

# Strategic Analysis Paper

28 February 2013

## China's Emerging Middle Class: Challenges and Opportunities

**John Boulter**

*FDI Research Analyst*

### Key Points

- There is no universally agreed upon definition of middle class but, regardless of the definition used, the Chinese middle class is growing.
- Incomes are grossly under-reported in China, thus obfuscating estimates of the numbers of middle class and affluent citizens.
- China risks stagnation of its GDP growth if the middle class does not rise to an adequate percentage of the population. The emergence of a robust middle class is threatened by considerable income inequalities and an unfair playing field.
- High savings rates among those with disposable income are contributing to global financial imbalances. The Chinese central government is taking steps to encourage domestic spending by expanding the social safety net.
- Australia can capitalise on China's growing middle class in such export areas as minerals, agricultural commodities and technology, biotechnology, tourism and medical technology.

### Summary

The middle class in China is often mentioned in the media; defining the middle class and determining the pace of its development, however, is subject to much debate and contention. The rising numbers in Asia's middle class are also expected to be a boon for the Australian economy, especially in the tourism sector.

How is the middle class defined? What will be the implications for China and the rest of the world? Commentators often say that China needs to rebalance towards more domestic consumption, to fix current global financial imbalances. Rising incomes in China may be good for world financial stability, but not necessarily for Chinese political stability.

## Analysis

### ***Defining the Middle Class***

Defining the middle class is a difficult proposition. It generally means different things to different people, across different countries and in different periods in history. Economists tend to define the middle class in terms of income, but even here there is a wide range of definitions. Other social scientists tend to use other indicators, such as education and occupation, to define the middle class.

One way to define it in a specific country is to take the median income and then calculate a range around it, for example, 75 per cent to 125 per cent of the median. This is rather pointless, however, when trying to look at the middle class across countries. One might be tempted to do the same for the whole world, but world household median income is US\$1,225 per year, hardly considered a median income in a developed country such as Australia.

In 2006, the McKinsey Global Institute defined a Chinese middle class household as one earning between 25,000 and 100,000 *yuan* per year. This equates to between \$3,800 and \$15,000 per year at current exchange rates and would be considered very low in Australia. In purchasing power parity terms, however, this figure would be considerably higher, as goods and services are much cheaper in China than they are in Australia; but it would still be below what an Australian would call middle class. A Chinese consumer, however, may be able to live quite comfortably in this range and, for example, afford to eat out regularly.

The Asian Development Bank defines the middle class as individuals earning between US\$2 and US\$20 per day in purchasing power parity (PPP) terms. This definition is hard to accept when the poverty line, as set by the World Bank, is individuals earning less than US\$1.25 in PPP terms. This suggests that, by this measure, people earning US\$2 per day may be able to feed themselves and have a roof over their heads, but should still be considered poor. A person should be considered middle class if they have a substantial amount of disposable income to spend on some small luxuries.

In a paper for the Organization for Economic Co-operation and Development, Homi Kharas, an economist who is now deputy director at the Brookings Institution, defines middle class as households that earn between US\$10 and US\$100 per day in PPP terms. Kharas himself admits that his definition is rather arbitrary. He also offers an alternative nomenclature – “the consumer class” – which points to the real reason that developing countries wish to study the middle class in China and in Asia more generally. In Australia, we are usually concerned about demand for our products. The common theme to most definitions of middle class therefore tends to be discretionary spending. To be middle class, a consumer

must have a reasonable amount of disposable income. If we are framing the question of what is middle class in terms of social unrest or demand for better governance, however, measures of education levels may be of more use.

Even after having decided on a purely economic definition, pinning down the middle class in China is difficult. The amount of graft committed by officials and judges means that a significant proportion of income goes unreported. Tax evasion is also widespread; being well connected means being able to sidestep income tax. In 2010, a Credit Suisse-sponsored report by Wang Xiaolu, an economist and deputy director of the National Economic Research Institute based in Beijing, has some interesting estimates on the size of the “grey economy” in China. The term grey economy is used as a catch-all to describe illegal and quasi-legal incomes. For example, “red packet” gifts of money, an overwhelmingly common cultural practice, may be exceptionally generous at the weddings of children of government officials – a thinly veiled bribe. A friendly game of mah-jong with a customs official might be necessary to get shipments through smoothly; the stakes will be high and the entrepreneur will make no effort to win (note that gambling is illegal but widespread in China). The term “grey” income also refers to straight out corruption; although it might not be possible to prove that the money gained was ill-gotten. Wang’s report estimates that grey income totals 15 per cent of national income and that disposable income per capita is approximately 32,000 *yuan* – almost double official figures. This should be kept in mind when analysing the consumer power of the middle class.

### ***Middle Class Projection to 2030***

No matter the definition used, there is little doubt that the middle class is growing. Wang uses the Kharas definition of middle class households, with daily expenditures of between US\$10 and US\$100 in purchasing power parity terms, and assumes reasonably consistent GDP growth. He predicts that the middle class will rise from just over ten per cent of the population in 2009 to over 40 per cent in 2020 and over 70 per cent by 2030. Expectations of continued strong GDP growth to 2030 may not be a given, but there is at least the potential for such growth, as GDP per capita in China is still significantly lower than other advanced Asian economies, such as South Korea or Japan.

### ***Avoiding the Middle Income Trap***

The middle income trap is the phenomenon experienced by countries such as Brazil and South Africa, where GDP per capita is stuck at a level substantially lower than that attained by developed nations. It typically occurs because a country can no longer compete with poorer countries in low skill manufactures due to its wage increases, but equally does not have the technical expertise to compete with developed countries in high value products. Somewhat ironically perhaps, the lack of a big middle class is often described as a major contributor to a country finding itself in the middle income trap. The middle class tends to drive a substantial proportion of consumption and, additionally, is the source of entrepreneurship, a necessary requirement for the growth of more advanced industries. There is no guarantee that China, now considered an upper middle income country, will avoid this. Therefore, it is important to look at the extent of income inequality in China and

the efforts underway to reduce it. If it is not addressed, it may be a significant constraint on the growth of the middle class in China.

Kharas and Ghertz, in *The New Global Middle Class: A Crossover from West to East*, provide some suggestions on how to ensure further growth of the middle class. An increase in the state safety net, mentioned above, would boost consumption and increase numbers and wages in the manufacturing and services sectors. They suggest that instead of profits from state-owned enterprises being reinvested in the enterprises, they instead go back to Treasury to lower the tax burden on middle income earners. This would increase incomes and again boost consumption, increasing the numbers that could be attributed to the middle class. Others suggest that reform of the financial sector could bring about significant change. At present, small to medium sized firms have limited access to credit, as the state-owned banks have very stringent rules placed on lending policy, which generally speaking favours other large state-owned firms. Making finance available to smaller operations would allow this sector of the economy to grow and create more middle class jobs.

### ***Income Inequality***

One challenge to the rise of the middle class is income inequality. As Wang Xiaolu puts it: 'If you reduce income inequality, you can improve domestic consumption.' A high degree of income inequality means lower numbers of middle class citizens, as more wealth is held by a small percentage of affluent individuals. The Gini coefficient is a widely used measure of income equality. It is measured between zero and one, with zero indicating the highest level of equality and one the greatest measure of inequality. In 2009, Brazil and South Africa, two countries considered to have fallen into the middle income trap, had Gini coefficients of 0.55 and 0.63 respectively. Chinese government sources recently reported that China has a Gini coefficient of 0.474. Some economists believe that when Gini coefficients are over 0.4 they breed political instability. Another estimate, based on surveying households, puts it at 0.61; others believe it is even higher, as the super-rich are usually unavailable for surveys. In addition, they are unlikely to be willing to disclose their true income due to the "grey income" issue.

Much as in the United States, where wealthy Wall Street tirelessly lobbies the federal government against curbing financial industry excesses, the wealthy in China strongly oppose any concrete changes to put more money in the pockets of those that have less. A state plan to reduce inequality has taken eight years to develop and has been significantly weakened by opposition from state-run firms. Those in power grow rich under the status quo and so there is little incentive to change. State-owned enterprises receive subsidies and have advantages such as a monopoly over sectors that allow them to make large profits. Generally speaking, most dividends paid to the state are generally reinvested back into the company. Politicians and directors connected to the upper echelons of these state-owned enterprises, grow rich through their connections.

Rural-urban income disparity remains a big contemporary issue in China. In 2010, the urban mean disposable income was more than three times the rural level; 19,100 *yuan* compared with 5,900 *yuan*. This large rural-urban disparity can, in part, be attributed to the central

government's recent history of promoting investment in urban areas. A rebalancing of growth towards rural sectors will be necessary to lift rural residents into the middle class.

### ***Imbalances in the Chinese Economy***

The lack of a social safety net in China requires its citizens to save more to provide for future illness, education for their children and retirement. This means that a rise in incomes in China does not bring about the same consumption changes as a similar rise in incomes elsewhere. In fact, the household saving ratio has increased from 27 per cent of disposable income in 2000 to 38 per cent in 2007, which has produced lower than expected consumption growth in the context of rapid GDP growth. Nevertheless, due to that rapid GDP growth, consumption has been rising.

Explanations of high savings rates generally focus on the fact that China has a poor social safety net. Funds are put aside to cover future ill health, children's education and retirement. Chinese children are also expected to support their parents, so money needs to be put aside for their potential ill health too. In urban areas there is usually no sibling to help with support.

Another factor is demographic; a high proportion of the population is of working age and tends to save more. As the population ages (in China this phenomenon is expected to be severe), this factor should reduce saving rates. Shang Jin-Wei from *Forbes* magazine posits that China's extreme gender imbalance is also a significant factor; being financially secure is highly beneficial for men trying to attract a partner in a highly competitive market.

Apart from reducing consumption increases, the high saving rates in China have contributed to global financial imbalances. The high savings rate in China (and Asia more generally) has been referred to as the 'global savings glut'. Many economists consider it a major factor in the global financial crisis. A large amount of savings funnelled into OECD countries with deep capital markets has lowered long-term interest rates to extraordinarily low levels and helped to fuel a property price bubble which subsequently burst with devastating results. There are concerns that this global imbalance has yet to be addressed. China still has an underdeveloped capital market and savings rates continue to be high. With the middle class growing, it appears that the savings glut may get worse before it gets better, perhaps leading to more destabilising asset bubbles.

The Chinese Government is taking steps towards financial liberalisation and is also working on increasing the social safety net. Existing social security programmes are generally still in pilot stages and not big enough to make a dent in the saving rate. The Economist reported in 2012 that the foundations of social security exist, but it is mostly very basic, with some pensioners receiving as little as 55 *yuan* per month. The abolition of the *hukou* system, where rural migrants do not have access to city-based services, such as education and healthcare, would also help to reduce saving rates; migrants would have greater access to these services without spending large amounts of money. The central government has been slowly relaxing *hukou* rules.

### ***Emerging Consumption Patterns***

Even with household savings restraining the effect of a sustained increase in GDP per capita, Chinese household consumption has increased, year on year, by around eight per cent in the past two decades.

Rising incomes have brought about an increase in the total quantity of food consumed, as well as a change in the types of food consumed. Daily per capita kilocalorie consumption has increased from 2,580 in the early nineties, to 2,970 in 2005-07. In the same period, the US, by comparison, had a per capita kilocalorie consumption of 3,770. While it is not definite that Chinese consumption will reach similar levels, there is still room for growth.

The Chinese diet has traditionally been rice or wheat-based meals, with vegetables and a very small amount of meat for flavour. Rising incomes have brought about an increased appetite for animal products, a three per cent year-on-year increase in meat consumption over the past five years. This raises concerns about food security in China, as animal products require more agricultural resources to produce, but China's water and arable land resources are already stressed.

Rich Chinese and members of the middle class have been travelling. China's outbound tourism market in recent years has been increasing by about 20 per cent year-on-year. In Australia, the number of Chinese tourists increased by 36 per cent in the year from mid-2011 to mid-2012.

There is a growing demand for luxury goods and consumption of luxury goods is predicted to rise by 18 per cent per year from 2010 to 2015. Although it may seem that this is driven by wealthier individuals, the members of the middle class are also big consumers of luxury goods. They may, for example, save up to buy a Louis Vuitton handbag, as an easily visible sign of success in a country that is all about "face". They are more likely to have cheaper things in their home, where entertaining is not as widespread; the Chinese prefer to treat their friends to a meal at a restaurant. *Euromonitor* says that China will overtake the US as the largest consumer of wine by 2015, on an absolute basis. A big driver of this trend is an increase in the number of women who drink alcohol.

The number of Chinese mobile phone users in 2011 was approximately 770 million, over 20 per cent of had access to the internet through their phones. Just one year later, the total number of internet users across China was 564 million. Such usage has seen an explosion of the micro-blogsphere, the biggest in China is *Sina Weibo*, which has around 250 million users.

### ***Effect of the Middle Class on Political Stability***

In the so-called "Arab Spring", the use of social media is considered by many commentators to have been a key tool in the dissemination of uncensored information and the organisation of protests. The Chinese Government is wary of this and has a blanket block on Western-based services, such as Facebook and Twitter. Weibo is heavily censored, by both an internal team, which risks fines and other sanctions if it is deemed not to have provided adequate censorship, and an external police unit, which watches the internet more generally. As much

as 13 per cent of content is deleted and many search terms are censored. Some criticisms do remain online and it does take some time for censors to get on top of a story. In addition, Weibo might be seen as an important monitoring tool for the central government, especially in keeping an eye on local government developments. Weibo users have become expert in dodging censorship; an entire subculture has emerged, referring to certain events in ways to avoid censorship. There are two schools of thought about Weibo and political stability. One is that it is a controlled way for members of the middle class to let off some steam when they have grievances. The other view is that Weibo is becoming increasingly hard to control and the middle class is becoming more outspoken and more open to different points of view. This may bring about some degree of political instability.

Reports indicate that small-scale demonstrations in rural settings are commonplace in China, usually to do with land rights. It is interesting, however, to note the recent large-scale demonstrations in relatively affluent cities. Late last year, a planned expansion of a refining and petrochemicals facility in Ningbo was scrapped after thousands of people protested. For the moment, such protests are apolitical and are considered “safer” as they are not opposing the state. But as the middle class grows and protests like the one in Ningbo are successful, the possibility of political protests grows. There is a widespread acknowledgement of official corruption, but direct political protests are still absent. A chemical manufacturing plant that has an impact on a middle class citizen’s health may be considered a more direct threat than the politician up the road who is growing rich off the masses. There is another school of thought, however, which says that growth in the middle class engenders more political stability rather than less. This is based on the premise that members of the middle class are conservative and happy with the status quo. This might especially be the case in China, where much of the middle class is made up of bureaucrats and party officials. Some minds might be changed, however, in the event of a recession, something not experienced in China for some time.

### ***Opportunities for Australia***

Australia will not be manufacturing large quantities of goods for members of China’s middle class anytime soon. Manufacturing cars in Australia is marginal at best and the manufacture of white goods is practically non-existent. There are, however, many sectors that Australia can capitalise on. If the Chinese economy continues to grow, there will be continued demand for Australian iron ore and coal. Agricultural commodities and technologies will also be in high demand, as a rising middle class consumes more food, and specifically more meat, at a time when there are serious limitations on food production in China.

Australia is also in a great position to capitalise on biotechnology research, in which it is a world leader. Australian medical expertise and technology is of high quality and should be in high demand as the expanding Chinese middle class demands more access to medical procedures and as the population begins to age. In 2011, Australian exports of medicines were the biggest of the high-tech export sectors, with exports of \$3.74 billion. If Australia continues to innovate in the medical industry, there will be a great ongoing demand for Australian medical products. There may be some scope to grow the medical tourism sector in Australia, but Chinese medical tourists to Australia would probably not include the middle



class, as Australian medical procedures are much more expensive than in other countries that promote medical tourism. At present, the Australian medical tourism industry is very small. If this sector is to grow, that growth is more likely to be from the very affluent in China and the rest of Asia, demanding the highest quality medical treatment. In that regard, Australia has a good reputation and is cheaper and closer than the US, for example; but it will not be able to compete on a cost basis with countries such as Thailand, Malaysia or India, where medical services are much cheaper.

Greater numbers of Chinese tourists can be expected to contribute to an already strong tourism market in Australia. Australia has not had to cope with a huge increase in demand in the tourism sector because the increase in Asian travellers has been offset by the recession in Europe, which has caused a big drop in the number of European travellers. As European markets rebound, Australia must be adequately prepared for a further increase in tourist numbers if it wants to continue to be seen as an attractive destination, including to a growing Chinese middle class.

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