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# Global: Economic Comment

## India on the Move

**What's new:** I am returning from my fourth trip to India in the last three years with great enthusiasm. I focused on three key themes — infrastructure, rural reform, and entrepreneurialism. India impressed me as being on the move on all three counts — especially encouraging since the macro story is also improving.

**Conclusions:** The macro and micro are coming together as a powerful combination for India. (1) Saving and investment shares are now in the 32-33% range of Indian GDP — a major breakout from the 20-25% shares of the past 15 years. (2) These threshold effects unshackle many of India's inherent strengths — a sharply rising population of scientists and engineers, a large stable of world-class companies, and an outstanding entrepreneurial class. (3) The entrepreneurs are making great progress in three of India's most important areas — rural reforms, retail, and infrastructure.

**Market implications:** As the darling of the liquidity play into emerging market equities, much of India's good news may well be in the price. In light of India's increasingly positive fundamentals, Ridham Desai, our India equity strategist, believes that any corrections in the 15-20% range should be viewed as an important buying opportunity.

**Risks:** India suffers from over-fixation on the China comparison. In the end, the story is not China *or* India — but most likely China *and* India. That poses an equally critical question: Are the rich countries of the developed world prepared for the ultimate endgame of globalization?

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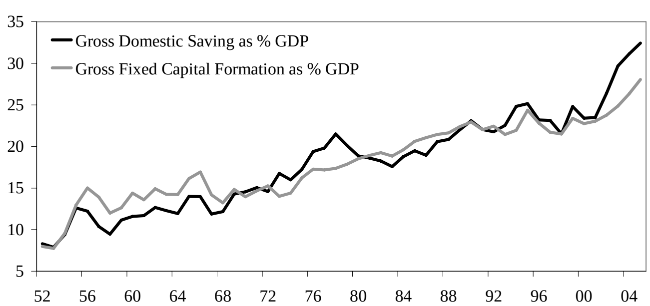
# India on the Move

I am returning from India with great enthusiasm. Many serious problems remain — especially the ravages of poverty. But in the past couple of years, India has faced many of its macro imperatives head-on — especially low saving, inadequate infrastructure, and lagging foreign direct investment. It is now making solid progress on two of those counts — saving and FDI — and infrastructure seems set to follow. These are the breakthroughs that can unshackle India's greatest strengths — a high-quality stock of human capital and the magic of its entrepreneurial spirit. As a result, there is now good reason to believe that the macro and micro are coming together in the world's second most populous nation. India is now on the move and could well be one of the world's most exceptional economic development stories over the next 3-5 years.

There's no dark secret about India's once seemingly chronic macro deficiencies. It is widely agreed that the key impediment has been an inadequate saving-investment equilibrium. The takeoff phase of economic development has long been associated with saving and investment rates in excess of 30% of GDP. China's breakthrough came when its ratios pierced the 40% threshold. Yet for decades, those of India have lingered in the 20-25% range. Lacking in internal saving and maintaining a relatively restrictive stance toward foreign direct investment, India has been unable to achieve critical mass in infrastructure and capacity growth — the main drivers of any investment-led development strategy.

Exhibit 1
**India's Saving and Investment**




Source: Central Statistical Organization of India, Morgan Stanley Research

That is changing. Official data now put national saving at 32.4% in the 12 months ending March 2006 — up significantly from the 25% average of the 1990 to 2004 period. At the same time, the aggregate investment ratio has moved up to 33.4% as of March 2006 — a major breakout from the 26% average of the preceding 15 years. And foreign direct investment is on target to hit US$13 billion in the 12 months ending March 2007, more than double India's previous best of $5.5 billion hit in the previous year. Infrastructure, however, remains a glaring laggard — likely to have held around 4.3% of Indian GDP in the 12 months ending March 2007 and little different from the range prevailing since the early 1990s.

No, these are not Chinese-style readings — saving and investment rates in the 40-50% range and foreign direct investment in the $50-60 billion vicinity. And the infrastructure contrasts are painfully obvious to anyone who travels in both India and China. But the challenge for India is not the race with China but more the race with itself. I have long feared that too much is being made out of this comparison between Asia's two giants. The more important point for India is that it is now climbing out of the macro saving-investment quagmire of the past. In my view, that's what matters most insofar as the threshold effects of economic development are concerned.

With India's macro headwinds turning into tailwinds, it stands a much better chance of tapping its inherent strengths — namely, a high-quality stock of human capital, a large number of world-class companies, and a spectacular entrepreneurial spirit. In my earlier trips to India, I spent considerable time boring into the human capital story. My focus was on the dynamic IT services and business-process outsourcing companies — Infosys, Wipro, TCS, Accenture, and Genpact. Far from call centers and data processing, these organizations are all in the business of providing high-value added, increasingly complex systems solutions to multinational companies around the world. And they do it by exploiting what could well be one of India's greatest inherent strengths — a highly educated, IT-enabled workforce that is benefiting from the addition of about 700,000 science and engineering graduates each year. That now puts Indian colleges and universities well ahead of those in the US, Europe, Japan, or China in turning out new entrants in these key segments of the knowledge workforce; that's also a near quadrupling of the number of scientists and engineers coming out of India's schools of higher education a decade earlier.

While I don't want to minimize India's human capital angle, in many respects, it's old news. What blew me away last week were the corporate and entrepreneurial stories. For all the buzz over China, one of the great paradoxes of the world's greatest development story is that it only has a handful of truly world-class companies. By contrast, India has a much deeper and broader stable of very powerful businesses. Moreover, it's not just IT services — it's also telecom, pharmaceuticals, energy, steel, and auto components. The just-announced Tata-Corus steel merger could well be a harbinger of the next wave of India's already impressive industrial prowess — the coming of age of the India-centric multinational corporation.

The strength of Corporate India starts at the top with outstanding leadership. Over the past few years, I have had the pleasure of spending time with many of India's corporate titans — from Ratan Tata and the Ambani brothers to its IT visionaries and senior bankers. True, it requires far more than brilliant executives for a nation to excel in competitive prowess. But in terms of strategic vision, innovation, execution focus, and cost-efficiency management, I would compare India's corporate leaders favorably with their counterparts in any other country in the world. Not only is this a huge advantage when compared with China, but it is likely to be a major plus for India as it fights for market share in the global competitive sweepstakes in the years ahead.

But the real spark in India's talent pool is a truly extraordinary entrepreneurial spirit — the risk-taking, innovative visionaries who have an uncanny knack to view new businesses as solutions to important problems or as building blocks to new markets in goods and services. Mukesh Ambani, Chairman of Reliance Industries, is an excellent good example of what is so special about the Indian entrepreneur. Not satisfied with the success of Reliance's core businesses in energy, petrochemicals, and textiles, Mukesh is now pushing ahead simultaneously on two of India's greatest challenges and opportunities — retail and agriculture. India's highly fragmented retail sector — populated still by over 12 million Mom-and-Pop-style establishments across the country — has long been ripe for a major efficiency campaign. In addition, India's agricultural sector, home to over 60% of the nation's population, has been the biggest laggard in the nation's growth story. Mukesh Ambani's current passion is to create a powerful synergy between these two opportunities — integrating what he calls the agro-input supply chain with a new network of large-scale retail establishments. His initial focus is on an IT-enabled agricultural distribution system, drawing on the scalable efficiencies of the Israeli kibbutz model while utilizing new IT platforms and growing rural connectivity. At the same time, he is forging ahead on the opening of new large-scale retail outlets — more than 50 stores have been opened in the past year with many more in the immediate pipeline. The concept and execution are both fascinating, and the benefits for India in terms of lifting rural incomes and boosting consumer purchasing power fit the nation's macro imperatives to a tee.

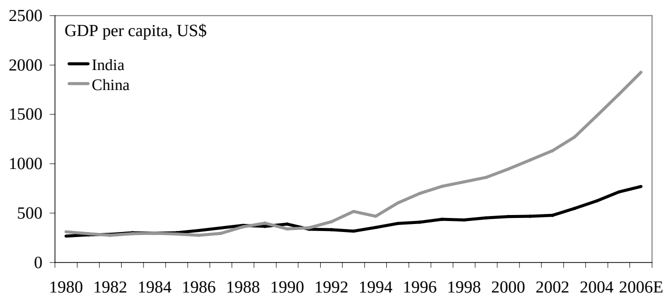
The entrepreneurs are also hard at work on the infrastructure story — tackling one of the most obvious of India's bottlenecks. While the aggregate numbers have yet to turn up, there's nothing but upside on the drawing boards. New Delhi highway construction is visible as soon as you leave the airport. The airport, itself, will be rebuilt by the GMR Group — the same organization that is pushing ahead on the new airport at Hyderabad. I had lunch with the Chairman and founder of this company, G.M. Rao — a self-made entrepreneur from very humble rural roots, who has an extraordinary vision of the future of Indian infrastructure. He spoke not just of new airports but of the "aerotropolis" concept that is now shaping the newest large airports of the world. GMR is also forging ahead on two other key aspects of Indian infrastructure — road construction and power generation. Mr. Rao's impressive track record, along with his drive, determination and vision, was contagious.

I had a similar impression after discussions with Dr. E. Sreedharan, Head of the Delhi Metro Rail Corporation and developer of a world-class subway in the Indian capital. I even took a ride on the new metro to see it for myself. As a frequent New York City straphanger, I instantly fell in love with the sleek, quiet, and ever-efficient Delhi subway. I also met with two key government officials charged with policy initiatives on the Indian infrastructure front — Praful Patel, Minister of Civil Aviation, and Sudhir Kumar, the number two official in the Ministry of Railways. These two very determined gentlemen stressed a powerful common theme — a customer-centric, market-driven public-private sector partnership as the only option for Indian infrastructure. Driven by reform-minded ministers who have remained steadfast in the face of political opposition, both India's rail system and the civilian aviation sector are likely to benefit significantly from a major acceleration of investment in the years ahead.

Finally, I spent some time with my old friend Rajiv Lall, Head of the Infrastructure Development Finance Corporation and a former member of our global economics team at Morgan Stanley in the 1990s. Rajiv is very focused on creative financing solutions that would enable India to achieve the intermediation capabilities to transform rising saving into accelerated infrastructure spending. He is confident in the macro endgame — an infrastructure investment share that rises from 4.3% of Indian GDP at present to 8% over the next 3-5 years. Based on what I learned on this trip from entrepreneurs, regulators, and financiers, it's hard to argue with that conclusion — a point that Chetan Ahya, head of our

India economics team, has been making for some time (see his November 2005 report, “India Infrastructure: Changing Gears”).

Exhibit 2
**Two Asian Development Paths**




Source: IMF, Morgan Stanley Research

This was my fourth trip to India in the past three years. Each of these missions is like peeling way the layer of an onion — the story comes into sharper and sharper focus. This time, I was focused on three key themes — infrastructure, rural reform, and entrepreneurialism. India impressed me as being on the move on all three counts. The China comparison is overdone. In my opinion, India suffers from excessive fixation in measuring itself against Chinese-style development metrics. We all know that China has opened up an extraordinary gap with India over the past 15 years — going from parity in per-capita GDP in 1991 to a tripling of India’s standard of living today. I am a huge fan of the Chinese miracle — and the investment-saving dynamic that has driven its spectacular development story. But China has pushed this model to its limits and now faces critical rebalancing imperatives of its own. Meanwhile, India is making great progress on the macro saving-investment constraint, which enables it to draw increasingly on its inherent strengths of human capital, thriving world-class companies, extraordinary entrepreneurs, and a well-developed financial system.

In the end, the story is not China *or* India — but most likely China *and* India. And that poses what undoubtedly is the biggest challenge of all: Are the rich countries of the developed world prepared for the ultimate endgame of globalization? Right now, that is not the case (see my 2 February dispatch, “Unprepared for Globalization”). Meanwhile, the developing world is not about to wait for the developed world to get its act together. I saw that first hand last week in India.

For investors, there is an important twist: As the darling of the liquidity play into emerging market equities, much of India’s good news may well be in the price. Even so, the longer-run outlook for Indian equities is still very promising. In light of India’s increasingly positive fundamentals, Ridham Desai, our India equity strategist, believes that any corrections in the 15-20% range should be viewed as an important buying opportunity.

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