PERSPECTIVE

Insights for America's Business Leaders

The Chindia Effect:

What It Means for U.S. Companies

Executive Summary:
- The economic rise of Chindia
- The forces driving growth
- Where business opportunities will be created
- India's economic landscape at a glance
- Why U.S. companies should engage India

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"People ask me what about India vs. China? But I ask them what about India plus China. It's being called Chindia."[1]

– Bill Gates Chairman, Microsoft Corporation

The Ascendancy of Chindia

As the world watches in awe, China and India are replacing their historic differences with a new form of cooperative relationship – forged by closer economic links – and are rapidly emerging as two of the most economically powerful nations in the world.

Fueled by massive populations, huge domestic markets, cheap labor, and governments pursuing investment-friendly policies, both countries are projecting their influence in virtually every aspect of 21st century global business.

What will this *Chindia Effect* mean for U.S. companies? With the profound impact these two giants will make on global commodities and consumer markets, U.S. business leaders can no longer afford not to consider China and India.

An Economic Force

With annual growth forecasted at 8-10% for China and 8% for India in the foreseeable future, Chindia is projected to have a 10.5% share of Global Domestic Product (GDP) at $6.3 trillion[2] by the year 2020 and will, according to Hong Kong-based investment group CLSA:

- Make up 40% of the world's total population
- Consume 50% of its natural resources
- Become the largest exporter of manufactured goods and services

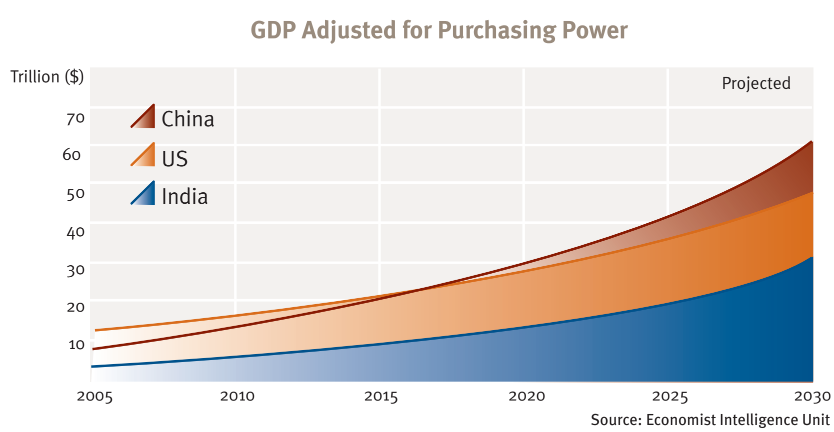
For all the similarities in their rapid emergence, the development paths of China and India could not have been more different. Let's take a look at what's powering this economic juggernaut:

CHINA'S GROWTH DRIVEN BY:

- Foreign direct investment (FDI)
- Exports
- Large-scale manufacturing
- *Economic Model: State Capitalism*

INDIA'S GROWTH DRIVEN BY:

- Consumption
- Vibrant capital markets
- World-class IT and services sectors
- *Economic Model: Private Enterprise*



China and India are on a trajectory to join the U.S. as the top three global economic powers by the year 2030.

It could be argued that China, with its massive factories, serves as the world's workshop, while India, with its fast-growing IT and outsourcing sectors, is becoming the world's back office – both complementing each other even as they compete for resources.

This phenomenon is the genesis of the word "Chindia," coined by Indian politician Jairam Ramesh to describe their combined economic clout.[3]

"China and India will be the two pagodas of economic power in the 21st century."[4]

– Wen Jiabao, Premier, People's Republic of China

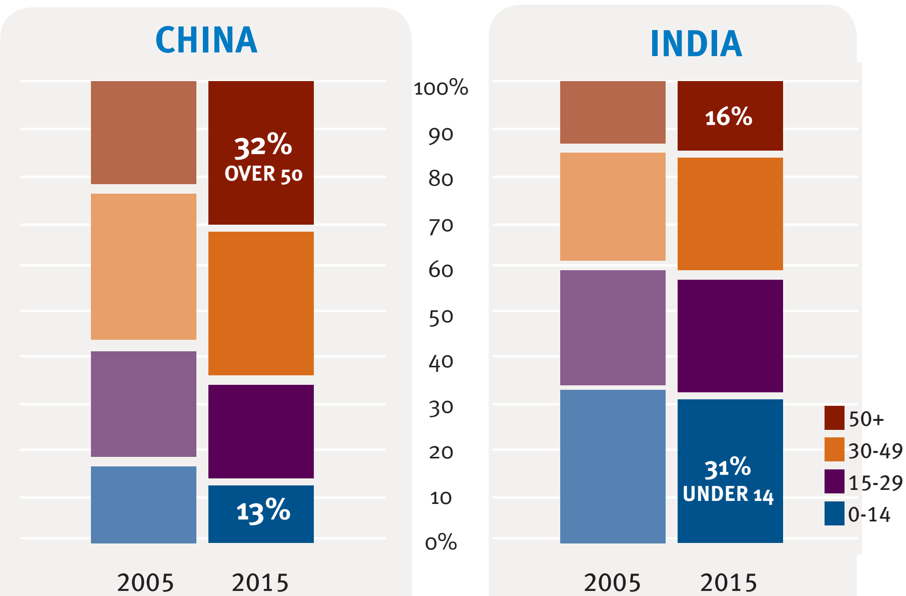
Demographic Drivers

China's population – roughly 1.3 billion – is rapidly aging, and its low birth rate, attributed to the government's one-child policy, will cause a demographic drag on growth, according to Ms. Jing Ulrich, Managing Director and Chairman, China Equities, JPMorgan. By 2015, one third of its population will exceed 50+ years of age. At that point, China's working-age population will peak at 1 billion and then drop steadily.

India, with a population of 1.1 billion and a high fertility rate, will reap the dividends of a large, young, and growing workforce. Projections indicate that by 2015, 58% of the population will be below 29. By mid-century, India's population is expected to reach 1.6 billion and 220 million more workers than China.[5]

An aging population versus a young population

(Population by age group)



Source: Clint Laurent, Global Demongraphics, Ltd. From Chindia, Beyond the Cliches, by Jing Ulrich, Managing Director and Chairman, China Equities, JPMorgan.

Over time, the shifting age groups will determine which services, products and industries will benefit each country, and where the business and investment opportunities will be for U.S companies.

China's growing "empty nest" and "senior" populations will make excellent targets for travel, hotel, service, pharmaceutical and insurance marketers.

India's large "married with children" segment – which spends on food, education and housing – will create business opportunities for department stores and supermarkets.

Consumer Market Drivers

Seduced by la dolce vita, hundreds of millions of new Chinese and Indian consumers are set to ignite an investment and spending boom. The rise of this huge middle class will feed a rapidly growing demand for household products and the raw materials used to make them.[6]

By 2020, it is projected that Chindia will have:

- One third of the world's mobile subscribers and a $100 billion mobile handset market
- A $480 billion packaged food market, equivalent to 1-1/2 times the present U.S. market
- Bank loans valued at $9 trillion – twice the current GDP of Japan[7]

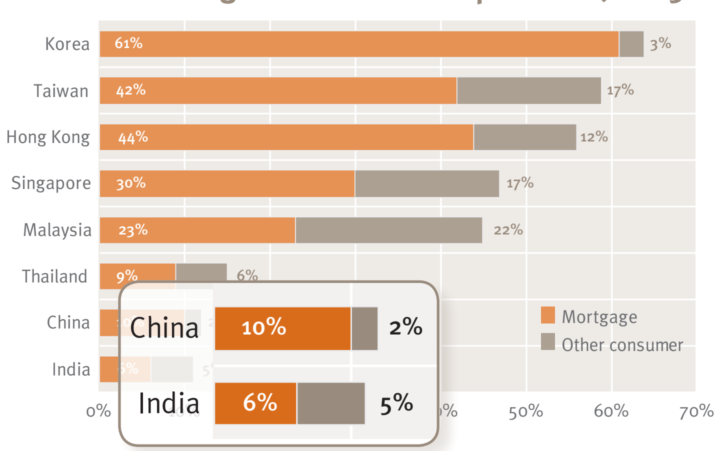
In China's retail sector, the modern retail format accounts for over 30% of total retail sales. China has been aggressively expanding its retail landscape to bring in more name-brand retailers and international luxury brands to satisfy the needs of its well-heeled middle class.

Conversely, India's modern retail stores handle only 5% of total retail sales. As the "land of shopkeepers," India's protectionist policies have kept large foreign retailers like Wal-Mart and Carrefours out to protect the 100 million jobs in this area. Changes are coming, albeit slowly, as India begins opening up its retail sector to foreign players through joint ventures and licensing agreements to meet rising demand for competition.

Financial Market Drivers

Financial sector assets in China are eight times larger than India's, with new lending far exceeding equity and debt issues over the last six years. However, capital market fund raising is tiny when compared to bank lending.

Percentage of Consumer Dept to GDP, 2005



Source: CEIC. JPMorgan research by Samuel Chen. From Chindia, Beyond the Cliches, by Jing Ulrich, Managing Director and Chairman, China Equities, JPMorgan.

Consumer credit in Korea, Taiwan, Hong Kong and Singapore represents a substantial percentage of each country's GDP – much less so when compared to India and China.

With smaller financial sector assets, India's distribution across loans, equity and debt issues is more balanced than China's. India has the advantage of strong capital markets, which have grown 400% over the last five years as a result of increased foreign institutional investment (FII) and a rise in domestic savings.

Common to both countries is a weakness in consumer credit that remains underdeveloped as a result of:

- Banks tending to lend to companies and ignoring consumers
- A lack of established credit bureaus
- Age-old attitudes towards acquiring personal debt

However, as income levels rise, and attitudes towards debt begin to change, consumers will demand and be supplied with more sources of credit. When matched up with a fast-developing housing market, mortgages, plus credit cards and personal loans, will become more attractive growth opportunities for Chindia's banks.

China's explosive growth has captured the dragon's share of global interest, and you may be more familiar with that part of the Chindia equation. However, the economic rise of the Indian "Tiger" has been no less a compelling story in its own right.

The Indian Moment

India is on the verge of something big. With globally competitive companies, thriving stock markets, and a banking system that's not saddled with bad loans, India is having a dramatic effect on re-shaping the global economy by:

- Supplying the demand for a highly skilled, technically qualified, and relatively inexpensive workforce around the world
- Putting more buying power in the hands of its massive middle-class consumer sector, and creating a growing market for U.S. companies across multiple lines of business
- Moving towards the *full convertibility* of the Indian Rupee enabled by its growing foreign exchange reserve

Opening India's Economy

To accelerate its economic growth, India needs better infrastructure, more foreign investment, and a more open policy towards foreign trade. Fortunately, the Indian government has undertaken a number of initiatives to address these needs by:

- Relaxing and simplifying regulations for setting up a business
- Showing greater willingness to allow more foreign ownership in selected sectors
- Establishing special economic zones (SEZ)

Historically, wherever the government has loosened control and moved out of the way, industries like India's renowned IT and services sectors have flourished. Combine this liberalization with an annual private sector growth rate of 15%, and this bodes well for India's rapidly emerging retail, real estate, infrastructure, healthcare and energy markets.

FDI for infrastructure, a critical requirement for India's future, is expected to double in 2006-2007, with huge investments coming in the software, financial services and manufacturing sectors, according to Kamal Nath, India's minister of commerce.[8]

The country's FDI needs should also get a much-needed B-1 shot now that S&P Rating Services has upgraded India's credit rating to investment grade from non-investment grade or "junk" status. Analysts project that the higher rating will boost FII into stock markets and FDI into new projects and infrastructure.[9]

India is also enjoying a strong and growing economic relationship with the U.S.

Bilateral trade has grown over the last five years with two-way trade in goods increasing from $14 billion to over $26 billion.[10] The U.S.-India Trade Policy forum, a key strategic agreement established in 2005, is enabling the enhancement of trade and investment flow, supporting economic reform, and improving market access to goods and services between the two countries.

The Indian Economy At-A-Glance

- GDP of $750 billion ($3.7 trillion on PPP terms)
- Per capita GDP of $700 ($3,400 on PPP terms)
- FX reserves of $162 billion
- GDP growth rate of 7%+

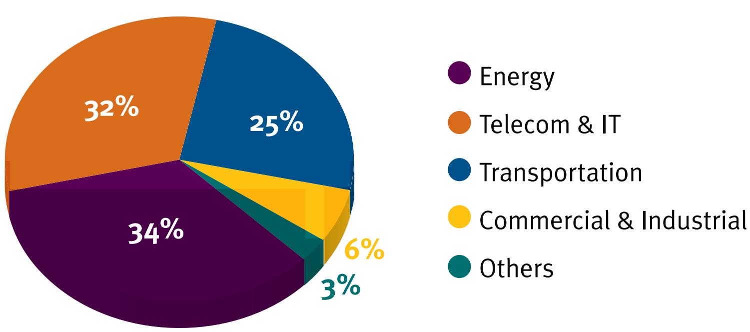
A Sound Strategy for American Companies

India's burgeoning economic and business environment offers U.S. companies practical reasons and diverse opportunities for operating there. Start with its inexpensive supply of talent, its deep financial markets, and the one sixth of the world's consumers who live there, then consider its:

- Educated and hard-working labor force
- 200 million strong – and growing – middle class
- Stable, free-market democracy
- Established legal system
- English as the primary business language
- Clear guidelines for Intellectual Property Rights
- Domestic consumption-led growth
- Export competitiveness in select industries

Factor in India's young and burgeoning population over the next several decades, plus a healthy increase in infrastructure investment and growth, and you'll quickly grasp why India is taking its place as an emerging economic power.

India's Infrastructure By Industry



Source: Developing an India Strategy, by Vishal Bharat, Senior Vice President, JPMorgan Chase.

Infrastructure in India is growing aggressively as a result of increased government commitment, linking the economic benefits from infrastructure, and encouraging greater private sector participation.

"Western nations must prepare for a future dominated by China and India, whose rapid economic rise will soon fundamentally alter the balance of power."[11]

– James Wolfensohn, former World Bank President

Dancing With the Dragon and the Tiger

By the year 2050, the E7, the world's seven emerging economies – China, India, Russia, Brazil, Indonesia, Mexico and Turkey – will overtake the economies of the G7 – U.S., Japan, Germany, UK, France, Italy and Canada.

In this scenario, China and India will lead the E7 pack[12] and create exciting business and investment opportunities for savvy U.S. companies across multiple markets, including consumer, agricultural, industrial, banking and logistics.

There is no denying that Chindia faces significant economic challenges. China's state-owned companies are financially troubled, the financial industry is debt ridden, and the economy is open, but politics remain tightly closed. India is weak in industrial fundamentals, lags in manufacturing, and lacks social infrastructure.

For all of that, Chindia **will** become an economic superpower to be reckoned with – and one that corporate America must engage ■

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