With 632 million Internet users, China has already become the world’s largest e-tailing market, with almost $300 billion in sales posted in 2013. Although digital marketplaces have changed the face of Chinese retail, however, other major sectors such as manufacturing and healthcare have been much slower to embrace the Internet. China’s digital transformation is just beginning, which means that over the next few years, the world’s second-largest economy will radically transform the way it does business. And as new research from the McKinsey Global Institute [1] projects, that change (from the adoption of online marketing and supply-chain management to cutting-edge innovations such as big data analytics and the Internet of Things) could fuel as much as 22 percent of China’s total GDP growth through 2025. How much of this potential China will actually see depends on the government’s ability to create a supportive policy environment, the willingness of companies to go digital, and the adaptability of workers.

As of 2012, only about a quarter of China’s small and medium-sized enterprises had begun to use the Internet for functions such as procurement, sales, and marketing. When they do go online, they and larger companies alike will be able to streamline their operations, find new ways to collaborate, and expand their reach via e-commerce. These types of changes are beginning to ripple through traditional industries outside the tech sector, translating into faster productivity growth.

Consider the real estate sector. Chinese homebuyers and renters increasingly search for their ideal home on sites such as SouFun.com, which combines listings and advertisements. The ability to identify serious buyers quickly is streamlining real estate searches and transactions, reducing developers’ and agents’ marketing and carrying costs. Local governments can now conduct land auctions online, and Taobao has launched an auction platform for foreclosed properties. Developers, contractors, and hotel chains now frequently purchase construction materials, equipment, and décor on e-commerce platforms that reduce purchasing costs by 5–30 percent. Property management companies are experimenting with online communities that connect with residents of a particular development to conduct regular administrative and maintenance work or to offer value-added services. As a result, property developers are able to maintain a continuous relationship with residents beyond one-off property sales and monetize the relationship to generate more revenue.
Beyond its effects on GDP and productivity, the Internet can inject transparency into opaque corners of the economy. E-tailing, for instance, began with a cash-on-delivery business model, but Internet payment platforms build trust between consumers and e-merchants. China’s used-car market is still in its infancy, but there is tremendous room for growth as e-commerce makes information about each vehicle and each transaction more readily available. New Internet tools can help lenders assemble and analyze credit histories in a much more detailed and sophisticated way than ever before. This will reduce the rising tide of nonperforming loans and allow more capital to flow to more productive businesses, forcing large and small companies alike to up their games.

Chinese companies have long been geared toward mass production, but they will have to focus on the individual customer experience in a more digital marketplace. The Internet gives them new capabilities to glean more detailed customer insights, tap a wider range of suppliers, and produce a more diverse range of niche products. In a digital world, customers can compare offerings and take their business elsewhere with a few clicks of a mouse. This transparency can bring down prices and improve the quality of products, creating a huge consumer surplus. But it also eats away at margins, putting pressure on companies to cut costs by using Internet technologies to make back-office functions and logistics more efficient.

Just as it has done in economies around the world, the Internet will create new billion-dollar markets, but it will also destroy older markets. Chinese enterprises will have to brace for more intense competition than they have ever seen. For example, in the financial sector, tech companies rose as a new competitor for incumbent banks. With their substantial user base and analytic capabilities, tech companies were more easily able to provide new services, such as microloans for small and medium-sized enterprises and money market funds with higher rates of return than bank deposits. Realizing the changing landscape, incumbent financial institutions started defending their turf by developing their own digital ecosystem to increase traffic and interest in their own products. The Internet gives start-ups the ability to scale up rapidly and at low cost, unburdened by legacy systems and time-honored ways of doing business. New winners are likely to emerge in a variety of industries.

Chinese workers will also have to grapple with disruption. Some jobs will be automated away. Some companies will face a shortage of digital talent. The success or failure of individual companies will ride on the willingness of their employees to learn new skills and adapt to new roles. The Chinese government and the country’s business leaders will need to consider whether displaced workers have avenues for retraining and whether the education system is producing the digital skills demanded by a more digital economy. Especially in the early stages of adoption, government and business leaders will need to prepare for disruptions. However, as the digital revolution evolves, the Internet will also generate novel employment opportunities by creating new markets and facilitating capital allocation to more productive and competitive areas.

China’s small and medium-sized businesses are a critical source of employment—a role that will take on added importance as larger companies digitize their operations, potentially shedding employees. The Internet will lower barriers to entry for these firms, allowing entrepreneurs with new ideas to scale up rapidly and at low cost. Cloud computing reduces the need for hefty investment in IT systems, and online
marketing can be purchased in small increments to target specific consumer segments. E-commerce marketplaces offer instant and direct access to consumers, along with support services such as payment and logistics. The Internet can even improve export capabilities: many small and medium-sized Chinese firms are becoming “micromultinationals” that sell to overseas customers in business-to-business marketplaces. Start-ups could be a source of breakthrough ideas; in fact, China’s biggest Internet giants, such as Alibaba and Tencent, are relatively young companies themselves.

The first step toward harnessing the Internet’s potential to increase productivity and GDP is, of course, building out the necessary digital infrastructure. Household broadband penetration in China stood at only 39 percent in 2013, but the government aims to achieve 50 percent penetration and 32.5 percent 3G/LTE coverage by the end of 2015. According to the latest statistics from the Ministry of Industry and Information Technology, China is on track to achieve that goal.

A great deal of the Internet’s potential value stems from data sharing. In health care, for example, combining hospital reviews and ratings from multiple users can make outcomes and patient satisfaction more transparent, leading to improved performance, while the sharing of electronic medical records across multiple hospitals can lead to better continuity of care for individuals and more effective public health management.

But policymakers have to strike the right balance between encouraging data sharing and protecting individual privacy. In late 2012, China’s government announced a preliminary set of rules regarding online privacy, including getting user consent on data collection and usage. But additional measures, such as ways to manage the consequences of violating the rules and a broader regulatory framework beyond telecom and Internet sectors, are needed. A balanced set of regulations governing the kinds of information companies can share, the types of usage that are allowed, and the type of consumer consent that is required could remove hesitation about adopting big data analytics.

Regulators will need to be fluent in technology so they can participate in discussions with industry players and keep current with the latest innovations. Many sectors are waiting for official guidelines that will determine the degree to which companies can use the Internet. In financial services, for example, what business lines banks can move online will depend on regulations governing whether certain transactions have to be completed in person. Online platforms can develop the used-car market, but regulations on cross-provincial transactions may need to be adjusted.

One central issue for policymakers is China’s stated goal of “letting the market mechanism function.” Because the Internet can intensify winner-takes-all competition, the government may have to monitor how markets evolve to ensure maximum productivity gains for the broader economy. A clear, transparent market mechanism that allows for failures and resolutions could reinforce risk management among business owners. In addition, balancing intellectual property protections and enforcement with the need to disseminate and combine new ideas will also help unleash innovation.

For two decades, China has relied on heavy capital investment and labor force expansion to fuel its rise, but now those engines are running out of steam. The next stage of digital development will no doubt bring risks and disruptions, but by unleashing the productivity potential of individual businesses, the
Internet can help China fulfill its goal of moving toward a more sustainable economic model.