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Lucky 8

Understanding and Capturing China's New Growth

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The jackrabbit days of 12 percent annual growth in China are over. Still, unlike the economies of most of the rest of the world, the Chinese economy is still moving forward, albeit at a more modest 8 percent annual growth rate. But while 8—a lucky number in China—may be the new 12, today's growth is not the same as yesterday's. Understanding the certainties and unknowns of the nation's new growth model is essential for success in China.

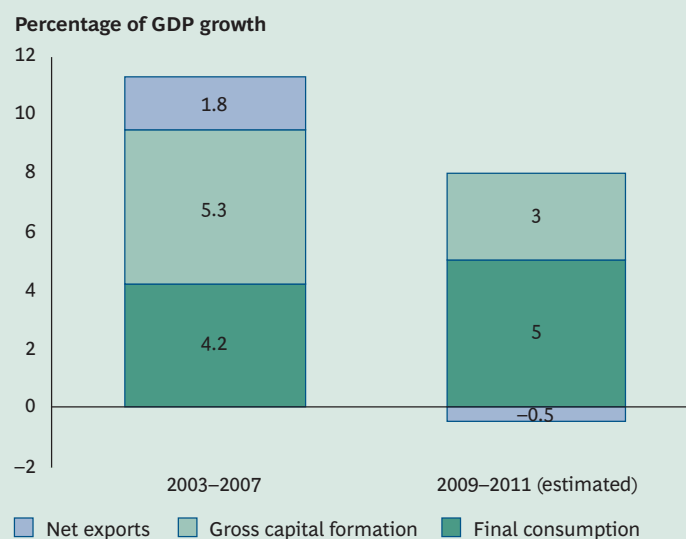
Many global companies have been understandably preoccupied with cutting costs and revising their strategy and operations close to home. But the sooner they return their attention to China, the better prepared they will be to understand, access, and serve this kaleidoscopic market, whose power and potential have been temporarily veiled by the global recession.

New Growth

With the global economy likely to keep trading water for the rest of this year, China is rapidly gaining relative strength. Goldman Sachs predicts that China will overtake Japan as the second-largest global economy in 2010. In the new economy, government investment, global expansion, and consumer spending will play much larger roles.

One way to understand the differences between China's old and new economy is to break GDP down into its three components: final consumption, gross capital formation, and net exports. (See the exhibit below.) Final consumption—spending by households, businesses, and especially government—will provide the largest contribution to GDP growth, according to Dragonomics, a Beijing-based research house. Capital formation will decelerate, and future investments will be directed increasingly toward infrastructure projects and industrial retooling. The shift away from export-oriented manufacturing investments will

The Composition of China's Economic Growth Is Changing Rapidly



Sources: Dragonomics Advisory Services; BCG analysis.

help produce a more well-rounded industrial base. Meanwhile, flat to declining net exports will actually be a drag on GDP growth over the next few years.

Four other trends are shaping the Chinese economy:

- ◇ Greater consumer spending
- ◇ A more forceful governmental role
- ◇ The growth of domestic companies
- ◇ A more productive relationship with Taiwan

Greater Consumer Spending. Despite popular assumptions in the West, China's economy has not been a one-trick export pony. While exports have certainly helped fuel China's booming economy, their contribution to GDP has been more modest than is generally believed. From 2003 to 2007, at the height of China's growth, net exports contributed about 16 percent to GDP—a significant but not an overwhelming share. (Gross exports, which make up a much larger share of GDP, do not deduct the value of imported components that are eventually shipped abroad.) But even in those years, consumption and capital formation, rather than exports, were the primary economic drivers.

While the rest of the world was busily buying inexpensive Chinese goods, China's own domestic economy—the urban private-housing sector, in particular—was chugging along without encouragement from overleveraged Western consumers. The evaporation of Western demand in 2008 certainly played a role in China's economic slowdown. The greater culprit, however, was the dramatic decline of the domestic property market and the disappearance of construction activity—a direct result of government efforts to dampen the economy.

Looking ahead, the economy will tilt more heavily toward domestic consumption. The property market is already starting to regain momentum. The value of housing sales, for example, rose by 36 percent in the first quarter of 2009. Construction is likely to resume as the government's fiscal easing policies take hold. In the first three months of this year, Chinese banks lent more money than they did in all of 2008.

The 4 trillion yuan (\$586 billion) stimulus package should ripple through the domestic economy over the next several years. Unlike its U.S. counterpart, the Chinese plan is largely devoted to direct investments rather than to transfer payments and tax relief. Fixed-asset investments already increased 30 percent in the first quarter of this year over the same period in 2008.

While it won't happen overnight, Chinese consumers will inevitably start to increase their spending. They currently save 36 percent of their disposable income and hold household deposits totaling \$3.5 trillion. Consumers in China save partly out of concern over health care and educational costs. But a wave of government reforms will encourage them to spend more freely. Health care reform will steadily expand coverage and access. The government intends to spend \$123 billion by 2011 to implement basic universal coverage. A set of financial services reforms will ease credit availability for individuals and small businesses. Finally, rural land reform will gradually enable farmers to better tap the value of their land.

An underestimated source of strength is China's resilient and flexible workforce. The massive layoffs at export-oriented factories last year captured headlines in the West but obscured the larger story. China has the highest literacy rate in the developing world. Many workers have quickly adapted to the new reality by accepting lower wages, finding new work, and retraining.

A key plank in the stimulus package is the encouragement of inland economic development, which will enable many migrant workers to have more sustainable careers closer to home. One province alone is currently retraining 4 million workers.

The new dynamics will reorder the economic landscape. Large companies and state-owned enterprises will have easier access to credit. Export-oriented companies will struggle to achieve success comparable to

that of the recent past. Companies in rural areas, which will receive a disproportionate share of stimulus spending, are likely beneficiaries, along with health care companies.

A More Forceful Governmental Role. An overlooked aspect of China's stimulus programs is the reshaping of ten domestic industries—including automobiles, steel, shipbuilding, petrochemicals, electronics, information technology, and logistics—which account for 40 percent of GDP. The government is moving well beyond stimulating these industries to active engagement in industrial policy.

The support for these industries is aggressive, even by China's standards. To create greater competitiveness, the government is encouraging consolidation and is offering tax relief, favorable export policies, and subsidies for R&D, technology upgrades, and pollution reduction. To stoke demand, subsidies and rebates are available for certain products, such as autos and appliances. This rising tide will not lift all boats equally. Some of the interventions are broadly based, but others will benefit particular companies within an industry and not others.

China's new industrial policy has many goals: to move the center of gravity of the industrial base to the west and away from the coast, encourage domestic consumption, accelerate the nation's climb up the economic pyramid, and reduce its reliance on foreign technology. Of course, the policy also has enormous implications for global companies that compete in these industries, dramatically changing the patterns of demand and competition. Subsidies will distort the market. Some local state-owned competitors may merge, creating stronger local foes. Export tax rebates may strengthen Chinese companies in international markets. R&D incentives may be offered only to certain local companies. These developments are already unfolding, and foreign companies risk being caught flat-footed.

The Growth of Domestic Companies. Many domestic companies are rapidly acquiring the scale, capital, expertise, and market savvy needed to compete in both domestic and foreign markets. Previously obscure companies are now giants. Aluminum Corporation of China, known as Chinalco, China's largest aluminum producer, recently sought to invest \$19 billion in Rio Tinto, the Anglo-Australian mining company. Ultimately unsuccessful, the bid nonetheless reflects both China's ambition and its ready access to capital. Tencent, the Internet giant that is publicly traded on the Hong Kong Stock Exchange, has been relatively unscathed by the crisis. It has several hundred million customers, a \$20 billion market capitalization, and—this year—an estimated annual growth rate of 33 percent and operating margin of 44 percent. It is barely ten years old.

Chinalco and Tencent represent the ambitions of the new China, the competitive zeal unleashed in recent decades, and the great diversity of China's companies—from traditional state-owned giants to dynamic private-sector players. A new generation of companies will benefit from growth in their home market, while companies in other markets struggle to tread water. Many will receive government assistance and gain access to ready capital that they can deploy to buy Western assets at attractive prices. The new Chinese economy will be less trade dependent, but it will be more competitive in global markets than ever before.

A More Productive Relationship with Taiwan. Relations between China and Taiwan have improved dramatically since the Nationalist Party, which was driven from the mainland by the Communists in 1949, took power last year in Taiwan. President Ma Ying-jeou says he is committed to reversing the course pursued by his predecessor, Chen Shui-bian, who aggressively supported Taiwanese independence.

The rapprochement has been rapid. There are already more than 270 direct flights across the Taiwan Strait every week, after a nearly 60-year absence of any such connection. An expansion to 800 flights per week is in the works. These flights are opening the tourism floodgates in both directions and symbolize the potential exchange of capital, management expertise, and creativity. Taiwan, for example, has many well-trained managers, who are in high demand in China, and many small manufacturing operations that could use China as a springboard to achieve global scale. Chinese and Taiwanese companies, even government-owned ones, have already begun launching new joint ventures. The economic multiplier effect of cross-strait trade and investment will spread throughout the economy.

What Next?

For global companies, these changes bring opportunities and challenges. Most have geared their China businesses to the old normal. They have targeted growth in export-oriented regions and banked on strong GDP growth. They have counted on the government's gradually stepping back from its role in shaping industries. With a new era dawning, most companies are unprepared for—or, even worse, unaware of—the shifts that are occurring. China's new growth will likely be oriented toward regions less dependent on foreign trade and will take place in industries benefiting from government support and domestic demand. Each industry will undergo a unique pattern of growth that will be different from what it experienced in the past.

In light of these new realities, all companies should take stock of China in several specific ways:

- ◇ **Understand the new Chinese stimulus programs, industrial policy, and reforms and their market implications.** The government will be a primary actor on the economic stage for the foreseeable future. Global companies need to understand the ways in which Chinese competitors will benefit from the new industrial policy—and how they themselves could benefit. There may be opportunities for nimble Western companies.
- ◇ **Adapt go-to-market models.** Rather than the export-oriented regions, rural and government markets are likely to be sources of future growth. A health care company, for example, recently reorganized to serve new types of hospitals that are being set up as part of China's health-care reform. Similar opportunities are arising in many sectors.
- ◇ **Pursue mergers and acquisitions in China.** The economic crisis is driving down valuations of leading companies and creating opportunities for local acquisitions. Crisis-stricken Western companies, too, are selling their assets in China at fire sale prices. Telstra, SK Group, GIC Group, and others have made major investments in China in recent months. Conversely, big, cash-rich Chinese companies are starting to acquire assets abroad. Raw materials, industrial goods, and technology companies are likely targets.

Global companies need to pay attention to their home markets during these times, but they ignore developments in China at their peril. While most of the rest of the world slumbers, China is once again on the move.

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