Notions of shopkeepers

Why the new middle classes are so good for their countries' economies.

Most Western businessmen think the middle class in emerging markets matters because of its spending potential. One day those billions of Chinese, Indians and Brazilians will be buying awesome quantities of toothpaste or computers. A global consumer society will be born.

Walking around the stores of Sanlitun Village, a shopping mall in central Beijing, it is tempting to imagine that those dreams are already coming true. Young Chinese couples dressed to the nines ogle the latest computers and BMWs. The architecture looks like a collection of recent international design-award winners: the Apple store a cool glass box, the Adidas one a jagged shard of orange and ochre, all arranged around the obligatory skating rink.

It's magnificent, but it is not the typical middle-class shopping experience. A more representative specimen can be found in central India, a five-hour drive from Hyderabad, on the outskirts of Gulbarga in Karnataka state. This shop, described by Abhijit Banerjee and Esther Duflo, is a dimly lit corner of a family house. The goods are kept in plastic jars: one of snacks, three of sweets, two of chickpeas, 20 teabags, three packs of washing powder—22 products in all. The family also runs a scrap-metal business and earns between $2 and $4 a day. During a two-hour visit, two customers came by. One bought a box of incense, the other a single cigarette.

Yet between them the village shopkeepers and the yuppie shoppers are changing the economies of both their home countries and the globe. Surjit Bhalla reckons that the larger a country's middle class, the faster its economic growth: according to his calculations, a nation's growth rate rises by half a point every time the size of the middle class increases by ten percentage points (so if a country's middle class accounts for 50% of the population, it will, other things being equal, have a growth rate one percentage point higher than a country whose middle class makes up 30%).

Bill Easterly of New York University reaches similar conclusions, though he defines the middle class differently. "Countries with a middle-class consensus", he says, "have higher levels of income and growth…more human capital and infrastructure accumulation…better economic policies, more democracy, less political instability, a more 'modern' sectoral structure and more urbanisation." On his measurement, an increase of one standard deviation in the middle class's share of national income is associated with one extra percentage point of growth per person.

Why should the middle class encourage growth? The simplest explanation is that it doesn't. The middle class and growth go hand in hand because they are both results of something else: economic policies. In essence, the policies that made possible China's vast increase in wealth over the past 30 years were determined by just one man: Deng Xiaoping. There was no frustrated incipient middle class urging change in 1978. It was a similar story in India in 1991: the middle class grew bigger thanks to the willingness of Manmohan Singh, then the finance minister, to tear up the "Licence Raj". At first shrug, the expansion of the middle class seems to be a consequence of change elsewhere, not a cause of anything in its own right.

Avid consumers

Yet there is a handful of reasons for thinking that something special about the middle class itself—some intrinsic quality of middle-classness—contributes to growth, efficiency and the enrichment of a society. The most common argument is that the middle class matters because it does a lot of consuming.

The new bourgeoisie has created an enormous market, even if you ignore wild extrapolations about the future. In 2008 the number of cars sold in the big emerging markets exceeded that sold in America for the first time. In 2007 India had slightly more mobile-phone users than America and China had more than twice as many. Since 1994 business services in a range of emerging markets including India and Brazil have grown by 250-700%; in Europe and America they have roughly doubled.

The newly affluent in emerging markets echo the tastes of the English middle class 150 years ago. They want travel, improved health services, private schools and better public infrastructure. Like the Victorians, they are also keen on self-improvement. On one (conservative) estimate, 30m Chinese children are learning to play the piano. “The discipline will be good,” says one proud mother. On a more frivolous note, Brazil is number one in the world for liposuctions, number two for plastic surgeries (after America) and number four for the number of gyms.

But as Diana Farrell points out, the really transformative thing about middle-class consumption is the signal it sends to producers. The demands of middle-class consumers in the developing world feed investment in new sorts of production, which raises income levels and changes the way business is conducted.

The best-known example is the Nano, the $2,500 car designed by India’s Tata Motors. Until it made its appearance, nobody in the automobile business believed that you could design a proper car that sold for less than about $5,000. By radically simplifying production and by stripping down the design, Tata’s engineers managed to cut that supposed floor price in half.

In the pink

There is no guarantee that the Nano will succeed. It has been plagued by well-publicised production problems. It may not satisfy its target market, being too cheap for the rich who can afford traditional small cars and too dear for the middle classes who currently ride motorbikes.

But if it does take off, it could change car-buying habits around the world. At one-fifth of the price of a cheap family saloon in the West, some American or European families might decide to buy two or even three Nanos instead.

A similar story has emerged in banking. ICICI, an Indian bank, has cut the transaction costs of banking to far below those of its competitors by adding lots of new features to mobile-phone banking and cutting out layers of waste, says the bank's Mr Vaidyanathan. Just five people manage the 250,000 daily transactions processed by ICICI Direct, its online share-trading arm. The cost of mobile-phone banking in India is roughly one-third of what it is in America. This has made it possible for ICICI to reach previously unbanked customers in India's second- and third-tier cities, reaping further economies of scale. Last year it added 4m new customers.

Seen as a market, the new middle class in emerging countries is still relatively poor but very large, so it provides incentives to offer things that are cheap and can be sold in their millions. In terms of its total spending power, though, it still lags well behind its peers in the rich world; nor is that likely to change soon. According to a World Bank study in 2007, the rich (in this instance meaning everyone with an income per person above the average for Italy, wherever they live) accounted for 57.5% of total world income in 2000, a figure that is likely to rise to 69% by 2030 (because the ranks of the rich are swelling, too). The share of world income taken by the global middle class (on $13-50 a day), at 14%, will remain more or less flat between 2000 and 2030. So its role in consumption can be only part of the story.

Keen investors

To grasp the true economic significance of the global middle class, says Daron Acemoglu of the Massachusetts Institute of Technology (MIT), you have to look at the second main reason why it contributes to growth. It is more committed than the elite to a mixed, competitive economy.

For many rulers in poor and middle-income countries, political control is based on control of resources, especially land. The aristocrats of pre-industrial Europe were all landowners. Nowadays the same sort of political control is exercised in oil-rich economies through control of the oilfields and the distribution of oil wealth.

An elite that depends on land or raw materials, argues Mr Acemoglu, tends to be wary of new economic activities that might compete with its source of wealth and erode its political power. And since openness to foreign ideas is the single most important source of new technology and skills in developing countries, a reluctance to invest in new things is also likely to keep an economy more technologically backward, less skilled and more inward-looking. This can suit the elite perfectly well.

Consider Russia since the Kremlin elite expanded its influence over the oil sector under Vladimir Putin (who is now prime minister). The oil industry has lost foreign technical input, the country has become less open to the outside world and the influence of the middle class, already weak, has ebbed further. The Kremlin regards this as a success.

Unlike the Kremlin, the emerging-market middle class does not have a political monopoly to defend. Its members are therefore more willing to invest in businesses and technologies that might offer competition to the elite; they are also more likely to be open to the outside world. So middle-class growth, trade openness and new businesses tend to go together. That is in evidence in China, whose elite is not gorging itself on oil money. There, the cities of the eastern seaboard, especially in the Yangzi and Pearl river deltas, are the fastest-growing, most technologically advanced, most open and also most middle-class areas of the country.

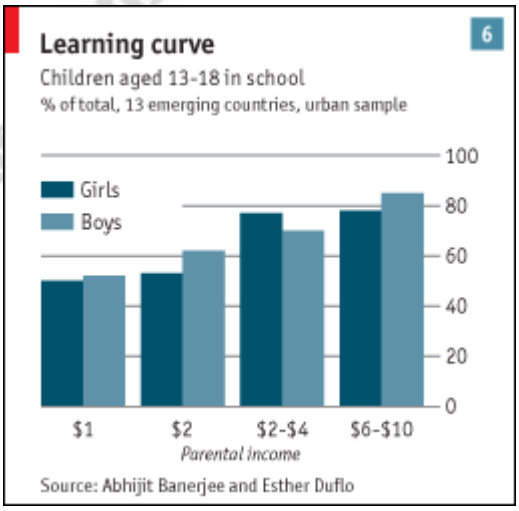
Thanks to this middle-class predilection for investment, China has been able to tread a classic path towards increasing the value of its exports. Starting in the 1980s with labour-intensive activities like simple plastic assembly and mass-market textiles, it moved into more capital-intensive but low-margin electronics and consumer goods in the early 2000s and is now trying to move further up the chain into higher-value electronics and business services. A single town half-way between Shenzhen and Guangzhou, in an area which used to be all collective farms, started off making toys in township and village enterprises and by 2002 was producing 40% of the magnetic recording heads used in hard-disk drives throughout the world.

Something similar is happening in India, albeit in a more confusing manner. Whereas China exports a relatively narrow range of products, India exports all kinds of goods, ranging from those typically made by very poor countries to those produced by very rich ones, and everything in-between. It has huge capital-intensive businesses such as steel and shipbuilding, labour-intensive ones like making T-shirts and farming, and low-capital but high-skill ones such as information-technology services. The mix partly reflects the Indian middle class's willingness to invest in almost anything.

Creating human capital

But aptitude for investment is only part of what makes the middle class important to economic growth. Mr Banerjee of the MIT's Poverty Action Laboratory, who with Ms Duflo did an extensive analysis of the emerging world's middle class, lists three more characteristics that are just as vital.

First, the middle class is committed to education. Current theories about economic growth stress the importance of what economists call "human-capital accumulation". Human capital means more children at school and university, higher educational qualifications, more adult education and healthier lives. The more advanced the economy, the more educated people are needed to control the processes of wealth creation (more computer designers, more logistics technicians and more white-collar workers in general). The richer the country, the higher its human capital, and vice versa.



Education is high on any list of middle-class values. Around the world, parents scrimp and save to send their kids to school and compete with one another to get into the best schools. The middle class invests more in the next generation than do either the poor or, in one way, even the rich. Middle-class families do not take their children out of school to work in the fields or in a sweatshop because they do not need the tiny extra income a child's labour brings in. In several countries, school enrolment rates for children aged seven to 12 in families earning $6-10 a day are twice as high as in families on less than $2. Members of the middle class are also

more likely to let their children stay on at school as teenagers, especially if they live in cities. Among the rural poor, fewer than half have children aged 13-18 in education, whereas among those living in cities and earning over $2 a day the figure is over three-quarters (see chart 6).

The rich in emerging markets certainly believe in educating their own children. But they often do not support universal public education, for fear that this will lead to demands for more democracy and challenges to their political dominance. The middle class in most countries strongly backs state schools.

As you would expect, middle-class families also spend proportionately more money than the poor on their children's education. Mr Banerjee and Ms Duflo sifted through household-spending accounts in 13 developing countries and found that in Nicaragua, for example, those on less than $1 a day spent 5.6% of their income on schooling; those on $2-4 a day spent 8.6%; and those on $6-10 about 9%. Mexico, Peru, Indonesia and Panama all showed a similar pattern.

Part of this extra money goes on keeping children at school for longer, but most is spent on private-school fees or on private tutors after school hours. Especially in India, private schools (many costing as little as 50 cents a day) are springing up everywhere. According to one study, two-fifths of all boys of secondary-school age in urban India are getting some after-school tutoring.

Moreover, these numbers understate how much middle-class people are spending per child. In emerging markets, Mr Banerjee and Ms Duflo found, middle-class families have fewer children than the poor. Among the very poorest (those scraping by on less than $1 a day), the number of children in the household ranged from 1.8 to 3.6 per adult woman. In families that live on $6-10 per person, the average number of children per household was between 1 and 1.3 (these figures do not include China so they are not influenced by that country's one-child policy). The middle class spends substantially more on each child.

The same sort of thing is happening in health care, another aspect of human capital: middle-class people lead healthier lives than the poor, go to the doctor more often and spend more per visit. If investing in human capital is the key to growth, then a large middle class will make that key easier to find.

Natural entrepreneurs

The middle class's third distinctive contribution to growth is its gift for entrepreneurship. "Armed with a capacity and a tolerance for delayed gratification," says Mr Banerjee, new entrepreneurs "emerge from the middle class and create employment and productivity growth for the rest of society."

The middle class is better at entrepreneurship than the elite partly for the reasons cited by Mr Acemoglu: it is more likely to invest in new businesses and more willing to learn new ways of doing things. But that is only part of a wider picture.

The middle class is more numerous and more heterogeneous than the rich, and therefore more likely to produce both a mass of hard-working business people and a few exceptional entrepreneurs: people such as Nandan Nilekani, one of the founders of India's Infosys and Forbes magazine's Businessman of the Year for Asia in 2007; or Li Qinfu, a former Red Guard who built a miniature replica of America's Capitol in Shanghai as headquarters for his textile and manufacturing conglomerate—and put a three-tonne statue of himself on the top.

Most importantly, argues Mr Banerjee, the cream of the middle class is a better source of entrepreneurship than the poor because it can set up companies big enough to create lots of

jobs. Profitable investments often incur substantial fixed costs. The dream of a couple of college kids with a few savings creating an Apple computer in a garage could come true only in a rich country, with a big financial sector and a low-cost distribution system. Emerging markets do not have those.

Businesses owned by the poor—and, indeed, by the poorer end of the middle class—remain resolutely small. Hardly any of the companies owned by people earning less than $10 a day surveyed by Mr Banerjee and Ms Duflo had more than three employees. Most were run by one person. To create companies that employ tens or hundreds of people, you need hundreds or thousands of dollars. If, say, a talented car mechanic in central India or north-west Brazil wanted to set up a string of garages, he might well need $10,000-worth of equipment. In the absence of a sophisticated banking system, his chances of borrowing that sort of money would be remote. So setting up new companies of any size usually requires resources available only to the rich—who may not be interested—or to the well-off middle class. Infosys was created by seven people from this sort of background. One was the son of a schoolteacher, another the son of a textile-mill manager. A third pawned his wife's jewels to help raise money. Infosys now employs 91,000 people.

The middle class's last distinctive contribution to growth comes through its support for the right economic policies and its backing for democracy. That is the subject of the next article.

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