2006 SPECIAL EDITION

The McKinsey Quarterly

# The value of China's emerging middle class

## Article at a glance

As global companies have entered China, many of them focused mainly on serving its urban-affluent consumers. However, if these companies continue to use this strategy they risk missing the real opportunity—the emerging middle class.

During the next 20 years we expect a huge middle class, with enormous spending power, to emerge in China's cities, following two distinctive waves of growth.

As incomes increase, the spending patterns of this consumer group will evolve, fueling various levels of growth across consumption categories.

Although it will be difficult, companies should broaden their focus to include this swiftly evolving middle class. Since this segment is a hard one to serve, companies must think creatively to succeed.


# The value of China's **emerging middle class**

*Demographic shifts and a burgeoning economy will unleash a huge wave of consumer spending in urban China.*

**Diana Farrell, Ulrich A. Gersch, and Elizabeth Stephenson**

**As China's economy** has soared at consistently astonishing rates, many global companies have focused on serving the country's most affluent urban customers. When these well-off urbanites were the only consumers with significant disposable income,[1] this strategy of skimming the cream from the top made sense. But new research by the McKinsey Global Institute (MGI) highlights the emergence of a far larger, more complex segment—the urban middle class, whose spending power[2] will soon redefine the Chinese market (see sidebar, "About the research," on page 68). While some companies are already focusing on the evolution of this new class, many others have yet to broaden their vision and thus risk missing a significant opportunity.

The lure of China's urban-affluent segment is easy to understand. These consumers earn more than 100,000 renminbi (about $12,500) a year[3] and command 500 billion renminbi—nearly 10 percent of urban disposable income[4]—despite accounting for just 1 percent of the total population. They consume globally branded luxury goods voraciously, allowing many

---

[1] Disposable income = after-tax income, including savings.
[2] Spending power or consumption expenditure = disposable income – savings.
[3] All renminbi figures are given in real year 2000 terms.
[4] All data in this article were generated by the Q1 2006 version of an MGI econometric model on Chinese consumer demand.


companies to succeed in China without significantly modifying their product offerings or the business systems behind them. And since this segment is currently concentrated in the biggest cities, it's easy to serve, both for companies now entering the Chinese market and for old hands seeking a steady revenue stream.

However, fixating on the urban-affluent consumer could mean that companies fail to capitalize on the dramatic changes that lie ahead as China's economic growth, barring unforeseen shocks, improves the livelihood of hundreds of millions of its citizens. Over the next 20 years more people will migrate to China's cities for higher-paying jobs. These working consumers, once the country's poorest, will steadily climb the income ladder, creating a new and massive middle class.

Although producers of luxury goods may continue to cater only to the wealthiest households, other companies—especially manufacturers of mass consumer goods—can win the bigger prize by broadening their focus to include the emerging middle class. Because tomorrow's middle-class consumers are today's urban workers (dispersed across many cities and still relatively poor), serving them will naturally require a company to change its strategy significantly. Early movers, such as Coca-Cola and P&G, have already begun creating models to target this segment profitably.

### Recognizing tomorrow's middle class

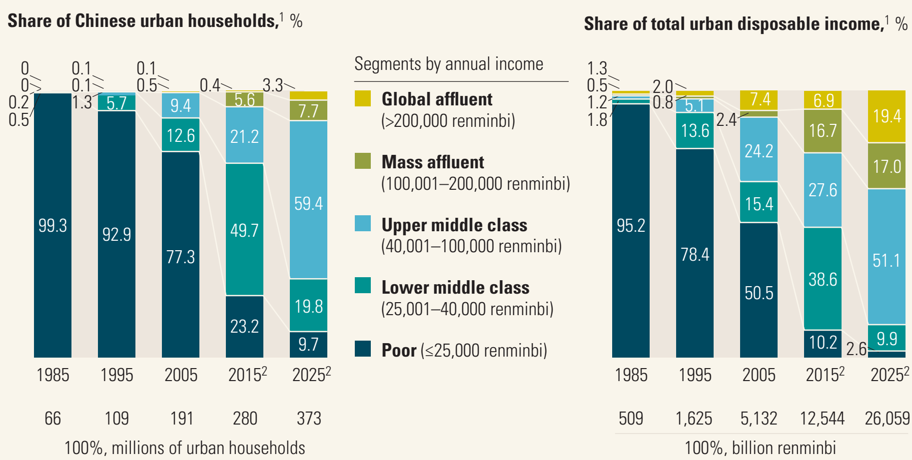
The rising economy in China will lift hundreds of millions of households out of poverty. Today 77 percent of urban Chinese households live on less than 25,000 renminbi a year; we estimate that by 2025 that figure will drop to 10 percent (Exhibit 1). By then, urban households in China will make up one of the largest consumer markets in the world, spending about 20 trillion renminbi annually[5]—almost as much as all Japanese households spend today.[6] Furthermore, since these estimates were calculated at today's tightly

[5] Urban households will, on average, save slightly more than 20 percent of their total disposable income each year, translating into annual savings of 6 trillion renminbi in 2025.

[6] According to the Organisation for Economic Co-operation and Development (OECD), Japanese household consumption was $2.7 trillion in 2004.

EXHIBIT 1

**Spending power is on the rise**




[1]Some figures do not sum to 100%, because of rounding; disposable income = after-tax income, including savings; real renminbi, base year = 2000; 1 renminbi = $0.12.
[2]Base case forecast, Q1 2006.

Source: National Bureau of Statistics of China; McKinsey Global Institute analysis

managed exchange rates, they may significantly underestimate China's future consumer purchasing power.[7]

Rapid economic growth will continue to transform the impoverished but largely egalitarian society of China's past into one with distinct income classes. This evolution is already creating a widening gap between rich and poor, and tackling the resulting social and economic tension has become a focus of government policy. Our projections indicate, however, that China will avoid the "barbell economy" that plagues much of the developing world: large numbers of poor, a small group of the very wealthy, and only a few in the middle.[8] Even as the absolute difference between the richest and poorest continues to widen, incomes will increase across all urban segments.

As this economic tide rises, we anticipate two phases of steep growth in the middle class, with waves of consumers in distinct income brackets emerging and receding at specific points (Exhibit 2, on the next page). The first wave, in 2010, will be the lower middle class, defined as households with annual incomes of 25,001 to 40,000 renminbi. A decade later the upper middle

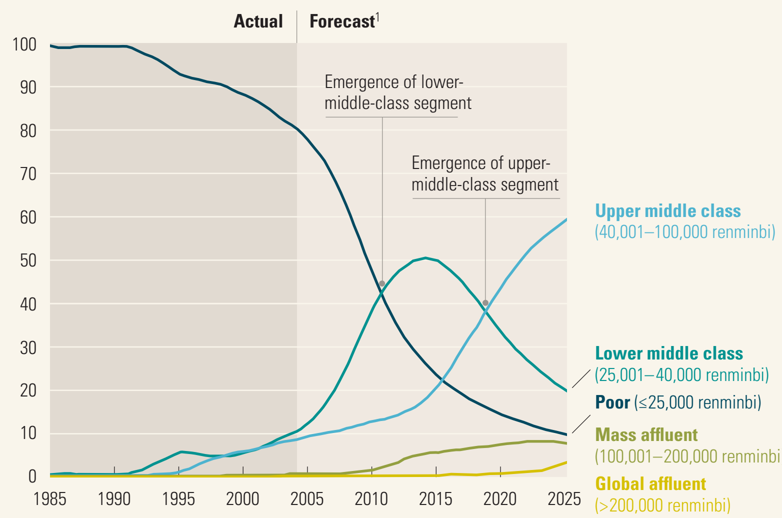
[7]The Chinese government currently manages the renminbi's exchange rate. If the renminbi were allowed to float freely to its natural purchasing-power-parity level, goods at global market prices would become more affordable to Chinese consumers and the total size of the market, measured in US dollars, would be even larger. Some analysts estimate the renminbi's purchasing-power parity at 2.3 to $1, for example, implying an urban Chinese consumer market of $8.7 trillion in real dollars in 2025. By comparison, the US consumer market was worth $7.6 trillion in 2004, according to the OECD.

[8]We project that the Gini Index, a common measure of income inequality, will remain relatively stable in urban China through the next two decades as incomes rise at all levels.

EXHIBIT 2

## The emergence of a middle class

Share of urban households by income class, %




[1] Base case forecast, Q1 2006.

Source: National Bureau of Statistics of China; McKinsey Global Institute analysis

class, with annual household incomes of 40,001 to 100,000 renminbi, will follow. These numbers may seem low compared with consumer incomes in the world's richest countries—current exchange rates and relative prices tend to underplay China's buying power—but such people are solidly middle class by global standards. When accounting for purchasing-power parity, a household income of 100,000 renminbi, for instance, buys a lifestyle in China similar to that of a household earning $40,000 in the United States.

By around 2011 the lower middle class will number some 290 million people, representing the largest segment in urban China and accounting for about 44 percent of the urban population, according to our model. Growth in this group should peak around 2015, with a total spending power of 4.8 trillion renminbi. A second transition is projected to occur in the following decade, when hundreds of millions will join the upper middle class. By 2025 this segment will comprise a staggering 520 million people—more than half of the expected urban population of China—with a combined total disposable income of 13.3 trillion renminbi.

Two features of China's emerging middle class are already particularly notable. First, it will be unusually young compared with that of most developed markets, whose highest earners tend to be middle aged. In the

United States, for example, income generally peaks between the ages of 45 to 54.[9] Since higher-paying jobs, on average, require a higher level of education and training than what older generations have obtained, the Chinese government currently makes substantial investments in higher education for the younger cohorts, meaning that the country's wealthiest consumers will be from 25 to 44 years old.[10]

Second, the urban middle class will dwarf the current urban-affluent segment in both size and total spending power. From 2010 onward we will see some distinct subsegments among the affluent—including the mass- and global-affluent categories—but they will still total only 40 million households by 2025, accounting for just 11 percent of all urban dwellers. Their total consumption will equal 5.7 trillion renminbi[11]—just 41 percent of middle-class consumption.

While total spending by the middle class will exceed that of urban-affluent consumers, the latter will remain a critical market for some companies. These upper-tier households already account for 25 percent of Chinese household savings and will continue to control the bulk of the nation's accumulated wealth—60 percent by 2025. Their importance to banks and other financial-services firms will therefore increase. As in other countries that have under-developed consumer credit markets, Chinese households with sizable savings are the most likely to buy relatively expensive items, such as automobiles and durable goods.

>>> *For more information on serving Chinese consumers, see "A guide to doing business in China" (www.mckinseyquarterly.com/links/22137).*

Nevertheless, the biggest opportunity for companies selling mass-consumer goods and services will be the newly empowered middle class. To serve these households successfully, companies will need to understand how the saving and spending patterns of consumers change as their incomes increase.

## Hitting a moving target

Although the middle class will not reach its full spending potential for nearly 20 years, its household saving and consumption patterns have already begun to take shape. Today China's thrifty households tuck away a quarter[12] of their after-tax income—one of the highest saving rates[13] in the world.

---

9 *Consumer Expenditure Survey 2002*, US Census Bureau.
10 McKinsey & Company's proprietary 2004 personal-financial-services surveys in China.
11 We project that by 2025 urban-affluent households will save 3.8 trillion renminbi, or approximately 40 percent, of their disposable income.
12 "National Bureau of Statistics of China Household Income and Expenditure Survey," *China Statistical Yearbook*, 2004.
13 Household saving rate is measured as a percentage of household disposable income.

Our research suggests that while the emerging middle class will continue to save heavily, they will also spend increasing amounts of money.

A McKinsey survey indicates that the top two reasons for high saving rates in China are concerns about health care and retirement.[14] Although China's social safety net may gradually improve as the country grows richer, ingrained attitudes toward saving will change even more slowly. We project that urban saving rates will decline moderately but remain above 20 percent over the next two decades, boosting total urban consumption by 8.7 percent a year during this period. The growth will be driven not only by the rapidly increasing urbanization rate but also by a substantial (6.1 percent) annual increase in per capita consumption.

As incomes rise, spending patterns change. Families tend to buy more discretionary and small luxury items, and the share of the household budget that goes toward food, clothing, and other necessities shrinks. In China this shift seems to be happening more quickly than it has in other developing countries. For several years now, urban Chinese consumers have dedicated a smaller share of their household budgets to the basics than South Koreans did at a similar point in their country's economic development, for example.[15]

While basics may decline as a share of consumption, in absolute terms they will continue to grow as the overall economy expands. We expect, for example, that urban spending on food[16] will grow by 6.7 percent annually during the next two decades, holding its place as the largest consumption category in urban areas and making China one of the fastest-growing food markets in the world (Exhibit 3). Spending on most other categories will rise faster, however, so food's relative share of wallet will actually decline (Exhibit 4, on the next spread).

Housing and health care will be two of the fastest-growing categories. In many emerging economies consumers spend proportionately less on housing as their incomes increase. Since private ownership of China's housing stock has only recently begun and government subsidies for housing have been reduced, Chinese consumers will have to allocate more of their income to paying for shelter and utilities. These outlays are expected to reach a combined 16.6 percent of household budgets by 2025. In addition, increased home ownership will fuel spending on construction services, building materials, and furnishings. Given the importance of health care to Chinese families, the country's rapidly aging population, and the challenges facing

[14] Kevin P. Lane and Ian St-Maurice, "The Chinese consumer: To spend or to save?" *The McKinsey Quarterly*, 2006 Number 1, pp. 6–8 (www.mckinseyquarterly.com/links/21991).
[15] Measured by real GDP per capita in US dollars.
[16] This category also includes tobacco and both alcoholic and nonalcoholic beverages.

EXHIBIT 3

**What will urban Chinese consumers buy?**

For urban China (real renminbi, base year = 2000)

| Product category | Projected change in absolute consumption, billion renminbi[1]: 2004 | Projected change in absolute consumption, billion renminbi[1]: 2025 | Absolute growth, 2004–25, billion renminbi[1] | Projected compound annual growth rate, 2004–25,[1] % |
|---|---|---|---|---|
| Food[2] | 1,223 | 4,786 | 3,562 | 6.7 |
| Recreation, education | 507 | 3,415 | 2,908 | 9.5 |
| Transportation, communication | 452 | 2,920 | 2,468 | 9.3 |
| Apparel | 369 | 1,322 | 953 | 6.3 |
| Housing, utilities | 321 | 3,313 | 2,992 | 11.8 |
| Health care | 257 | 2,582 | 2,325 | 11.6 |
| Household products | 223 | 857 | 634 | 6.6 |
| Personal products | 119 | 771 | 652 | 9.3 |

[1]Base case forecast, Q1 2006; 1 renminbi = $0.12.
[2]Figures do not sum to total, because of rounding.

Source: National Bureau of Statistics of China; McKinsey Global Institute analysis

the public health care system, we project that private health expenditures by urban consumers will grow at a rate of more than 11 percent annually over the next two decades. This increase in spending will create significant opportunities for health care providers, insurance companies, medical-equipment manufacturers, and pharmaceutical companies.

As incomes rise, Chinese consumers will also devote a larger proportion of their household budgets to educational expenses (such as tuition, tutors, and textbooks)—more than their counterparts in developed countries. This spending will be driven by the strong link between education and higher salaries, as well as by the growing number of options for both higher and vocational education.

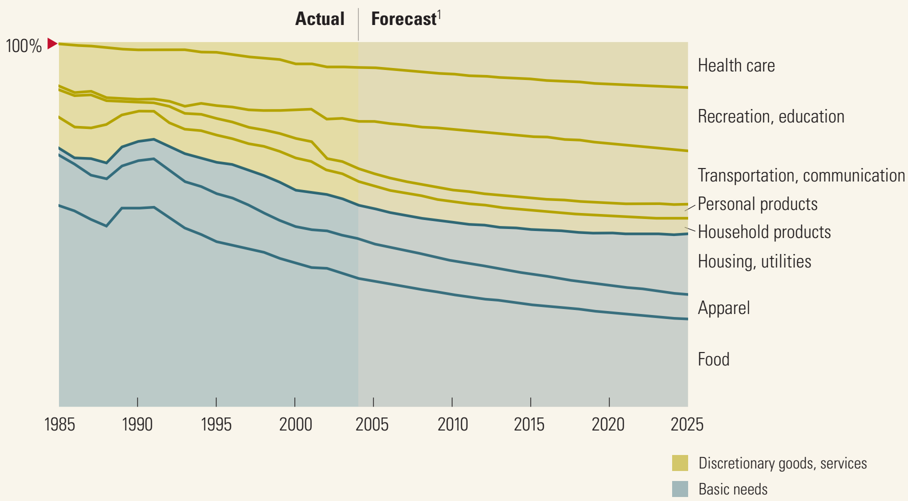
## Serving tomorrow's middle class today

Even companies that understand and anticipate changes in consumer saving and spending patterns may struggle to serve China's growing middle class. While the future of the consumers who make up this segment is bright, they are currently relatively poor and dispersed across cities of all sizes in China. Nowadays they are largely blue-collar workers; over the next 20 years they will increasingly migrate into service and knowledge industries. With an average household income of 17,600 renminbi, these people currently have little discretionary income to spend. Differences in exchange rates mean that products with components purchased on the global market rather than

EXHIBIT 4

**A changing share of wallet**

Relative share of urban consumption categories over time, %




[1]Base case forecast, Q1 2006.
Source: National Bureau of Statistics of China; McKinsey Global Institute analysis

## About the research

The McKinsey Global Institute used an econometric approach to project income growth across different segments of China's population and to assess the implications for household spending in 18 major consumption categories. Specifically, we built a proprietary database of information on Chinese income, savings, and consumption patterns using primary data from the National Bureau of Statistics of China and other sources. We focused on urban Chinese consumers, rising from 42 percent of the total population today to more than 60 percent by 2025. Our numerical estimates were complemented by consumer research across cities of all sizes in China, as well as insights gained from our experience on the ground.

For variables such as GDP growth and inflation, we formulated a base case scenario resting on a mutually consistent set of consensus estimates. We assumed average growth of 6.5 percent in per capita GDP from 2005 to 2025 (a midrange forecast), with higher annual growth initially but slowing after 2015. We also assumed an absence of major exogenous shocks to the economy. Certain events—for example, a dramatic shift in exchange rates, an avian flu epidemic, or the disruption of the government's market-friendly policies—could make our GDP assumptions overly optimistic. Conversely, other factors (such as increased labor productivity, a more efficient capital allocation, or land reform) could make them too conservative. An analysis of the scenario for Chinese urban disposable income in 2025 therefore indicates a wide potential range of 16.9 trillion to 39.4 trillion renminbi.

For more detailed information, see the McKinsey Global Institute's Web site, at www.mckinsey.com/mgi.

sourced domestically will usually be too expensive for them. This limitation applies not only to manufactured and imported goods but also to services, such as international travel.

Despite such obstacles, some companies have already begun targeting urban working households. As incomes rise, new entrants will find more profitable opportunities to accompany these consumers up the growth curve. By serving them today, businesses will gain the exposure and experience necessary to stay relevant as the incomes—and tastes—of urban consumers evolve.

Given the challenges of such a rapidly changing market, some companies have already had to think creatively about lowering product costs, reconfiguring business systems, and shifting to local sourcing strategies. The German retailer Metro, for example, keeps costs down by sourcing 95 percent of the products for its Metro China shops from domestic suppliers. Even a successful formula for current market conditions can soon become obsolete, however. Companies that target current urban working consumers—say, by reducing prices and repositioning products for lower-end segments—may find that these customers will abandon the brands as soon as their pocketbooks allow. To avoid this trap, several companies have adopted multitiered branding strategies, enabling them to follow their customers up the income ladder. P&G, for example, offers more affordable Olay products in supermarkets and hypermarkets and high-end lines such as Olay Regenerist in department stores.

China is evolving from a relatively monolithic, poor country into a vibrant marketplace with complex and rapidly developing consumer segments. Instead of focusing mostly on urban-affluent customers, who are just the tip of the consumer iceberg, more companies should adjust their strategies to include the emerging middle class as a core customer segment. This approach poses many challenges, but for companies that anticipate the changes that lie ahead, the opportunities will be as vast as the country itself. Q

The authors would like to acknowledge the contributions of their colleagues on the McKinsey Global Institute China demand team—Jonathan Ablett, Eric Beinhocker, Ezra Greenberg, Grace Hu, Yuan Luo, Jani Moliis, and Vivien Singer, and of Geoff Greene, an external adviser to MGI—as well as Kevin Lane and Ian St-Maurice.

•

**Diana Farrell** is director of the McKinsey Global Institute, **Ulrich Gersch** is a consultant in McKinsey's New York office, and **Elizabeth Stephenson** is a consultant in the San Francisco office. 

E-mail this article to a colleague
www.mckinseyquarterly.com/links/22060