Ten forces forging China’s future

In early June 2013, several hundred of the world’s leading CEOs gathered in Chengdu, China, and discussed that country’s rapidly evolving business environment: growth is slowing and wages are climbing just as a new upper middle class emerges, a new wave of innovation rises, and a new generation of leaders steps to the fore. Executives at this year’s Fortune Global Forum, in Chengdu, were reading “China’s next chapter,” a special edition of McKinsey Quarterly, now available in digital form. What follows here is a snapshot of highlights and takeaways: ten critical issues that will be facing China during the years ahead and what they mean for you. Read it on its own. Or follow the links to delve deeper on individual topics.

1. The great rebalancing
China’s number-one economic question is how to increase consumption while reducing reliance on exports and investment. Chinese household consumption as a share of GDP is barely half that of the United States. Some see promising signs of progress in government plans to raise the dividend payouts of state-owned enterprises, a proposed carbon tax, and the planned removal of energy subsidies.

Winners and losers
Others warn that there will be winners and losers. Peking University’s Michael Pettis expects a sharp drop in commodity prices over the next few years and a fall in the growth of spending on construction equipment and heavy manufacturing. The consumer-goods sector and other low-cost countries should benefit.
2. **Infrastructure advances**

Over the past 20 years, an incredible 8.5 percent of China’s GDP has been plowed into infrastructure—twice the level of India and more than four times that of Latin America. China’s stock of infrastructure as a percentage of GDP is well above the global average, but still ranks only 48th in a survey of factors contributing to global competitiveness. Some 70 new airports, 43,000 kilometers of new expressways, and a major expansion of port facilities are planned to be ready by 2020, as well as 22,000 kilometers of additional rail track by 2015. Not surprisingly, five of the top ten global construction and engineering companies (by 2010 revenues) are Chinese.

**Filling the roads**

China’s not just building roads, of course—it’s populating them, too. Thanks to the new upper-middle-class spenders, McKinsey predicts, the country will overtake the United States as the world’s largest market for premium cars by 2016. Research comparing the preferences of consumers in China and Germany (whose carmakers hold about 80 percent of the Chinese premium-auto market) suggests that advanced power trains are much more important for high-end buyers in China than for their German counterparts. Fuel efficiency looms large for affluent Chinese consumers hesitant to step up.

3. **The green challenge**

A thick and severe smog overwhelmed almost all of China’s east coast earlier this year, demonstrating the urgent need to address environmental issues and green the economy. By 2020, an additional 300 million Chinese will become urban residents, who consume as much as four times more energy and two-and-a-half times more water per capita than rural Chinese do. While environmental challenges create demand for green products and services, they don’t guarantee profits. For example, 2012 saw a boom in solar installations—about 5,000 megawatts of new solar capacity. But it proved to be a terrible year for solar-module manufacturers, given lower selling prices, weakening European demand, industry overcapacity, and rising trade barriers.

**Curbing energy consumption starts at the top**

Manufacturers who become more efficient can help reduce emissions while boosting their own bottom lines. To convey the seriousness of an energy-efficiency drive, one company’s CEO paid a secret midnight visit to his flagship factory. He was dismayed to find no one working in a key unit where employees should have been making energy-saving temperature adjustments. A week later, the CEO announced a wholesale replacement of the plant’s leadership. The company also created a new organization, headed by a group vice president, responsible for reducing energy consumption, which has since fallen by 12 percent.

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**Further reading:**
- Chinese infrastructure: The big picture
- Getting to know China’s premium-car market
- Forecasting China
- Seizing China’s energy-efficiency opportunity: A case study
4. **Manufacturing’s makeover**

Besides playing a part in helping to solve China’s environmental troubles, manufacturing faces a range of new challenges: rising wages and other factor costs, growing consumer sophistication, more complex value chains, and heightened volatility. Many of the barriers to operational improvement are organizational, not technical: too many managers still lack the experience to identify root causes of inefficiency. Chinese companies have to get beyond the “faster, cheaper” fixation that’s characterized their approach to R&D in recent decades, adapt supply chains to a new consumer reality, and build logistics hubs closer to the opportunity-laden cities of China’s interior.

**Competing through collaboration**

An automotive joint venture recently began working with 60 of its suppliers to address 30 pressing quality problems. It fixed them in only six months and put in place a new performance-management system ensuring that both the automaker and its suppliers would keep up their ends of the bargain. Collaboration was also important when a multinational lighting manufacturer was pushing its Chinese and global R&D units to join forces. For ten weeks, a mixed R&D team worked with representatives from the marketing, procurement, supply-chain, and quality groups. This approach helped spark improvement in unusual areas, including product packaging.

5. **Rise of the upper middle class**

By 2022, McKinsey research suggests, more than 75 percent of China’s urban consumers will earn 60,000 to 229,000 renminbi ($9,000 to $34,000) a year—in purchasing-power-parity terms, somewhere between the average income of Brazil and Italy. A mere 4 percent of urban Chinese households were in this range in 2000. Of particular importance is a wealthier upper-middle-class group that in less than ten years’ time will account for more than half of urban households and of urban private consumption. Also on the rise: confident and independent-minded Generation-2 (G2) consumers, comprising teenagers and people in their early 20s, who are set to shape consumption much as their baby-boomer counterparts in the United States did (though by 2022, G2 will be almost three times as numerous).

**In practice**

Companies such as Wrigley Asia Pacific and Bayer Consumer Care are consciously pursing a dual marketing strategy to ensure that they don’t neglect their more established mass-market business while pursuing the upper middle class. Another multinational consumer-packaged-goods company is continuing to emphasize its traditional bar-soap products in northern China, a relatively low-income region with a large mass market. But it’s also preparing to convert customers to higher-margin liquid soap as they transition into the new upper middle class. And in southern China, where consumers already prefer liquid soap, the company is focusing on persuading customers to upgrade from cheaper, local brands as they become more affluent.
6. E-tailing extraordinaire

Almost overnight, China has become the world’s second-largest e-tail market, a development that is accelerating the broader shift from an investment- to a consumption-led economy. Estimates for 2012 e-tail revenues have been as high as $210 billion, reflecting a compound annual growth rate of 120 percent since 2003. In 2012, e-tailing commanded about 5 to 6 percent of total retail sales, roughly the same proportion as in the United States. McKinsey research suggests a dollar of online consumption in China replaces roughly 60 cents of sales in offline stores and generates around 40 cents of incremental consumption. E-tailing’s impact is even more pronounced in the country’s small and midsize cities. Online prices are on average 6 to 16 percent lower than prices in China’s stores. Apparel, household products, and recreation and education (the three largest online-retail segments) typically offer the biggest price discounts.

Big contrasts with developed markets

Whereas the dominant model in the United States, Europe, and Japan involves brick-and-mortar retailers or pure-play online merchants (such as Amazon.com), around 90 percent of Chinese electronic retailing occurs on sprawling virtual marketplaces. These megasites, which include PaiPai, Taobao, and Tmall, in turn are owned by bigger e-commerce groups, such as Alibaba. National brick-and-mortar retailers of the kind seen in the retail markets of most developed countries have yet to emerge in China. As e-tailing continues to grow, however, the sector may leapfrog straight from domination by strong regional players to multichannel competition.

7. Innovation’s new spark

The e-commerce revolution has helped rev up China’s surprisingly well-oiled innovation engine. Long perceived as the imitator, copier, and fast follower of other countries’ fashions, China is starting to show real innovation leadership. Chinese universities are playing a growing role in the local innovation ecosystem; globally recognized scientific journals are increasingly filled with publications from leading Chinese researchers. Also significant is the emergence of a new generation of young Chinese graduates. Tao-Sang Tong, president of Tencent’s Social Network Group, says his company prefers pulling talented prospects directly from college, “before they are exposed to less innovative Chinese company cultures.”

Protecting intellectual property

Although the Chinese government handled almost 40 percent more “violation” cases last year, IP issues remain a concern for global and domestic innovators alike in China. Some are compartmentalizing knowledge so that only a few individuals have a complete understanding of complex systems. It’s increasingly common to require that camera-enabled devices be stored under lock and key before their owners can enter R&D facilities. Many companies have banned portable hard drives and USB thumb drives, which can be used to transfer media electronically. Finally, a number of companies are trying to make intellectual-property protection a core part of corporate culture, sometimes demanding an annual review of conduct codes and a formal sign-off process by employees.
8. Financier to the world?
As the world’s largest saver, China is playing a major role in the shifting postcrisis global financial landscape. The value of the country’s domestic financial assets—including equities, bonds, and loans—has reached $17.4 trillion and now trails only that of the United States and Japan. In cross-border capital flows, China has defied global trends: foreign direct investment (FDI), cross-border loans and deposits, and foreign portfolio investments in equities and bonds are up 44 percent over their 2007 level. Since 2009, Chinese loans to Latin America have exceeded those of both the Inter-American Development Bank and the World Bank. Total foreign investment into China reached $477 billion at the end of 2011, exceeding the 2007 peak of $331 billion.

Unfinished business
For China to become a true global financial hub and establish the renminbi as a major international currency, the country’s new economic team would need to pick up the pace of reform. Job one: developing deep and liquid domestic capital markets for renminbi-denominated financial assets. Also critical is progress toward capital-account liberalization and other reforms to enable full renminbi convertibility.

9. Investor confidence
China may be flexing its own financial muscles, but the country’s entrepreneurs also depend on outside capital to finance their growth and expansion. That’s why the precipitous 2011 and 2012 fall of the stock-market capitalization of Chinese companies listed in the United States—in response to allegations of fraud and lack of transparency—was such a cause for concern. Many corporate and private-equity investors, reinventing their due diligence, are developing trust by looking beyond the usual statutory and regulatory disclosures. There is a new interest in forensic equity research, by analysts who specialize in looking for potential fraud in listed companies.

Private equity
Generally speaking, however, the private-equity sector is upbeat if realistic. Four leading players from Bain Capital, the Canada Pension Plan Investment Board, Hony Capital, and TPG point out that the investment climate is tougher than it was in the last decade. Gone are the days of above-average returns powered by a strong macro tailwind. In this new era, there are still great opportunities, but they require greater “hands on” private-equity support to help entrepreneurs and executives add value, find exit options, and make acquisitions outside China.
10. Cultivating human capital

China's potential—and the billions spent on its physical infrastructure—will remain underexploited without efforts to develop its human infrastructure. Yingyi Qian, dean of Tsinghua University’s School of Economics and Management, says demand is growing for better teamwork, communications, and presentation skills. Chinese executives must be more ambitious and think more creatively (not always easy in a traditionally hierarchical society). Western managers need to master China’s hidden rules and understand its local sensitivities, such as the importance of “face.” One telling tale: US participants in a cross-cultural psychology study, when shown “a picture of a group of fish with one fish out in front of the others,” were more likely to think the fish was leading. Chinese participants thought it was an outlier.

Tea, not coffee

As companies in China step up corporate-capability building, they too need to acknowledge China’s unique culture. Teaching managers how a “lean” perspective can address different types of waste didn’t work well at a Chinese state-owned enterprise, because the example intended to bring it all to life involved coffee making. But none of the managers had ever used a coffee machine. Focusing instead on tea making has proved much more sensible.

Further reading:
- Developing China’s business leaders: A conversation with Yingyi Qian

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