

# CHINA'S CONSUMERS STAY THE (SLIGHTLY SLOWER) COURSE

By Jeff Walters and Youchi Kuo

CHINA'S ECONOMY CONTINUES TO make global headlines, with each uptick or downtick in GDP growth, industrial output, retail sales, or other measure pored over like tea leaves for what it portends. Meanwhile, China's consumers keep spending, albeit a bit slower at the moment, and consumption growth is still on a staggering trajectory. China's consumer economy is expected to expand by about half, to \$6.5 trillion, by 2020—even if annual real GDP growth cools to 5.5%, which is below the official target. The incremental growth of \$2.3 trillion over the next five years would be comparable to the world's adding a consumer market 1.3 times the size of today's Germany or UK.

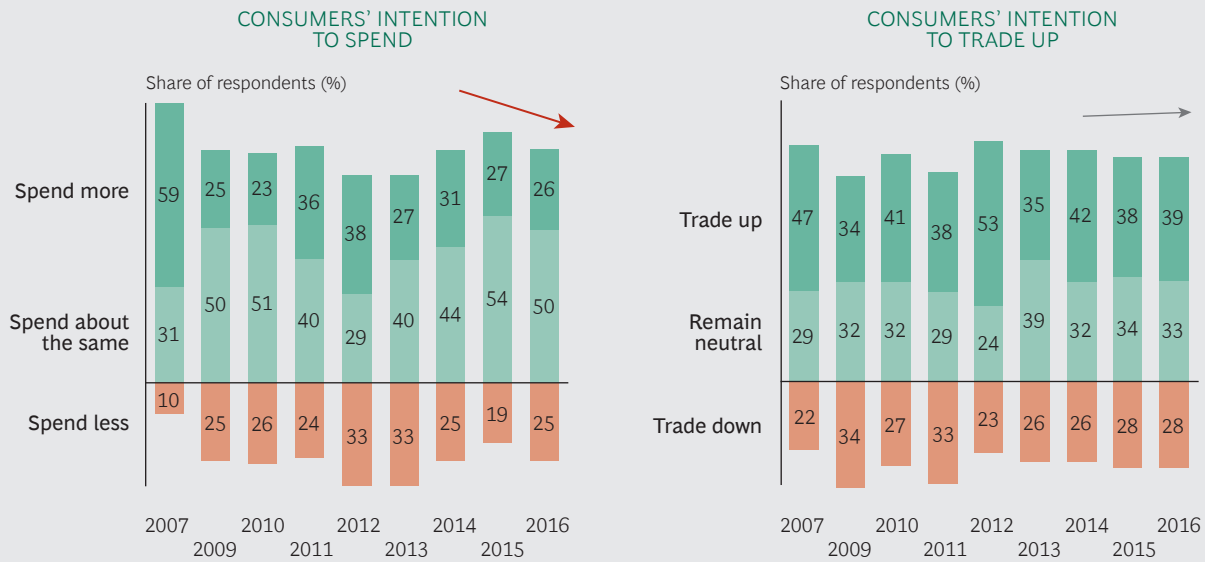
China's two-tier consumer economy, whose upper-middle-class (UMC) and affluent households disproportionately drive overall consumption, remains a defining force. (See our publication "A Tale of Two Chinese Consumers," BCG article, June 2015.) The UMC, the young, and those employed in high-end services will be the source of much of the spending action in the near

to medium term. Consumers continue to want to trade up. And there are multiple opportunities for marketers to engage increasingly sophisticated consumers and address their emerging dissatisfaction. All in all, The Boston Consulting Group's latest consumer-sentiment survey provides good news for companies that are attuned to the shifts underway in China and that are prepared to adjust accordingly. (See Exhibit 1.)

## Consumption Growth Moderates but Remains Robust

As of mid-2016, consumption patterns in China were holding up despite slowdowns and volatility in other areas. Nominal household consumption in the first quarter of 2016 grew 9.3%, compared with 8.6% a year earlier, and climbed faster than growth in the full year of 2015. In real terms, consumption growth was stable. We expect growth for the rest of 2016 to soften somewhat, as one of the critical drivers—the willingness to spend—loses some momentum. Indeed, following the strong first quar-

## EXHIBIT 1 | Consumer Sentiment Has Only Slightly Moderated



Source: BCG China Consumer Sentiment Surveys, 2007–2016.  
 Note: Because of rounding, not all numbers add up to 100.

ter, year-over-year growth in retail sales showed a small decline in April and May.

Even as sentiment moderates, it is important to note that we are looking at a slow-down in consumption *growth*. Consumption in 2016 will be tantamount to consumers' moving from the fast lane to the middle lane on the economic highway. They are not pulling into the breakdown lane. The two principal sources of growth in consumption are consumers' ability and their willingness to spend more. The ability to spend remains strong: more than 40% of Chinese urban households today are firmly in the middle class and affluent (MAC) category.<sup>1</sup> The willingness to spend is strong relative to other countries as well, but it's down from its peak in 2007 as slowing household-income growth—a reflection of the broader economy—takes a modest toll. Three-quarters of consumers still plan to maintain or increase the level of their spending in 2016, compared with 81% in 2015.

Household income growth declined to 8.7% in the first quarter of 2016 from 9.4% a year earlier. This is the second consecutive year in which a substantial share of households had no income growth, and this year, the share of households in which income

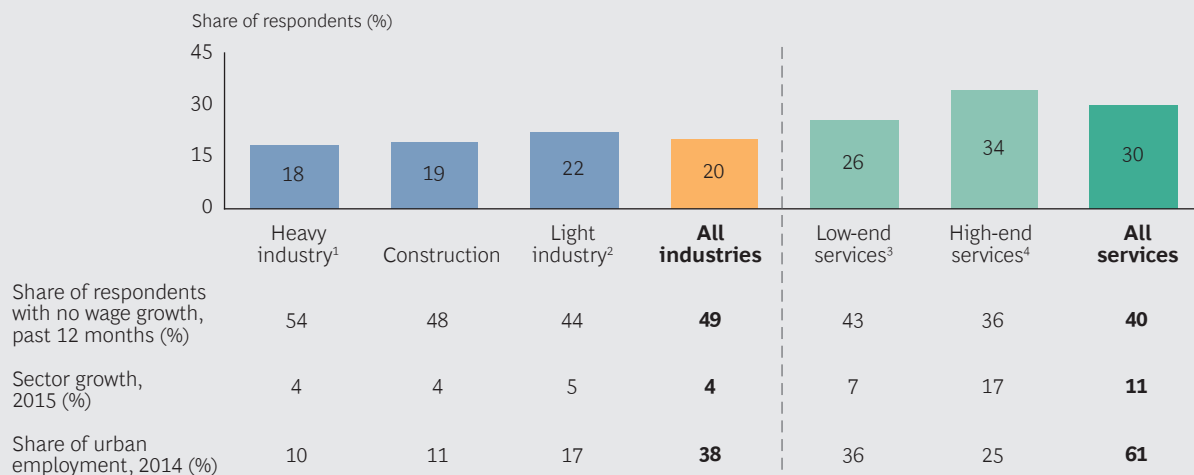
growth exceeds 10% has also dropped significantly, from 38% to 26%. Job worries and anxiety about the future are rising, and the share of those who are worried or anxious increased from 20% to 25% and 22% to 28%, respectively.

The combination of declining income and still-growing consumption suggests that savings growth may have temporarily slowed. But people are now feeling a pinch: many more consumers in this year's survey tied spending intent to income growth—58% compared with 47% in 2015 and 39% in 2014. Three-quarters of consumers with high-income growth expect that their income growth will decline in the next 12 months. We believe that a general sense of caution and a desire to maintain savings will be the norm.

Because household income growth follows the industry profit cycle, slowing income growth is more pronounced among those employed in the industrial sectors of the economy, who make up approximately 40% of urban consumers. (See Exhibit 2.) Approximately 49% of these consumers experienced no income growth in the past 12 months, and only 20% plan to spend more in 2016. Since industrial profit growth was

## EXHIBIT 2 | Slowing Industry Growth Has Reduced Wage Growth and Intention to Spend

### CONSUMERS' INTENTION TO SPEND MORE, BY EMPLOYMENT SECTOR



Sources: National Bureau of Statistics of China; BCG China Consumer Sentiment Survey, 2016.

<sup>1</sup>Mining, energy, and heavy manufacturing.

<sup>2</sup>Manufacturing of consumer goods.

<sup>3</sup>Retail and commercial services.

<sup>4</sup>Public service and the technology and finance sectors.

negative throughout 2015, we can expect another two to three quarters of low growth in household incomes and consumer spending. Industry profit growth rebounded in the first quarter of 2016 to 7.4%, but it remains to be seen whether this level can be sustained.

The service sector is facing its own set of challenges. Although the sector is sustaining job growth, as the economy matures, a shift in employment toward low-wage service jobs (those in the retail and commercial sectors) is leading to slower income growth overall. Fully 85% of incremental urban employment in 2014 (the last year for which such figures are available) was in low-end services, compared with 45% the year before. This resulted in a 20% decline in average new-job income. Low-end service jobs, which are mainly with small and midsize businesses, grew at 15% in 2014, while the number of high-end service positions grew only 5%, and the average monthly wage for low-end jobs—RMB 3,174—is only about 60% of the high-end average, RMB 5,171.

We do not expect consumption growth to slow too much more, but a return to peak growth levels is also unlikely, absent a turn-

around in the industrial sectors. There is a high correlation between retail and industry growth in China. This is reflected in retail sales-growth patterns in 31 regions (22 provinces, four municipalities, and five autonomous regions). Only six of these regions experienced more modest reductions in GDP and retail sales growth, owing to a relatively high percentage of high-end service jobs. Eleven regions suffered significant slowdowns in retail sales growth because of their high concentration of industrial-sector jobs.

### The Drivers of Continued Growth

In late 2015, we observed that the Chinese consumer market was in the midst of a transformation that was offering big new opportunities. Two of the forces ushering in this transformation were the rise of UMC and small-city MAC households feeding consumption growth, and the emergence of a new generation of young, freer-spending, sophisticated consumers. (See *The New China Playbook: Young, Affluent, E-savvy Consumers Will Fuel Growth*, BCG Focus, December 2015.) The latest research by BCG's Center for Customer Insight confirms that the current softening of spending growth has not affected these long-term trends.

By 2020, the number of UMC and affluent households will have almost doubled, to about 100 million, and will account for 30% of the urban population. The spending intentions of this group remain constant, and the spending growth rate is rapid, at 17%. Almost 30%—the same as in 2015—are planning to spend more this year. Consumers in the emerging middle class, middle class, and aspirant categories, whose spending has been growing at 5%, indicated that some belt tightening was in order. A big reason for the spending resilience among UMC and affluent consumers is that half of UMC consumers and three-quarters of affluent consumers are employed in the high-end service sector.

MAC households in smaller cities remain spending bright spots. MAC growth in lower-tier cities will account for some 50% of future MAC growth, and consumers in this group have the most optimistic spending plans of all we surveyed. Companies have their work cut out to reach these consumers, however. There are high concentrations of such households in more than 2,000 Chinese cities. We estimate that to reach 80% of this market in 2020, companies will need to establish a presence in some 430 cities.

Purchasing patterns of small-city MAC households differ from those of their big-city peers. These small-city consumers are also on a journey of increasing income and consumption, but they are at an earlier stage and are focused on different product categories. For example, health is important to all urban consumers, but big-city UMC consumers spend more on food, especially fresh foods, while small-city MAC consumers buy more health and nutrition products. Cars are a more important category for MAC consumers in small cities than they are for big-city UMC consumers.

China's "young generation" is growing quickly in both numbers and income. Those aged 18 to 30 years old will likely make up more than one-third of the urban population by 2020. Their consumption is growing at a 14% annual rate—twice the pace of the "last generation," those older than 35. The young generation's share of

total consumption is projected to increase from 45% to 53% by 2020. These consumers, for the most part, grew up during a time of expanding wealth as China made the transition to a market-based economy. They have not experienced the periods of contraction and hardship that older generations remember. One result is that they are notably more aggressive in their spending intentions: 60% agree with the statement, "It seems like every year, there are more things I want to buy." UMC young-generation consumers are particularly free-wheeling. Almost two-thirds believe, "Some products are just too important to me to scrimp on." One constraint on their intentions may be their wages: many young-generation workers are employed in lower-paying retail and commercial-service jobs than their last-generation counterparts.

## Trading Up Beats Trading Down

Although spending growth remains relatively steady, where consumers choose to spend is more fluid. Chinese consumers remain selective, and they like to trade up. In late 2015, we noted that although the expansion of China's emerging-middle class over the past decades has fueled rapid revenue growth in many categories—especially fast-moving consumer goods—the volume growth in such product categories is now slowing as the market approaches saturation. Furthermore, we expected that spending for many higher-value products would accelerate as more consumers entered the UMC and affluent categories and that there would be an emphasis on such categories as luxury goods, wine, automobiles, and overseas travel.

Changing times are resulting in some changing patterns. Infant and baby products, consumer electronics, and financial services remain the three categories in which consumers are most likely to trade up. Personal-care products—such as for skin care and beauty—and travel and vacations are moving up the list. Cars and durable goods are moving down, perhaps indicating that consumers are manifesting some uncertainty in the current environment by postponing trading up in big-ticket categories. Here

again, however, spending patterns of big-city and small-city consumers diverge. The top categories for trading up among big-city UMC consumers are travel and vacations and skin care and beauty, while small-city MACs put more emphasis on home appliances and health care and nutrition.

## Homes over Stocks

Some of the biggest headlines to come out of China recently have been about stock market gyrations and their broader impact on individual investors and consumers. But stock market volatility has little impact on their daily lives, including consumption. More than half of China's consumers see the recent stock-market volatility as normal; more than 40% consider it a correction to the stock market bubble that formed after a sustained period of strong growth. For almost half of consumers, stock market gains or losses do not affect consumption. About 70% of urban households do not invest in stocks, and those that do have both higher incomes and higher likelihood of increasing spending than those that do not.

Housing-market stability is a much more critical consideration for Chinese consumers, who continue to be optimistic about housing prices. More than 80% of urban households own their homes, and 60% of these homeowners are sitting on unrealized gains in value. Almost 60% of consumers expect home values to rise in one to two years, and one-third said that they would buy property in the next one to two years. Younger and more affluent consumers and those living in midtier cities are the most optimistic: almost two-thirds of young-generation, UMC, and affluent and midtier consumers expect housing prices to increase in the next one to two years. A change in the housing market and residential-property values would likely have a significant impact on consumer sentiment.

## Emerging Sources of Dissatisfaction

As Chinese consumers become more sophisticated, they also grow more concerned about leading a more modern,

healthier, and better-balanced lifestyle. Satisfaction with their circumstances varies widely by generation. Owing to higher expectations and awareness, the younger generation (18- to 25-year-olds) is the least satisfied. They report an overall dissatisfaction rating of 43%, compared with 34% for those aged 46 and older. (See Exhibit 3.) Among all the pain points, food safety tops the list, with 57% of all consumers claiming that current offerings fall below expectations, followed by health care (both the quality and the availability).

Dissatisfaction with more modern concerns—healthy city life (for example, convenient city lifestyle and green environment), investment, and work-life balance—is also more significant among the young, with substantial portions of these consumers believing that their needs are not being met. Again, the younger the consumer, the higher the expectations.

## How Companies Can Adjust

China will remain one of the world's most important growth markets, but as we noted in our December 2015 report, the nature of consumption is changing, and what used to be winning strategies are falling behind the times. Greater affluence and a new generation of consumers, as well as the rise of e-commerce, are shifting the action to different product categories, branding strategies, and retail channels. It is more important than ever before that brands adjust their strategies in line with the trends that are shaping consumption and that they understand the ramifications for such market aspects as segment, category, region, and channel. Successful companies will also target the points of relative dissatisfaction discussed above.

Engaging modern Chinese shoppers—especially the younger shoppers—is less about pushing product information and more about playing a helpful role in consumers' lives and addressing the issues they perceive as important. Targeting mass-market consumers with nondifferentiated brands at big-city hypermarkets is a good way to lose share.

### EXHIBIT 3 | Growing Dissatisfaction Among Young Consumers

SHARE OF RESPONDENTS WHO SAID THAT THE REALITY OF THE FOLLOWING ASPECTS IS BELOW EXPECTATIONS (%)

	All respondents	Aged 18 to 25	Aged 26 to 35	Aged 36 to 45	Aged 46 and older
Food safety	57	63	58	55	51
Health care <sup>1</sup>	47	53	48	44	43
Education	43	44	44	41	41
Convenient life <sup>2</sup>	43	45	45	40	33
Environment <sup>3</sup>	39	44	37	39	35
Social security	36	35	37	37	33
Investment <sup>4</sup>	27	28	29	27	19
Work-life balance	26	28	29	26	19
Overall	40	43	41	38	34

x Dissatisfaction is 4 to 8 percentage points higher than the mature group (46 and older)

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Source: BCG China Consumer Sentiment Survey, 2016.

<sup>1</sup>High-quality and safe medicine, sufficient high-quality health-care resources, convenient medical treatment.

<sup>2</sup>Convenient and efficient city public transportation with low levels of congestion.

<sup>3</sup>Living in a healthy and clean city, living in a good environment managed and supervised by government, having sufficient city green space and parks for leisure.

<sup>4</sup>Diverse banking and investment tools.

Companies that had an early start in China no longer necessarily have a competitive advantage: in many cases, they are in product categories with little appeal for the young and have been slow to adapt to new retail trends. Moreover, local competitors have hardly been standing still, and many of them have important advantages in factors such as costs and distribution networks, particularly in small cities with fast-growing MAC segments.

Recently, we also suggested that, in the broader context of emerging markets generally, multinational companies (MNCs) in particular need to rethink their strategies and priorities as growth in these markets slows and competition becomes more intense. (See *Transformation in Emerging Markets: From Growth to Competitiveness*, BCG Focus, February 2016.) While the assessment of growth potential remains critical, MNC strategy also has to focus on profitability and returns on investment. More and more companies are asking such questions as, What is the investment risk in each of our markets? Which customer segments can we serve competitively? Do we have prod-

uct segments in which slowing growth and declining profitability mean that we should question the viability of the business?

The biggest difference between past and future assessments needs to be a more radical examination of the actual competitiveness of the MNC's local operation in each market and segment. The best companies know exactly how big the cost differentials are between their operations and those of their strongest local competitors. They will develop a systematic approach to gaining local competitive intelligence, regularly analyze their competitors' offerings (often by reverse engineering them), and assess the strategic and operational gaps.

**I**N CHINA, IT IS more important than ever before for companies to be highly strategic in the way that they pick targets. Even though overall consumption will continue to boom over the medium term, targeting the wrong income segment, playing in the wrong categories, and being underrepresented in the fast-growing online channels will be a formula for slow growth. On the

other side of the coin, taking the time to get these decisions right will mean continued growth and profitability in the world's second-largest and still most-dynamic economy.

**NOTE**

1. Middle-class and affluent households whose monthly income exceeds RMB 8,000.

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