The rise of second-tier cities in India

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As the impact of India's robust economic growth has extended to its smaller cities, a young population with rising disposable income is finding that many Western and upmarket domestic brands are increasingly accessible. Meanwhile, consumer goods companies are stepping up efforts to expand to these second-tier cities.

Issue

Nearly 35 Indian cities have a population exceeding 1.0 million and a rapidly growing consumer market with rising incomes. They are referred to as second-tier cities, and the Indian government is keen to encourage economic expansion there.

As foreign and domestic investors are making the most of government incentive policies and tapping into the expanding consumer market in second-tier cities, consumers are presented with a wider range of international and upmarket domestic brands and services.Importance

India's economic performance in recent years has been robust:

Real GDP grew at an annual rate of 9.4% in the fiscal year 2006 (ending March 2007), the fastest expansion for 18 years. The services sector has been the main driver of growth;Strong economic growth has boosted disposable income and consumer spending. In 2006, annual household disposable income reached an average Rs116,400, up 6.6% over 2001 in real terms;The impact of India's robust economic growth has spread to smaller cities. According to the National Council for Applied Economic Research (NCAER), in 2006 half of India's 10.7 million households with an annual income of up to US$23,000 were in smaller cities such as Vadodara, Nagpur, Ahmedabad and Vijayawada;These smaller cities are often referred to as second-tier cities as opposed to first-tier cities or metropolises (e.g. Delhi, Mumbai and Bangalore). Economic growth in these smaller cities is increasingly driven by a manufacturing boom and the expansion of business services outsourcing industries.

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Real GDP growth and annual household disposable income (at constant 2001 prices): 2001-2006Source: Euromonitor International from IMF and national statisticsImplications

The rising incomes and purchasing power of consumers in second-tier cities will open up opportunities for a wide range of businesses as well as impacting the economy as a whole:

International consumer goods companies will intensify efforts to expand to second-tier cities, where middle-class consumers are rising in number as well as being increasingly ready to embrace new concepts, brands, and services. Organised retailers (including international supermarket chains) will also reach out to second-tier cities, although the presence of such retail chains will likely squeeze millions of small shop-keepers out of business;Second-tier cities have lower labour costs and often enjoy large investments and incentive policies from the central government. In the city of Nagpur (2.5 million population), for example, in 2007 the government allocated US$280 million to a number of urban development projects, including renovating the local airport and constructing an eco-friendly mass-transit system to absorb an expected surge in road traffic. The aim is to improve the infrastructure of second-tier cities and attract investors;Overall FDI will be boosted significantly. In 2006, India received US$17.0 billion in FDI inflows (an amount equivalent to the combined inflows to the country during the preceding three years), but this is much lower in comparison to China which attracted US$69.0 billion in 2006;Unemployment in second-tier cities will decline as companies invest and set up production there. For example, the government estimated in 2007 that the ongoing construction of a special economic zone (with good infrastructure and tax breaks for companies setting up business there) in Nagpur could potentially bring 100,000 technology jobs to the city. Although unemployment has declined in recent years, the national rate of unemployment remained relatively high at 8.1% in 2006. Job creation in second-tier cities will also help divert migrants away from over-populated first-tier cities;Rising employment contributes to enhancing income levels. There will be a growing market for consumer goods companies, especially Western and upmarket domestic brands. Consumer demand will rise not only for basic consumer goods but also more luxurious items such as cars;

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Demand of consumer durables in India: 1996-2010'000Source: National statisticsNote: Demand refers to the quantity that has actually been bought in a given year or that is projected to be needed in the future. Data for 2010 are forecasts.The property market in second-tier cities will grow rapidly as international goods companies set up shops and factories there. In addition, after the Indian government allowed 100% FDI in construction development projects in 2006, foreign developers are pouring funds into India and increasingly expanding beyond the already expensive metropolises. However, rising house prices can squeeze ordinary families out of the property market whilst also reducing the disposable incomes of homeowners with mortgage loans;Building companies will receive increased orders in smaller cities, leading to a higher share of construction in the economy. In 2006, the construction sector accounted for a modest 6.1% of the national economy.Future scenarios

In 2007, the government pledged to spend US$29.0 billion over the seven years to 2014 in order to modernise second-tier cities and turn them into economic hubs besides existing metropolises. Thanks to government investment and incentive policies, second-tier cities across India will gain greater importance both as engines of economic growth and as expanding consumer markets.

Analysts predict that the development of these cities will be the key to boosting and sustaining India's economic growth. This is particularly important in the context where India's annual real GDP growth is projected to moderate (to 8.0% in 2007 and then rise to 8.3% in 2008, down from 9.2% in 2006) due to capacity constraints (i.e. constraints such as material unavailability or lack of resources that prevent the expansion of production to meet rising demand).Print this page E-mail a friendÂ Â

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