

# Hitting the sweet spot

The growth of the middle class in emerging markets

In collaboration with



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**Acknowledgment**

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# Hitting the sweet spot

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## Introduction

The world has seen two great expansions of the middle class since 1800 – and we are living through the third. In the 19th century, the Industrial Revolution created a substantial middle class in Western Europe and the United States. Another period of middle-class growth occurred after World War II, once again in Europe and North America and also in Japan. Today's expansion is happening in the emerging markets (EMs). In Asia alone, 525 million people can already count themselves as middle class – more than the total population of the European Union. Over the next two decades, it is estimated that the middle class will expand by another three billion people, coming almost exclusively from the emerging world.<sup>1</sup>

In this report, we examine the growth of the middle class in EMs and explore how this will change both the developing and the developed world. By 2030, so many people will have escaped poverty that the balance of geopolitical power will have completely changed – global trade patterns will be unrecognizable too. The intervening 20 years will see more and more people enter the middle classes with new money and new demands. Economists are hoping that this growing cohort of consumers can help to keep the foundering global economy afloat. Meanwhile, companies accustomed to serving the middle-income brackets of the old Western democracies will need to decide how they can effectively supply the new bourgeois of Africa, Asia and beyond.<sup>2</sup>

1. *Innovating for the next three billion*, Ernst & Young, 2011, p. 1.
2. This paper is partly based on "The Great Equalizer: The Rise of the Emerging Market Global Middle Class," which was produced by the Skolkovo Institute for Emerging Market Studies (IEMS), Ernst & Young. You can read it here: <http://iems.skolkovo.ru/publications/28-the-great-equalizer>.

## Who are the middle classes?

“Middle class” is a broad term; in many countries it is loaded with political, social and historical implications. For both economists and business executives, who need accurate and quantifiable information, it’s not really an issue of “class” at all, but rather income and spending power. But even when reduced to pure economics, quantifying the middle class is still a remarkably contentious issue; for instance, depending on the standards used, estimates of the size of India’s current middle class range from 30 million to 300 million.

One way to measure the middle class is to define it in relation to other “classes.” This is useful when looking at a single country, in which case you can define the middle class as simply all those except the richest and poorest 20%. But this makes comparison between countries very difficult, because every country has a different median income level. A wage that affords somebody a comfortable lifestyle in developing nations might barely cover basic expenses in much of the developed world.

For “middle class” to be a useful term for economists and businesses, it needs to have a global definition. There is a surprisingly wide range of income brackets currently used for this purpose. For instance, the World Bank uses the range US\$2-US\$13 per day. In 2011, the African Development Bank claimed that a third of Africans had entered the middle classes using the range US\$2-US\$20 per day.<sup>3</sup>

Both of these income ranges are problematic for businesses operating in the developed world. Can somebody earning the equivalent of only US\$2 per day really be considered middle class? Two-thirds of the African Development Bank’s middle class earned between US\$2-US\$4 per day. In any developed country, an income this low would be well below the poverty line.

By the World Bank’s measure of US\$2-US\$13 per day, the celebrated economic growth of emerging nations has put millions of people into the middle class in recent years. In China, the number of people earning US\$2-US\$13 per day has increased from 175 million in 1990 to 800 million in 2005, and in India 150 million to 265 million over the same period. These 15 years saw the cohorts of the middle class almost double globally, growing from 1.4 to 2.6 billion.

There are limitations to this optimistic picture. People whose income only just exceeds US\$2 per day are not really middle class by the standards and expectations of any developed economy. The disposable income of people in this bracket will not stretch to consumer goods such as washing machines and televisions. And putting spending aside, it is likely that people earning just over US\$2 per day have very limited access to aspects of middle-class life taken for granted in the West, such as good health care and education.<sup>4</sup> The World Bank itself separates its middle class into two brackets, US\$2-US\$9 and US\$9-US\$13. Adding this detail, a slightly more realistic picture emerges: between 1990 and 2005, 10 times as many people entered the lower income bracket than the higher. The millions of people earning only slightly more than US\$2 per day also risk slipping back into poverty, should economic growth reverse or even just stall.

The World Bank’s definition of the middle class is a useful way of ascertaining how many people have been lifted out of poverty – and the numbers who have moved into this bracket in the developing world is something to be applauded. But this definition is not very helpful for companies dependent on sales to those with large disposable incomes; they require a more realistic estimation of the number of people entering their target markets. For most businesses, a much more useful definition of middle class is people earning between US\$10 and US\$100 per day. At this level, consumers start having the kind of disposable incomes that will allow them to buy the cars, televisions and other goods that have been the staples of bourgeois life in the West for 60 years. People in this income bracket can be considered a “global middle class” – middle class by the standards of any country.

3. “Pleased to be bourgeois,” *The Economist*, 12 May 2011, <http://www.economist.com/node/18682622>, accessed 20 February 2012.

4. See “Pleased to be bourgeois,” *The Economist*, 12 May 2011.

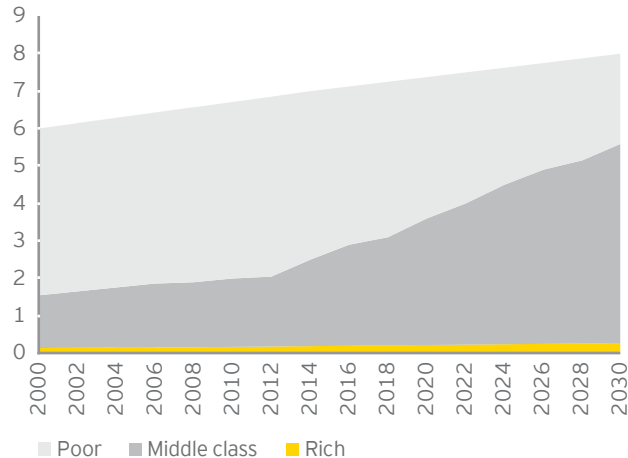
## Entering the global middle class

Since 1995, the remarkable growth of the EM economies has brought millions out of abject poverty, but it has put far fewer people into what we have called the global middle class. Only a quarter of the world's population makes the US\$10-US\$100 income bracket; 60% of these 1.8 billion people live in the developed world and 20% in the BRIC countries. By this definition, rather than the World Bank's, a sobering 70% of the global population is poor (i.e., earn less than US\$10 per day) and only 2% is rich.

But it is this richer, global middle class that we forecast will begin to grow rapidly over the next 20 years. A broad range of research has made the same prediction. One study asserts that the global middle class could constitute 50% of the world's population by 2030 – up from 29% in 2008 – and another study suggests that this could be as much as two-thirds.<sup>5</sup>

Figure 1

### Forecasting a surge in the global middle class (thousands of people)



Source: The World Bank; Kharas and Gertz, 2010.

This period of growth will completely change the distribution of wealth around the world. By 2030, we project that two-thirds of the global middle class will be residents of the Asia-Pacific region, up from just under one-third in 2009. On the other hand, although the middle-class populations in North America and Europe will remain roughly constant, their respective shares of this population are drastically reduced in our forecast – Europe's declining by more than half to 14% by 2030. A significant proportion of the new Asian middle class are also expected to be at the upper end of the income bracket and boast impressive spending power.

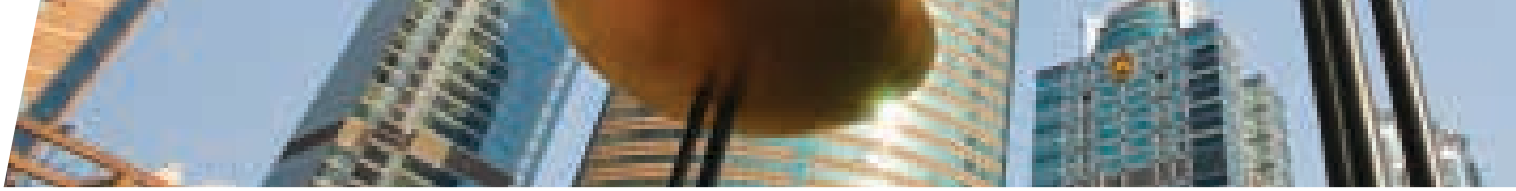
Table 1

### The middle class: size and distribution (millions of people, global share)

	2009		2020		2030	
North America	338	18%	333	10%	322	7%
Europe	664	36%	703	22%	680	14%
Central and South America	181	10%	251	8%	313	6%
Asia-Pacific	525	28%	1,740	54%	3,228	66%
Sub-Saharan Africa	32	2%	57	2%	107	2%
Middle East and North Africa	105	6%	165	5%	234	5%
World	1,845	100%	3,249	100%	4,884	100%

Source: IEMS; Kharas and Gertz, 2010.

5. *The Expanding Middle: The Exploding World Middle Class and Falling Global Inequality*, Goldman Sachs, 2008 and Homi Kharas and Geoffrey Gertz, *The New Global Middle Class: A Cross-Over from West to East*, Wolfensohn Center for Development, 2010, respectively.



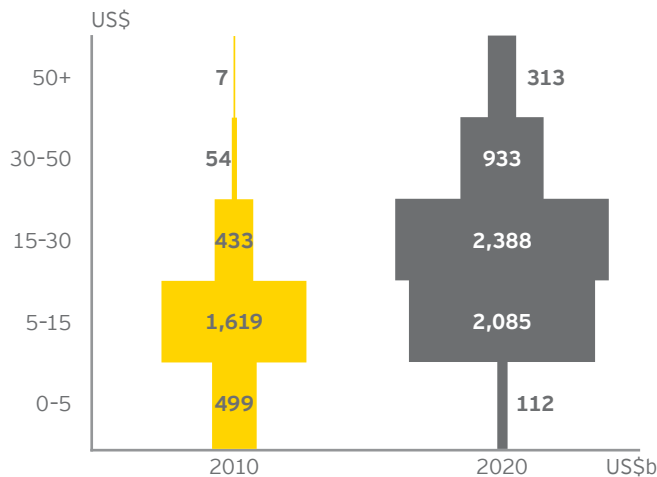
## China and India: tomorrow's middle classes

Large populations and rapid economic growth mean that China and India will become the powerhouses of middle-class consumerism over the next two decades. Of course, these huge countries will not be the sole contributors to the global middle class, as other EMs continue to grow. For instance, as Ernst & Young's *Rapid-Growth Markets Forecast* explores, in Mexico, the number of households with annual disposable incomes in excess of US\$50,000 is expected to have reached 7.1 million by 2020 – and 9.4 million in Brazil. For both countries, this is an increase of over 50% on current figures.<sup>6</sup>

Nevertheless, the Chinese and Indian contributions will be substantial. Today, China has around 150 million people earning between US\$10 and US\$100 per day. As long as China continues to grow, and that necessary economic reforms are made, we expect that as many as 500 million Chinese could enter the global middle class over the next decade. By 2030, around one billion people in China could be middle class – as much as 70% of its projected population.

Figure 2

### China: total income by band 2010 and 2020 (annual income, thousands of people)

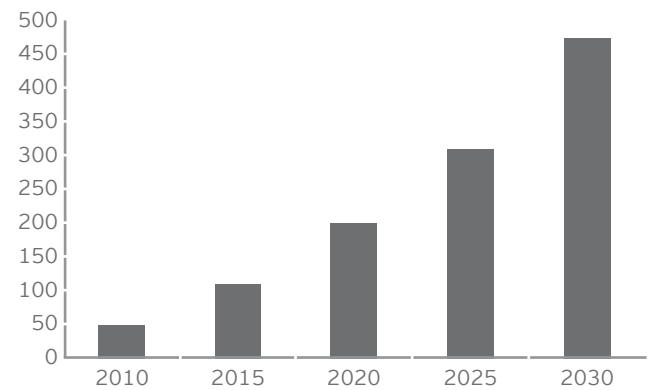


Source: Oxford Economics.

India's global middle class, meanwhile, is much smaller at around 50 million people, or 5% of its population. We project that this group will grow steadily over the next decade, reaching 200 million by 2020. After this, we expect India's middle-class growth to really accelerate, reaching 475 million people by 2030 and adding more people than the Chinese to the global middle class worldwide after 2027.

Figure 3

### India's global middle class (millions of people)



Source: IEMS.

China's middle class will grow rapidly earlier because it has more people on the verge of earning over our threshold of US\$10 per day: at present, around 25% of the Chinese population earns US\$5-US\$10 per day and 40% earn US\$2-US\$5. India's spectacular economic growth since the early 1990s has lifted millions out of abject poverty, but it has not built the lower-income middle class to match China.

China's higher average level of per capita income is also likely to contribute to earlier growth of the middle class – and not only because people are closer to the necessary US\$10 income threshold. In 2008, average per capita income in China reached the equivalent of US\$6,000 per year. History has shown that this level of income tends to trigger an acceleration in domestic private consumption; the Chinese have experienced this in the last few years. India is not expected to reach this growth "sweet spot" until 2017 – hence the projection of rapid middle-class expansion in the 2020s.

6. Ernst & Young *Rapid-Growth Markets Forecast: Spring edition – April 2012*, Ernst & Young, 2012, p. 25.

## The middle-class effect and the sweet spot of growth

The notion of a growth “sweet spot” extends beyond a simple trigger-threshold of rapid consumer growth. For economists, the growth sweet spot occurs when people start leaving poverty and entering the middle class in their millions. But for businesses, a more useful sweet spot occurs when significant numbers of people begin earning the equivalent of over US\$10 per day, and enter our global middle-class bracket. At this point, purchasing habits should attract the attention of companies accustomed to supplying to middle-class markets in the developed world.

The power of the sweet spot also produces a “middle-class effect,” where the size of the middle class is directly proportional to the rate of economic growth. Hitting the sweet-spot level accelerates growth, which, in turn adds more people to the middle class, producing a virtuous circle. The economist Surjit Bhalla has claimed that every 10 percentage-point increase in a nation’s middle class results in a 0.5 percentage-point rise in its growth rate. For these reasons, the year that a country hits its sweet spot – on average, approximately US\$6,000 per capita income – is key to assessing growth potentials.<sup>7</sup>

Table 2

### When will the EM countries hit their sweet spots? (projected)

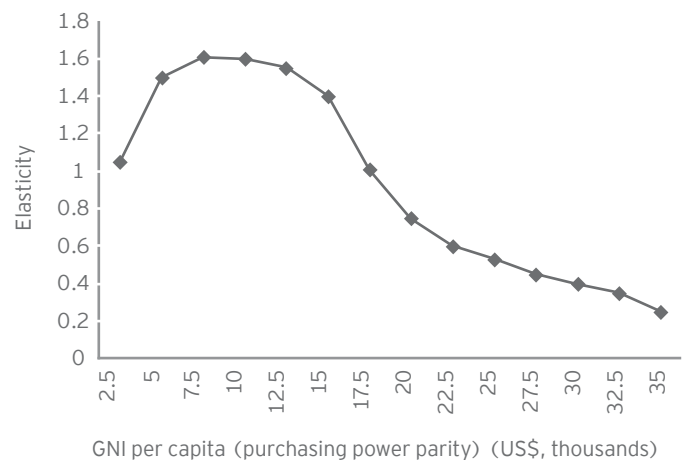
Country	Year
Egypt	2011
Indonesia	2015
India	2017
Philippines	2019
Vietnam	2019
Pakistan	2024
Nigeria	2025
Bangladesh	2029

Source: Economist Intelligence Unit (EIU).

Projecting economic growth is important, but companies hoping to tap EM middle-class markets need to have access to more specific information. Different markets have different sweet spots; for instance, the sweet spot for the motor vehicle market occurs between per capita income levels of US\$5,000 and US\$12,000, with a peak of around US\$8,500.

Figure 4

### Income elasticity of demand for the global automobile market



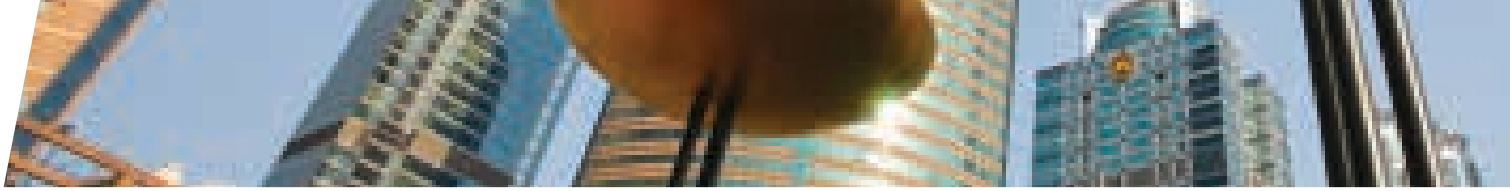
Source: IEMS.

China provides a good example of this process in action. China’s automobile market in 2001 was tiny, with total annual sales of less than a million units. As per capita incomes increased, reaching US\$6,000 in 2008, the automobile market underwent massive expansion. In 2004, General Motors sold 1 car in China for every 10 in the US; by 2009 this ratio reached parity.<sup>8</sup> In 2009, total automobile sales in China were in excess of 10 million units.

7. Surjit Bhalla, *The Middle Class Kingdoms of India and China* (Washington DC: Peterson Institute for International Economics, 2010) (forthcoming).

8. *Innovating for the next three billion*, Ernst & Young, 2011, p. 7.





## Global equality, but at a price

The economic progress of the EM economies over the past decade is significantly changing the global distribution of income. At the millennium, there were two distinct income clusters: in the developed world, there was an average income of around US\$25,000 per capita and in the emerging world around US\$2,000-US\$5,000. Today, this stark difference has been eroded. By 2030, although there will still be a broad distribution of incomes around the world, there will no longer be the sense that there are two distinct worlds.

However, this does not mean that everybody will be better off. This hard-won global equality will be offset by rising inequality *within* countries. In China today, average urban household incomes are three times as large as rural incomes. India, Russia and other EM nations have seen similar disparities develop. Wealth is being divided more equitably between countries, but within them, the old inequalities are still perpetuated.

Figure 5

### Per capita incomes (US\$, 2010)

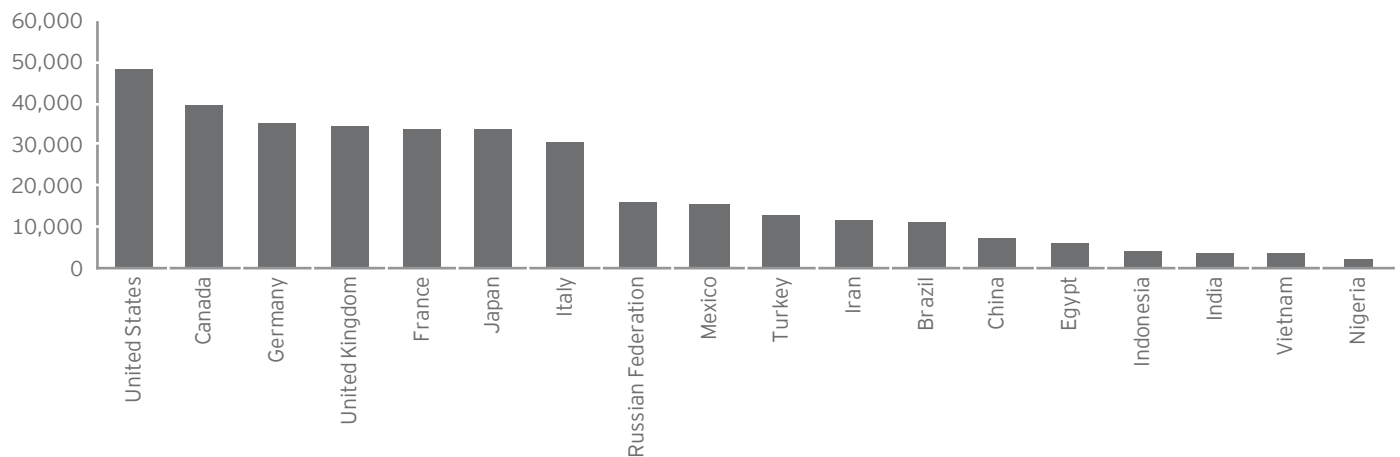
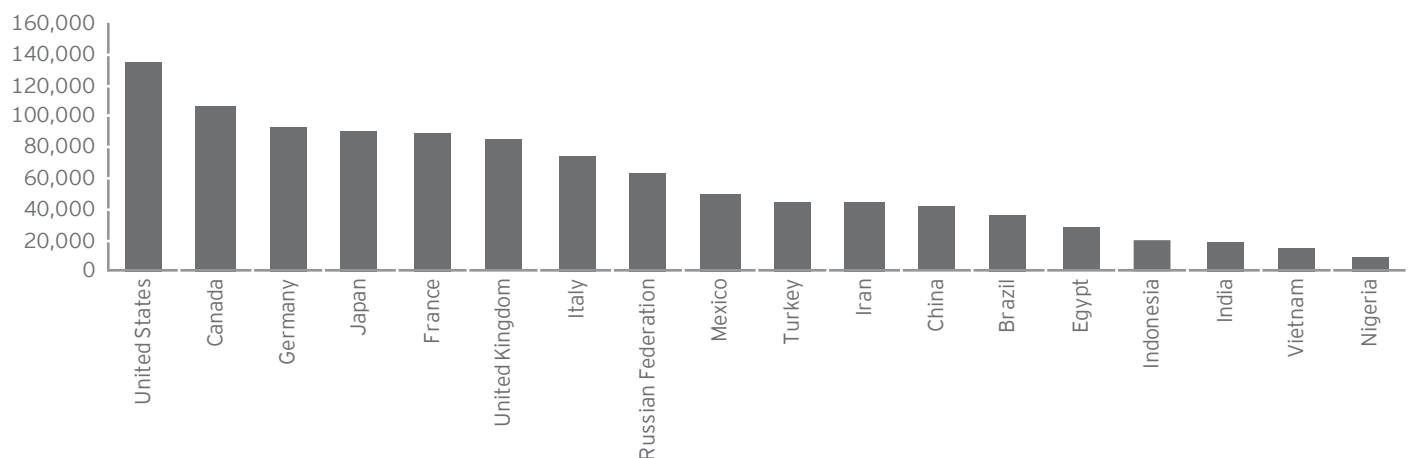


Figure 6

### Projected per capita incomes (US\$, 2030)



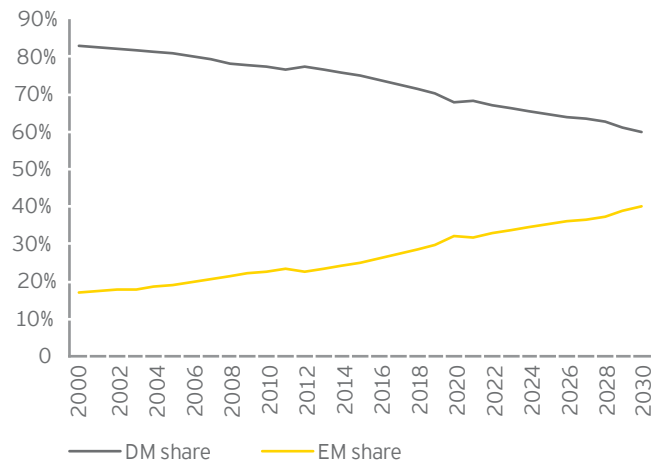
Source: EIU.

## A changing world

Although inequalities remain, over the last few decades the world has changed as the rapid growth of emerging nations, such as China and India, has brought millions out of poverty. However, we are only beginning to see the effects of millions joining the ranks of the middle class. Regardless of exactly how the forecasts play out, it's clear that by 2030 there will have been radical shifts in the distribution of wealth and the economic and political balance of power.

But what are the implications in the shorter term? A key question for economists is whether the new-found spending power of the EM consumers is enough to put the global economy back on track. Unfortunately, as Figure 7 shows, although the growth of EM spending has far outstripped developed market (DM) spending in recent years, there is still some way to go before contributions reach parity. Our research suggests that, although EM consumption is not sufficient to cause a return to pre-2008 global growth rates, it may be enough to prevent a return to global recession in the next few years (providing that DM consumption does not decline).

Figure 7  
**World consumption spending**

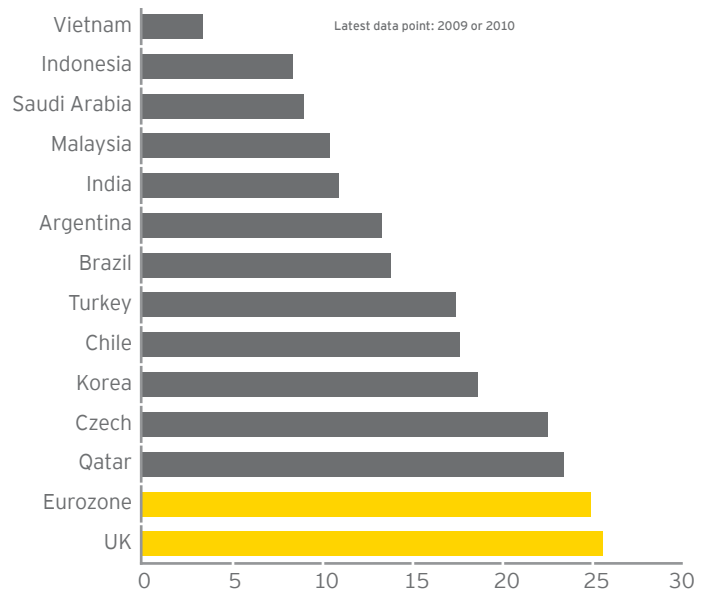


Source: EIU; IEMS' estimates.

There is no doubt, however, that the emergence of a new middle class, with spending power to match developed nations, will offer tremendous opportunities to businesses. As the example of the Chinese automobile market makes clear, these opportunities can arise very quickly and multinationals need to be ready to respond.

Business opportunities will not be confined to consumer goods: the emergence of a wealthy middle class will also open up the markets for financial services or the health sector, for instance, in new territories. As Figures 8 and 9 demonstrate, there is still plenty of room for businesses to expand in these sectors in the emerging world before parity with the developed world is reached.

Figure 8  
**Bank branches per 100,000 adults**



Source: Oxford Economics; World Bank.

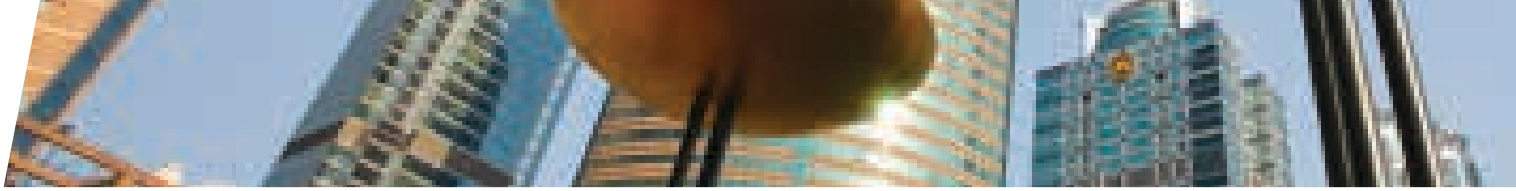
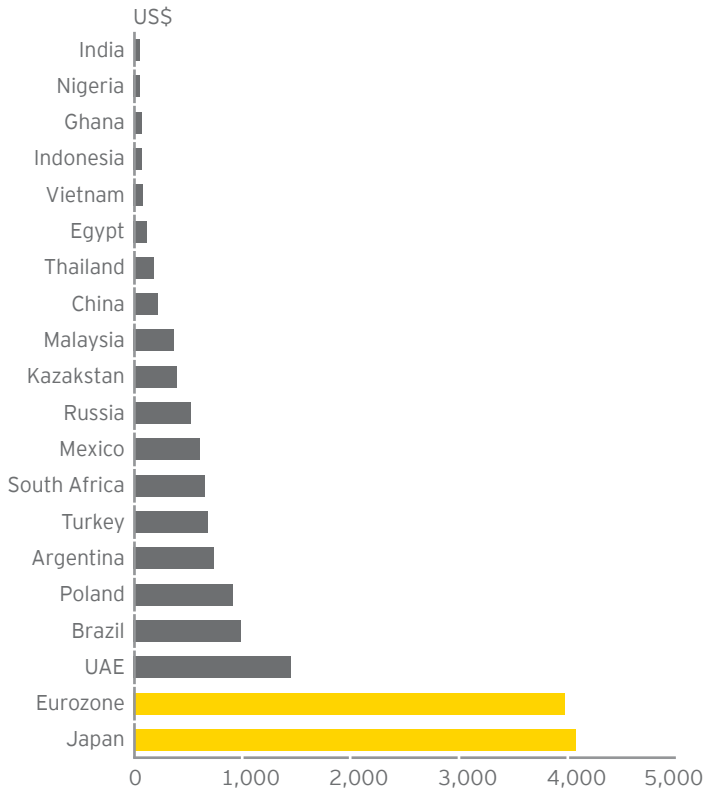


Figure 9

### Health expenditure per capita (US\$, 2010)



Source: World Bank.

Companies hoping to succeed in the markets opened up by the expanding middle classes over the coming years will have to overcome new challenges. As Ernst & Young's study, *Innovating for the next three billion*, explores in detail, successful companies will have to develop strategies that can accommodate both the differences and the increasing similarities of the new world and the old.



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