred brand.

There is a growing need for better, earlier design inputs for products for smaller city markets to help companies come up with new solutions, as current products will not meet current needs. Consumer habits in these smaller cities, often in the interior, are changing noticeably. Dealing with these changes won't be easy, because the key buying factors and effective media are different from those in the well-established megacities. When buying laundry detergent, for example, small-city consumers care more about price and are more responsive to promotions and in-store ads.

Companies should not apply a one-size-fits-all approach but instead differentiate marketing and operating models across cities. More granular and in-depth consumer and business insights are necessary to design effective marketing campaigns, allocate capital and human resources more efficiently, and develop innovative products.

2. Allocate resources intelligently

Businesses will need to optimize the allocation of resources across the emerging hub-and-spoke city clusters. Hub cities can no longer accommodate manufacturing activities that are land intensive and require competitively priced labor. The new role of hub cities will be to service manufacturing that will migrate to spoke cities, providing support such as R&D, marketing, and logistics. Transportation infrastructure across major clusters has improved to the point that this type of reallocation of functions is fully feasible: commuting to spoke cities is as easy as commuting

within the hub. In some regions (for example, the Pearl River Delta), many people even choose to work in the hub and live in the spoke.

Take the example of the Chengdu cluster: an established industry center that has seven leading national universities and rich hydroelectric and gas resources, while enjoying a labor- and land-cost advantage over southern coastal regions, Chengdu is following a strategy to redistribute activities within its cluster to assure future growth. Chengdu as a hub is now developing toward a service- and high-tech-industry focus and is gradually shifting its industries into new industrial parks that are located in suburban areas or in spoke cities such as Deyang and Mianyang. Companies should frame their resource-allocation plans based on the resource advantages and characteristics of the different clusters and of locations within clusters.

3. Serve the people

That was a Maoist slogan, and it may be ironic that we are using it to describe China's capitalist evolution. However, as we mentioned above, the service sector is going to become more important because it needs to. China's financial system, for example, needs upgrading; its IT capabilities do too.

For consumer-goods companies, the big opportunity encompasses the expansion of the modern commercial retail network to small cities and rural areas, the development of new consumer industries, and the improvement of service quality in existing ones. Time-stressed residents of coastal China, for example, are turning increasingly to catering and product-delivery services. Business services, such as finance, consultancy, and logistics, will see faster growth with the development of industry sectors. Creative services, such as education or culture and entertainment, also have great potential due to changing spending patterns.

Even in traditional manufacturing, service is going to be critical as a way to capture share and value. With more remote cities becoming the focus of growth, extensive and capable service and sales networks are now differentiators. In addition, better leverage of the supply chain through the management of contract manufacturers can make the difference in lowering costs of goods sold.

4. Brand management entails a multibrand portfolio

Although China is becoming increasingly integrated in the global economy, there remain quality gaps between the offerings of brands from multinational companies (MNC) and local companies in many sectors, an issue that the Chinese government wants to address. Options for Chinese companies include acquiring MNC brands, acquiring technology, launching joint ventures with MNCs, and partnering with specialized companies (for example, auto companies could partner with engineering companies).

Meanwhile, for MNCs, there are opportunities to capture in this quality differential, notably in joint ventures with Chinese companies. In this way, MNCs can build local awareness of their brands, leverage their partners' distribution channels and customer base, and build closer relationships with local government to better capture and understand relevant policies. They can minimize their risk by first obtaining a robust understanding of the local brand and the value-proposition or aspiration match with their partner and then managing culture differences.

In the big picture, almost everyone in China is getting richer, steadily. But it is those consumers who are new to the middle class who provide the greatest long-term potential. Companies should seek them out and build their loyalty as early as possible, through product design, branding, and marketing strategies. As wealth increases, discretionary spending will rise and could offer growth opportunities for businesses.

For example, as recently as 2005, 37 percent of annual household spending went to food. Now that figure is down to 27 percent. And that might even understate matters; more of that money might be going to prepared food or restaurant dining—the kinds of service-related industries that we expect will grow. Sectors such as leisure (defined as movie, theater, and coffeehouses), travel, and beauty products and beauty treatments are all likely to see brisk growth. We project that recreation and education-related spending, for example, already more than $160 billion annually, will grow 12 percent a year.

5. Balance the human-capital equation

As discussed earlier, China is on track to be the first country to get old before it gets rich, due to its one-child policy. The percentage of those over 65 is set to almost double by 2030, while the share of those under 15 is falling. The shrinkage of the labor force will be felt acutely in the countryside. Labor-intensive sectors, such as construction, retail, and restaurants, might find quality hires more elusive and expensive. Companies should increase productivity through automation and training, enhance employee loyalty through better working conditions and the removal of glass ceilings, and make production more flexible.

As the economy evolves, new skill sets will be required. Strategic planning, an established function at large MNCs, is increasingly in demand from domestic companies that want to grow. Instead of hiring professionals to make strategic plans, these companies want to build in-house talent. Similarly, as manufacturing companies introduce new automation, technicians are needed. These emerging skill-set requirements necessitate new human-resource strategies and investment in training.

Wages are still an important factor in attracting quality labor, but not the only one. Today's employees are different from those in their parents' generation, who worked extremely hard without complaints. The post-1980 generation asks for much more from its employment, including comfortable working conditions, aspirational career paths, and flexible working hours. Companies must respond to these changes to retain talent.

6. Innovate for China—and beyond

As China's consumers change, so must the dynamic between people and products and between the domestic and global market. What do we mean by that? For a start, this means seeing China as a launching pad for new brands, either for other Asian and developing economies or even other global markets. While affluent Chinese say they prefer foreign brands, there is a great deal of room for local brands at the lower end of the economic spectrum and also for those that can mimic foreign appeal. Moreover, many foreign brands have succeeded only after they tweaked their products for China—from offering tray tables in luxury cars to custom menus at fast-food restaurants. As was once true for Japan, China has become known for excellence in imitation; the next stage is to become adept at innovation, through R&D and improved consumer insights.

Businesses that want to innovate successfully in China should prioritize the following steps: they should build up innovation capabilities locally or leverage global innovation resources while drawing on a deep understanding of local Chinese markets. They should take advantage of government policies that support innovation. And as we have discussed in "A CEO's guide to innovation in China,"[2] in their China-based innovation activities, companies should instill a culture of risk taking and promote cross-team collaboration.

China's economy is starting its historic shift to a more consumption-driven and service-driven model that should help to sustain the country's growth, albeit at a slower rate, over the next decade and beyond. As was underlined at the 18th congress of the Communist Party, new government policies are helping to move the economy in this direction, even while investment as the historical motor of China's growth will still occupy the lion's share of the economy in the near term. These new policies favor household income growth, improve the social safety net, and support growth of the services sector and private enterprises, especially at the SME level. China's expanding cities—with the accelerated rise of smaller cities making a key contribution to growth—will play a major role in these trends. Companies that want to thrive in China should aim to develop and maintain an in-depth understanding of how these trends evolve across the country's complex economic landscape.

2 Gordon Orr and Erik Roth, "A CEO's guide to innovation in China," mckinseyquarterly.com, February 2012.

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