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A TALE OF TWO CHINESE CONSUMERS

By Jeff Walters and Youchi Kuo

DESPITE THE WELL-PUBLICIZED SLOWDOWN in economic growth, overall consumer sentiment in China can still be described as cautiously optimistic. More precisely, caution characterizes the lower end of the consumer market, while optimism envelops the high end.

China, in other words, has become a two-speed consumer market. The optimistic, "high-speed" consumer market disproportionately consists of middle- to upper-middle-class and affluent households.[1] These consumers also make up the bulk of the digital class of active online shoppers.

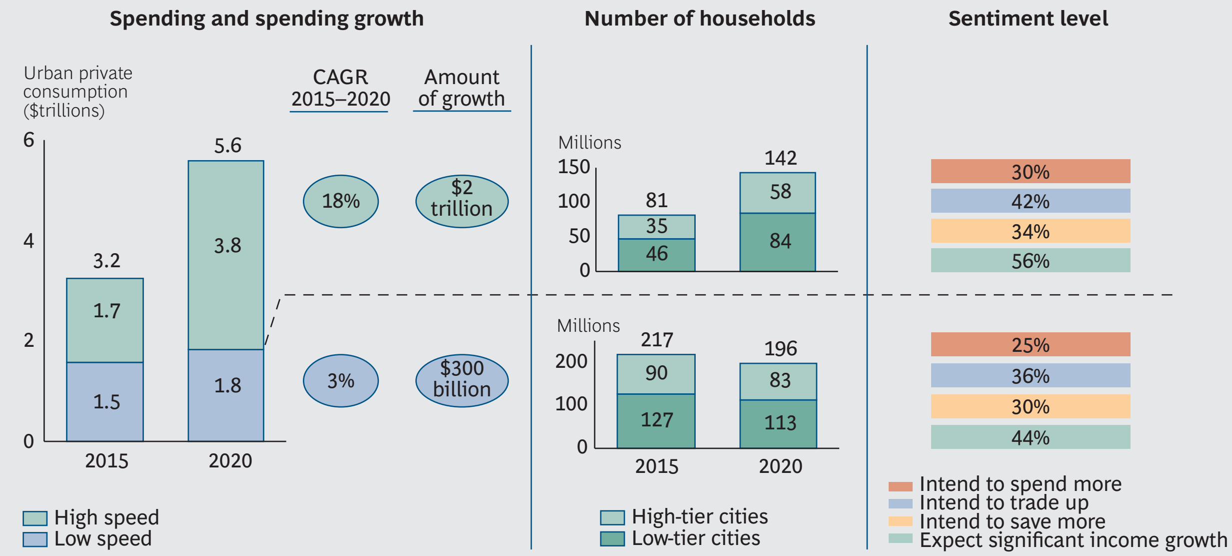
Today, high-speed consumers generate about $1.7 trillion of the $3.2 trillion in urban consumption anticipated for 2015. With rising incomes pushing more households into the middle class and above, the number of high-speed households will rise from 81 million today to 142 million in 2020, and they will generate about $3.8 trillion of the $5.6 trillion in total urban consumption. As their ranks swell and their incomes rise, these households will likely be responsible for nearly 90 percent of the increase in consumption during this period. (See Exhibit 1.)

These findings emerge from the BCG China Center for Consumer and Customer Insight's annual survey of consumer sentiment.[2] (Although the survey was conducted before the collapse of the market, its findings are still broadly relevant. It found that consumer sentiment was nearly the same among households that held stocks and those that did not. In any case, only 7 percent of households invest in the market.)

Rising incomes—and optimism that incomes will continue to rise—are driving this consumption growth. According to the survey, households with income growth exceeding 5 percent in the past year are twice as likely to spend more in the coming year than households with slower income growth.

Higher-income households are disproportionately benefiting from rising incomes. The average affluent household is expecting

EXHIBIT 1 | A Two-Speed Consumer Economy Is Emerging



Sources: Economist Intelligence Unit; National Bureau of Statistics of China; BCG China Consumer Sentiment Survey, 2015; BCG analysis.

nearly 11 percent income growth; the average aspirant household, only 6 percent.[3] This 5 percentage point difference, given the vast disparity in income levels between these two groups of consumers, translates into a 20-fold difference in actual earnings.

Despite the rapid growth of China's high-speed households, the survey results were not altogether positive. The survey found that while half of these consumers feel secure today, believe that their economic future is bright, and are ready to spend and trade up in the next year, the other half are much less confident. The total spending of less affluent urban consumers—the "low speed" households—will grow by just 3 percent annually from 2015 to 2020. More than half of these households anticipate slow or no income growth over the next year.

This two-speed consumption economy has vast implications for consumer-facing companies. A mass approach to such a huge market will not work. More than ever, companies must place their bets on the most promising income segments, product categories, and digital channels.

Reaching High-Speed Households

Companies that want to reach high-speed households will need to broaden their physical distribution channels. Of today's 81 million high-speed households, 46 million are located in lower-tier cities.[4] By 2020, 84 million of the projected 142 million high-speed households will be located in those cities. Companies currently need a presence in 530 cities to reach 80 percent of these households. By 2020, they will need to be in 615 cities.

Companies will also need a multichannel approach to reach high-speed consumers. These consumers are digitally savvy and active online shoppers, belying the common belief that online shopping is for students and bargain seekers. Forty percent of affluent households shop online frequently—at least once a week—compared with 20 percent of aspirant households.

Frequent online shoppers are younger and more affluent and like to buy in all channels. Compared with 24 percent of infrequent online shoppers, 35 percent of frequent online shoppers say they plan to increase their spending over the next year. Fifty-eight percent say they do not have enough things and want to buy more, compared with 44 percent of infrequent online shoppers.

Most notably, frequent online shoppers have moved 27 percent of their spending online, compared with 11 percent of infrequent shoppers. They spend more than $1,900 annually online, compared with about $775 for infrequent shoppers.

Overall Consumer Sentiment

When we look at the high- and low-speed consumer markets together, the overall picture remains positive—but is less than glowing. Overall consumer sentiment is slightly stronger than last year but still below what it was before the global financial crisis.

Three of our four consumer-sentiment yardsticks were higher this year than last year: a larger share of consumers reported the intention to maintain or increase spending; they also reported higher levels of financial security and job security—not surprising, given the continuing overall strong demand for jobs in China. But by a narrow margin, they reported slightly less willingness to trade up compared with last year. (See Exhibit 2.)

Spending is the most important of these yardsticks, so it is worth breaking down the results. The share of consumers planning to spend more in the next 12 months declined by 4 percentage points from 2014, from 31 percent to 27 percent, but the share that plans to spend less declined even more, from 25 percent to 19 percent. In the middle, the share of consumers expecting to spend the same in the next year rose from 44 percent to 54 percent. In other words, the overall consumer market is chugging along. It's not like the go-go years of the previous decade, but it's far better than most markets.

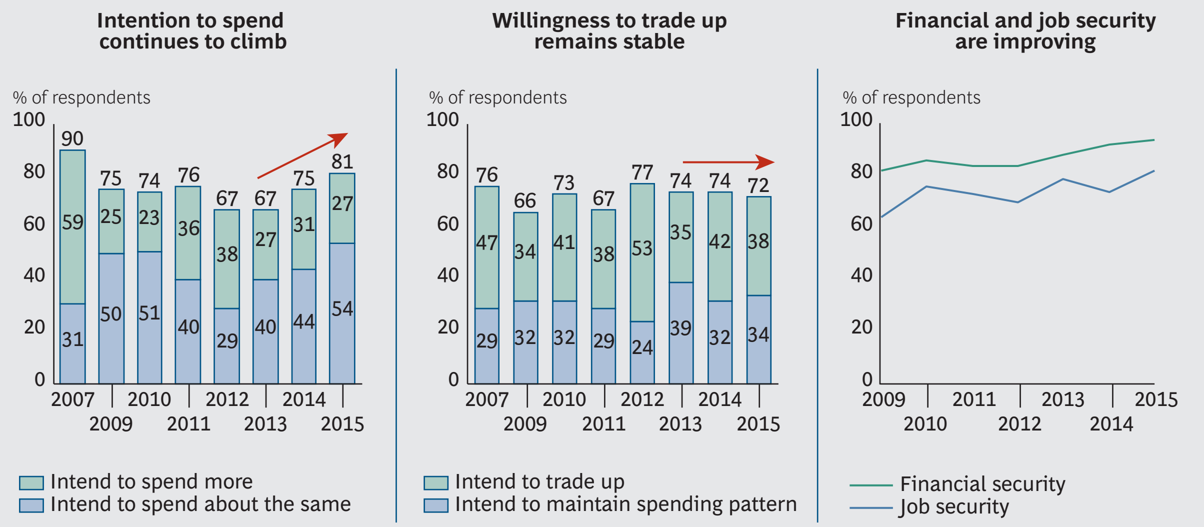
GDP and Spending Remain Decoupled

For as long as China has been a global economic giant, economists have wondered when consumer spending would play a greater role in its economy. In 2014 and early 2015, consumer spending actually grew faster than GDP. In the first quarter, nominal urban household income grew by 8.4 percent, compared with 5.6 percent GDP growth. The survey indicates that this gradual shift will continue.

GDP growth has never been a useful barometer of consumption growth in China. In the past, it was investment, not consumption, that mainly drove high GDP growth. Now it is mainly the decline in investment, not consumption, that is slowing GDP growth.

When they make purchasing decisions, Chinese consumers pay more attention to rising incomes than to slowing economic growth. Forty-seven percent of respondents

EXHIBIT 2 | Consumer Sentiment Is Higher Than at Any Time Since the Crisis



Sources: National Bureau of Statistics of China; BCG China Consumer Sentiment Surveys, 2007 to 2015; BCG analysis.

cited increased income and benefits as the key reason they plan to spend more, compared with 39 percent last year.

The cautionary flag in these findings is that corporate profits, which are a leading indicator of income and consumption, have been declining since late 2013. The tight labor market has helped protect wages, but profits can move in the opposite direction from income and consumption for only so long.

Rising Savings Rates Do Not Indicate Pessimism

Household savings rates in China are the highest of any major economy. Some theories suggest that "cautionary saving" prevents Chinese consumers from spending more. Rather than spend today, they are saving because of worries about the future. From this perspective, the rise in household savings rates from 20 percent to 32 percent between 2000 and 2014 suggests that consumers are becoming more pessimistic, especially in light of the government's steady expansion of the social safety net.

This year's survey suggests a very different view. Only 27 percent of households reported that they were saving for reasons of "general precaution," down from 46 percent two years ago, and fewer than 10 percent are saving as a precaution against an economic downturn. By contrast, 40 percent cited family, including elderly parents, as reasons for saving, and 36 percent cited investment and retirement.

However, these reasons do not explain the steady rise in savings rates, which vary from 40 percent of income for affluent households to 29 percent for aspirant households. The survey suggests that rising income, not pessimism, is driving the increase in savings. As Chinese households move into the middle class and above, their lifestyles and spending habits are not keeping up with their income growth. This is especially true in lower-tier cities. Among the middle and affluent class in lower-tier cities, 25 percent of respondents reported that they are saving simply because their income has risen.

Consumer companies have an unparalleled opportunity to convince these consumers, particularly the upper middle class and above, to spend more and save less—and so provide a boost to the economy. Each 1 percent reduction in the savings rate among high-speed consumers will generate $30 billion in additional spending, the equivalent of 0.3 percent GDP growth. By reducing their savings rate from 38 percent to the urban average of 32 percent, high-speed urban consumers would unlock $165 billion in spending and 1.7 percentage points in GDP growth. That's equivalent to adding the consumer spending of Finland or Portugal to the economy.

Spending Patterns

Not all categories are benefiting equally from consumption growth. Food safety issues, an increased focus on health and wellness, and a growing willingness to spend on children have made organic or fresh fruits, meats and vegetables, and baby-related products top spending priorities this year. Consumers also intend to spend a bit more on personal products such as apparel, skin care products, and vitamins. They do not, however, intend to spend more on luxury items, home care, and basic packaged foods and beverages such as carbonated soft drinks and snacks.

THREE LESSONS FOR consumer companies emerge from our survey:

- Expand your presence in lower-tier cities and online channels.
- Target your marketing and promotional activities to the higher-income segments in order to unlock the latent demand of households with rapidly rising incomes.
- Design your product portfolio around these consumers, with a particular emphasis, when possible, on health and wellness and personal products.

By focusing on the high-speed parts of the Chinese consumer economy, companies can avoid getting stuck in the slow lane.

NOTES

1. Specifically, this consumer market consists of upper-middle-class and affluent households in tier 1, tier 2, and tier 3 cities, whose monthly income exceeds RMB 12,000 or $1,900, and middle-class, upper-middle-class, and affluent households in tier 4, tier 5, and tier 6 cities, whose monthly income exceeds RMB 8,000 or $1,300.

2. The survey was conducted in May 2015, either in person or online, with 3,050 consumers in 250 cities of all sizes. China has a total of 2,291 cities and counties.

3. Chinese households can be divided into five major income classes: poor and aspirant (less than RMB 5,000 or $800 in monthly income); emerging middle class (RMB 5,000 to 8,000 or $800 to $1,300 in monthly income); middle class (RMB 8,000 to 12,000 or $1,300 to $1,900 in monthly income), upper middle class (RMB 12,000 to 23,000 or $1,900 to $3,700 in monthly income), and affluent (more than RMB 23,000 or at least $3,700 in monthly income).

4. China's 2,291 cities and counties are divided into seven tiers based on the size of their middle and affluent classes. The top 107 cities make up tiers 1, 2, and 3; the remaining 2,184 cities are grouped into tiers 4, 5, 6, and 7.

About the Authors

Jeff Walters is a partner and managing director in the Hong Kong office of The Boston Consulting Group. You may contact him by e-mail at walters.jeff@bcg.com.

Youchi Kuo is an expert principal in the firm's Hong Kong office. You may contact her by e-mail at kuo.youchi@bcg.com.

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