



The middle class in India

February 15, 2010

Issues and opportunities

The middle class is not (yet) the biggest segment of India's overall population. Given all the attention focused on India's middle class in recent years, it is important to keep a proper perspective on its size and potential purchasing power. While there is no official definition of the middle class, estimates range from 30 million to approximately 300 million people. Even using the most generous estimates of the group's size, the middle class comprises less than 30 percent of the population. Thus, the rich and the poor combined far outweigh the Indian middle class. The importance of the middle class lies in the fact that it is the fastest growing segment of the population.

The middle class is a growing consumer market. Going by one of the few estimates available, India's middle class consumption is roughly equivalent to Ireland's total private consumption and is forecast to triple as a share of India's total consumption over the next 15 years. Evidence shows that as income increases, the amount of discretionary spending and variety of this discretionary spending increases. For corporations, the middle class in India thus presents significant business opportunities. The sales growth of consumer goods such as televisions and mobile phones to the middle class has already been established, but a new range of products such as financial services is increasingly being geared towards this group as well.

Education improvements are needed to match the needs of the growing middle class and the growing Indian economy. In order to ensure that the growing middle class is absorbed into the economy and can contribute to growth, the right education is crucial. Currently, private education and tuition are seen as essential to gain the necessary skills to be competitive. The challenge is to increase the quality of public education (particularly universities) and foster more competition between private and public players.

Evidence on middle class apathy towards politics is vague. Although the middle class is often criticised by the media and politicians for its supposedly low voter turnout, the evidence remains mostly anecdotal.

The financial crisis has hit the middle class, but optimism about the future reigns. Over the past two years of the crisis, middle class households have been hit by job losses and wealth erosion from the fall in the value of investment portfolios and property prices. Difficulties in repaying credit cards and other personal loans have been on the rise and many households have cut back on discretionary expenditures. Despite this, the middle class remains optimistic about their own future as well as the future of the Indian economy.

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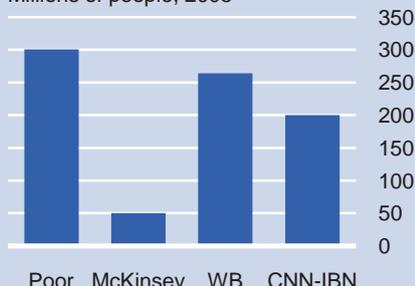
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Poor population still outweighs most middle class estimates

Millions of people, 2005

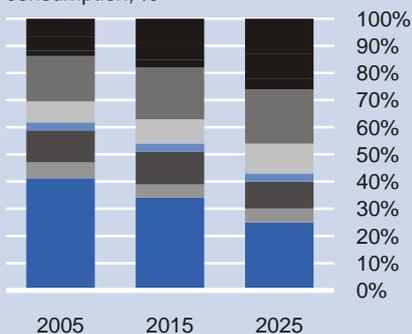


Sources: Planning Commission, McKinsey, World Bank, CNN-IBN, DB Research

1

Middle class consumption will diversify in time

Share of average annual household consumption, %



- Health care
- Education, recreation
- Communication
- Transportation
- Personal products, services
- Household products
- Housing, utilities
- Apparel
- Food, beverages & tobacco

Source: McKinsey Global Institute

2

Various definitions of the middle class lead to divergent size estimates

There is no official definition of the middle class in India. The middle class not only categorises an income group, but also a political and social class and a consumer market. Thus, quantifying this demographic group can yield varying results.¹ A McKinsey Global Institute study using National Council of Applied Economic Research (NCAER) data said 50 million people belonged to this group in 2005 if using the definition of real annual household disposable incomes between 200,000 and 1 million rupees.² At the other end of the spectrum, a study by the World Bank estimated the group at 264 million in 2005 using the median poverty line in 70 countries as a lower bound and the United States poverty line as an upper bound.³ Another method employed by CNN-IBN in its middle class survey utilised a consumption-based criterion. The survey looked at whether a household owned a car or scooter, colour television, or a telephone, and estimated that the middle class equaled approximately 20% of the population or slightly over 200 million people.⁴

Regardless of which estimate is used, it is important to keep a proper perspective on the potential of the middle class. The middle class in India has generated tremendous interest from the media and multinational corporations looking for a new market demographic. However, despite its anticipated growth, the middle class is still a minority segment of the overall population. Using India's planning commission estimates that 27.5% of the population in 2004-2005 was under the poverty line, then even the most generous estimates of India's middle class puts it on par with or likely smaller than the size of the poor population (see chart 1).⁵ In addition, some of these larger estimates of the middle class include people living on USD 2 per day, which is not quite the demographic often pictured in the media as a group with credit cards, mobile phones, and other consumer goods. The importance of the middle class comes from the fact that it is growing at a faster pace than the overall population, so it will represent an increasingly larger market for companies and new challenges for policymakers.⁶ McKinsey data estimates that while the total population will increase almost 30% between 2005 and 2025, the middle class population will increase approximately 10 times or almost 1000% during this period.⁷

The middle class is a growing consumer market

The Indian middle class as a growing consumer market has been widely covered. Chart 2 shows McKinsey estimates for how the middle class will change consumption distribution. There is a negative correlation between aggregate poverty and average consumption in India, whereby the decrease in poverty is associated with an increase in consumption.⁸ Studies have also shown that as income increases, a smaller percentage of it is spent on necessities

¹ For more information on the issues in defining the middle class, refer to "Emerging Asia's Middle Class." Deutsche Bank Research. August 21, 2009.

² McKinsey Global Institute (2007). Page 13.

³ Ravallion (2009).

⁴ State of the Nation Poll. IBN website. (2007).

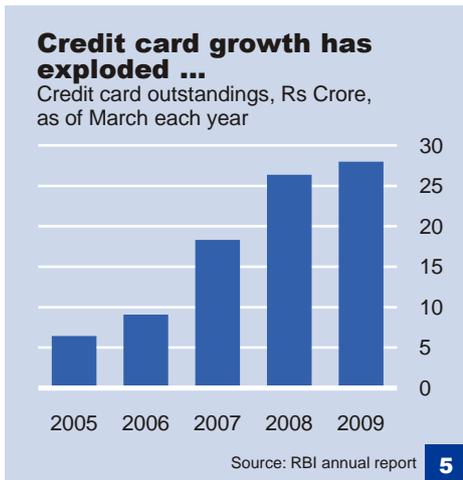
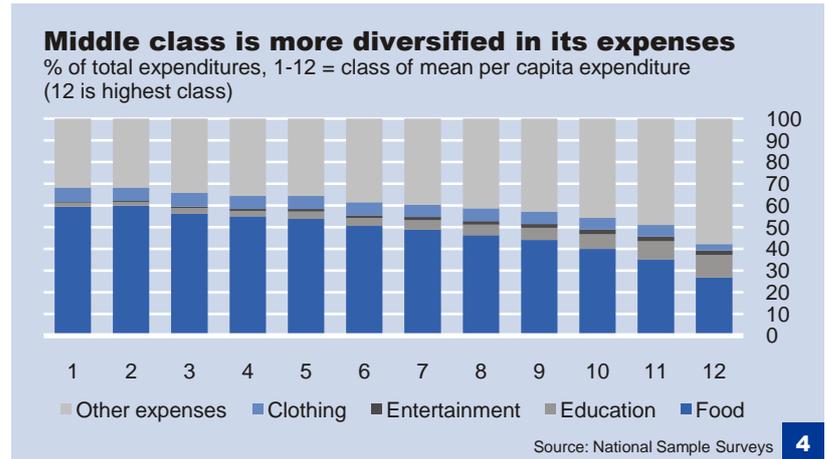
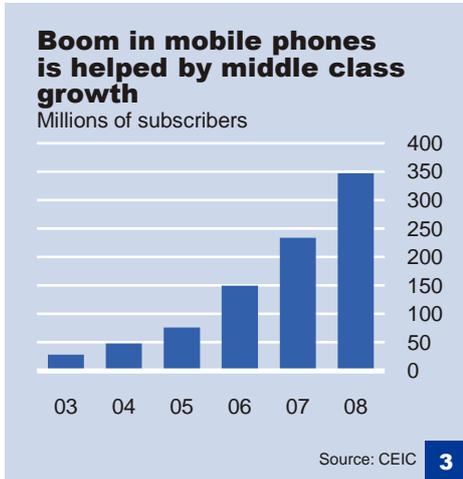
⁵ A revision to this figure to 36-37% of the population is possible if the new methodology of the Tendulkar committee is used.

⁶ Bussolo, De Hoyos, Medvedev, van der Mensbrugge (2007).

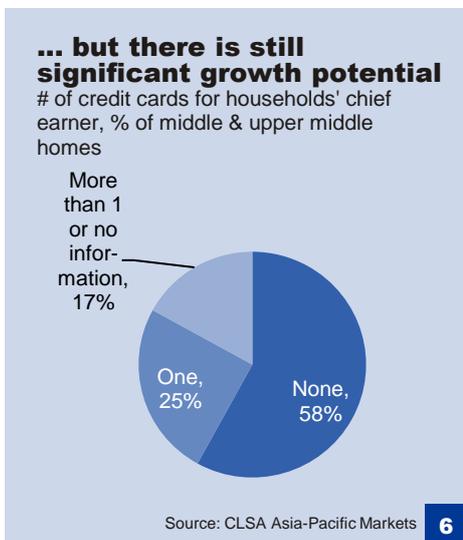
⁷ McKinsey Global Institute (2007). Page 12.

⁸ Economic Survey (2008-2009).

such as food and more is spent on optional items.⁹ Thus, it is evident that in comparison with lower-income households, the middle class in India has a greater amount of discretionary income (i.e. income available after taxes and essentials such as food and shelter are taken care of) to use and it will be more diversified in its consumption choices. Findings from the government's national surveys (see chart 4 below) verify this trend in India. The surveys show that at the higher classes (12 is the highest class as categorised by mean per capita expenditures), the percentage of expenditure on food declines and the percentage of expenditure on discretionary items such as entertainment increases.



Given the tremendous growth potential, an increasing number of products are being geared towards the middle class population. In the transport industry, which has traditionally been dominated by rail travel, newer cars like the Tata Nano (which retails for a little over USD 3,000) and low-cost airlines have enabled the middle class to be increasingly mobile. However, these items would only be available to those that fit into the McKinsey Institute's more narrow definition of the middle class with higher levels of disposable income. For the wider definitions of the middle class that include households with less disposable income, goods such as televisions and mobile phones have become increasingly popular. The growth in these products over the last several years (see chart 3) is largely attributed to the growing middle class.



The use of financial services by the middle class has also increased significantly. Credit card growth has ballooned over the last several years (see chart 5) and the retail banking market offering unsecured personal loans has also grown tremendously. Before the financial crisis took effect, households were increasingly placing their savings in shares and debentures (12% of savings in 2007/2008 vs. 9% of savings the previous year) vs. more traditional routes such as government bonds. As the market and economic growth both continue to recover, this trend should continue. This provides opportunities for brokers and personal financial advisors to target the middle class. Even new fields, such as life insurance and trusts and estates advice, are being geared towards this demographic. There are still tremendous growth opportunities in many of these fields as can be seen in chart 6 where the majority of respondents in a CLSA survey of middle income and upper-middle income households still did not own a credit card as of mid-2009.

⁹ Banerjee and Duflo (2008).

The middle class should drive growth in India

The growth of the middle class and the economic growth of India are in a virtuous cycle. Rising incomes lead to more consumption, which in turn leads to higher economic growth, then more employment opportunities and subsequently higher wages and the circle starts again.

Thus, as the middle class grows and continues to increase domestic demand, the economy will also continue to grow. In terms of consumption, real private consumption (including both households and private companies) accounts for approximately 55% of GDP. As highlighted in the previous section, the growth of the middle class will continue to increase household consumption in the country. The middle class also demands better healthcare and education. In addition to the benefit of strengthening human capital stocks¹⁰ and thus productivity, this also leads to more private expenditure on healthcare and education and thus improvements in existing infrastructure. In fact, the CLSA survey of middle income and upper-middle income behaviour showed that education was the third largest household expenditure behind essentials such as rent/mortgage and groceries.¹¹ In terms of investment (already around 35% of GDP), the growth of the middle class will also make an impact as it will force more business to expand or new business to take root.

The middle class is also increasing its share of financial investments and thus providing new sources of capital for companies. Although household savings and investment rates as a % of GDP have remained relatively the same over the past several years, investment in shares and bonds has risen over the past several years (see chart 7 – investments declined during the last year due to the financial crisis, but should be higher again in 09/10 as the markets have rebounded). As the middle class recovers from the crisis, this trend should continue.

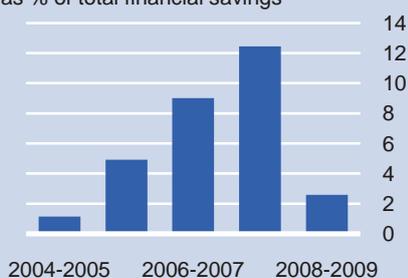
One key point to ensuring that the link between middle class growth and economic growth continues to strengthen is providing the right education and skills to the middle class and creating enough opportunities in society to absorb these employees. This point is discussed further in the next section.

Matching middle class skills with the demands of the growing economy

One benefit of India's strong economic growth is that the economy has the potential to provide employment for the growing middle class. The boom in call centres and other outsourcing industries helped many households to achieve higher incomes over this past decade. However, one challenge is to continue increasing skills at all levels of the income pyramid to ensure that the newly emerging middle class (or those on the fringe of the middle class) are viable employees. The second challenge, of a more general nature, is to increase the number of skilled professionals in the workplace to change the structure of the economy to a higher-skilled economy. Graduates often do not have the necessary skills to be effective in the marketplace. For instance, the World Bank estimates that a threefold increase in civil engineering graduates would be necessary to meet India's large infrastructure needs.¹² To ensure that their

Capital market investment rising

Investment in shares/debentures as % of total financial savings



Source: RBI Annual Report

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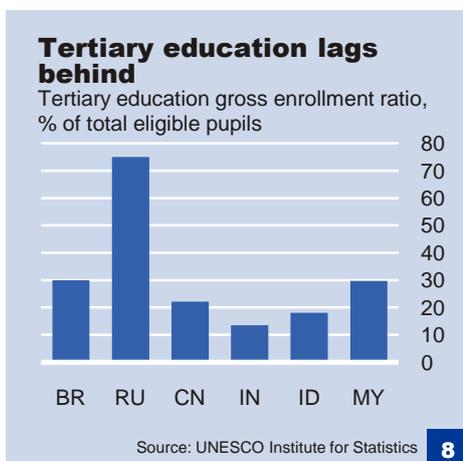
Lack of skilled workers driving up costs

Given the lack of skilled labour, wages for those with the right knowledge have gone up significantly over the past several years. The McKinsey Global Institute reported 30-40% average wage growth for top management and high attrition rates as skilled employees continually switched jobs to receive higher wages. Currently, skilled graduates often move into the more lucrative IT and financial services positions to receive better wages vs. industrial sectors (such as construction). Although the financial crisis of the last two years has slowed the upward wage trajectory, the trend is expected to continue as India moves back to 8%+ growth levels. As a result, some companies may choose to move operations to cheaper countries in Eastern Europe or other emerging Asian economies.

¹⁰ Bussolo, De Hoyos, Medvedev, van der Mensbrugge (2007).

¹¹ Dutta, Menezes, Radhakrishnan, Gill (2009).

¹² Financial Times. October 5, 2009.



Ongoing reforms in education are needed

children and they themselves have the necessary skills, families often spend significant amounts of their incomes on private education (see charts 2 and 3 in consumer section above on expenditure categories) and supplemental training (such as computer training) to remain competitive.

The challenge is shifting this burden to employers, policymakers, and private-sector education institutes. Employers could focus on workplace training programmes. Policymakers could focus on continued improvements in public education and introducing new policies that encourage high-quality talent, and foster competition between different public and private universities to deliver better programmes. Although the government has significantly improved the primary education system in India (the primary school enrollment ratio is now near 90%) and thus middle class students and those on the fringe of the middle class have opportunities at a young age, higher education participation still lags behind other emerging market peers. In 2007, only 13.5% of pupils leaving secondary education enrolled in tertiary education within five years (see chart 8 for comparison with other emerging markets).¹³ This is often attributed to the poor quality of the universities in India. The renewed emphasis on education in the current five-year plan, increasing government expenditure on education, and plans to open up the field to foreign universities for investment and establishment of local campuses should improve the competition and quality of domestic universities and thus create better value for middle class aspirants.

Ongoing reforms in terms of both public universities and in terms of education policy will be necessary. For private-sector education institutes, the challenge is to maintain high levels of quality education and thus be a source of competition among other universities (both public and private). This will help create more value for money and ensure those on the fringe of the middle class and unable to pay for education would be able to grow into the middle class. In combination, the efforts of employers and public and private education institutes will help to absorb the growing middle class more easily into the economy and thus contribute to growth.

The political economy of the middle class

From international newspapers such as the Times in the UK to local blogs, the middle class in India is often criticised for being apathetic towards politics.¹⁴ However, definitive statistics are difficult to find. Many analysts point to the low voter turnout in urban areas such as Delhi and Mumbai (where assumingly more middle class families live). However, using a more narrow definition of the middle class such as that from the McKinsey Global Institute, only 12% of urban households were middle class in 2005.¹⁵ In addition, even in some more rural states such as Uttaranchal and Chattisgarh, voter turnout has been low and in more urban states (such as Kerala) turnout has been high so using even a broader definition of the middle class and assuming a stronger urban middle class presence does not necessarily provide substantive proof of middle class apathy (see chart 9 for voter turnout in 2004 legislative elections).

However, there is widespread anecdotal and suggestive evidence that while the middle class may have strong opinions about politics and the shape of the country, actual participation in the democratic

¹³ UNESCO Institute of Statistics.

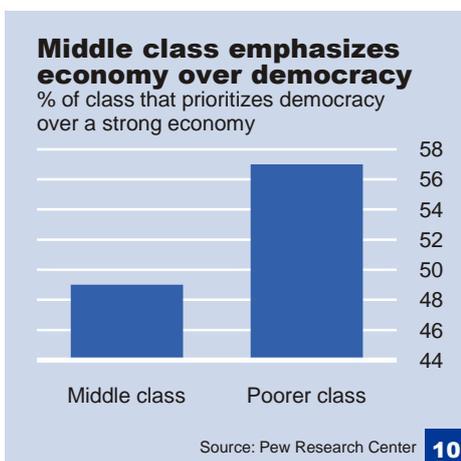
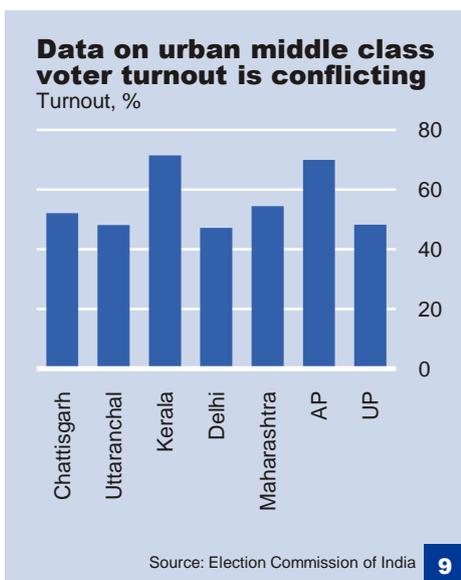
¹⁴ Times. April 19, 2009.

¹⁵ McKinsey Global Institute (2007). P. 68.

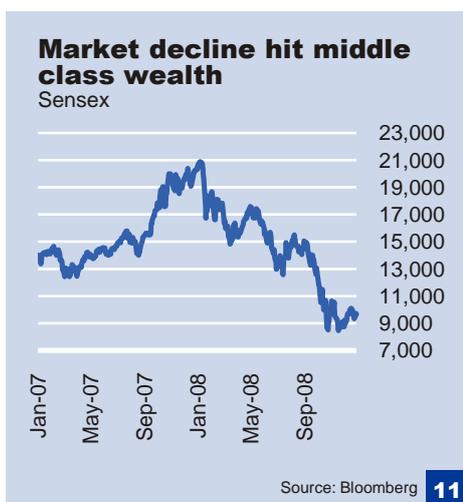
system lags behind. For instance, in a Pew Research Center survey of the middle class in 13 countries including India (skewed to the urban middle class), 53% of respondents felt honest elections were important compared to 51% of the poor. In terms of free speech, 46% of the middle class and 39% of the poor respondents felt this was an important ideal. The same trend held true for freedom of press, freedom of religion, and other democratic ideals. However, when respondents were questioned on whether they would prefer a strong democracy over a good economy, only 49% of the middle class said yes vs. 57% of poor respondents. This switch was only found in one other country (Venezuela) in the 13-country study. One reason for this divergence between attitudes about politics and participation in reality may be the middle class emphasis on economic issues. For instance, the middle class might see less of a link between their priorities (the CLSA survey found the number one political priority for the middle class over the next 12 months was employment) and a new government vs. the poor (who are typically more concerned with things such as basic healthcare infrastructure or farm loan waivers that are more directly linked to the government). Even among the youth, this trend seems to continue. Although middle class youths with higher levels of education are more likely to say that it is a citizen's duty to vote during election, actual election participation of youths with higher levels of education is less than their counterparts with lower levels of education.¹⁶

Voter activists and political party campaigns for the 2009 legislative elections tried to target the middle class and encourage voter participation through internet marketing campaigns and public service announcements, but anecdotally this only had a moderate effect. Even assuming the middle class makes up the majority of urban areas does not show any significant change (Delhi turnout increased slightly while Maharashtra's turnout declined).

The government already has a difficult task in preparing its policy agenda. Despite strong economic growth over the past decade, inequality in India has been on the rise. The Gini coefficient (a measure of inequality where 100 = high levels of inequality and 0 equals no inequality in an economy) is rather low for India overall compared to other EMs at less than 35 but has been increasing since economic liberalisation. Thus, although the poverty rate has been reduced, the rich continue to get richer in comparison. This presents a difficult challenge for the government. It must work to ensure that its economic agenda is beneficial to wide segments of society in order to retain ongoing support. If, rightly or wrongly, it is perceived that the middle class remains apathetic towards political participation as is currently thought, then the trend of focusing on poorer (often rural) voters to win elections could remain the dominant political paradigm in India. These voters often have strong turnouts and thus government programmes such as food subsidies and the National Rural Employment Guarantee programme are highly popular (notwithstanding their actual success). A stronger political drive in the middle class would force or enable the government to also focus on issues that are of concern to them.



¹⁶ DeSouza, Kumar, and Shastri (2009).



Difficulties in loan repayments have risen

The middle class remains optimistic despite being hit by the financial crisis

Although India is now recovering from the financial crisis of the past two years, it is important to note the effect of the crisis and economic slowdown on the middle class. While unemployment as a whole is still lower than earlier in the decade, job losses increased. Job losses have affected workers both in blue collar jobs (such as construction) as well as in white collar jobs (such as IT). In addition, the decline in the stock market (50% between the peak in 2007 and the end of 2008 – see chart 11) and real estate prices led to wealth erosion of the middle class because of their investments in these assets. In the CLSA survey on middle income and upper middle income households, 40% of respondents said that their employment had been affected by the downturn and over 30% of households' overall income had been hit. In addition, less than 20% said they had purchased stocks in the last 12 months and less than 15% planned to buy stocks over the next 12-month period.¹⁷ Given that only 1.4-4% of household assets are estimated to be held in equities¹⁸, the slowdown effectively put the brakes on a nascent trend.

As a result of these issues, many individuals in the middle class faced difficulties in repaying personal loans and credit cards that were rapidly accumulated in the boom years up through 2007. Personal loan delinquencies rose from approximately 4.5% in April to over 6% by early 2008.¹⁹ Local reports say that credit card defaults increased over 50% in 2009 from the year before and local banks such as State Bank of India are posting losses due to their credit card portfolios.²⁰ 65% of the CLSA survey respondents said that they were spending less on their credit cards, demonstrating the new cautiousness being felt by middle class consumers. In addition, many in the middle class cut down on discretionary spending and some of their savings. In the CLSA survey, a majority of respondents said that they had cut down on discretionary expenditures. Holidays were most frequently cut back, followed by jewelry and then transport.²¹

Despite the difficulties of the financial crisis, the middle class has still been relatively resilient and a majority appears to be optimistic about their own as well as India's future. 65% of respondents in the CLSA survey said they felt employment prospects would improve over the next year. While some cautiousness likely remains, these optimistic feelings may have gained strength in the last several months (the survey was taken in June 2009) as both growth and the stock markets have been recovering strongly since Q3 2009. This is perhaps the most striking feature of the middle class. While they may be hit by the economic crisis and are not particularly active at the ballot box about voting for any change, they believe that India is on its way to becoming a global economy and the opportunities are there for the middle class to thrive on this growth.

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¹⁷ Dutta, Menezes, Radhakrishnan, Gill (2009).

¹⁸ Financial Times. January 15, 2010.

¹⁹ DB GM Research (2009).

²⁰ Chopra (2009).

²¹ Dutta, Menezes, Radhakrishnan, Gill (2009).

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