Tracking the growth of India's Middle Class

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Tracking the growth of **India's middle class**

Over the next two decades, the country's middle class will grow from about 5 percent of the population to more than 40 percent and create the world's fifth-largest consumer market.

Eric D. Beinhocker, Diana Farrell, and Adil S. Zainulbhai

India's rapid economic growth has set the stage for fundamental change among the country's consumers. The same energy that has lifted hundreds of millions of Indians out of desperate poverty is creating a massive middle class centered in the cities. A new study by the McKinsey Global Institute (MGI) suggests that if India continues its recent growth, average household incomes will triple over the next two decades and it will become the world's 5th-largest consumer economy by 2025, up from 12th now.[1] Along the way, spending patterns will shift significantly as discretionary purchases capture a majority of consumer spending. India's potential should make it a high priority for most consumer goods businesses, but to succeed in this complex market they must overcome major challenges.

Private consumption has already played a much larger role in India's growth than it has in that of other developing countries. In 2005 private spending reached about 17 trillion Indian rupees[2] ($372 billion), accounting for more than 60 percent of India's GDP, so in this respect the country is closer to developed economies such as Japan and the United States than are China and other fast-growing emerging markets in Asia (Exhibit 1). Our study

[1] The full report, *The 'Bird of Gold': The Rise of India's Consumer Market*, is available free of charge online at www.mckinsey.com/mgi.

[2] We have converted Indian rupees to US dollars at the base year 2000 exchange rate of 45.7 rupees to the dollar. Purchasing-power-parity figures were converted at the rate of 8.5 rupees to the dollar.

Dinesh Khanna

Article at a glance

Over the next 20 years, India will likely grow to become the world's fifth-largest consumer economy.

A study by the McKinsey Global Institute suggests that if India can achieve 7.3 percent annual growth—a reasonable assumption if economic reforms continue—consumer spending will quadruple, from about 17 trillion Indian rupees ($372 billion) in 2005 to 70 trillion rupees in 2025. The dramatic growth in India's middle class, from 50 million to 583 million people, will power this surge.

Spending patterns will shift dramatically as expenditures grow rapidly on discretionary items ranging from personal products to consumer electronics. Incumbents will have to fight to retain their market dominance, while attackers could find lucrative ways to exploit the evolving tastes of India's massive new middle class.

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shows that aggregate consumer spending could more than quadruple in coming years, reaching 70 trillion rupees by 2025. Higher private incomes and, to a lesser extent, population growth will encourage this rise in consumption. Changes in savings behavior will play only a minor role.

With such growth on the horizon, it is unclear which companies will win in most product categories. Opportunities will blossom as millions of first-time buyers step up to cash registers and as the bulk of consumer spending moves from scattered, hard-to-reach rural areas to more concentrated, accessible urban markets. Indian consumer spending will shift substantially from the informal economy, with its individual traders, to the more efficient formal economy of organized businesses. That transition will lower prices and further boost demand.

But neither incumbents nor attackers will have an easy time. Bureaucratic hurdles and well-recognized infrastructure shortcomings will frustrate many strategies. In addition, while aggregate spending will rise tremendously, it will be spread across hundreds of millions of households, many with very modest incomes (by the standards of developed countries) and high sensitivity to price and value. Finally, in many consumer markets both Indian and multinational companies already compete intensely for customers. While the opportunities will be enormous, the challenges will force companies to be more dynamic by adapting their products, services, and business models to the rapidly changing needs and incomes of Indian consumers.

We examined the way India's consumer market will likely develop under a set of reasonable economic assumptions (see sidebar, "About the research"). In particular, our model assumes that real compound annual growth will be 7.3 percent over the next two decades and that economic-reform efforts will continue. If these conditions are met, the life of the average Indian will change vastly by 2025.

About the research

To assess the likely evolution of India's consumer market, MGI assembled a proprietary database with 20 years of data linking macroeconomic and demographic variables to the incomes and consumption behavior of Indian households. We made extensive use of our exclusive access to the Market Information Survey of Households (MISH) database (covering more than 300,000 households), created from income surveys conducted by India's National Council of Applied Economic Research (NCAER), as well as the Indian government's National Sample Survey (NSS) household consumption database, created from consumer expenditure surveys across thousands of villages and urban blocks. We integrated the MISH and NSS data, along with data from a variety of other sources, and then constructed an econometric model to forecast India's household income and spending from 2006 to 2025.

Our model is driven by a macroeconomic base case that shows overall real compound annual economic growth of 7.3 percent and real per capita growth of 5.9 percent to 2025. This base case is in turn built on a more detailed analysis of future productivity growth, sectoral growth rates, savings and investment, demographics, education levels, and other factors.

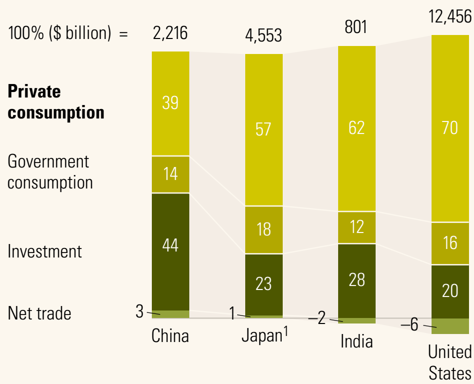
We have not based our projections for India on any profound shift in economic policy. Rather, we assume that recent rapid growth rates will cool down to a more sustainable (but still high) level, that the country will remain on a long-term path of economic reform, and that India will make necessary investments in its infrastructure and human capital. Faster reform, investment, and modernization would hasten the results we describe; a slower pace would delay them or put India's future progress at risk.

[1] Puducherry (formerly Pondicherry), a union territory, comprises 4 noncontiguous enclaves of former French India.

EXHIBIT 1

Private consumption: A starring role

% of GDP, 2005



[1]Figures do not sum to 100%, because of rounding.
Source: Global Insight; McKinsey Global Institute analysis

A market rising from poverty

India's economic reforms, begun in 1991, have substantially improved the country's well-being, and our analysis shows that further improvements are to come. In 1985 93 percent of the population lived on a household income of less than 90,000 rupees a year, or about a dollar per person per day; by 2005 that proportion had been cut nearly in half, to 54 percent. By our estimate, 431 million fewer Indians live in extreme poverty today than would have if poverty had remained stuck at the 1985 level. We project that if India can achieve 7.3 percent annual growth over the next 20 years, 465 million more people will be spared a life of extreme deprivation (Exhibit 2).

Contrary to popular perceptions, rural India has benefited from this growth: extreme rural poverty has declined from 94 percent in 1985 to 61 percent in 2005, and we project that it will drop to 26 percent by 2025. While the progress has been substantial—even historic—significant challenges remain. First, there are large regional disparities in growth and in the reduction of poverty: India's southern and western states prosper, while the northern and eastern states (with the exceptions of the capital region, Haryana, Himachal Pradesh, and Punjab) lag behind. Second, while India has been slowly urbanizing over the past two decades, it remains the least urbanized of the emerging Asian economies. Today only 29 percent of Indians live in cities, compared with 40 percent of the Chinese and 48 percent of Indonesians, and we project that the level of urbanization will increase to only 37 percent by 2025.[3] Finally, while more Indians are completing secondary and higher

[3]Methods of measurement differ across countries and may understate India's urbanization rate, but the general point remains valid.

education, the educational system remains severely strained and the quality of and opportunities for schooling vary widely.

In rural areas life may become less desperate thanks to continued growth and to government investment in infrastructure and development. But it will likely remain a struggle, particularly for subsistence farmers in the north and east and for others with little education. For India's urbanites, especially educated ones, the future looks promising. Many of these households will make the jump not only out of poverty but also into the new and aspiring middle class.

The birth of a new middle class

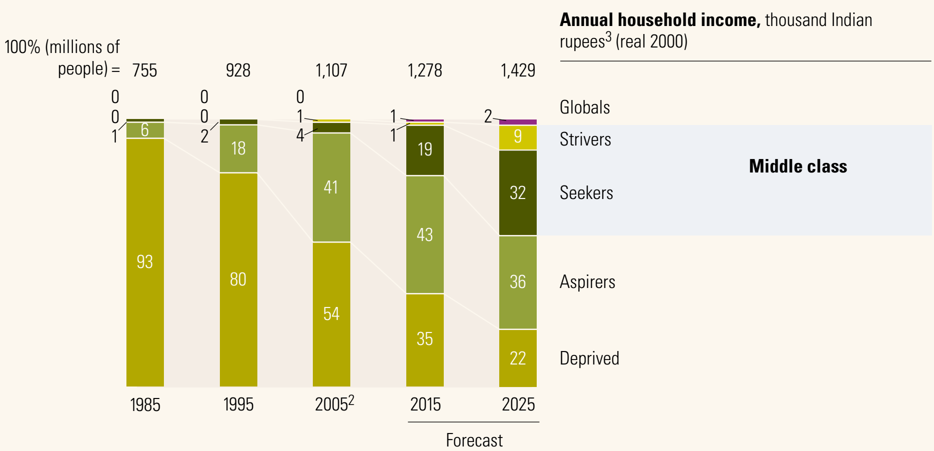
The growth that has pulled millions of people out of poverty is also building a huge middle class that will be concentrated in India's urban areas. While urbanization isn't proceeding as quickly as it is in other Asian economies, rapid population growth means that in absolute terms the country's urban population will expand significantly, from 318 million today to 523 million in 2025.

Urban growth will bring several important consequences. First, it will put tremendous pressure on the urban infrastructure, which is already heavily overburdened. (Our projections assume that infrastructure investments will at least keep pace with urban growth and that problems with transportation and utilities won't worsen to the point of hampering growth.) Also, in

EXHIBIT 2

Escaping poverty

Share of population by annual income bracket,[1] %



[1]Annual income: globals = >1,000,000 rupees; strivers = 500,000–1,000,000; seekers = 200,000–499,999; aspirers = 90,000–199,999; deprived = <90,000; figures may not sum to 100%, because of rounding.
[2]Estimated.
[3]45.7 rupees = $1 in real 2000 dollars or 8.5 rupees = $1 adjusted for purchasing power parity.

Source: McKinsey Global Institute analysis

India—unlike China, where urban growth is spread across a large number of cities—the economy will continue to be dominated by the megacities (Delhi and Mumbai) plus the six next-largest urban agglomerations.[4] Nevertheless, a handful of smaller places, such as Chandigarh and Ludhiana, will have per capita incomes rivaling those of the major cities and emerge as attractive markets. The shift in spending power from the countryside to the cities will place the bulk of India's private consumption within easier reach of major companies. Today 57 percent of private spending is spread across rural areas, but by 2025 cities will command 62 percent of the country's spending power.

Along with the shift from rural to urban consumption, India will witness the rapid growth of its middle class—households with disposable incomes from 200,000 to 1,000,000 rupees a year.[5] That class now comprises about 50 million people, roughly 5 percent of the population. By 2025 a continuing rise in personal incomes will spur a tenfold increase, enlarging the middle class to about 583 million people, or 41 percent of the population. In 20 years the shape of the income pyramid will have become almost unrecognizable (Exhibit 3).

The Indian middle class has already begun to evolve, and by 2025 it will dominate the cities. By then about three-quarters of India's urbanites will be part of the middle class, compared with just more than one-tenth today.

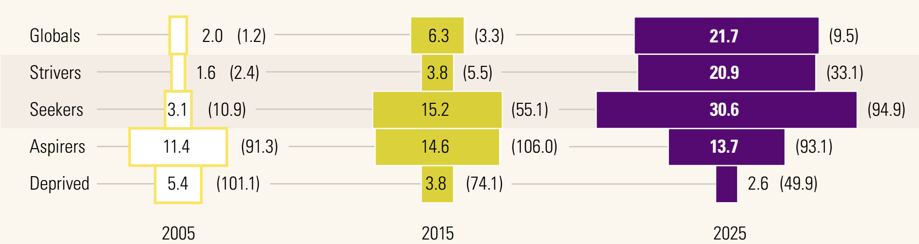
[4] The next six are Kolkata, Chennai, Hyderabad, Bangalore, Ahmedabad, and Pune.
[5] There is no standard definition of India's middle class. In our study we adapted a methodology, from India's National Council of Applied Economic Research (NCAER), defining the middle class as households with a disposable income of 200,000 to 1,000,000 rupees ($4,380 to $21,890) a year in real 2000 terms. That seems quite low in the context of a developed country, but because the cost of living is lower in India, this range of income buys a recognizably middle-class lifestyle. In purchasing-power-parity terms, the range is comparable to an income of $23,530 to $117,650 in a developed country such as the United States.

EXHIBIT 3

The expanding middle

Middle class (xx.x) Number of households, millions

Aggregate disposable income by annual income bracket, trillion Indian rupees[1]

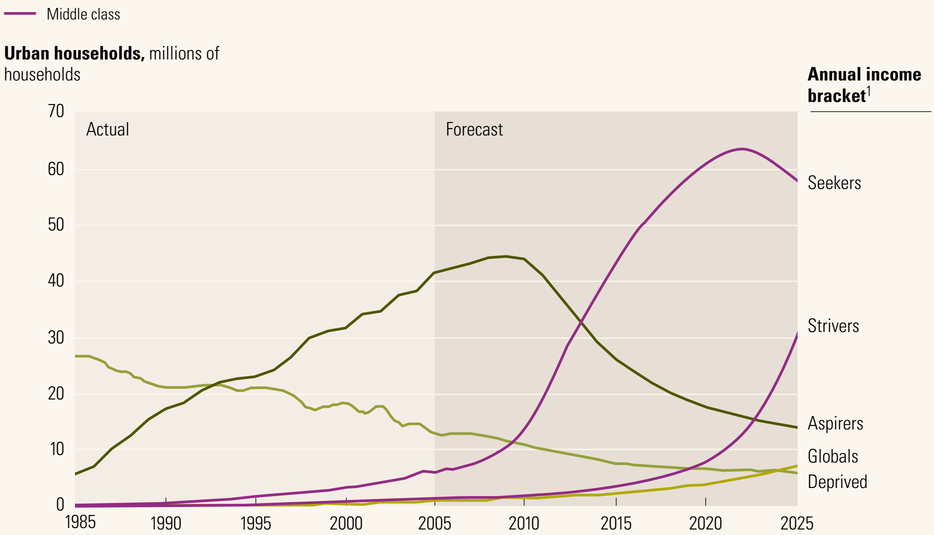


[1] Annual income: globals = >1,000,000 rupees; strivers = 500,000–1,000,000; seekers = 200,000–499,999; aspirers = 90,000–199,999; deprived = <90,000; 45.7 rupees = $1 in real 2000 dollars or 8.5 rupees = $1 adjusted for purchasing power parity; 45.7 rupees = $1 in real 2000 dollars or 8.5 rupees = $1 adjusted for purchasing power parity.

Source: McKinsey Global Institute analysis

EXHIBIT 4

Waves of change



[1]Annual income: globals = >1,000,000 rupees; strivers = 500,000–1,000,000; seekers = 200,000–499,999; aspirers = 90,000–199,999; deprived = <90,000.

Source: McKinsey Global Institute analysis

The expansion will come in two phases, with the lower middle class peaking around 2020, just as the growth of the upper middle class accelerates (Exhibit 4). About 400 million Indian city dwellers—a group nearly 100 million people larger than the current population of the United States—will belong to households with a comfortable standard of living. For many companies, the sheer scale of this new urban middle class will ensure that it receives significant attention.

What's more, companies shouldn't underestimate the market presented by the country's most affluent consumers: those earning more than 1,000,000 rupees a year—$21,890 in real 2000 dollar terms, or $117,650 in terms of purchasing power parity (PPP). They will remain a small portion of society: about 2 percent of the population in 2025, up from 0.2 percent today. But in absolute numbers, by 2025 India's wealthiest citizens will total 24 million, more than the current population of Australia. By that year too, India's affluent class will be larger than China's comparable segment, projected at about 19 million people.[6] Affluent India's share of national private consumption will increase from 7 percent today to 20 percent in 2025, which helps to explain the recent rush into the Indian market of luxury goods such as Louis Vuitton bags and Jimmy Choo shoes.

[6]See MGI's parallel study on China's consumer market, *From Made in China to Sold in China: The Rise of the Chinese Urban Consumer*, available free of charge online at www.mckinsey.com/mgi.

These "global" Indians live mostly in the eight largest cities, so they are very accessible to large domestic and multinational companies. Further, they have tastes similar to those of their counterparts in developed countries: brand name goods, vacations abroad, the latest consumer electronics, and high-end cars.

Changes in consumption

As Indians continue to climb the economic ladder, the composition of their spending will change considerably. In a pattern witnessed in many other developing countries, discretionary expenditures, such as mobile phones and personal-care products, will take up more room in the nation's shopping basket.

This shift from necessities, defined in our analysis as food and clothing,[7] is already under way—and taking place at lower income levels than we have seen in other countries (Exhibit 5). We expect that discretionary spending in India will rise from 52 percent of total private spending today to 70 percent in 2025. South Korea went through a similar transformation in the 1980s, when its per capita income levels were about twice those of India now.

Food (including beverages and tobacco) will post the sharpest decline in relative consumption, even as overall spending in the category rises. The fall in the share of food expenditures during our forecast period—to 25 percent, from 42 percent—is linked closely to the growth of the middle class. Despite this relative decline, food will remain the single largest category of expenditure, and we expect that growth in consumption will accelerate to 4.5 percent annually, from 3 percent over the past 20 years.

That growth, however, will appear tepid compared with the rise of other categories. In particular, spending on purchases that improve the economic prospects and quality of life of a person or family—health, education, transport, and communications—will soar and eventually command a greater share of consumption than they do elsewhere. The inadequacy of India's public-health system, for example, means that private health care is a high priority for many Indian families when their incomes grow. This imperative will drive growth in private health care spending by almost 11 percent a year, so that it will account for 13 percent of the purchases of Indian households by 2025, a larger share than current levels in all of the countries we examined[8] except the United States.

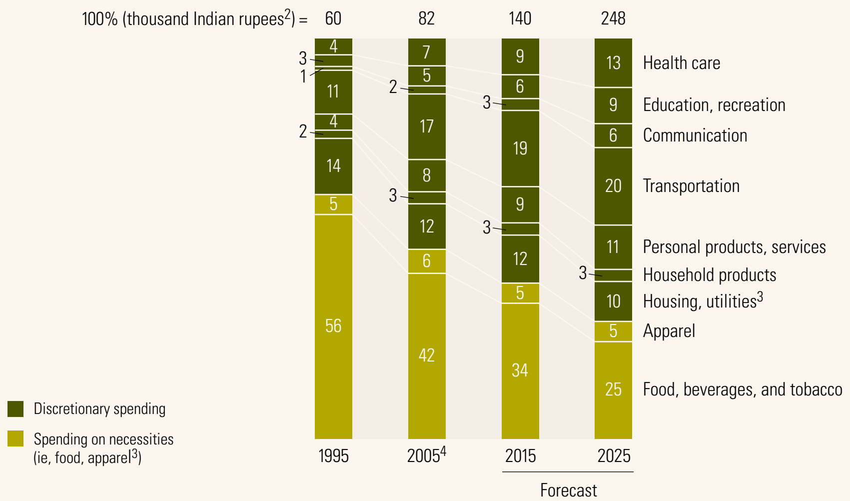
In another remarkable shift, spending on education will grow by 11 percent over the next 20 years, to 9 percent of household consumption, higher

[7] Housing too could reasonably be considered a necessity, but we excluded it in our cross-country comparisons because of significant variations in national housing market structures, regulations, and measurement methodologies. By contrast, the consumption of food and apparel is fairly comparable across countries.
[8] Brazil, China, Germany, South Korea, and the United States.

EXHIBIT 5

Beyond necessities

Share of average annual household consumption, %[1]



[1]Figures may not sum to 100%, because of rounding.
[2]Real 2000 rupees; 45.7 rupees = $1 in real 2000 dollars or 8.5 rupees = $1 adjusted for purchasing power parity.
[3]McKinsey Global Institute's cross-country comparisons of necessary consumption exclude housing from the category of necessity because of significant variations in national housing market structures, regulations, and measurement methodologies.
[4]Estimated.

Source: McKinsey Global Institute analysis

than today's levels in any of our benchmark countries. In rural areas, households emerging from poverty will make educating their children a priority, while higher-income urbanites will be spending more on better-quality education, university degrees, and study-abroad programs. Meanwhile, despite India's fondness for cricket and "Bollywood" movies, recreational products and services will take a smaller slice of household spending there than in other countries.

Transportation, already the largest category of expense after food, will take a bigger portion of household budgets in coming years, exceeding its share in all of our benchmark countries. The highest growth will come from car purchases. Categories such as clothing and household goods are expected to post slower annual growth relative to overall consumption—6.4 percent and 6.9 percent, respectively—and thus to lose share of wallet. Yet even in these categories, growth rates will remain highly attractive as compared with those in other markets around the world.

What it means for businesses

Three-quarters of India's consumer market in 2025 doesn't exist today—about 52.6 trillion rupees a year in future purchases will be up for grabs. Also, India's rapid upward mobility means that many of India's households will be new consumers, enjoying significant discretionary consumption in the organized economy for the first time in their lives. Incumbents and challengers alike face a sea change. India's incumbents, mostly domestic companies, will start with many advantages: existing relationships with customers, an understanding of their needs, and recognized brands. The incumbents also have established distribution channels—very important in a country of vast geography and limited infrastructure.

But growing incomes and consumption will pressure incumbents from two directions. First, such companies must adjust to the pace and magnitude of change, for as consumers rise through the income brackets, their needs, tastes, aspirations, and brand loyalties will evolve along with their lifestyles. Second, India's growing consumption will attract a raft of challengers, and ongoing economic reform will significantly intensify competition in many markets. New competition will come from multinationals entering the Indian market, from established Indian companies looking for expansion opportunities, and from entrepreneurs. Indeed, if the country's policy makers create the conditions for India's entrepreneurs to succeed, major new companies could be built on the back of consumer growth.

Many incumbents haven't prepared enough for this discontinuity. They will have to develop a deep understanding of how the consumer's needs and aspirations will change as incomes grow and find ways of creating innovative products that meet those changing needs. In addition, they must think about how they should introduce new consumers to their products, whether their brands are appropriate for those consumers, and what prices and cost positions will help them compete most effectively for a share of this new middle-class market. Nor is that all: incumbents will have to keep a wary eye on the actions of their current competitors and on new market entrants. That's a full agenda, and companies that begin preparing today will be in the best position to benefit from the changes.

For attackers, the challenge will be to spot the gaps and opportunities that arise as India's income and class structure change; they might, for example, ask themselves where small markets or limited competition, or both, have served middle-class consumers poorly. Attackers could also turn to other emerging economies to seek lessons on how tastes and needs will likely evolve in India, perhaps looking in particular for categories in which spending shifted from local products and brands to international ones as aspirations rose. Attackers seeking to exploit these changes should consider what new needs will be unique to Indian tastes and the market as the middle class grows.

In India, as in many emerging markets, multinational companies will find themselves squeezed between the desire of the country's consumers for a modern middle-class lifestyle and the realities of their limited budgets. In 2005 the average middle-class family spent just over 300,000 rupees annually—roughly $6,600—a very modest sum in real terms, but in PPP terms equal to around $35,000. As one multinational executive noted, however, "You can't put PPP dollars in the bank, only real dollars." Multinationals must innovate to deliver an aspirational middle-class lifestyle to families on an Indian budget. Companies that can develop new business models, design products with carefully targeted features, and create brands that appeal to India's upwardly mobile people will attract huge numbers of eager consumers.

The future we have described assumes that India will continue on its recent path of strong growth. There are many reasons to believe that this assumption is realistic, most notably the scope for improved productivity in the economy. But India's outlook depends strongly on continued long-term economic reforms that are needed to address serious deficiencies in the country's infrastructure, modernize the financial system, and promote investment in human capital through better education and health care.

India's emergence as the world's fifth-largest consumer economy will bring significant benefits to the country and the world. Growth will pull hundreds of millions of people out of poverty and into the world's middle class. With rising incomes, Indians will have the opportunity to realize comforts and pleasures enjoyed by middle-class families around the world. In addition, rising domestic consumption will create further economic growth and employment as companies work to meet the new consumer demand. For the world's businesses, India represents one of the largest consumer market opportunities of the next two decades. During the first millennium, merchants referred to India's glittering and dynamic market as the "bird of gold." That bird is preparing to take flight again. Q

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