

Morgan Stanley & Co. Incorporated **Stephen S. Roach**
Chief Economist
Stephen.Roach@morganstanley.com
+1 (1)212 761 7153

October 31, 2005

Global: Economic Comment

Here Comes the Indian Consumer

What's new: India is on the cusp of something big. After my third trip there in 18 months, I am as enthusiastic about India as I was about China in the late 1990s. What excites me the most is the potential for an increasingly powerful internal consumption dynamic — the missing link in most development models.

Conclusions: The analytics and evidence of an emerging Indian consumption dynamic are compelling: (1) India's consumption share of GDP is 64% — higher than that of Europe (58%), Japan (55%), and China (42%). (2) Corporate India has very sophisticated pro-consumption strategies — about to be augmented by a hyper-store-led consolidation of a very fragmented retail distribution system. (3) The political constraints of its coalition government are overblown; in a meeting with Prime Minister Manmohan Singh, I detected a fierce resolve on the reform front. (4) The context of reforms is shifting to "inclusion" — focusing increasingly on the rural poor, with surprisingly powerful pro-consumption implications. (5) India's approach to growth is better balanced than the resource-mobilization model of China.

Market implications: With its foundation of consumer support broadening and deepening, the Indian GDP growth dynamic could now shift toward the upper end of a 7-8% range. I have long argued that global rebalancing will not occur as long as the world remains hooked on one consumer — namely the American consumer. Think India if you want a way out of that trap.

Risks: India's constraints — infrastructure, saving, foreign direct investment, and politics — are well known. Yet on this trip, I saw visible signs of progress on most of those fronts.

Recent Reports

The Bernanke Challenge Stephen S. Roach	10/28/05
Tough Flying Conditions Stephen S. Roach	10/24/05
Wrong on the China Slowdown Stephen S. Roach	10/21/05

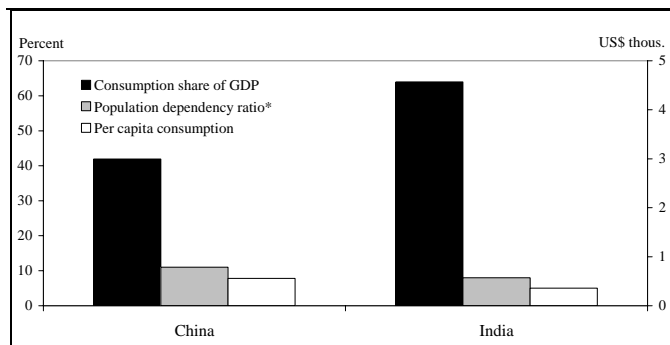
Here Comes the Indian Consumer

India is on the cusp of something big. After my third trip there in 18 months, I am as enthusiastic about India as I was about China in the late 1990s. While comparisons with China are inevitable, the case for India is very different. What excites me the most is the potential for an increasingly powerful internal consumption dynamic — an ingredient sorely missing in most other Asian development models, including China. India's constraints — infrastructure, saving, foreign direct investment, and politics — are well known. Yet on this trip, I saw visible progress on most of those fronts. The consumption story — the organic sustenance of sustainable growth and development — casts India in a very different light.

Don't get me wrong — the Indian consumer is hardly a powerful force on today's global stage. As the accompanying chart shows, India's per capita income and consumption levels are about half those of China's. But it is growth at the margin that always drives powerful macro and market trends. And the Indian consumption story is, first and foremost, one of accelerating growth off a low base. The potential comes from the structure of the Indian economy: Private consumption currently accounts for 64% of Indian GDP — higher than shares in Europe (58%), Japan (55%), and especially China (42%). India's transition to a 7% growth path in recent years is very much an outgrowth of the emerging consumerism of one of the world's youngest populations. The increased vigor of private consumption provides a powerful leverage to the Indian growth dynamic that is rarely found in the externally-dependent developing world.

Exhibit 1

Consumerism: India versus China



Note: Data are shown for the latest year available.
* Ratio of the population aged 65 years or over to the population aged 15-64.
Source: China National Bureau of Statistics, India Central Statistical Organization, UN, Morgan Stanley Research

This came through loud and clear on my recent travels through India. Over a span of four days, I met with a number

of corporate executives, investors, and senior government officials. Everywhere I went, the focus was on the Indian consumer. I met with the managements of a good cross-section of India's major consumer companies — Hindustan Lever (softgoods), Pantaloon (retail), Raymond Textiles (clothing), and McDonald's (fast food). I also spoke with executives from banks and drug companies — all of whom have important consumer businesses. And I met with leading industrial companies such as Reliance, where a major five-year initiative has just been announced for the development of nationwide chain of hyper-stores and super-markets. I even went to the Phoenix shopping mall in Mumbai, which was bustling with activity. I have made similar trips to malls in China. There was one key difference between these two experiences — the locals were buying in India. This is consistent with what I heard from most of the consumer companies I saw — solid acceleration in same-store sales comparisons over the past six months.

In my discussions with India's major consumer companies, one thing stuck out — strategy. These companies all had very sophisticated marketing and product development plans. Moreover, the multinationals that were operating in India were doing so with business models that were tailor-made to local markets and customs. For example, while McDonald's has the same look and feel as its global brand, about 95% of the menu content differs from that offered in the US. Big Macs come in chicken and vegetable forms. In the pharma area, Indian business practices are tilted increasingly toward consumers — especially those at the low end of the income spectrum in serious need of medicine. In the softgoods area, sophisticated "upgradation" strategies are pushing consumers up the value chain. And all of the banks I met were very focused on consumer-oriented growth strategies, especially in the mortgage finance and credit and debit card businesses.

Most of India's major consumer players are looking for an imminent consolidation of the country's highly fragmented retail sector. Currently, there are over three million retail outlets in India — an industry structure that is ripe for efficiency enhancement. The threat of foreign competition is already spurring a big consolidation push. Wal-Mart is apparently poised to enter India as soon as restrictions on retail FDI are lifted. That appears to be no more than 18 months away. In the meantime, local players like Pantaloon and Reliance are scaling up in an effort to meet the coming Wal-Mart challenge head-on. The competitive juices are coursing through the veins of India's consumer industry.

October 31, 2005

Global: Economic Comment

Unlike other Asian economies, India's entrepreneurs are eager to compete.

For me, the highlight of this trip to India was a meeting with Prime Minister Manmohan Singh. Unlike most of the meetings I have had with heads of state in the past, the room was not swarming with aides or other visitors — it was basically just the two of us discussing macro. And unlike most heads of state, his rich portfolio of experience as an economics professor, central bank governor, and finance minister put this discussion on a very different plane. In his characteristically soft-spoken manner, he challenged me with some very tough questions — from US current-account financing sustainability and the China investment formula to Indian infrastructure deficiencies, fiscal constraints, and rural employment and income deficiencies.

Dr. Singh is the real thing when it comes to India's reforms — he led the charge in the opening up of the early 1990s. Today's political context is obviously quite different: As a majority party official he was able to drive the reform process far more forcefully back then than is the case today, with a delicate left-leaning coalition government. Mindful of those constraints, the key code word in current coalition governance circles is "inclusive" — emblematic of a development strategy that is being refocused to deal with the income-disadvantaged citizens of rural India. The Prime Minister is very philosophical when it comes to integrating his reform philosophy within the political imperatives of a broader base of Indian economic development. While his government has been stymied by the politics of inclusion on several fronts — namely on infrastructure and privatizations — I get the strong sense that Dr. Singh does not interpret these developments as fundamental setbacks on the road to Indian reform. In my opinion, he still has the heart of a reformer and the quiet determination to stay the course in the context of major political constraints.

The same conclusion was buttressed by recent conversations I had with other government officials and corporate executives in India. The "inclusive economy" is viewed as one that is biased toward consumption-led growth — reinforcing my conclusions on the coming shift to Indian consumerism. To the extent that rural development will result in Indian productivity enhancement — a very reasonable presumption — real incomes and consumer purchasing power should rise. The bulk of the early dividends from rural reform are widely expected to come from small and medium-size businesses. Successful agricultural reform would be the icing on this cake. Given the already large consumption share of the Indian economy, rural development could actually end up being a

levered play on the Indian consumer. Investors always cringe when they hear words like "left, rural, and agriculture." For India, they conjure up images of long standing failures on the development front. I think it is important to get beyond that knee-jerk reaction. With a foundation of consumer support that is broadening and deepening, the underlying Indian GDP growth dynamic could now shift toward the upper end of a 7-8% range.

In addition, I think there is risk of going too far in condemning the recent backsliding on reforms. That's especially the case with respect to infrastructure. Here, I will commit the cardinal sin of macro and rely on the personal anecdote. The roads and airports are still terrible in India — the traffic jam and driving conditions going to the Mumbai airport the other night were unbelievable. But compared with conditions I saw 9 to 18 months ago, there is a palpable sense of improvement. Signs of road construction are evident everywhere. I saw my first new airport terminal in Mumbai, and watched passengers jump on several new low-cost airlines, such as Deccan and Kingfisher, which have helped push annualized growth in domestic passenger traffic up by 20-25%. At the same time, the government knows full well it must come to grips with India's FDI deficiency. Likely breakthroughs on the retail front (i.e., Wal-Mart) are especially encouraging, as is a \$1.5 billion, or 10% stake, just taken by Vodafone in Bharti Tele-Ventures, India's largest mobile phone operator. These are clear signs that multinational corporations are also betting on the Indian consumer. As long as the government doesn't get in the way, I suspect that the momentum of market-based reforms will continue to outweigh the political constraints. For the time being, Prime Minister Singh seemed very comfortable with such a second-best outcome.

The China comparison can't be avoided when it comes to analyzing India. What strikes me most in that regard is the sharp dichotomy between China's export- and investment-led growth and India's more balanced growth dynamic. Collectively, exports and fixed asset investment make up over 80% of Chinese GDP — and are still growing at close to a 30% annual rate. The recent acceleration in Chinese GDP growth reflects further gains in these two sectors. Without the foundation of private consumption, this is not a sustainable growth dynamic for any nation, including China. India, by contrast, has the balanced-growth foundation that China would die for. Over the past 25 years plus, China has repeatedly outdistanced India by its brilliant execution of resource mobilization — putting together the pieces of the greatest export machine the world has ever seen. But now transition time is looming for China. It must come up with new sources of growth such as those that are evident in India's

consumption-led model. India lost the first round of the race with China by a wide margin. The jury is still out on the endgame.

Of all the trips I make around the world, India is by far the toughest. It's not just the quality of the travel experience. Poverty is everywhere — not just in rural India but in the swanky neighborhoods of its vast urban centers of Mumbai, New Delhi, as well as in the pulsating new tech centers of Bangalore and Hyderabad. And it is poverty and human tragedy on a scale unlike anything I have ever seen — including that of rural China. An inclusive India seems utterly determined to meet this daunting challenge head on. As far as I am concerned, there is nothing but upside to such efforts — it's just a question of degree. But with that upside comes yet another new source of Indian consumption growth — absolutely vital for India's balanced economic growth dynamic. I have long argued that global rebalancing will not occur as long as the world remains hooked on one consumer — namely, the American variety. Think India if you want a way out of that trap. And prepare yourself — here comes the Indian consumer.

The information and opinions in this report were prepared or are disseminated by Morgan Stanley & Co. Incorporated and/or Morgan Stanley & Co. International Limited and/or Morgan Stanley Japan Limited and/or Morgan Stanley Dean Witter Asia Limited and/or Morgan Stanley Dean Witter Asia (Singapore) Pte. (Registration number 199206298Z) and/or Morgan Stanley Asia (Singapore) Securities Pte Ltd (Registration number 200008434H) and/or Morgan Stanley & Co. International Limited, Taipei Branch and/or Morgan Stanley & Co International Limited, Seoul Branch, and/or Morgan Stanley Dean Witter Australia Limited (A.B.N. 67 003 734 576, holder of Australian financial services licence No. 233742, which accepts responsibility for its contents), and/or JM Morgan Stanley Securities Private Limited and their affiliates (collectively, "Morgan Stanley").

Global Research Conflict Management Policy

This research observes our conflict management policy, available at www.morganstanley.com/institutional/research/conflictolicies.

Important Disclosures

This report does not provide individually tailored investment advice. It has been prepared without regard to the circumstances and objectives of those who receive it. Morgan Stanley recommends that investors independently evaluate particular investments and strategies, and encourages them to seek a financial adviser's advice. The appropriateness of an investment or strategy will depend on an investor's circumstances and objectives. This report is not an offer to buy or sell any security or to participate in any trading strategy. The value of and income from your investments may vary because of changes in interest rates or foreign exchange rates, securities prices or market indexes, operational or financial conditions of companies or other factors. Past performance is not necessarily a guide to future performance. Estimates of future performance are based on assumptions that may not be realized.

With the exception of information regarding Morgan Stanley, reports prepared by Morgan Stanley research personnel are based on public information. Morgan Stanley makes every effort to use reliable, comprehensive information, but we do not represent that it is accurate or complete. We have no obligation to tell you when opinions or information in this report change apart from when we intend to discontinue research coverage of a company. Facts and views in this report have not been reviewed by, and may not reflect information known to, professionals in other Morgan Stanley business areas, including investment banking personnel.

To our readers in Taiwan: This publication is distributed by Morgan Stanley & Co. International Limited, Taipei Branch; it may not be distributed to or quoted or used by the public media without the express written consent of Morgan Stanley. To our readers in Hong Kong: Information is distributed in Hong Kong by and on behalf of, and is attributable to, Morgan Stanley Dean Witter Asia Limited as part of its regulated activities in Hong Kong; if you have any queries concerning it, contact our Hong Kong sales representatives.

This publication is disseminated in Japan by Morgan Stanley Japan Limited; in Canada by Morgan Stanley Canada Limited, which has approved of and takes responsibility for its contents in Canada; in Germany by Morgan Stanley Bank AG, Frankfurt am Main, regulated by Bundesanstalt fuer Finanzdienstleistungsaufsicht (BaFin); in Spain by Morgan Stanley, S.V., S.A., a Morgan Stanley group company, supervised by the Spanish Securities Markets Commission (CNMV), which states that it is written and distributed in accordance with rules of conduct for financial research under Spanish regulations; in the US by Morgan Stanley & Co. Incorporated and Morgan Stanley DW Inc., which accept responsibility for its contents. Morgan Stanley & Co. International Limited, authorized and regulated by Financial Services Authority, disseminates in the UK research it has prepared, and approves solely for purposes of section 21 of the Financial Services and Markets Act 2000, research prepared by any affiliates. Private UK investors should obtain the advice of their Morgan Stanley & Co. International Limited representative about the investments concerned. In Australia, this report and any access to it is intended only for "wholesale clients" within the meaning of the Australian Corporations Act.

Trademarks and service marks herein are their owners' property. Third-party data providers make no warranties or representations of the accuracy, completeness, or timeliness of their data and shall not have liability for any damages relating to such data. The Global Industry Classification Standard (GICS) was developed by and is the exclusive property of MSCI and S&P. Morgan Stanley bases projections, opinions, forecasts and trading strategies regarding the MSCI Country Index Series solely on public information. MSCI has not reviewed, approved or endorsed these projections, opinions, forecasts and trading strategies. Morgan Stanley has no influence on or control over MSCI's index compilation decisions. This report or portions of it may not be reprinted, sold or redistributed without the written consent of Morgan Stanley. Morgan Stanley research is disseminated and available primarily electronically, and, in some cases, in printed form. Additional information on recommended securities is available on request.

The Americas

1585 Broadway
New York, NY 10036-8293

United States

Tel: +1 (1) 212 761 4000

Europe

25 Cabot Square, Canary Wharf
London E14 4QA

United Kingdom

Tel: +44 (0) 20 7 425 8000

Japan

20-3 Ebisu 4-chome
Shibuya-ku

Tokyo 150-6008, Japan

Tel: +81 (0) 3 5424 5000

Asia/Pacific

Three Exchange Square
Central

Hong Kong

Tel: +852 2848 5200