



# The 'Bird of Gold': The Rise of India's Consumer Market

May 2007

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# Preface

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This report is the product of a year-long research project conducted by the McKinsey Global Institute (MGI) in collaboration with McKinsey's Global Strategy Practice and McKinsey's offices in India.

Eric Beinhocker, a senior fellow at MGI based in London, worked closely with me to provide overall leadership for the project. The project was managed initially by Ulrich Gersch and then by Sumit Gupta, engagement managers in New York and Silicon Valley respectively. Ezra Greenberg, a specialist with MGI in Washington, DC, led the econometric modeling team which included Jonathan Ablett, a senior research analyst, and Geoffrey Greene, an independent econometrician based in Washington, DC.

The team also included several members of McKinsey's India office and the McKinsey Knowledge Center and we are grateful for the efforts of Aadarsh Bajjal, Anupam Bose and Shishir Gupta. In addition, we would like to recognize the work done by Elizabeth Stephenson, Ambika Walia, Avinash Chandra, and Ashish Garg in laying the groundwork for this project.

The report would not have been possible without the support and expertise of partners in McKinsey's offices in Delhi and Mumbai. We owe particular thanks to Adil Zainulbhai, Subbu Narayanswamy, Ireena Vittal, Leo Puri and Ranjit Pandit. In addition, our work has benefited tremendously from in-depth discussions with Gautam Kumra, Shirish Sankhe, Noshir Kaka, Pierre Avanzo, Tilman Ehrbeck, Peter Haden, Vipul Tuli, Palash Mitra, Rajiv Lochan and Prashant Gupta.

Moreover, we would like to thank Janet Bush for her editorial efforts, Martha Laboissiere for shepherding this report through production, Rebeca Robboy and

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Sunali Rohra for their assistance with external relations, Deadra Henderson, MGI's practice administrator, Terry Gatto, Sara Larsen and Sian Stockley, our executive assistants, and McKinsey's production services for their much-appreciated contributions.

Finally, we could not have undertaken this work if it were not for the National Council of Applied Economic Research (NCAER) in India, whose historical survey data provided a critical contribution to our income and consumption model. We would like to express our sincerest thanks to Dr. Suman Bery, Director General of NCAER, and Dr. Rajesh Shukla, senior fellow at NCAER, for acting as advisors on this project.

This report is a companion to a similar study we conducted on China's consumer economy, *From 'Made in China' to 'Sold in China': The Rise of the Chinese Urban Consumer*, published in November 2006. Our goal with both studies is to provide business leaders and policy makers with a fact-base and insights into one of the most important trends in the world economy over the next two decades—the integration of well over a billion new consumers from emerging economies into the global marketplace. As with all MGI projects, this work is independent and has not been commissioned or sponsored in any way by any business, government, or other institution.

Diana Farrell  
Director, McKinsey Global Institute  
May 3, 2007  
San Francisco

# Executive summary

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India's economic growth has accelerated significantly over the past two decades and so, too, has the spending power of its citizens. Real average household disposable income has roughly doubled since 1985. With rising incomes, household consumption has soared and a new Indian middle class has emerged.<sup>1</sup>

Yet much remains unknown about how India's consumer market will evolve in the future. Will Indian incomes continue to keep pace with overall economic growth? How will the distribution of incomes change? Who will benefit most from growth? How big is India's middle class today and how large will it become? How will income be distributed geographically? What will Indians spend their new-found wealth on, and which industry sectors will be the winners and which the losers from changing spending patterns?

To answer these questions the McKinsey Global Institute (MGI) undertook a year-long study to examine the future of the Indian consumer market. We assembled a proprietary database of 20 years' data linking macroeconomic and demographic variables to Indian incomes and consumption behavior. We made extensive use of our exclusive access to the Market Information Survey of Households (MISH) database created from income surveys conducted by the National Council of Applied Economic Research (NCAER) covering over 300,000 households, as well as the National Sample Survey Organization (NSSO) household consumption database created from consumer expenditure surveys across thousands of villa-

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<sup>1</sup> R.K. Shukla, S.K. Dwivedi, and Asha Sharma (with assistance from Sunil Jain), *The Great Indian Middle Class: Results from the NCAER Market Information Survey of Households*, National Council of Applied Economic Research (in association with Business Standard), 2004, (<http://www.ncaer.org/Downloads/PublicationsCatalog.pdf>).

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ges and urban blocks. After integrating the MISH and NSSO data with our own dataset, we constructed an econometric model to forecast Indian household income and spending from 2006 to 2025.

Our analysis shows that if India continues on its current high growth path, over the next two decades the Indian market will undergo a major transformation. Income levels will almost triple and India will climb from its position as the 12th-largest consumer market today to become the world's fifth-largest consumer market by 2025. As Indian incomes rise, the shape of the country's income pyramid will also change dramatically. Over 291 million people will move from desperate poverty to a more sustainable life, and India's middle class will swell by over ten times from its current size of 50 million to 583 million people. By 2025 over 23 million Indians—more than the population of Australia today—will number among the country's wealthiest citizens. While much of this new wealth and consumption will be created in urban areas, rural households will benefit too. Annual real rural income growth per household will accelerate from 2.8 percent over the past two decades to 3.6 percent over the next two. Indian spending patterns will also evolve, with basic necessities such as food and apparel declining in relative importance, and categories such as communications and health care growing rapidly. But in order for India to achieve these positive results, the country must continue to reform and modernize its economy, as well as address significant shortfalls in its infrastructure and education system.

We briefly outline these findings below. Readers interested in the detailed results and analyses are directed to the main chapters of the report, while those interested in our methodology, assumptions, data sources, and category-specific results are directed to the appendices.

### **INDIAN INCOMES WILL ALMOST TRIPLE OVER THE NEXT TWO DECADES**

Forecasts for India's real GDP growth rate over the coming two decades generally range between 6 and 9 percent per year. Our base case assumes real compound annual growth of 7.3 percent from 2005–2025, a marked acceleration from the 6 percent growth of the previous two decades.<sup>2</sup> We believe this optimism is justified because of the substantial scope for continued productivity increases in Indian businesses, the growing openness and competitiveness of the Indian economy, and favorable demographic trends.

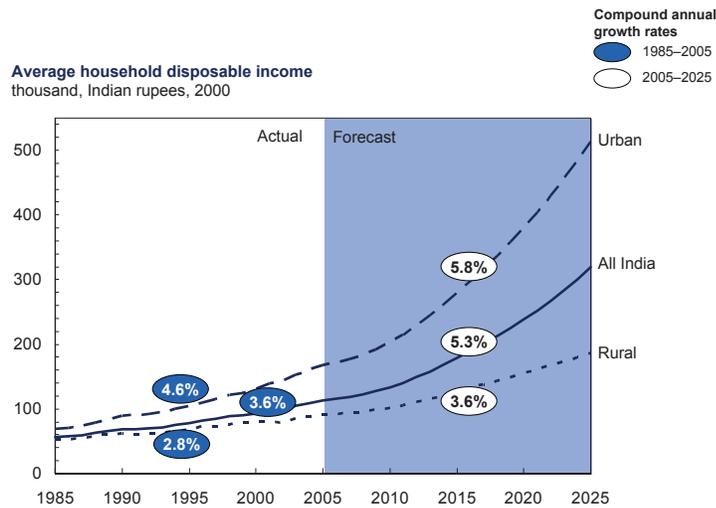
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<sup>2</sup> Our forecast of GDP growth is derived from a macroeconomic model developed by Oxford Economics. Unless otherwise noted, growth figures are reported as real compound annual growth rates (CAGR) and thus may appear somewhat lower than the nominal average annual growth rates that are often reported.

Our analysis shows that if India does in fact achieve this growth path over the next 20 years, Indian income levels will almost triple. Average real household disposable income will grow from 113,744 Indian rupees in 2005 to 318,896 Indian rupees by 2025, a compound annual growth rate of 5.3 percent (Exhibit 1).<sup>3</sup> This is significantly more rapid than the 3.6 percent annual growth of the past 20 years—and with the exception of China, much quicker than income growth in other major markets. For example, US average real household income increased at a compound annual growth rate of 1.5 percent over the past two decades; for Japan the figure was 0.25 percent.

### Exhibit 1

#### HOUSEHOLD INCOME GROWTH WILL ACCELERATE ACROSS INDIA



Source: McKinsey Global Institute

#### RISING INCOMES WILL LIFT 291 MILLION OUT OF POVERTY AND CREATE A 583 MILLION-STRONG MIDDLE CLASS

India's rising real incomes have already had a significant impact on poverty reduction. In 1985, 93 percent of the population had an annual household income of less than 90,000 Indian rupees, or less than \$1,970 per year or \$5.40 per day—an income bracket we categorize as *deprived*.<sup>4</sup> By 2005 this had dropped

<sup>3</sup> Unless otherwise noted, figures throughout this report are quoted in real 2000 rupees. Figures quoted in other currencies are also adjusted for inflation, using 2000 as the base year. Indian fiscal year figures are reported as the year in which nine out of 12 months of the results occurred, e.g. FY 2006 is reported as 2005.

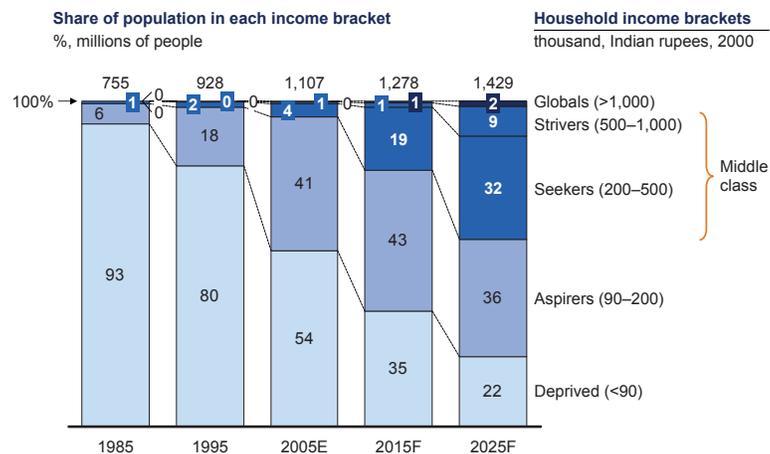
<sup>4</sup> Our definition of poverty—the deprived segment—at less than 90,000 Indian rupees household disposable income is also the measure used by NCAER. India's official definition of poverty is based on caloric intake and is set at 2,400 calories per capita per day for urban regions and 2,100 calories for rural areas. According to this lower threshold, extreme poverty dropped from 36 percent of the population in 1993 to 29 percent in 1999 (Source: UN).

by about two-fifths to 54 percent of the population, with the biggest fall occurring since 1995. Thus more than 103 million people moved out of desperate poverty in the course of one generation—not just in India’s urban centers but in its rural areas as well. This is all the more impressive given that India’s population grew by 352 million during this period. So, in effect, there are 431 million fewer poor people in India today than there would have been if poverty had remained at its 1985 rate. In short, India’s economic reforms, and the increased growth that has resulted, have been the most successful anti-poverty program in the country’s history.

Our forecast shows that overall economic growth will continue to benefit India’s poorest citizens and that the deprived segment will further drop from 54 percent of the population in 2005 to 22 percent by 2025 (Exhibit 2). The rural deprived will drop from 65 percent of the total rural population to 29 percent. Overall a further 291 million people will move out of poverty during a period when 322 million people will be added to the country’s population. In effect, this means that India will have 465 million fewer poor by 2025 than if the poverty rate remained at 2005 levels, and over a billion less poor people than if the rate had remained stuck at 1985 levels.

**Exhibit 2**

**INDIA WILL SEE FURTHER REDUCTION IN POVERTY AND GROWTH OF ITS MIDDLE CLASS**



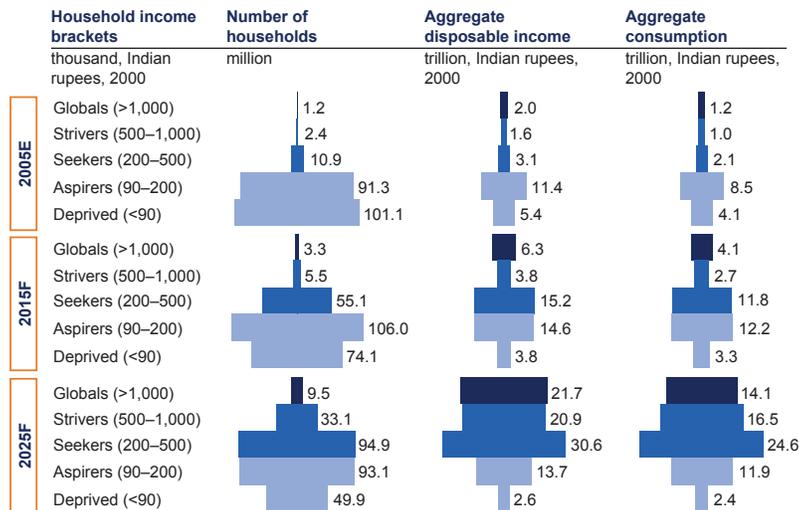
Note: Figures are rounded to the nearest integer and may not add up to 100%.  
Source: McKinsey Global Institute

As Indian incomes rise the shape of the country’s income pyramid will also change dramatically (Exhibit 3). Apart from a substantial reduction in poverty, India will create a sizeable and largely urban middle class. For the purposes of this report

we follow the conventions used by NCAER and define the middle class as comprising two economic segments: *seekers* with real annual household disposable incomes of 200,000 to 500,000 Indian rupees (\$4,380 to \$10,940 or \$23,530 to \$58,820 at purchasing power parity or “PPP”) and *strivers* at 500,000 to 1,000,000 Indian rupees (\$10,940 to \$21,890 or \$58,820 to \$117,650 at PPP).<sup>5</sup> In 2005, the Indian middle class was still relatively small, comprising approximately 5 percent of the population or 13 million households (50 million people). However, if India achieves the growth rates we assume, its middle class will reach 41 percent of the population or 128 million households (583 million people) by 2025. In addition, households with real earnings of more than 1,000,000 Indian rupees a year (classified as *global*—greater than \$21,890 or \$117,650 at PPP) will comprise approximately 2 percent of the population, but earn almost a quarter of its income.

### Exhibit 3

#### THE SHAPE OF INDIA'S INCOME PYRAMID WILL CHANGE DRAMATICALLY AS INCOMES GROW



Source: McKinsey Global Institute

#### INDIA WILL BECOME THE WORLD'S FIFTH LARGEST CONSUMER MARKET BY 2025

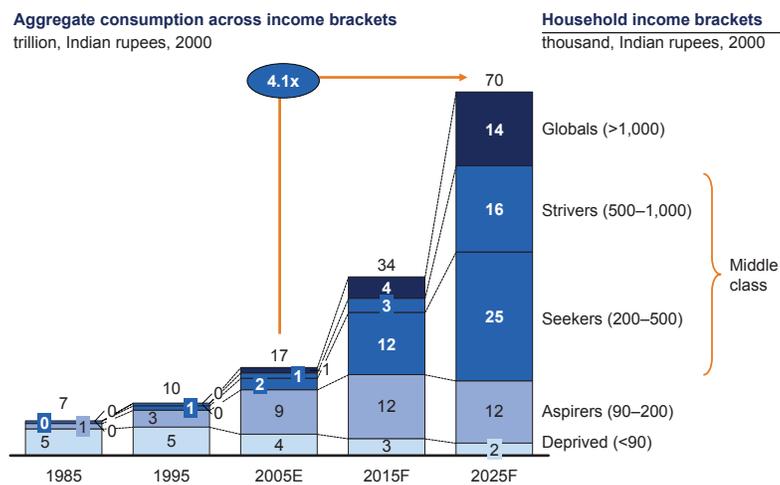
The combination of rapidly rising household incomes and a robustly growing population will lead to a striking increase in overall consumer spending. We fore-

<sup>5</sup> The labels and cut-off points that we have used for our income classes are broadly similar to those used by NCAER and reported in their publication, *The Great Indian Middle Class: Results from the NCAER Market Information Survey of Households*. However, we have re-calibrated the specific brackets for the time period that we examine.

cast that aggregate consumption in India will grow in real terms from 17 trillion Indian rupees today to 34 trillion by 2015 and 70 trillion by 2025—a fourfold increase (Exhibit 4).

#### Exhibit 4

### INDIA'S AGGREGATE CONSUMPTION WILL QUADRUPLE OVER THE NEXT 20 YEARS



Note: Figures are rounded to the nearest integer and may not add up exactly to column totals.  
Source: McKinsey Global Institute

This soaring consumption will vault India into the premier league among the world's consumer markets. Today its consumer market ranks 12th. By 2015 it will be almost as large as Italy's market. By 2025 India's market will be the fifth largest in the world, surpassing the size of Germany's consumer market. We should note, however, that the size of India's market will still be tied closely to its large population. On a per capita basis, real spending will remain modest at 48,632 Indian rupees in 2025 (or \$1,065)—although this will still represent a tripling from today's level.

We also find that income growth will be the biggest driver of increasing consumption, far outweighing population growth or any change in savings behavior. We estimate that 80 percent of consumption growth will come from rising income, while 16 percent of the increase will be due to growth in the number of households. Only 4 percent will come from changes in India's household savings rate.

As incomes grow, the class structure of consumption will change significantly as well. Consumption today is dominated by the deprived and aspirer income

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segments, which together control 75 percent of spending. By 2025, however, the global segment will wield 20 percent of total spending and the new middle class will come to dominate, controlling 59 percent of India's consumption power.

### **MIDDLE-CLASS GROWTH WILL SPREAD BEYOND TOP-TIER CITIES**

The geographic pattern of India's income and consumption growth will shift too. Today, despite their lower incomes, rural households, due to their majority share of the population, are collectively India's largest consumers—57 percent of current consumption is in rural areas versus 43 percent in cities. The challenges of accessing and serving rural markets mean that much of the Indian market has not been addressable by major companies and is served by the informal economy instead.

Income growth will be fastest in urban areas where real average household incomes will rise from 166,922 Indian rupees today to 513,042 Indian rupees by 2025, an annual increase of 5.8 percent. This is not to say that India's rural areas will be left on the sidelines. Average real rural income growth per household will accelerate to 3.6 percent over the next two decades and consumption will reach today's average urban household level by 2018.

However, by 2025 the Indian consumer market will largely be an urban affair, with 62 percent of consumption in urban areas versus 38 percent in rural areas. Urban areas will account for over two-thirds of the future growth in the Indian market despite the fact that even in 2025, urban areas will have only 37 percent of the population. This represents an important opportunity for many companies because urban areas are often easier for the formal sector of the economy to address. Indian and multinational businesses will thus see their addressable market grow substantially.

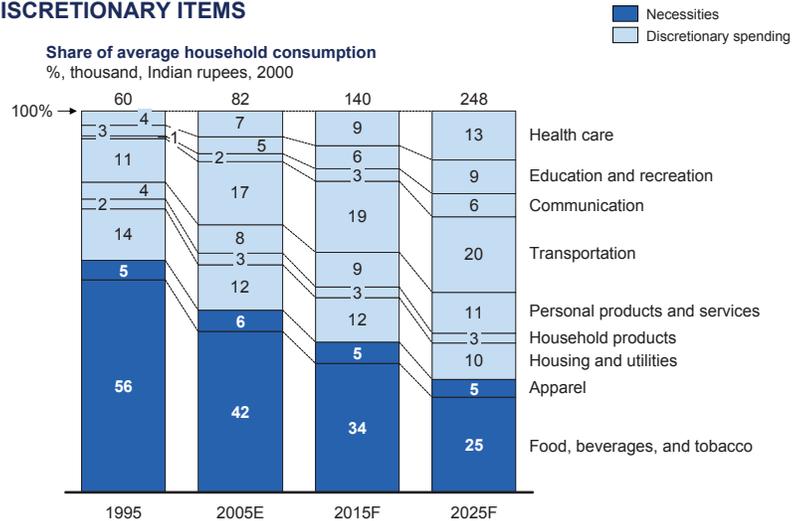
Within urban areas we will also begin to see India's middle tier and smaller cities begin to emerge as increasingly attractive markets with substantial numbers of middle class customers. While India's two largest conurbations, Delhi and Mumbai, will continue to be the country's biggest markets and the top eight cities will remain the dominant locations for upper-income global consumers, we estimate that almost two-thirds of India's middle class opportunity will lie outside these top-tier urban areas. For example, mid-size cities such as Chandigarh, Ludhiana and Amritsar have experienced significant income growth and currently have average incomes equal to, or higher than, the top-tier cities.

## DISCRETIONARY SPENDING WILL ACCOUNT FOR 70 PERCENT OF ALL SPENDING BY 2025

As Indian incomes rise, the “share-of-wallet” of consumer spending will change significantly too. We have projected spending patterns in nine major consumption categories and 30 subcategories. Our results show that all categories will experience growth in absolute terms, but some will grow much faster than others. The percentage of Indian spending on discretionary items will grow dramatically, while spending on necessities will grow more slowly (Exhibit 5).

### Exhibit 5

#### INDIA'S SHARE-OF-WALLET IS SHIFTING FROM BASIC NECESSITIES TO DISCRETIONARY ITEMS

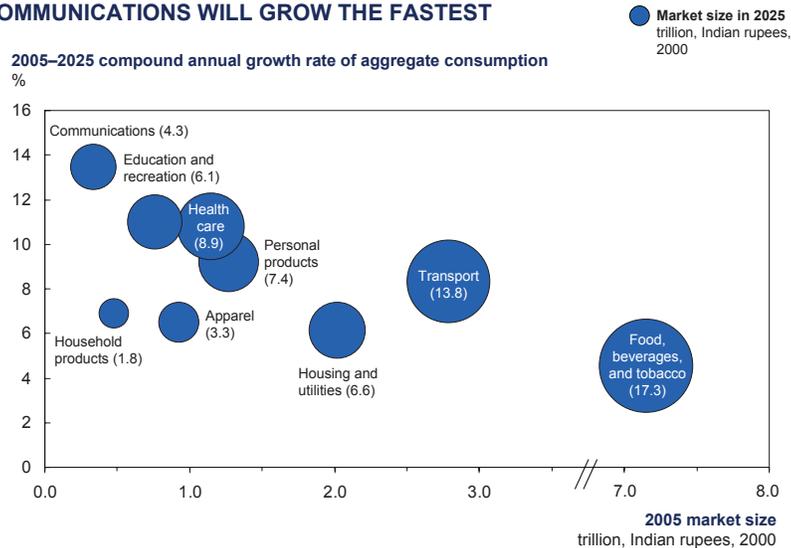


Note: Figures are rounded to the nearest integer and may not add up to 100%.  
 Source: McKinsey Global Institute

Today the largest categories of Indian spending are food, beverages, and tobacco (FB&T); transportation and housing. By 2025 FB&T will still be the biggest category, although its share will have dropped from 42 percent to 25 percent. Transport and health care will be the second and third biggest markets respectively. Communications, which accounts for only 2 percent of spending today, will be one of the fastest expanding categories with growth of over 13 percent a year (on an aggregate basis). Other categories that will see annual growth of over 8 percent include transportation, personal products and services, health care, and education and recreation as these categories evolve into sizable markets (Exhibit 6).

## Exhibit 6

### FOOD WILL REMAIN THE LARGEST CONSUMPTION CATEGORY WHILE COMMUNICATIONS WILL GROW THE FASTEST



Even India's slower growing spending categories will represent significant opportunities for companies because these markets will still be growing rapidly in comparison with their counterparts in other parts of the world. Indeed India's relative share of world markets will rise in virtually every product and service category. If the consumer markets of the OECD countries continue to expand at their current rates, we estimate that India will grow from accounting for 2.1 percent of total OECD plus India demand today to 4.6 percent by 2025.

### POSITIVE CHANGES BUT IMPORTANT CHALLENGES

The upcoming changes in the Indian consumer market will create major opportunities and challenges for Indian and multinational businesses alike. For example, companies will need to attract and educate large numbers of new consumers, establish and retain brand loyalties as tastes change with rising incomes, and introduce high-value products and services at sufficiently low prices to be accessible to the emerging middle class. The quadrupling of the Indian market will present companies competing in India with a critical discontinuity to navigate—who the leaders of this changed market will be has yet to be decided.

Growth in Indian incomes and consumption will also deliver extensive societal benefits, with further declines in poverty and the growth of a large middle class. We should emphasize again, however, that the overall outcome we have described,

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depends significantly on India maintaining a relatively high rate of long-term growth, in the range of 7 to 8 percent.<sup>6</sup> That in turn depends crucially on the government continuing to pursue a pro-reform, pro-growth economic agenda. Our results do not assume an unrealistic breakthrough, but rather that India continues to open its markets to both domestic and foreign competition, and that the government follows through on its pledges to address key infrastructure and education issues. Faster reform would provide further upside to our results. But at the same time, slower reform and failure to act on India's significant challenges could dampen growth and put the opportunities we have described substantially at risk.

During the first millennium AD, merchants referred to India as the "Bird of Gold" due to the glittering dynamism of its market. Over the next two decades, that bird may take flight once again.

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6 The impact of varying growth rates on our model is generally to shift the timing of results. For example, slower GDP growth would imply slower income and consumption growth, thus pushing the point at which Indian consumption triples out past 2025. Likewise, faster growth would accelerate the rate at which that point is reached.



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