China's Post-Olympics Economy

Sustaining momentum through turbulent times

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Jonathan Woetzel
Janamitra Devan

McKinsey&Company

Preface

The Olympic Games in Beijing focused the world's eyes on China with unprecedented intensity. Generally regarded as a spectacular success, the Games are now over and China returns to business-as-usual. This gives us an opportunity to take stock of the nation's economic prospects in a period of heightened uncertainty in the global economy.

Can China continue to grow at the spectacular pace that we have seen over recent years? Will consumers take up the baton from exports and investment to become a major driver of GDP? What is the likely impact on China of financial pressures arising out of the United States as markets continue to adjust to the fall-out from the subprime mortgage crisis? How will high energy prices impact on Chinese industry and consumption and how will business cope? Will China continue to build up foreign-exchange reserves to the dramatic degree that we have seen in the recent past? What are the likely trends in China's financial markets and will they develop to the extent necessary to continue supporting growth? What key risks could jeopardize China's high growth trajectory?

In the next few pages my colleagues, Jonathan Woetzel, Director in our Shanghai office and Janamitra Devan, Senior Fellow of the McKinsey Global Institute who is based in Shanghai, address these questions and the macroeconomic risks and opportunities that are likely to unfold for China in the near-term and over the next five years. Given the unprecedented uncertainty in the global economic environment, this document represents our current, but evolving perspective on China's macroeconomic prospects.

Andrew Grant
Managing Director, Greater China Office
McKinsey & Company

Executive Summary

Consensus forecasts indicate continued, though somewhat muted growth—a post-Olympics slump appears unlikely. China now drives world growth as much as do the European Union and the United States

Underlying forces of growth appear strong

- High savings utilized effectively for urban investments
- Growth in middle-class consumption is buoyant
- Net exports may take a slight dip but will remain stable in the mid term
- Government expenditures are increasing and social services spending has been keeping pace

Key short term macroeconomic risks include

- Exposure to heightened global recession
- Periodic inflation due to bottlenecks in food, housing, and energy
- Pressure on exporters to maintain competitiveness
- Regional inequalities persisting with the potential for social unrest
- Domestic asset price volatility given recent financial turmoil and potential for increased non-performing loans in the face of declining housing prices

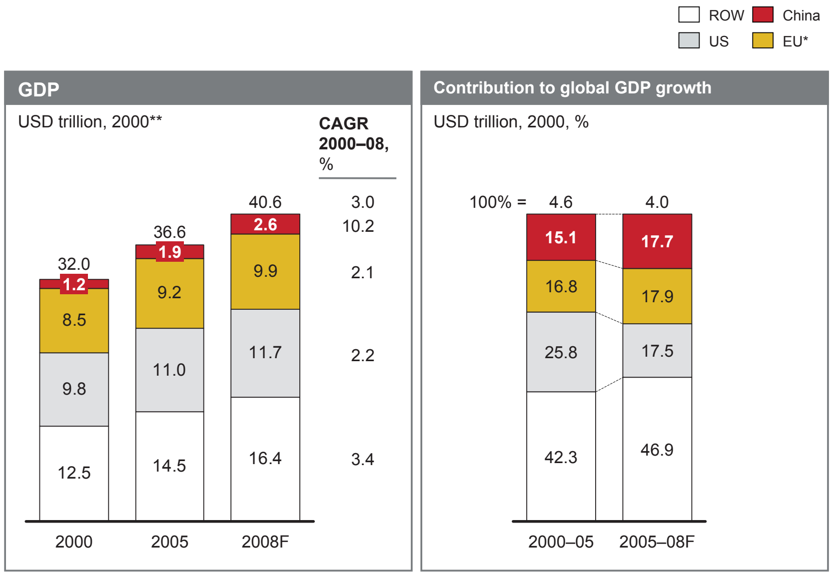
The median forecast calls for real GDP to slow through to the end of 2009, with moderate growth expected over the ensuing 4 to 5 years. The end of the Olympics by itself is a non-issue.

The financial crisis currently unfolding has clearly raised concerns among Chinese leaders with the People's Bank quickly easing monetary policy. Barring a severe global recession, we believe the effects on China of the current turmoil will be short lived. Chinese financial institutions have minimal exposure to their US counterparts and demand for Chinese exports to the US has in the past proved to be somewhat resilient to recessions. Nevertheless, we expect there may be a slowing of the economy by the end of this year that is likely to continue into 2009.

A concern that China needs to address is food and product safety. The current "milk crisis" follows a stream of product and food safety issues in recent years that, if left unaddressed, could become a systemic risk (e.g., prolonged impact on exports of food products) that could take years to mitigate.

Overall the momentum China is currently riding on the wave of rapid urbanization, sustained investment growth, and increased consumerism will temper any slowdown. To the extent that we see risks in the short-term, we would look at the potential for domestic asset market turbulence as the main source for concern, while a short-term reversal in domestic housing prices could result in heightened incidents of non-performing loans.

China's contribution to global GDP growth now equals those of the European Union and the United States



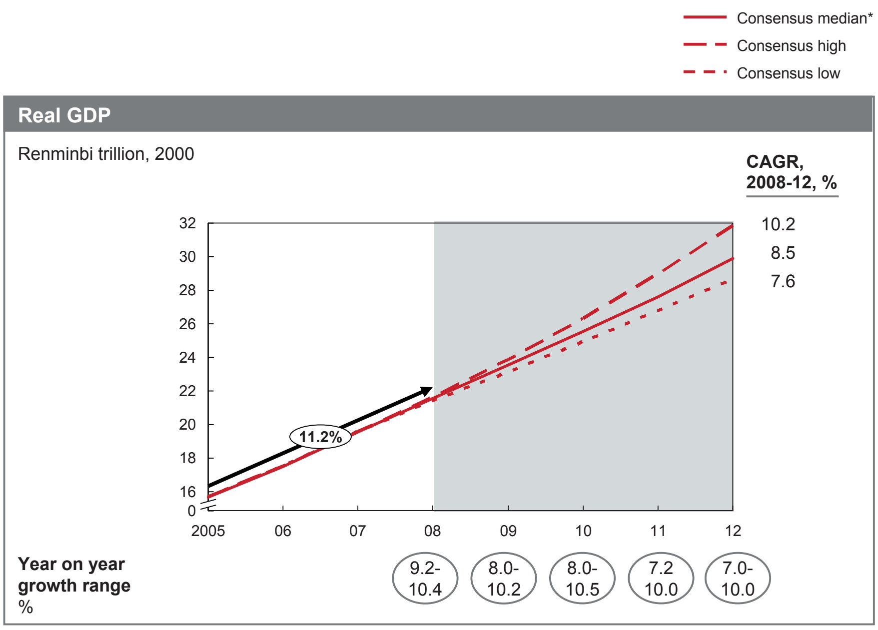
* The 27 EU member states (as of Aug 2008) are used to calculate the real GDP of the EU from 2000–08

** All figures in this report, unless otherwise stated, are given in 2000 constant terms. The current nominal exchange rate is about 6.8 renminbi to the dollar

Source: Global Insight; McKinsey analysis

China is not only a superpower in terms of its huge population but is rapidly becoming a global economic force. We expect China's real GDP to more than double between 2000 and 2008, growing at a compound annual rate of 10.2 percent over the period. By the end of this year, China's economy will account for some 6 percent of global real GDP. Not only will the pace of China's economic growth have eclipsed that of most of the rest of the world between 2005 and the end of this year—China's contribution to the increase of global GDP at almost 18 percent during this period would about equal the contributions of the United States and the European Union.

The median forecast calls for real GDP to slow by end-2008 and moderate growth over the next five years



* Consensus forecasts were published from Oct 2007 to Sept 2008
Source: Various forecasts; Global Insight; McKinsey analysis

China's GDP growth will slow to about 10 percent this year from the blistering 12 percent it registered in 2007. The consensus median forecast of the Chinese economy calls for this rate of growth through to 2009. Given more recent information on the turmoil in global financial markets precipitated by credit conditions in the United States, growth could trend slightly lower in 2009 to about 9 percent. The consensus prognosis beyond 2009 has China's GDP growing at a compound average growth rate of 8.5 percent through 2012.

The end of the Olympics will not lead to a nation-wide economic slowdown given Beijing's small share of China's GDP

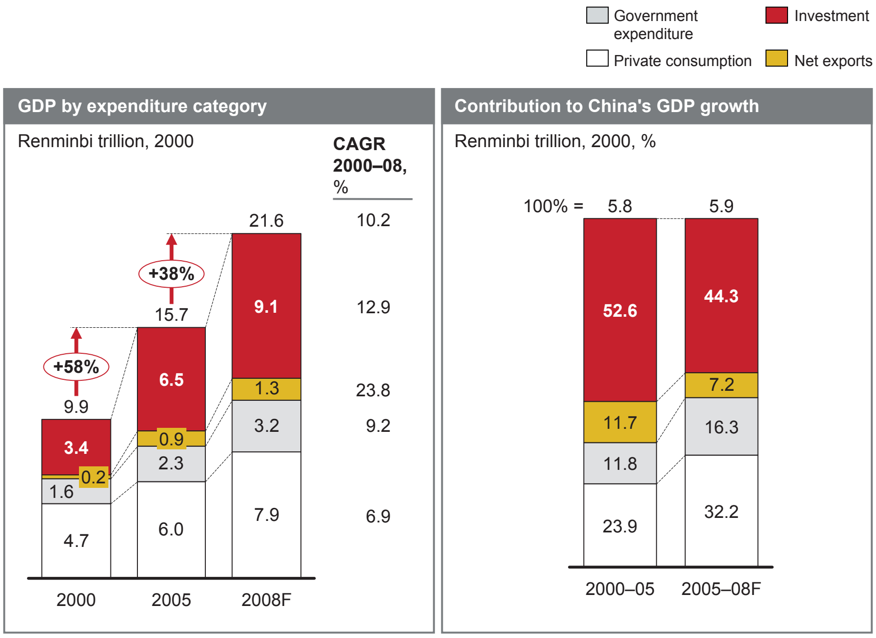
Olympic host city	Host city share of country GDP %	Changes in growth rates year after Olympics % GDP	Investment*
Athens 2004	54.6	-0.8	-5.3
Seoul 1988	25.9	-1.9	7.3
Barcelona 1992	8.1	-0.2	0.2
Sydney 2000	8.0**	-0.2	12.0
LA 1984	5.4	-1.0	-5.6
Beijing 2008	3.6		
Atlanta 1996	1.7	1.7	3.4

- Previous host countries experienced varying degrees of post-Olympic slowdown depending on the host city's share of the country's GDP
- US Olympic cities represent the most relevant historical benchmark for China but did not exhibit a clear pattern of GDP growth after the Games

* Real gross fixed-capital formation
** Using Sydney 2003–2004 GDP/Country GDP ratio due to data availability
Source: Global Insight; McKinsey analysis

The ending of the Beijing Olympic Games does not necessarily portend a decline in China's economy. Beijing accounts for only 3.6 percent of China's nominal GDP and we expect the city economy to slow down in the post-Olympic period, given the size of the investment made for the Games and the number of jobs that this generated leading up to the Games. However, we do not expect the city's economic deceleration to last very long, not least because some construction activity that was halted in the lead-up to the Games in Beijing and its vicinity will now resume.

Investment has been the main driver of GDP but consumption has picked up in the last three years



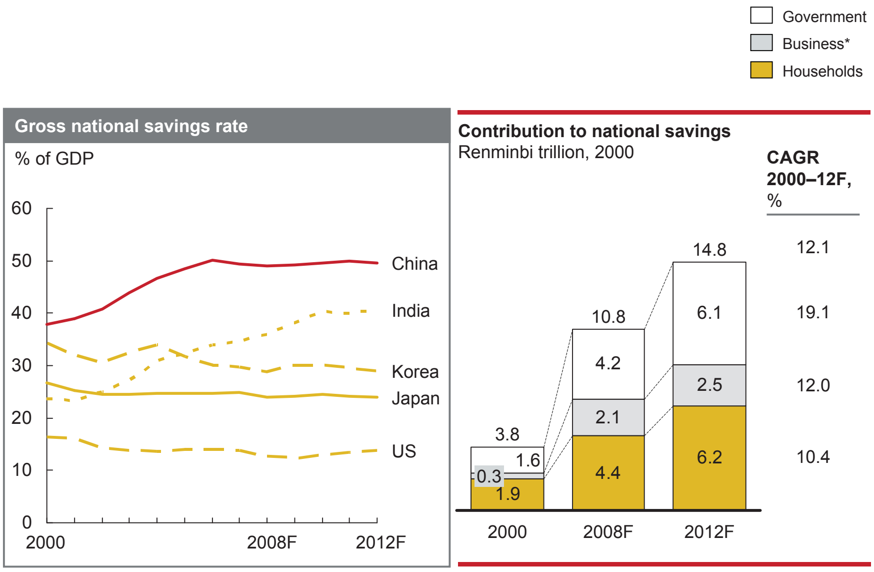
Source: Global Insight; McKinsey analysis

Investment has continued to be the dominant driver of China's rapidly expanding economy. Public and private investment in fixed assets, including outlays on infrastructure, building, and capital goods accounted for 42 percent of China's real GDP in 2000 – over 9 trillion renminbi in real terms.

Taking a longer-range historical view, investment was responsible for some 38 percent of the cumulative increase in China's GDP between 1990 and 2000. More recently investment has become an even more important factor in China's GDP growth. From 2000 to 2005, it accounted for more than 50 percent of cumulative GDP growth. However, this figure will fall to about 45 percent between 2005 and the end of 2008.

Viewed from a different lens, the investment required to produce a $1 increase in GDP in the past few years has increased relative to the 1990s (~$4.3 in the 2001-08 period). A continuation of this trend would imply that China will derive less and less output from additional investment spending.

China's national saving rate is much higher than in other economies, kept up by buoyant savings across sectors

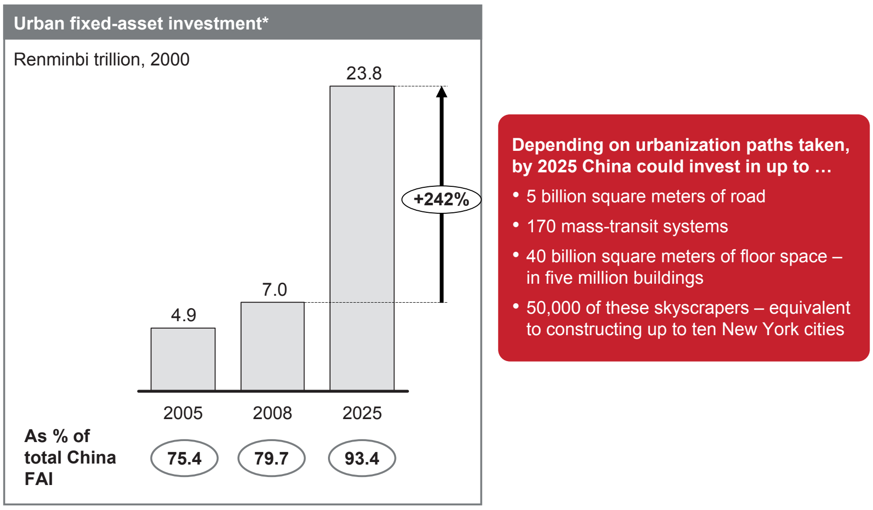


* Includes state-owned enterprises
Source: National Bureau of Statistics of China; McKinsey Global Institute China Consumer Demand Model; McKinsey analysis

China's savings rate is high, funding high investment levels. Part of the reason for this is that the country's social-safety net continues to be weak. People save more in such a circumstance even in the face of rising incomes, as a precaution to ensure that they have funds available for a "rainy day." The likelihood, therefore, is for savings to remain stubbornly high, thereby muting the pace of growth in China's consumption for several more years. The counterpart to this dampening impact on consumption, however, is that China's high savings rate will continue to buoy rapidly expanding investment growth.

Over the long term, there is no doubt that a lowered savings rate in China concomitant with a rising savings rate in the US would bode well for the international economy. A sustained difference in savings between two economic giants—in the same way that trade imbalances have remained pronounced between the two—would cause imbalances in the future that would have to be rectified by fundamental change in other factors such as exchange rates.

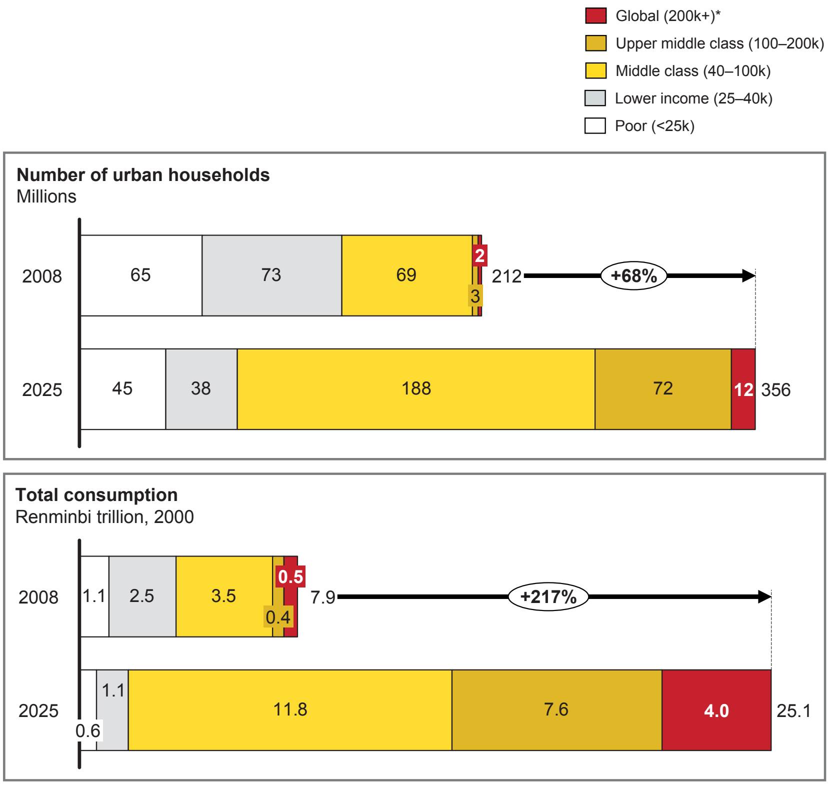
Urbanization alone will drive significant investment growth over the next two decades



* Trendline forecast
Source: McKinsey Global Institute China All City model; McKinsey analysis

Most of China's investment will go to urbanization. By 2025, urban China will contribute over 90 percent of China's real GDP from 75 percent today. This continuing urban expansion will ensure that China will fulfill the ambitious economic growth target set out at the 17th Party Congress in 2007 of quadrupling per capita GDP by 2020. However, China's urbanization could take distinct paths that will dictate the economic impact of this phenomenon. The McKinsey Global Institute recently modeled China's urbanization under several scenarios depicting different degrees of urban concentrations (see *Preparing for China's Urban Billion*). The analysis shows that concentrated urbanization would yield the greatest gains in terms of GDP growth benefiting from a greater upside in productivity associated with this form of urbanization.

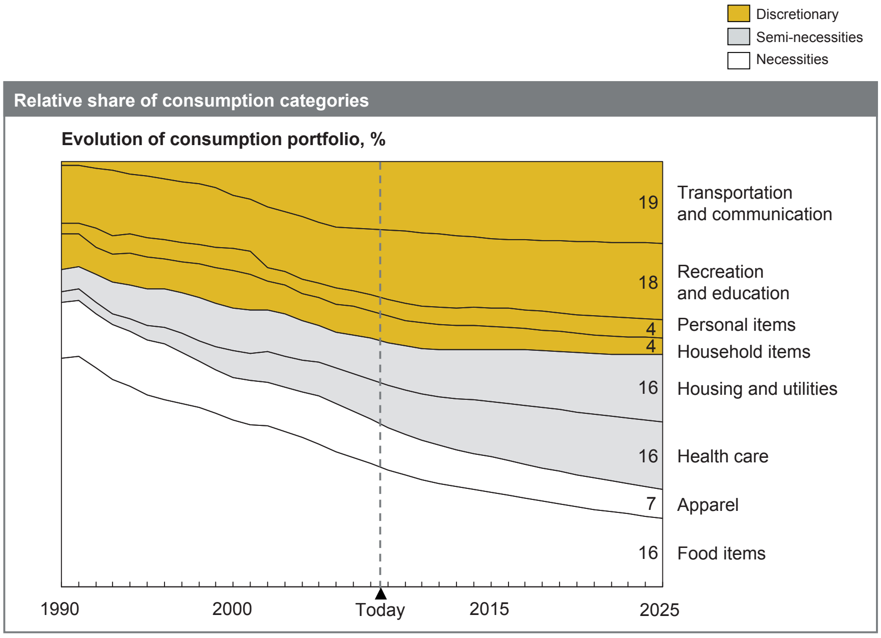
China’s middle class will grow rapidly in numbers and even more so in terms of its consumption



* 2000 renminbi per household per year
Source: McKinsey analysis

Sustained investment-led growth and urbanization will also drive consumption. As investment accumulates, we expect that Chinese households will progressively capture a greater share of total factor income. This means that, even as overall economic growth moderates, household incomes will continue to rise rapidly. China’s middle class will expand to comprise 70 percent of the urban population by 2025. To put this into an international context, China will add roughly twice the number of households of the US middle class today to its urban middle class. Research by the McKinsey Global Institute sees the rising incomes that are vaulting people into the middle class on this scale leading to a tripling in consumption by 2025.

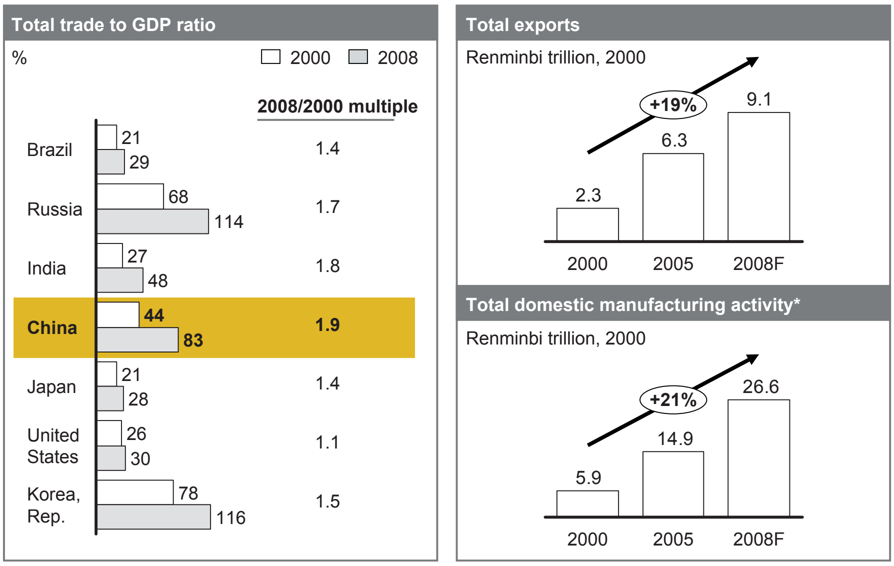
Urban China's consumption will on average gradually shift toward discretionary spending



Source: McKinsey Global Institute China Consumer Demand Model

As China's incomes rise, creating a burgeoning middle class, there will be a perceptible change in consumer preferences. As we have seen in other developing economies when incomes reach beyond a certain threshold, consumers will switch a portion of their consumption away from basic necessities such as food and apparel to more discretionary items including transportation and communication, and recreation and education.

China's economic openness has almost doubled in ten years driven by export manufacturing activity

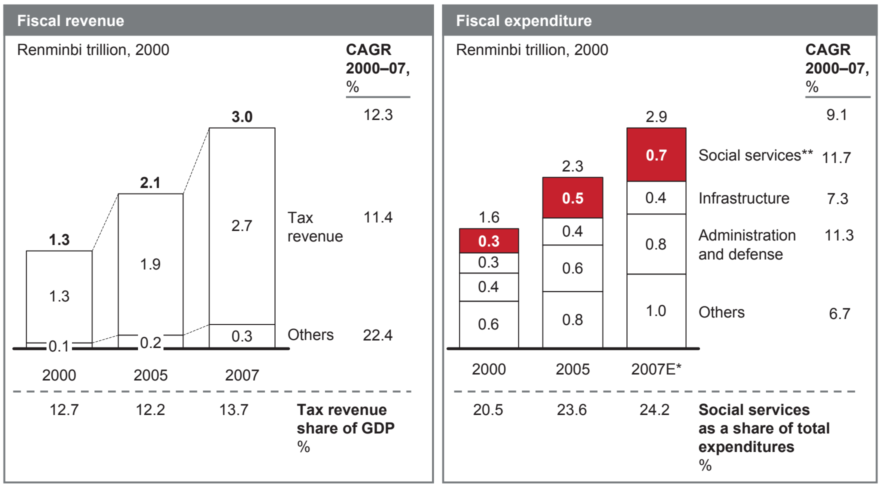


* Includes value of all sales including intermediate goods
Source: Global Insight; McKinsey analysis

Since 2000, China has increasingly opened up to the global economy, becoming ever more actively involved in trade. China's ratio of total trade to GDP shows that the economy is twice as open today as it was at the turn of the century. Relative to other major world economies, this measure indicates that China is more than twice as open as the United States and about three times more open than Japan.

Chinese exports have been growing rapidly. However, domestic manufacturing activity has grown even more substantially. We believe that exports and domestic demand together will drive overall industrial production over the near-term. Neither factor acting alone will be enough to sustain momentum.

Fiscal revenue is growing faster than GDP, accommodating greater social services spending



* 2007E: Estimated using 2006 fiscal expenditure breakdown
** Social services expenditure includes social security, education and healthcare
Source: China Statistical Yearbook; McKinsey analysis

China's fiscal position is close to balance, as it has been for some years. We do not expect either significant deficits or surpluses in the near future as China continues to maintain a disciplined expenditure regime. Nevertheless, healthcare, education, and social security will be key pressure points (note that a significant amount of social services are accounted for at the local level). Spending on these items has increased, but has been holding at about a quarter of total expenditures at the national level—it is unlikely this share will be sufficient in future years, particularly in view of government policy that has committed China to broadening social provision to China's huge and expanding urban migrant populations. For example, trendline forecasts by the McKinsey Global Institute indicate that urban public service requirements (education, healthcare) will grow at a compound annual rate of more than 10 percent over the coming decades. Meeting these requirements while maintaining fiscal balance will require continuous focus on achieving efficiency improvements in the provision of these servi-ces.

Risk dashboard: A few macroeconomic risks are worth watching

Caution Limited risk Watch

				Growth projections		
Key risks	**Risk potential**	**Rationale**	**Key indicators**	**'08**	**'09**	**Outlook**
Exposure to global recession		• Chinese exports historically robust to mild recessions • Turmoil in financial market anticipated to reduce FDI	• Global GDP • FDI	2.3–2.5% 25-30%	2.6–3.2% 10-15%	• Expect lower growth due to recent market developments • H1/2008 data indicates FDI growth above forecast
Inflation		• Prices reversing to a more moderate level • Government taking action to slow prices even further	• CPI	6.7–7.2%	4.4–4.5%	• Expect occasional spikes in key categories like food and housing
Resource bottlenecks		• High demand growth for energy in particular	• Energy demand (QBTUs)	3-5%	3-5%	• Growth in urban GDP to outpace decline in energy intensity
Export competitive-ness		• Productivity gains have mitigated impact of producer price pressure on competitive position • Product and food safety currently a major concern of trade partners	• FX rate (RMB/$) • PPI • N/A	6.6–6.9 5.9–7.0%	6.3–6.7 3.7–5.2%	• China ripe for manufacturers to move up value chain • Expect potentially prolonged reduction of exports of affected products in the face of a crisis of confidence among importing countries
Regional inequalities		• Potential social instability from growing regional income disparities	• Income inequality (Gini index)	0.45-0.50	N/A	• This will worsen over next 5–10 years before improving
Asset market turbulence		• Risk of asset bubbles emerging and then rapidly unwinding	• Stock market volatility* • NPLs	10-15% 5.4-5.8%	N/A N/A	• Expect further correction in equity market; rise of NPLs if housing prices decline

* Standard deviation of monthly Shanghai composite index returns
Source: Global Insight; Economist Intelligence Unit; McKinsey analysis

China's economic development has been a remarkable success story, achieved in a very short timeframe. Nevertheless, a range of macroeconomic risks have now surfaced that could pose discontinuities to the smooth trajectory of China's economic expansion. These risks are what lead us to expect growth through 2009 in China to be closer to consensus median forecast (~9 percent) than consensus high levels. (See appendix for a more detailed list of macro-economic, price related, and financial stability risk factors)

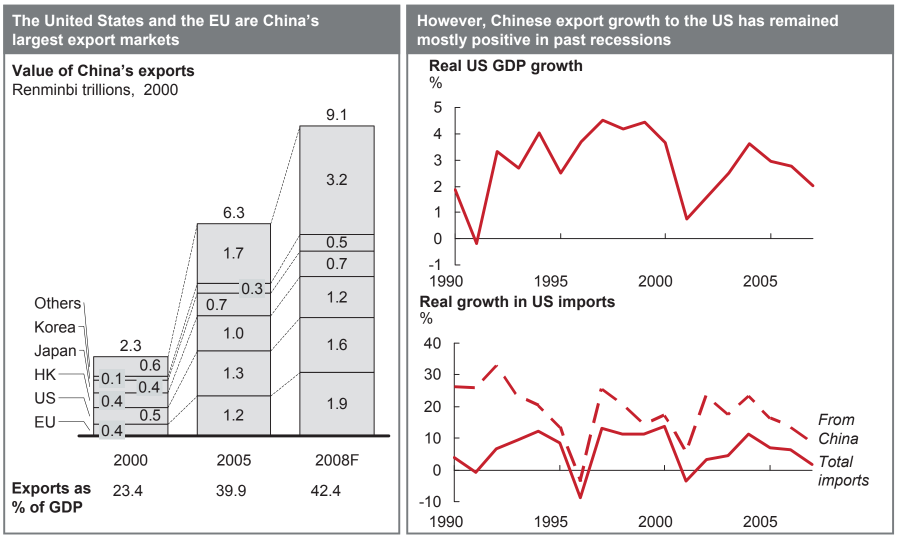
There is a great degree of uncertainty about US economic prospects against a background of the subprime mortgage crisis and the squeeze on credit that has ensued. Domestic asset price volatility could be expected in the short term as markets adjust to the new risk environment.

The question on everybody's lips is whether the United States is heading for a deep recession and what knock-on effect this might have on the rest of the global economy, China included. In the domestic economy, there has been widespread concern about inflation and its effect on consumer demand and exporter competitiveness. Similarly, the appreciation of China's real estate market, until recently, has raised concerns about the possible emergence of a bubble. Over the longer term, there are worries about growing inequalities within China and the regime's ability to maintain social stability in the face of such disparities.

The recent "milk crisis" that has been widely publicized, comes on top of several other product and food safety crises, and is impossible to ignore. Reports of a growing number of countries imposing bans on the imports of affected dairy products from China may not be merely a temporary phenomenon. Since there has been a series of such scares over the past few years, this could well become a wider systemic risk, leading to a prolonged loss of export competitiveness. Worse still would be an extended retreat by domestic consumers from locally-made products.

Our judgment is that these are genuine short-term macroeconomic concerns that should be considered alongside a generally favorable long-term growth outlook. A burgeoning middle class, rapid technological penetration, continued investment-led growth, and the continuing urbanization of the Chinese economy, have a momentum that, in our view, makes the possibility of their reversal a remote one. The fact is that, although China's growth has been extremely rapid and its economy has reached a substantial size in aggregate, in per capita terms—whether per capita GDP, energy use, or employee value added—China is still at a relatively early stage in its development. There is, in short, a great deal of remaining upside for this economy.

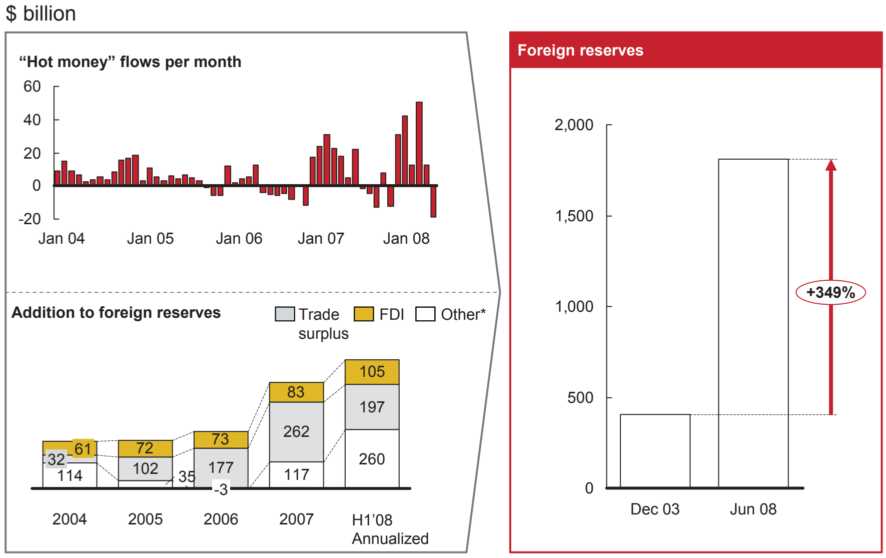
During past US recessions, China's exports have slowed but still posted growth



Source: US Bureau of Economic Analysis, Global Insight; McKinsey analysis

The United States and the EU remain the largest markets for Chinese exports, accounting for 40 percent of total exports in 2008. Given the likelihood of a recession in these markets over the short term, we anticipate that growth in China's exports will slow. However, Chinese export growth to this market has remained mostly positive, indicating as some commentators have stated, that a high share of Chinese exports to the United States are necessities as well as counter-cyclical goods.

Foreign direct investment and current account surplus have driven foreign reserves higher – but recent flows of "hot money" have played a role



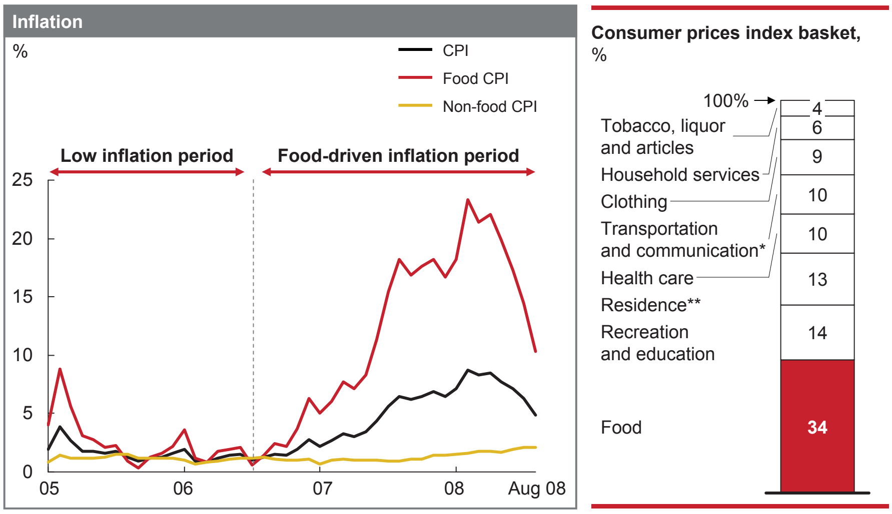
* "Other" refers to fund transfers, portfolio investment, interest income, and others; "hot money" falls into this category

Source: CEIC Data; McKinsey analysis

Another startling characteristic of China's recent economic history—and one that has prompted persistent international attention—is the rapid pace that the country has accumulated foreign reserves. China's reserves have expanded from just over $400 billion at the end of 2003 to some $1.8 trillion in June 2008 and we project will hit the $2 trillion mark by the end of the year. The largest driver of this build-up of reserves is direct investment and China's very large trade surplus. These massive reserves not only constitute an insurance policy against a liquidity crisis but also give China the opportunity to make large strategic investments.

There has also been an element of speculative inflows as international investors have bet on an appreciation in the value of the renminbi. However, the authorities have moved to impose controls on the influx of this so-called "hot money" and we believe that this official action should allay concern that the expansion of China's money supply might lead to higher inflation.

The recent spike in inflation was due almost entirely to food prices that have begun to reverse dramatically

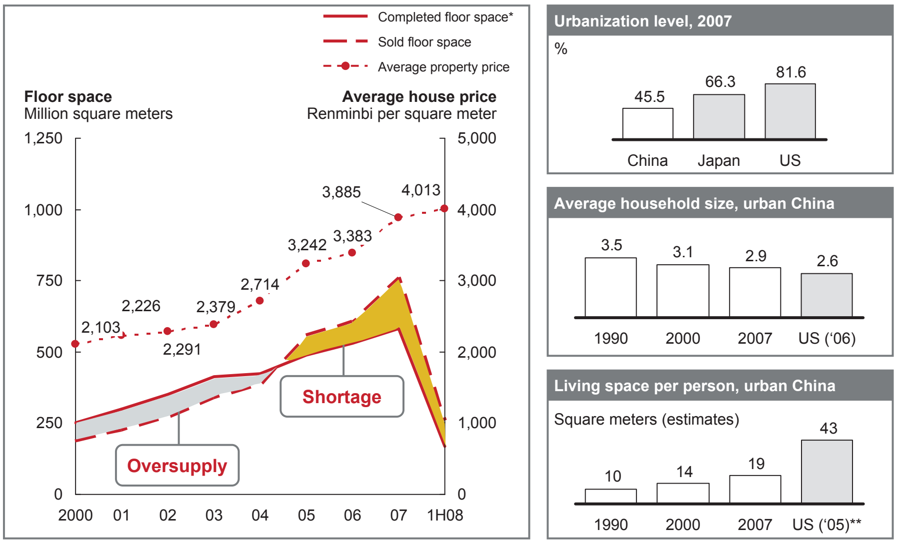


* Transportation and communication category includes fuel costs
** Residence includes building and decoration, rent, private housing and water, electricity and fuel
Source: China Banking Corporation; McKinsey analysis

China has recently experienced a spike in inflation but this was largely due to rising food prices—in particular the price of pork. Energy prices are highly regulated, insulating most citizens from the impact of recent price volatility. Although this increase in inflation caused a sense of panic that prices were going out of control, the fact is that inflation has already trended downward for four months in a row.

We view consumer price inflation as a well mitigated risk under current conditions. The People's Bank of China has tightened monetary policy throughout most of 2008 to slow the economy. Evidence that this policy has been effective is the fact that the People's Bank has now felt comfortable enough about the inflation outlook to ease monetary policy in response to the financial turmoil in US markets.

Housing prices have gone up recently but longer term real-estate demand drivers are strong

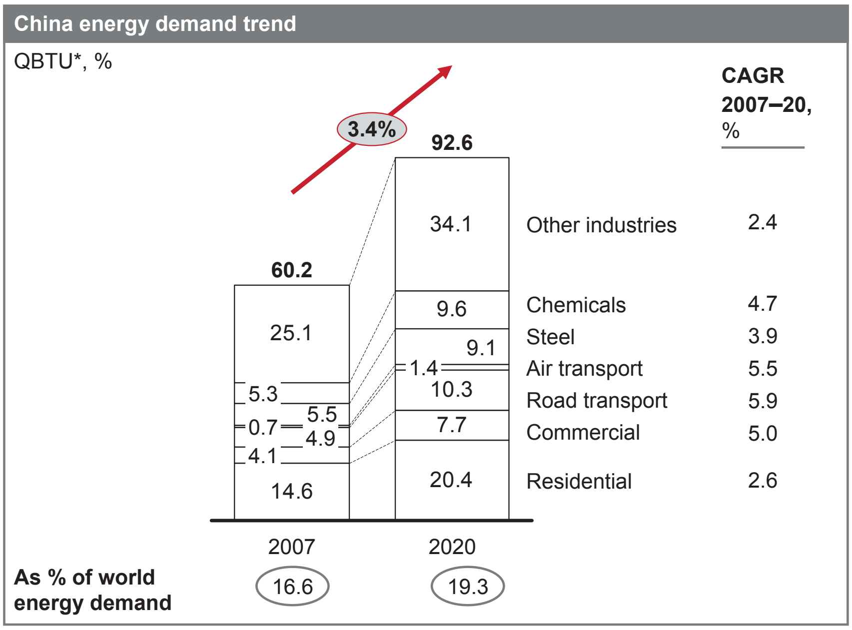


* Completed residential property during the year
** National median size of unit over average household size
Source: Chinese Statistical Yearbook; Global Insight; American Housing Survey; McKinsey analysis

Property prices have been increasing uncomfortably quickly, particularly between 2006 and 2007, however, there has been evidence recently that the property market is softening. In August, fixed-asset investment in property dipped below the level of the previous month. Our view is that prices will now stay flat for a period. Also, while national trends indicate a continuing shortage of housing, developers confirm that oversupply situations in several locales persist.

Decline aside, longer term real-estate demand drivers are strong. The rate of home ownership in China is still a long way below those in industrialized countries, suggesting that, as long as GDP growth continues to expand robustly, demand for housing will also remain strong. In addition, a shrinking in the average household size in China for fundamental demographic reasons (China's one-child policy and an aging population, for instance) will tend to promote demand for housing. The average family size of 3.5 in 1990 has now diminished to 2.9 and families with fewer children spend more on housing. In addition, the average space per person in urban China has expanded considerably since 2000. Chinese families had one of the lowest space per square meter allocations in the world. However, with incomes rising rapidly, demand for more space has been rising. Finally, the ongoing migration taking place from the countryside to urban China is further fueling demand for housing.

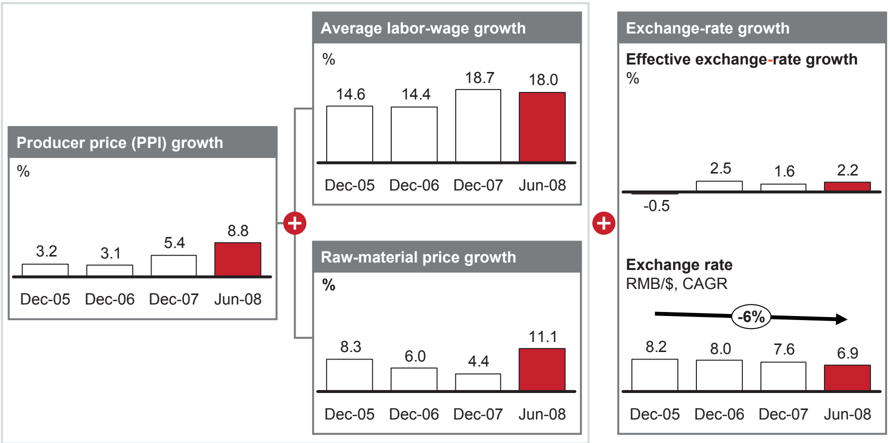
China's end-use energy demand will grow at 3.4 percent a year to 2020



* Quadrillion British thermal units
Source: Chinese Statistical Yearbook; McKinsey Global Institute Global Energy Demand Model; McKinsey analysis

The McKinsey Global Institute's recent report *Preparing for China's Urban Billion* finds that, under any urbanization scenario, urban energy demand will almost double by 2020—and more than double by 2025 from 60 QBTUs to more than 140 QBTUs in the most energy intensive urban scenario. This is because a quintupling in urban GDP to 2025 will more than compensate for a fall in urban China's energy intensity (the amount of energy consumed per renminbi of GDP) across residential, services, industrial, and agricultural end-use sectors. With rural areas' energy demand not increasing to the same degree as urban consumption, China's urbanization is bound to drive robust growth in energy demand over the coming decades.

Producers – particularly exporters – are facing a range of simultaneous cost pressures



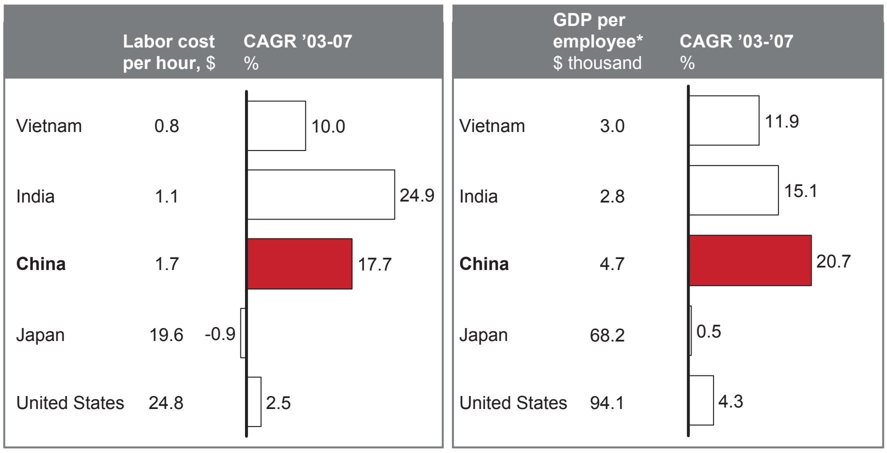
Source: China Statistical Yearbook; Bank for International Settlements; press search; McKinsey analysis

While we do not regard consumer price inflation as a significant issue for China, we do believe that producer price inflation is a trend to be watched. In August, factory-gate inflation nudged up to 10.1 percent from 10 percent the previous month and from 8.8 percent in June. It is notable that the inflation rate in two of the significant components of the Producer Price Index (PPI)—wages and raw materials—stood at a hefty 18 percent and 11.1 percent in June 2008 (the latter compared with the low of 4.4 percent reached in 2007). Some observers (including government officials) argue that the rise in producer prices has some longer-term benefits. First, they argue that this trend could accelerate a shift of companies from relatively high-cost coastal China to relatively low-cost inland provinces and therefore act to distribute wealth more evenly around the economy. Second, they say that higher producer prices will encourage businesses to move higher up the value-added scale.

As well as producer-price inflation, exporters are additionally being squeezed on price by the prospect of an appreciating currency for the foreseeable future—the fact that the renminbi appreciation is secular in nature only reinforces its upward trend because this attracts “hot money” flows into the currency that are betting on this further appreciation. In both nominal and trade-weighted terms, the renminbi has risen against world currencies, raising fears that Chinese exporters will become uncompetitive.

Although labor costs have increased, GDP contribution per employee has risen by even more

2007, nominal



* Estimated for Japan and the United States
Source: China Statistical Yearbook; Economist Intelligence Unit; Global Insight; McKinsey analysis

China's labor costs have risen and are now relatively high compared with those in other regional economies. However, employee contribution to GDP and productivity has been increasing at a quicker pace than costs therefore preserving China's competitiveness. Chinese companies can build on these productivity gains to accelerate movements up the value chain. What better time to do this than from the current position of strength?

China's Eastern coastal region has won most investment but investment has picked up in the Interior and the West

□ 2000
■ 2007

Region**	Average wage level 2007* Renminbi	Real GDP growth 2000–07 %	Foreign direct investment Renminbi billion, 2000	CAGR 2000–07 %	Fixed-asset Investment Renminbi billion, 2000	CAGR 2000–07, %
Eastern	29,660	10.6	292 552	9.7	1,987 4,290	11.6
Interior	20,536	9.4	30 87	16.7	745 2,000	15.1
Western	24,294	9.8	15 44	16.4	648 1,629	14.1

* Nominal average annual wage of the provinces belonging to each region
** Eastern region refers to Beijing, Tianjin, Hebei, Liaoning, Shanghai, Shandong, Jiangsu, Zhejiang, Guangdong, and Hainan; Interior regions includes Shanxi, Jilin, Heilongjiang, Anhui, Jiangxi, Henan, Hubei, Hunan; others are categorized as Western
Source: Chinese Statistical Yearbook; McKinsey analysis

China's Go West policy was intended to encourage the movement of businesses and investment into western regions but the policy has not been particularly effective because of a lack of real incentives. However, we are now seeing relatively high wage costs in eastern coastal regions and we expect to see FDI and domestic investment shift focus westwards over the next five years. FDI flows to interior regions and the west have been increasing at over 15 percent per annum. Even more significantly, fixed-asset investment in these regions has risen sharply since 2000 and is growing at a higher rate than in the east.

In 2007, China overtook France, the United Kingdom, and Germany to become the world's third-largest financial market

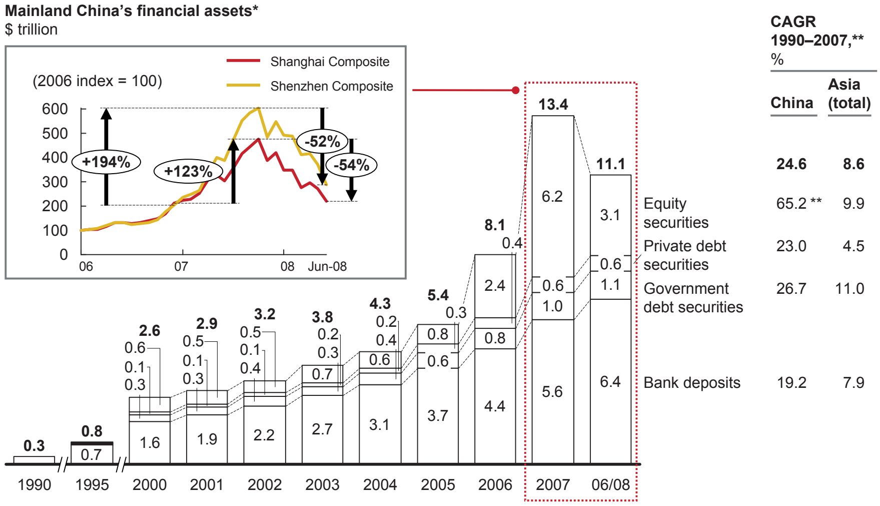
Financial assets
$ trillion, constant 2007 exchange rates*

Ranking of top 20, 2006		Ranking of top 20, 2007		Change in ranking	Growth %
US	56.7	US	61.2	–	7.9
Japan	20.4	Japan	20.1	–	-1.6
Germany	10.6	China	13.4	+3	55.7
UK	10.2	Germany	11.3	-1	7
France	9.1	UK	11.1	-1	7.9
China	8.6	France	9.8	-1	8.1
Italy	6.6	Italy	7.0	–	6.2
Spain	5.5	Spain	6.6	–	19.7
Canada	4.6	Canada	4.9	–	5.4
Netherlands	3.5	Netherlands	3.8	–	8.5
Australia	2.9	Australia	3.5	–	17.9
Brazil	2.6	Brazil	3.3	–	27.3
Switzerland	2.6	India	3.2	+2	56.7
Korea, Rep.	2.6	Korea, Rep.	3.0	–	16.6
India	2.0	Switzerland	2.6	-2	0.4
Belgium	1.8	Russia	2.3	+1	32.5
Russia	1.7	Hong Kong	1.9	+2	23.8
Taiwan	1.7	Belgium	1.9	-2	5.6
Hong Kong	1.6	Taiwan	1.7	-1	3.8
Sweden	1.4	Sweden	1.5	–	6.3

* Exchange rates at year-end
Source: McKinsey Global Institute Global Financial Assets database; McKinsey Global Institute analysis

Another significant trend of recent years is the development of China's financial markets. In just one year—2007—China vaulted ahead of France, the United Kingdom, and Germany to become the world's third-largest financial market measured by total assets and will likely retain this ranking despite the sharp decline on China's domestic bourses during 2008.

China's financial assets have increased strongly to reach $13.4 trillion but falling equity valuations recently have tempered this growth

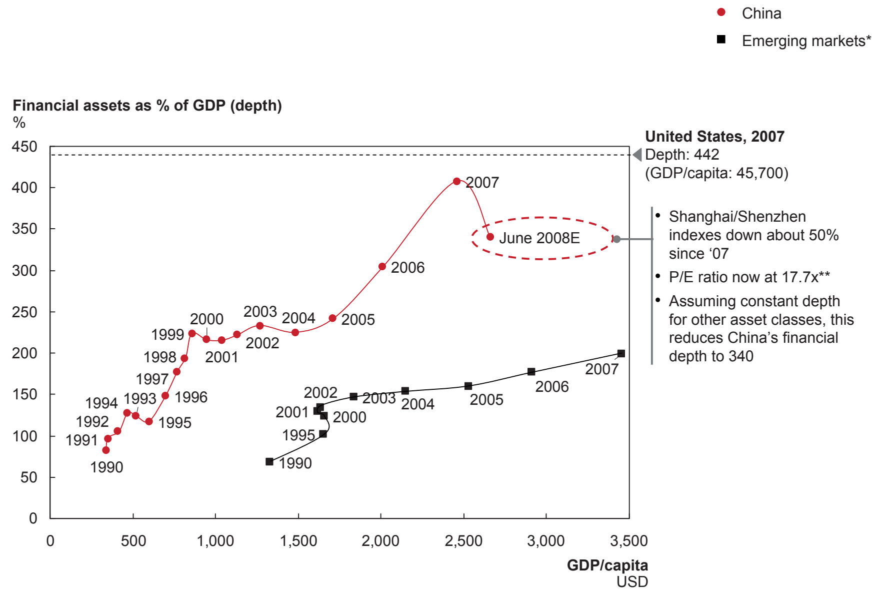


* Assets measured at year-end exchange rates
** Equity CAGR is from 1991 to 2007 due to 0 value in 1990
Source: Shanghai and Shenzhen Stock Exchanges; Global Insight; McKinsey Global Institute Global Financial Assets database; McKinsey analysis

Since 2002, according to research by the McKinsey Global Institute, China's financial assets have grown by 33 percent annually, with only India posting a larger percentage increase. Equities dominated the growth in financial stock, comprising 84 percent of the financial stock expansion observed until 2007. However, the value of China's equities was inflated by soaring market valuations and price-earnings ratios that surpassed 50 at the equity-market peak.

During the first half of this year we observed a significant correction in the value of Chinese equity markets which recently led the government to take a number of measures to shore up the market and bolster investor confidence. As a result of these developments, we expect the debt market will start to play more of a larger role in China's financial markets.

China's financial markets have gained considerable depth but still have a long road to maturity



* Emerging markets definition based on MSCI index
** P/E ratio for equity available to global investors (B & H shares; does not include A share market)
Note: Smoothed curve included for illustrative purposes only
Source: McKinsey Global Institute Global Financial Assets database; McKinsey Global Institute analysis

China's financial base has deepened in a relatively short period of time as we saw in an earlier chart. However, China's financial deepening has largely gone ahead of its GDP growth and it will now need to "grow into its depth". In other words, too rapid a financial deepening has taken place, certainly much more rapidly than other emerging market pathways. It was primarily caused by a quickened pace of market valuation that peaked in 2007.

Of late, the deepening (measured as financial assets as a percent of GDP) has stopped and China is back to its mid 2006 position.

Takeaways for companies

Developments for companies to watch for

- Global recession will generate cost pressure on Western firms potentially leading to increased demand for Chinese sourcing
- Opportunities in urbanization projects particularly in medium-sized and megacities
- Watch for new solutions emerging from China to deal with shortages of energy
- Prepare for periodic inflationary spikes—maintain value-product position through the cycle
- Domestic financial turbulence might lead to M&A opportunities
- The continued pace and scale of China's transformation will throw up risks that are often unheard of in other markets (e.g., no global dairy company ever thought to test for melamine in milk)

Opportunities abound as China grows. The global recession is likely to push companies still holding out to make more aggressive investments in low cost countries like China. Urbanization particularly in medium-sized and megacities will act as a strong pull for companies to position themselves in clusters of cities, some boasting upwards of 60 million people—mini countries almost.

The opportunities to participate in infrastructure projects, for example, will be too tempting for any company to treat at arms length for too long. In the energy market, new solutions will be in high demand. While producer price inflation will be ever present over the next few years, this represents an opportunity for companies to strive for better value positioning of their products. Domestic financial turbulence is a cause for concern but will also be an opportunity for companies to make opportunistic deals.

China in a nutshell is not going to come tumbling down anytime soon.

Appendix

Risk dashboard – macroeconomics metrics

Limited risk · Watch · Caution

%

	Actual* (average to date)	Anticipated (2008)	Interpretation	Risk potential
World GDP (real) growth	3.7	2.3-2.5	• Global growth is expected to decelerate and in McKinsey's view could cause upwards of a one percentage point decline in China's GDP in 2009	Watch
China GDP (real) growth	10.1	9.2-10.4	• China growth rate will continue to be high despite global slowdown and Sichuan earthquake	Limited risk
Fixed asset investment growth	24.0	20.5-30.3	• To the 2nd quarter of 2008, FAI reached over 6.8 trillion renminbi and has grown strongly. Little expectation of a significant slowdown for the rest of 2008	Limited risk
FDI growth	26.7	30.0	• During 2007–08, China was the biggest recipient of FDI in Asia but growth has fluctuated somewhat recently (2005: 19.4%;2006: 0.3%;2007:13.8%)	Watch
Trade surplus growth	-12.2	-13.6- -15.0	• A perceptible decline began in 2008 Q1. Q2's decreased even faster indicating heightened pressure on export price competitiveness due to faster exchange rate appreciation	Limited risk
Disposable income growth	25	24-26	• Actual disposable income growth was much lower than expected for the first half year. The second half should see more of the same with some caution that it could decline due to lower GDP growth	Watch

* YoY growth 2Q 2008 except for FDI where annualized growth was considered due to large fluctuation in H2 '07 FDI

Source: Global Insight; EIU; CIC; Interviews with members of the McKinsey China Council of Business Economists (MCCBE); McKinsey analysis

Risk dashboard – price related metrics

Limited risk · Watch · Caution

%

	Actual* (2Q 2008)	Anticipated (2008)	Interpretation	Risk potential
CPI growth	7.8	6.7-7.2	• Inflation picked up pace during the year largely due to food price spikes. However, prices are reversing to moderation very quickly to the point now where there is little concern for a renewed spiking during the rest of the year	Limited risk
Producer price index growth	8.4	5.9-7.0	• Raw materials have spiked—China sets price internationally but also takes the brunt of higher prices. A slow down in global GDP growth will ameliorate the spike in the second half of the year	Caution
Average wage growth	19.2	17.4-23.0	• Urban wages continue to grow quickly, but real wage growth has slowed given the inflationary conditions of the first half of the year. There is still some upward pressure on wages driven by inflationary expectations	Watch
Exchange Rate RMB/USD	6.86	6.64-6.94	• The appreciation of the renminbi relative to the dollar will slow toward trend (about 5%) and likely to hold at this pace throughout 2009	Limited risk

* YoY growth 2Q 2008

Source: Global Insight; EIU; CIC; Interviews with members of the McKinsey China Council of Business Economists (MCCBE); McKinsey analysis

Risk dashboard – financial stability metrics

Limited risk (green) · Watch (yellow) · Caution (red)

	Metric	Crisis scenario	Actual value* (2Q 2008)	Risk potential
Value destruction in the corporate sector	• ROIC minus WACC	• Less than 0	• ~60% of selected companies in SH & SZ had ROIC >WACC	Watch
Interest coverage	• Interest Coverage Ratio (ICR)	• Less than 2	• Median ICR for Chinese listed companies of 8~10 since 2003	Limited risk
Bank profitability	• ROA	• ROA Less than 1%	• ~1%	Watch
Lending portfolio growth	• Bank loans growth	• Lending over 20 percent per annum. for over two years	• Steadily increasing from 6% in 2000, to 21% in 2003 ,17% in 2007 and 15% in 20081h (yoy)	Watch
Shrinking deposits or rapidly rising deposit rates	• Bank deposits • Repo rate	• Continued slide in deposits • Rapid rise in rates	• Deposits rising 15% in 2007, 18% in 20081h (yoy) • 1-year deposit rate from 2.52% to 4.14% in 2007 to the present	Limited risk
Non performing loans	• NPL to Total Assets ratio	• Over 5 %	• Commercial banks NPL at 6.2 % in 2007, 5.58% in 20081h (ytd)	Caution
International capital flows	• FDI growth	• Growth in flows more than three times the GDP growth	• FDI grew lower than GDP growth between '05 and '07, but tripled as of GDP in 20081h (yoy)	Watch
Asset price bubbles	• Stock index • Real estate prices	• 20 percent per annum growth for over 2 years	• 06 and 07 were rapidly escalating asset prices with a 97 percent growth rate, but this dropped to 28% in 20081h (yoy)	Caution

* Updated to June 2008 or latest data available

Source: Dangerous Market - Wiley Finance 2003; CPAT; Bloomberg; CSRC; CBRC; PBOC; Interviews with members of the McKinsey China Council of Business Economists (MCCBE); McKinsey analysis

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