

China and the world: Inside the dynamics of a changing relationship

China has made progress in integrating with the world economy, achieving true global scale as a trading nation, but not in other areas such as finance. Now the relationship between China and the rest of the world is changing. A great deal of value could be at stake depending on whether there is more or less engagement. Businesses will need to adjust their approach to navigate the uncertainties ahead.

- China, which became the world's largest economy in purchasing-power-parity terms in 2014, is a global power in scale but not always in global integration. It became the world's largest trading nation of goods in 2013. However, although China has 110 Global Fortune 500 companies, more than 80 percent of their revenue is still earned at home. China's banking, securities, and bond markets rank in the global top three in size, but international players have limited presence.
- The relationship between China and the world is changing. On the new McKinsey Global Institute China-World Exposure Index, China's exposure to the world in trade, technology, and capital has fallen in relative terms. Conversely, the world's exposure to China has increased. This reflects the rebalancing of the Chinese economy toward domestic consumption. In 11 of the 16 quarters since 2015, consumption contributed more than 60 percent of total GDP growth. Exposure to China varies significantly among sectors and geographies, according to our analysis of 20 sectors and 73 economies.
- China's technology value chains are highly integrated globally. Our analysis of 81 technologies in 11 categories found that more than 90 percent of technologies used in China follow global standards. Our study of three value chains suggests that Chinese players have grown rapidly, but they still import critical components such as reduction gears (robotics), power electronics (electric vehicles), and equipment (semiconductors).
- China's consumer market is likely to remain buoyant on the back of rising incomes. The level of integration with the world in a range of consumer categories is already high, with scope for even more. The penetration of

multinational corporations in Chinese consumer markets is higher than the penetration in US markets, but they are now facing competition from domestic players. Of 30 consumer categories, multinationals have lost share in 11. Two trends offer further opportunities for domestic and foreign players. First, Chinese consumers are demanding more and better choices in goods and services. Second, more Chinese people are traveling abroad. Outbound trips have grown at 13 percent per year since 2010 and reached 150 million in 2018.

- Our simulation shows that \$22 trillion to \$37 trillion of economic value (equivalent to about 15 to 26 percent of global GDP by 2040) could be at stake from less or more engagement between China and the world in five areas: (1) growth as an import destination; (2) liberalization of services; (3) globalization of financial markets; (4) collaboration on global public goods; and (5) flows of technology and innovation. Less engagement between China and the world could mean higher tariffs, more limited trade and technology flows, and continuing gaps in addressing key global challenges. More engagement could see China importing more from the rest of the world, greater two-way flows of technology, and a more competitive Chinese services sector; reaching solutions to global issues would be more likely. In both scenarios, different stakeholders could experience upsides and downsides as well as conflicting priorities.
- Businesses may need to adjust their approach to uncertain, and potentially higher, risk conditions. We suggest four areas for consideration: (1) assess their short- and long-term exposure to the China-world relationship; (2) determine their investment and value chain posture; (3) develop the operational excellence needed to manage risks and uncertainty; and (4) adopt a "survivor's mind-set," both optimistic and realistic, improving their balance sheet and maintaining robust access to capital, and looking for opportunities to acquire and restructure amid the uncertainty.

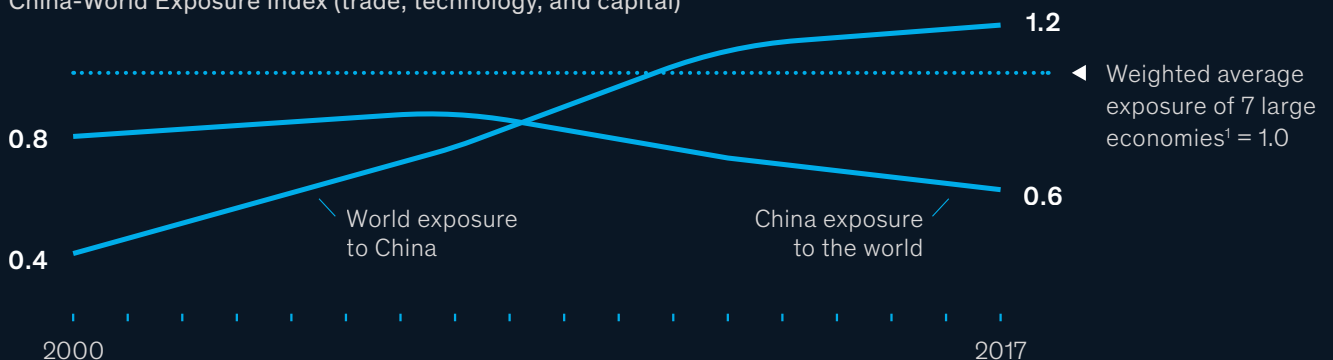
China and the world: A changing relationship

China has achieved global scale, but more can be done to integrate



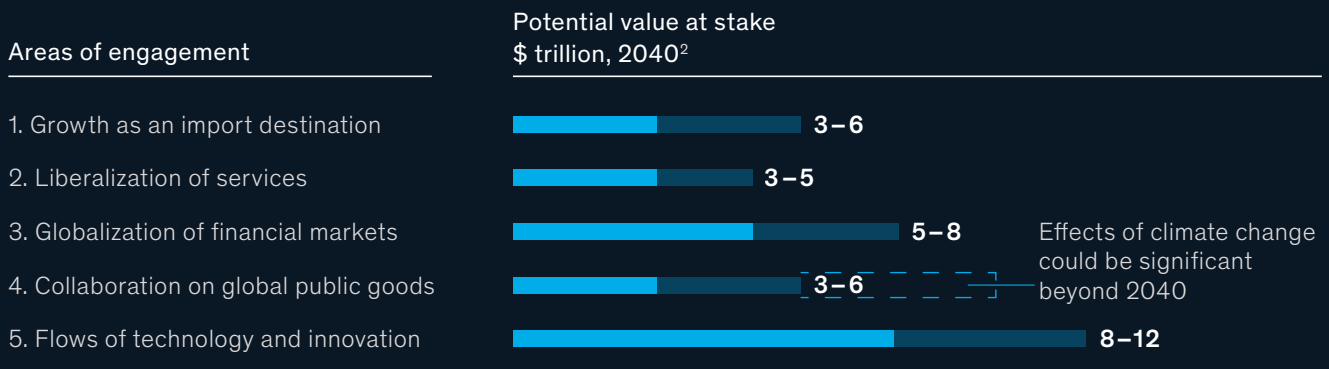
China has been reducing its exposure to the world, while the world's exposure to China has risen

China-World Exposure Index (trade, technology, and capital)



Significant value is at stake from less or more engagement between China and the world

Simulated impact, 2040



Between \$22 trillion and \$37 trillion of economic value (equivalent to about 15 to 26 percent of global GDP by 2040) could be at stake from less or more engagement between China and the world

¹ China, Japan, Germany, France, India, United Kingdom, and United States.

² Estimated value at stake based on specific conditions and assumptions, and should not be taken as a forecast.