

# MIDDLE MARCH

## Will an expanding global middle class open doors for investors and the world economy?

BY SUSAN TRAMMELL, CFA

**T**he growth of the emerging global middle class has given rise to a number of tantalizing scenarios. The GDP of emerging countries could triple to US\$24.3 trillion by 2030, pushing their share of global output from 23 percent currently to 33 percent of a potential US\$75 trillion global economy. Members of the global middle class, numbering 430 million people in 2000 by one measure, could rise to 1.15 billion in the same period. The developing markets, home to 56 percent of the expanding middle in 2000, could account for up to 93 percent of the global middle class in only two decades. Moreover, this bulging middle class could become a major engine for the world economy as the role of middle-class consumers in the United States and Western Europe shrinks. With such healthy vital signs, why probe the patient further?

For one thing, rosy projections do not take into account local issues that could hinder consumption in any country. While this newly minted middle class is jangling more change in its pockets, not everyone is ready to head out for a major shopping spree.

These basic facts set the stage for some of the more complex issues that are likely to become increasingly meaningful to practitioners in the investment industry. Expectations should be tempered by an understanding of the characteristics that define the global middle class and the prospect of regional shifts in global output. Moreover, the expanding middle seems to present a paradox, with narrowing global income inequality amid evidence of rising income disparities within the very same emerging economies that are rapidly converging with higher-income economies. Perhaps most importantly for investors, several consumer-centric factors will influence how these new middle-class consumers dispose of their discretionary income.

### Who's in the Middle?

By most accounts, the global middle class will at least double over the next 20 years. The emerging middle class demographic can be measured in two ways: by comparing populations of different countries or by comparing people within the population of the same country. The members of the first group are those who are classified as middle class by any standard. The World Bank defines the middle class accordingly as ranging from the average per-capita income of Brazil to the average per-capita income of Italy in terms of purchasing power parity (PPP). By this definition, the members of this global middle class make up about 10 percent of the developing world's population and are likely to have more in common with their middle-class counterparts in other countries than with the poor in their own country.

The second definition refers to those who are middle class by the standards of emerging market countries but not developed economies. This population has gone from approximately a third of the developing world's population in 1990 to 49 percent in 2005 and is now set to achieve a majority for the first time in history.<sup>1</sup>

Goldman Sachs predicts that two billion additional people may join the world middle class by 2030. By then, approximately 50 percent of the world population would fall within an annual income bracket of US\$6,000 to US\$30,000 (Goldman Sachs' definition of middle class in PPP terms)—compared with 29 percent currently. This global middle-income community would include three BRIC countries (China, India, and Brazil) and six of the so-called Next 11 (Egypt, Philippines, Indonesia, Iran, Mexico, and Vietnam).<sup>2</sup>

The Brookings Institution, a U.S.-based think tank that researches global economic policies, defines middle class as having an average daily per capita income that ranges from US\$10 to USD\$100 in PPP terms. Under these guidelines, the global middle class already includes

- 1 M. Bussolo, R. De Hoyos, and D. Medvedev, "Is the Developing World Catching Up? Global Convergence and National Rising Dispersion," Policy Research Working Paper No. 4733 (September 2008).
- 2 D. Wilson and R. Dragusanu, "The Expanding Middle: The Exploding World Middle Class and Falling Global Inequality," Global Economics Paper No. 170, Goldman Sachs (July 2008).
- 3 H. Kharas, "The Emerging Middle Class in Developing Countries," OECD Development Centre Working Paper No. 285 (January 2010).



Rural-to-urban migration typically means higher income levels and a growing middle class. The pattern has recently played out in Brazil, with increasing migration of workers to urban centers. The crowded commuter trains going to and from Central Station in Rio de Janeiro are evidence of the trend. In 2009, 135 million people, like the passengers pictured here, used train services at Central Station.

1.8 billion people. The greatest concentrations today are in Europe (36 percent), Asia-Pacific (28 percent), and North America (18 percent). Asian consumers, however, could account for more than a 40 percent share of global middle-class capital consumption in 10 years.<sup>3</sup>

For handy reference, think of residents of the expanding middle class as those who have about a third of their income left for discretionary spending after providing for basic food and shelter. This standard includes disposable income not only for goods but also for such services as health care and education.

### Shifting Shares of Global GDP

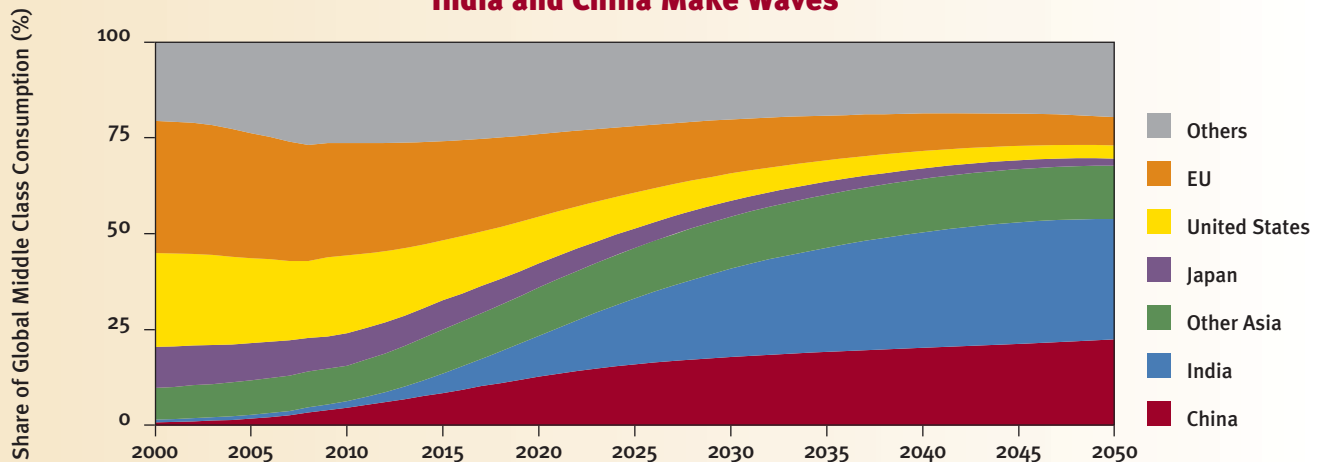
The majority of this middle-class surge will be attributable to a combination of higher economic growth rates taking place within the developing countries, which will pull their citizens out of poverty, and above-average population growth rates in countries with expanding middles.

Under a baseline scenario modeled by the World Bank, the emerging economies' share of global GDP has risen from 39 percent to 49 percent since 1990 and is set to surpass the developed world in the next two decades. China and India will account for a sizable share of the surge. The G7 economies, which accounted for 65 percent of global GDP (measured at market exchange rates) for four decades between 1965 and 2004, could see their share of global activity decline to less than 25 percent by 2034. Although econometric modeling by the Brookings Institution suggests that while real output growth of the converging economies will slow to 8.2 percent annually over the next 30 years, it will still far surpass that of the rich countries, which will slow to 2.3 percent (See Figure 1).

The vast bulk of the expanding middle can thus be explained by high economic growth rates in the developing countries. "What we really want to know is the class of people who are actually spending a certain amount of

FIGURE 1

### India and China Make Waves



The composition of global middle class consumption will shift heavily toward China, India, and other Asian countries (ex Japan) as the high-income countries see their share decrease.

Source: H. Kharas, "The Emerging Middle Class in Developing Countries," OECD Development Centre Working Paper No. 285 (January 2010).

money,” says Homi Kharas of the Brookings Institution. “There are some thresholds which make them more willing to spend on consumer durables and brand names and other things that we associate with middle-class consumption.”

Relying on household survey data and consumption expenditures derived from national incomes, Kharas developed middle-class growth projections for 145 countries, representing 98 percent of the world’s population and 99 percent of global GDP. He concluded that because poor and populous countries are growing faster than the more mature economies, the world will be significantly wealthier 25 years from now.

As World Bank research shows, however, the convergence of average incomes between countries will be accompanied by widening income distributions in two-thirds of the developing economies. Why should income levels be diverging within emerging markets that are simultaneously closing their income gap with developed economies?

### Three Measures of Income Distribution

There are three widely accepted approaches for determining global income distribution, each of which undertakes a slightly different measure.

**Intercountry inequality**, favored by macroeconomists, measures relative income movements among countries. This methodology reveals widening average income disparity between countries at different income levels

(although there appears to be some convergence among the average incomes of wealthier economies).

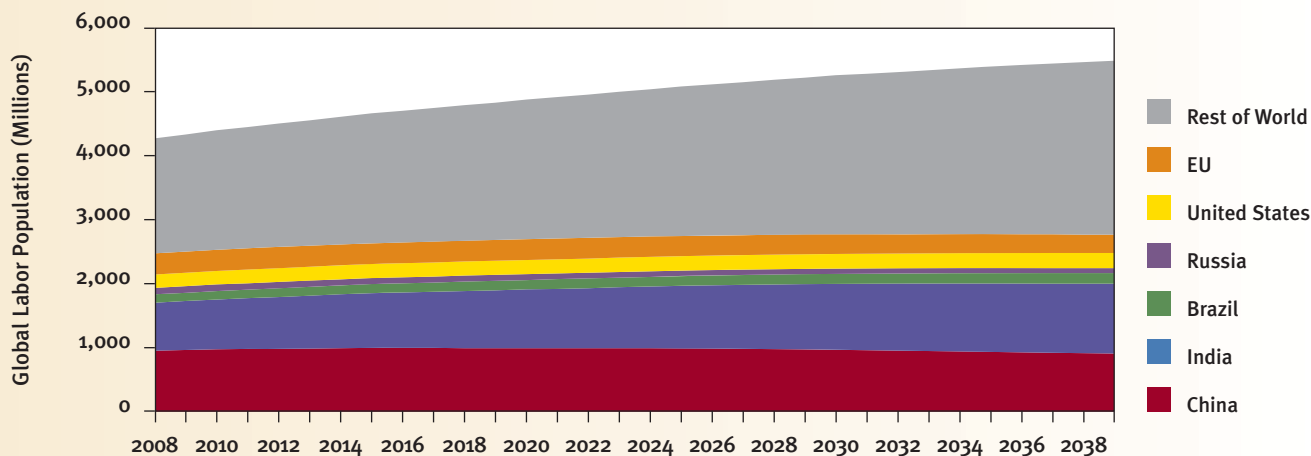
**International inequality** is a population-weighted measure. For example, China and Hong Kong both have experienced a rise in average per-capita income, but China’s contribution to global income convergence will be greater than Hong Kong’s. By international inequality measures, the income distance between countries has decreased. When China and India are excluded, however, international inequality has *increased* in the past two decades.

**Global inequality**, which compares individual incomes, takes within-country inequality into account. By this measure, global inequality has remained more or less constant since the late 1980s. According to a World Bank study of low- and middle-income countries representing 86 percent of the developing-world population, more than two-thirds of the countries in the sample are projected to experience an increase in intracountry inequality by 2030.

Under the World Bank’s assumptions, global income inequality will fall by 2030 because of the income convergence effect across countries but at the expense of certain populations *within* countries. Goldman Sachs compares the phenomenon to a world in which countries are clustered into two groups—a group of rich countries and a group of poor countries. Within each group, income inequality may be rising. But if the average income of a large portion of the poor group grows more quickly and

FIGURE 2

## Global Labor Growth



Virtually all of the projected growth in global labor population will be in the developing countries, which could experience an increase in productivity as more youth join the labor force. In contrast, the developed economies and China will age significantly.

Source: H. Kharas, “The Emerging Middle Class in Developing Countries,” OECD Development Centre Working Paper No. 285 (2010).

**Egyptian traders at the Cairo Stock Exchange have seen their market fluctuate significantly in recent years. With Egypt included among countries expected to join the global middle-income community by 2030, what will Egyptian financial markets and those of other expanding middle-class economies stand to gain?**



Khaled Desouki/AFP/Getty Images

moves closer to the average income of the rich group, global income distribution will be more equal—even if intracountry inequality continues to widen.

Back in the real world, when (or even whether) a country’s middle-income demographic expands depends on conditions that are highly specific to that country. For example, the wider a country’s initial income inequality with the rest of the world, the less impact GDP growth will have on gaining it a greater share of the global middle class. Thus, countries in sub-Saharan Africa have farther to travel than countries in South Asia, where income is more evenly distributed to begin with and which will see their share of the global middle class increase with a rise in output.

Expected changes in three factors can alter intracountry disparity: a population’s demographic structure, rural-to-urban migration, and skilled-to-unskilled wage premia.

**Demographic Changes.** The emerging economies will add most of the world population growth projected by the World Bank—from about 6.5 billion people in 2005 to 8 billion people by 2030. Because of differences in fertility rates, regions whose populations are growing at rates above the world average could experience higher productivity growth as their labor force expands (see **Figure 2**).

Age distribution and education attainment are the two largest demographic contributions to intracountry income equality. A younger population means more workers and fewer dependents in the population as a whole. The population of elderly persons in developing economies is projected to rise from 12 per 100 workers in 2005 to 19 by 2020, but this is still far below the current average of 30 per 100 workers in developed countries. Other age-related demographic trends that contribute to same-country income equality take place within households. For example, having fewer children per household allows greater investment in per-child human capital. Two-income families with greater female labor-force participation enable households to earn and save more.

Younger generations are also more likely to achieve higher levels of education than have preceding generations. As workers move up the skill chain, they become more productive and enjoy higher wage rewards. In countries where educational infrastructures are still evolving, saving for education may command a sizable portion of households’ disposable income. McKinsey & Company reports that Chinese households, which save an estimated 25 percent of discretionary income on average, cite saving for a university education as the foremost reason.<sup>4</sup> The consulting firm estimates that increasing the use of student loans from a market penetration rate of 10 percent to a rate of 33–50 percent would boost China’s share of global consumption as much as 0.4–0.7 percentage points by 2025 (relative to the firm’s trendline scenario for China).

**Rural-to-Urban Migration.** When a country’s middle class is growing because of the upward mobility of its poor, the economy is almost always undergoing a period of rapid urbanization. In such cases, farm workers are typically underemployed for long periods of time. Transitioning to urban areas gives laborers the opportunity to work full time and in a more productive environment. The gains extend to the lowest income bracket, because even though the hourly wage may not rise, the number of hours worked goes up, resulting in higher income levels.

Allowing wages to rise in democratic countries where wealth is shared will slow economic growth rates, but domestic demand will increase as economic growth trickles down. In countries where the state has a large footprint in the economy and workers do not have access to collective bargaining, the government has an incentive to keep labor costs low to stimulate foreign and domestic investment. Such a policy, however, holds down personal consumption.

“To some extent, income disparity can help an economy grow more efficiently, but if you keep labor costs

4 “If You’ve Got It, Spend It,” McKinsey & Company (August 2009).

artificially low, that means people who work don't get a lot of pay," explains John Zhang, marketing professor at the Wharton School. "In that case, domestic demand is going to be a problem. It's something you observe today not only in China but also in other countries in Southeast Asia, such as Vietnam, where there are few opportunities for collective bargaining. That's not likely to happen in demand-driven economies where the workers can strike and hence have some say about their pay."

**Skilled-to-Unskilled Wage Premia.** As a country moves away from an agrarian economy toward an economy based on manufacturing and services, wage premia reward non-farming activities and skilled labor. The premium paid for higher skill levels tends to produce larger changes in intra-country inequality than other factors.

A country's shift toward skill-intensive sectors in both manufacturing and service industries generates a higher proportion of professionals, from educators to engineers. "These professionals are typically involved in activities that are connected to the global economy," says Kharas. "It's their ability to be part of that global economy that actually allows them to command a premium. If you think about it, the manager of an urban company that is sourcing products for Intel is going to be in a much more dynamic situation than the manager of a milk-marketing cooperative in some rural area."

### Precautionary Savings

When evaluating the likely impact of the emerging middle class, an important consideration is how households dispose of their discretionary income. Factors include levels of precautionary savings, the availability of consumer credit, the array of financial products, and the local retail experience.

Where social safety nets are frayed or nonexistent, households may save a higher portion of their income in the face of uncertainty compared with countries that have well-developed health care and pension programs. In developed countries, household savings rates typically peak in the middle years, when wage earners are at the top of their game. But in China, for example, where the "iron rice bowl" of lifetime guaranteed employment has been broken, McKinsey & Company found that the level of household savings follows an anomalous U-shaped pattern: Savings peak at the lower and higher edges of the age spectrum, reflecting the desire to save for education in younger years and as a substitute for adequate healthcare and pension schemes in later years. China's consumption-to-GDP ratio—at 37 percent—is only half that of the United States and the lowest ratio of any major country in the world.

Comprehensive reform, whether enacted through government or through employer-mandated programs, could make citizens of growing economies less anxious about their future and more willing to spend on discretionary goods and services. [For further discussion of this topic, see "Unsustainable Promises" in the March/April 2010 issue of *CFA Magazine*.]

### Lack of Consumer Credit

Until emerging market economies develop systems that enable consumers to buy on credit, their residents are likely to make large purchases out of savings or forgo them altogether. Euromonitor reported that 160 million credit cards were in circulation in China at the end of 2008, but the United States, which has only about a quarter of China's population, had nine times as many credit cards in use in 2006.

A reluctance to spend now and pay later may be technological, not simply cultural. For banks, extending mortgages is relatively easy (although home equity loans are often unavailable in many developing countries). Once lenders have information as to whether consumers are paying their mortgage on time, the next step is potentially to provide credit cards, but this move requires a level of sophistication in the management of information systems that many developing economies have ignored until now.

"In the credit card business, it's useful to know whether people pay their utility bills on time or not," Kharas points out. "Setting up credit bureaus and credit information institutions and then having them mature actually takes quite a long time and considerable investment in an information infrastructure. That does not exist in most developing countries. It is slowly starting to emerge as they become more middle class and as the demand for these services grows, but nobody's prepared to invest in structured information until you cross a threshold."

### Limited Financial Options

The capital markets in the developing countries are still evolving, and households and small businesses are the last to benefit. In countries such as China that have been dominated by state-owned or state-controlled enterprises, companies have little incentive to disburse profits as dividends or wages. Banks may be allowed to cap interest rates, but households will still be biased in favor of stashing away money with them because they are perceived to be safer than stocks, mutual funds, or corporate bonds. Higher investment income and greater participation in the financial markets would enable households to achieve higher income levels and boost their consumption.



Goh Chai Hin/APF/Gaety Images

**Chinese shoppers at a Beijing shopping mall pass a Volvo on display in March 2010 shortly after the announcement that Chinese company Zhejiang Geely Holding would purchase the Swedish auto manufacturer from Ford Motor Company. One question facing investors is how the global middle class will change consumption patterns. Will consumers in new middle-income countries desire the Western basket of goods or indigenous brands? “For multinational companies, the key will be not how many consumers in a country are on the cusp of moving into the middle-class bracket but how many are nearing the point of being able to afford their products,” says Homi Kharas of the Brookings Institution.**

In emerging markets, businesses may prefer banks to other capital sources because they permit the opportunity for re-contracting. In an environment where the risks are much less predictable, re-contracting can be quite useful. Suppose an export company’s order book suddenly experiences a dramatic drop. Rather than file for bankruptcy (an inefficient process that can destroy value), the borrower might be able to ask its bank to wait out an imminent turnaround.

“In the United States, even while we’re in the middle of one of the worst recessions, GDP last year will have declined by somewhere between 2 percent and 3 percent,” says Kharas. “In emerging economies, it’s not uncommon for the declines to be in the double digits. That’s just a completely different environment that firms have to deal with.”

### **The Retail Experience**

As incomes rise in the developing markets, members of the growing middle class may tolerate traditional sales channels, but they will eventually demand modern shopping experiences. Retailers may find large untapped opportunities in not only branded chains but also online sales, direct merchandising, leasing, and pre-owned durable goods. Increasingly, multinational corporations will find consumer preferences shaped by the residents of China, India, and other Asian countries whose middle-class populations are rapidly expanding. Goldman Sachs predicts that China will surpass Japan as the world’s top consumer luxury market by 2015, with a 29 percent global share.

Will the emerging middle desire the Western basket of goods or indigenous brands? They are likely to want both. People with a certain amount of spending money

will start to move away from buying things as pure commodities and begin buying things because of what they represent. For multinational companies, the key will be not how many consumers in a country are on the cusp of moving into the middle-class bracket but how many are nearing the point of being able to afford their products.

“There are some thresholds which make people more willing to spend on consumer durables and brand names and other things that we associate with middle-class consumption,” says Kharas. “What we really want to know is the class of people who are actually spending a certain amount of money.”

### **A Global March?**

The middle class is critical to the market economy and economic growth. But in the developing markets, a rising tide of prosperity won’t lift all boats, and for those who have accumulated newly earned wealth, spending patterns will be heavily influenced by a number of intracountry factors. Most of all, the emergence of this new middle class depends on local, healthy economic growth, and what happens in the developing countries is intimately linked to the pulse of the global economy.

“One should not misunderstand that because there is an emerging middle class in countries like China and India it means these countries will continue to prosper,” cautions Kharas. “What I want to know is what happens if the global economy isn’t fixed.” **▀**

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