

2010/256-524

## **Short Term Policy Brief 66**

### **The Chinese Middle Class**

**September 2012**

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This publication has been produced with the assistance of the European Union. The contents of this publication are the sole responsibility of ECRAN and can in no way be taken to reflect the views of the European Union.



This project is funded by the European Union



This project is implemented by a Consortium led by Steinbeis GmbH & Co. KG für Technologietransfer

## **Background Briefing: The Chinese Middle Class**

### **Executive Summary**

The Chinese middle class is a relatively new phenomenon having only really begun to seriously emerge in the late 1990s. This middle class has been a result of a growing white-collar employment market, continued urbanisation<sup>1</sup>, a decade of annual wage rises of (on average) +7%<sup>2</sup> and, the opening up of a private property market and a sustained period of overall economic growth for China.

It is this urban, educated, white-collar middle class that has primarily been the main driver of the expansion of China's booming domestic retail consumption market in the last five years. The success of a wide range of European companies from luxury brands such as Louis Vuitton and Chanel, to mid-market fashion brands such as Zara and H&M, as well as food and beverage and car companies is largely due to the growth and spending tastes of the middle class.

The growth of the middle class has been encouraged, and to an extent, 'subsidised' informally by the government to help achieve the target of 'rebalancing' the economy towards greater consumption. In this sense the middle class is an active economic agent but is not highly connected in a socio-political sense around various causes.

However, the middle class, while the major driver of consumption and discretionary spending, does have concerns. These are primarily around social security issues at present – healthcare and pensions being paramount. In an online poll conducted by China's largest internet portal in 2007, Sina, 50% of respondents in the middle class income bracket expected to have to fund their own pension entirely and only 20% believed that they would be able to rely partially on the government pension scheme.

Concerns over the future costs of pensions and healthcare among a middle class with aging

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<sup>1</sup> According to a May 2012 survey by Chinese survey company QQ and UK market researchers Mintel, while most of the middle class are second generation urban resident, 32% grew up outside of cities.

<sup>2</sup> According to the brokerage CLSA Emerging Markets, over the past decade, real urban incomes have risen by 151%.

parents and children could turn into anger at the government for lack of sufficient provision. Similarly, issues of self-protection arise when considering anything that threatens their property or assets - be this infrastructure, development projects or environmental degradation.

Finally, middle class self-protection has also become a more politicised theme as witnessed by middle class anger at the recent spate of food scares.

- The Chinese middle class is, at the present time, ostensibly an economic class rather than a political one, that is to say that its main drivers are economic advancement in order to gain greater personal/family levels of security and self-protection.
- The middle class is fulfilling the role of driving the expansion of the consumption economy. This is helping to 'rebalance' China's economy though this may become less significant as China's economy slows, wage growth is more restrained and the cost of living/inflation rise (referred to by Premier Wen Jiabao as China's 'uncaged tiger').

### **Introduction: Defining the Chinese Middle Class**

In 2012 Chinese middle-income households constituted fully 13.4% of total urban households in China, or approximately 30mn households.<sup>3</sup> This is equivalent to approximately 100mn people. However, this number grows somewhat when grey income is factored in - money that is gained neither through salary nor declared to the tax authorities. Although it is hard, if not impossible, to quantify this significant sum it does mean that the actual number of households with incomes at a level considered to be middle class will be higher than official numbers state.

China's middle class is overwhelmingly, if not totally, urban based. In 2012, China had a total of 421.4mn households nationwide, both urban and rural, and 221.4mn urban households (close to enough to half to show the roughly 50% urbanisation rate now in China).<sup>4</sup> While the Chinese middle class now represents 13.4% of urban households, it represents only

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<sup>3</sup> Research from the Shanghai-based market research company Access Asia and the journal *China Economic Quarterly*

<sup>4</sup> China's National Bureau of Statistics (NBS),

approximately 7% of total Chinese households. This shows that there are still considerable opportunities for growth; the differentiation in growth rates between urban households and middle class households shows that, although urbanisation is now clearly slowing, the number of existing urban households and families moving into the middle income bracket is growing healthily.

A number of factors allow the middle class to enjoy the possibility of home and asset ownership as well as disposable income on relatively low salaries. These include 'grey income', as well various effective 'subsidies' by the State, including low personal taxation rates, a degree of social security cover and insurance, centrally subsidised prices on key items such as food staples and petrol, low public transport costs and low service costs (due to the pool of low-cost labour provided by on-going urbanisation).

A snapshot of the current urban middle class in China would define them as follows:

- A minimum personal income of RMB7,000 (€844) per month in tier 1 cities; a minimum RMB5,000 (€603) per month in tier 2 cities;
- A minimum family income of RMB15,000 (€1,809) per month in tier 1 cities; a minimum of RMB10,000 (€1,206) per month in tier 2 cities;
- Professionally overwhelmingly white-collar office workers in either state or private business (and government), self-employed or small and medium sized enterprise (SME) owners;
- Educated at college level or above;
- Invariably property owners and most likely to be car owners.

### **Drivers of Middle Class Growth**

Significant rural-urban migration has driven rapid growth of the middle classes. A third of the middle class grew up outside of the cities where they now live, which shows the importance of urbanisation to the growth of China's middle class.

Additionally, China's traditionally high savings rate has allowed the new middle class to acquire property, assets and consumer goods as well as travel regionally and internationally. However, what are referred to as 'savings' are actually a more complex issue. Indeed the

term 'savings' is really a misnomer and the persistently high savings rate is effectively a form of self-taxation. The high savings rate (which is highest among the middle income group in China at between 20-50% of gross salary)<sup>5</sup> means that families do have significant reserves of disposable wealth, which must often be used in old age, and for healthcare and emergencies in the absence of a fully-functioning universal welfare state.

Property ownership is a major cornerstone of the foundation of the Chinese middle class and 50% already own their properties outright.<sup>6</sup> The rise of the Chinese middle class is almost synonymous with the opening up of China's property market to private buying and selling in the late 1990s. Property ownership is a major way in which the middle class has been able to grow as continued urbanisation has allowed more new urbanites buy their own homes. With the government's 2012 decision to significantly expand low income housing construction, more Chinese than ever before will become new home owners – the central government's targets are 5mn affordable apartments to be built by end of 2012, with a goal of reaching 36mn units by the end of 2015.

Crucially the Chinese middle class is working hard to pay off their mortgages as quickly as possible which, when achieved, frees up cash for discretionary spending. With 50% of the Chinese middle class already in ownership of their properties outright and new legislation preventing multiple purchasing of properties for speculation, this will free up additional money for future spending.

### **The Middle Class and Consumption**

Beijing's stated long term economic policy goal is to 'rebalance' China's economy by encouraging more consumption to offset the traditional reliance on the export economy and inward investment. The middle class is obviously key to this aim and is the major driver of most mid- to high-end consumer markets including cars, electronic appliances (brown and white goods), luxury goods and fashion, as well as imported food and beverage products (a key area for European companies).

The Chinese middle class consumer is demanding and, while willing to spend, looks for

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<sup>5</sup> QQ/Mintel 2012 Survey

<sup>6</sup> QQ/Mintel 2012 Survey

quality and innovation. Ownership of smartphones among China's middle class is almost universal<sup>7</sup> and they are the heaviest users of China's fast emerging e-commerce market.

However, one potential risk with this fast growing period of consumption is that while growth was initially cash-based it is now increasingly credit-driven, as Chinese banks and consumers discover various forms of credit – mortgages obviously, but also loans, hire purchase and credit cards. 43% of China's middle class now have one credit card and 52% more than one.<sup>8</sup> More worryingly, according to China's Central Bank, since 2010, the six-month overdue credit card debt rate has risen by more than 14%.

### **The Middle Class and the Environment**

Concern for the environment appears to be rapidly becoming a key middle class concern. Middle class Chinese have shown themselves to be increasingly supportive of grass-roots environmental movements with both money (donations) and time (volunteering). The range of issues is obviously broad – air, water, earth quality as well as species protection, waste and industrial pollution.

Additionally, the middle class has become more vocal on issues that it feels directly affect it or its assets. This is effectively another form of self-protection – maintaining a good property resale price can be as important as hygiene. And here the middle class has uncharacteristically been quite vocal in complaining and protesting. Examples have included the demonstrations in Shanghai around extensions to the Maglev train (a project involving several EU-based companies) and its proximity to properties and potential detriment to the health of residents nearby and the Xiamen PX case, a controversial petrochemical project begun in 2007 in southern China that was halted after a series of unprecedented demonstrations, mostly by middle class people.

Mr Pan Yue, a Vice Ministers within China's Ministry of Environmental Protection, told the western media in the aftermath of the Xiamen PX case, "The Xiamen PX Project is not a victory of people's opinion, but manifested a systematic problem. It shows the demands of

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<sup>7</sup> 95% according to QQ/Mintel

<sup>8</sup> QQ/Mintel 2012 Survey, backed up by similar numbers from MasterCard's own research.

the middle class on the environment. It shows the relationship between the environmental assessment, middle class and the environment.” It seems the Party has recognised middle class concerns about the environment.

### **Middle Class Self-protection Strategies**

Self-protection strategies can take many forms – educating children overseas (often in Europe); closely reading packaging labels; going organic; not buying goods in sectors where fakes and tainted products are common, such as infant formula or pharmaceuticals; buying goods overseas when travelling (‘arbitraging’); and seeking out imported food, beverage and other products, considered to be of a higher standard than local equivalents. This is a trend that European manufacturers are able to take advantage of in many areas. For instance, European brand household chemicals are considered more effective in promoting hygiene and killing germs thereby ‘protecting’ families.

Much of this activity has been the result of middle class fear of tainted products following repeated scandals around infant formula, milk and numerous other products that have become popular with middle class consumers.

Some of these self-protection strategies can seem innocuous – for instance the rise in Fairtrade products, organic food and official certification of products. Chinese consumers, when they can afford it, are trading up to ‘organic’ and ‘green’ produce as a potential way to self-protect – 80% are willing to pay more for organic and 87% more for ‘green’ products.<sup>9</sup> Similarly there is the small emergence of a Fairtrade movement in China too which consumers appear willing to pay more for; though this is at an extremely nascent stage at present. European manufacturers and brands potentially involved in food scares could, at best, find themselves with PR problems in China and, at worse, legal action taken against them. However, there are opportunities for European organic and green food concerns as well as local and regional certification bodies to become more involved in China’s troubled food sector.

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<sup>9</sup> QQ/Mintel Survey

## Conclusion

The Chinese middle class has arrived and is still growing and developing. Its future growth will not be a repeat of the last decade as China's economy slows, wage growth tapers off, the country's demographics fundamentally shift to an older weighted society and urbanisation slows. A slowing economy may have some detrimental effects on the middle class – wage growth combined with a rising cost of living and added inflationary pressure may curtail spending at the least, but could also lead to a rise in unemployment, mortgage defaults, credit non-repayment and a 'debt overhang' at worse. Ensuring that European banks with exposure to major Chinese lenders are aware of this scenario will be important for long term planning.

Ultimately the growth in both middle class numbers and middle class spending will increasingly come from tier 2 cities, as wealth filters outwards from the coastal cities in China promoting social movement upwards. This will take some time, particularly in an economy with more restrained growth rates, but China's society and consumer base should start to look more diamond-shaped (a few rich, a few poor and most people in the middle) rather than its current more pyramidal shape. This should be encouraging news for European brands across the board from cars and luxury goods, to everyday items (soap, shampoo, diapers, etc.) and fashion, as more middle class shoppers enter the consumer market.

- While presently the Chinese middle class is driven primarily by economic objectives – acquisition of property, financial savings and assets in order to provide security and self-protection – it is increasingly starting to realise that certain political ends are necessary to ensure this protection.
- Primary among these political goals are improvements in the legal system to protect assets, primarily personal property, savings and small businesses. But this political engagement is starting to move into areas that can be characterised as NIMBYism such as industrial project planning permission (i.e. Xiamen PX), infrastructure planning (i.e. Maglev extensions close to housing compounds) and general environmental degradation that threatens the ability to self-protect (i.e. water and air quality).



- The middle class has also shown itself to be particularly sensitive to ‘scares’ that may threaten it – for instance food scares.
- Members of China’s middle class may not yet be fully aware of their shared concerns and values – NIMBYism, environmentalism, concerns over food scares and economic growth, etc. However, they do have the ability to connect up various campaign issues if they wish through almost universal access to means of communication such as smartphones and the internet.

### **Policy implications**

The EU needs to be aware that the key consumer group driving growing consumption of European products and services in China is the new emerging middle class. This middle class consumer group is highly aware of the origin of the imported products/services that they purchase and increasingly look to self-protect through buying products perceived to have high production and safety standards. Therefore, a Europe-wide effort to persuade the Chinese middle class consumer that European standards are high in terms product safety and reliability could be beneficial. Convincing the Chinese middle class consumer of this should yield a strong brand image for “Made in Europe” products and ultimately sales.

Middle class Chinese parents are increasingly keen for their children to study abroad; after the USA, the UK is second choice, with non-English speaking Europe third. The EU should be aware that this desire to study abroad continues to grow and that much of the decision-making process about where to study is often based on ease of access to visas. It is generally agreed that Australia has become a more desirable overseas study location of late due to easy visa issuance; European border control authorities need to see Chinese students as a key group of visa applicants.

The EU should also appreciate the growing global spending power of the Chinese middle class as it travels abroad and increasingly shops overseas. Europe is a target destination for aspiring middle class Chinese shoppers and they are keenly aware of both visa limitations in some markets (i.e. the UK), as well as the ability to claim tax back when leaving the EU (allowing them a significant discount on mandatory high luxury taxes in the PRC).

As demonstrated above the emerging middle class is becoming increasingly concerned about a number of issues that could lead them to become more politically engaged than at present. Primary among these are the environment and its potentially adverse impact on health and lifestyle. Additionally the other set of issues that are of most concern to the emerging middle class are social welfare issues, in particular healthcare and pensions. Beijing is aware of this discontent and is keen to seek advice, often from European countries and the EU, on potential alternative funding systems for healthcare and pensions.