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India Economics

Monthly

The Retail Revolution – The Macro Story – Indian retail continues to be one of the largest segments attracting fresh investments from the private sector. Apart from existing players (such as Pantaloon) ramping up their retail chain store operations, many large business groups, including Reliance Industries, Birla group and the Bharti-Walmart combine, have announced their intention to cumulatively invest over US$10 billion over the next five years to capture a share in the fast-growing pie of the organized retail segment. *See page 4*.

RBI Adopts Wait-and-Watch Policy Stance – In its mid-term review of monetary policy, the Reserve Bank of India (RBI) left the reverse repo rate (the rate at which RBI absorbs excess liquidity) unchanged at 6% and announced a 25 basis point hike in the repo rate (the rate at which RBI infuses liquidity) to 7.25%. We read this as a wait-and-watch policy stance with a pro-growth bias. *See page 9*.

2008: The Year of Payback – As cyclical factors supporting growth reverse over the next two years, GDP is likely to decelerate. After recording a GDP growth of 8.5% in F2007 (fiscal year-ending March 2007), we expect India's GDP growth to moderate to 7.3% in F2008 and 6.9% in F2009. *See page 12*.

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Asia Ex-Japan Economic Forecast Summary

	2002	2003	2004	2005E	2006E	2007E
Real GDP Growth (%)						
Asia Ex Japan	**6.6**	**7.0**	**7.9**	**7.7**	**8.0**	**6.9**
AXJ (x-China and India)	**5.0**	**3.9**	**5.9**	**4.8**	**5.2**	**4.4**
Asia Pacific*	**6.3**	**6.5**	**7.3**	**7.1**	**7.3**	**6.2**
China	9.1	10.0	10.1	10.2	10.5	9.3
Hong Kong	1.8	3.2	8.6	7.2	6.6	5.0
India	4.5	7.4	7.3	8.2	8.4	6.8
Indonesia	4.4	4.7	5.1	5.6	5.3	5.3
Korea	7.0	3.1	4.6	4.0	5.1	4.3
Malaysia	4.4	5.5	7.2	5.2	5.5	5.0
Philippines	4.4	4.5	6.0	5.1	5.5	4.2
Singapore	4.0	2.9	8.7	6.4	7.5	5.0
Taiwan	4.2	3.4	6.1	4.0	4.3	3.5
Thailand	5.3	7.0	6.2	4.5	3.9	4.0
Australia	3.9	3.3	3.2	2.6	2.5	1.1
CPI Inflation (%, Period Average)						
Asia Ex-Japan	**1.4**	**2.0**	**3.5**	**3.0**	**3.1**	**3.0**
Asia Pacific*	**1.5**	**2.1**	**3.4**	**2.9**	**3.1**	**2.9**
China	-0.8	1.2	3.9	1.8	1.5	2.5
Hong Kong/[1]	-3.0	-2.6	-0.4	0.9	2.0	2.5
India	4.3	3.8	3.8	4.0	5.1	4.2
Indonesia	11.9	6.8	6.1	10.5	13.2	6.0
Korea	2.8	3.5	3.6	2.8	2.7	2.5
Malaysia	1.8	1.1	1.4	3.1	3.8	2.8
Philippines	3.0	3.5	6.0	7.7	7.3	6.3
Singapore	-0.4	0.5	1.7	0.5	1.3	1.2
Taiwan	-0.2	-0.3	1.6	2.3	0.6	1.0
Thailand	0.6	1.8	2.8	4.5	5.0	4.3
Australia	3.0	2.8	2.3	2.7	2.8	2.2
Current Account (% of GDP)						
Asia Ex Japan	**3.5**	**4.2**	**4.1**	**5.1**	**5.9**	**5.7**
China	2.4	2.8	3.6	7.2	8.8	9.0
Hong Kong	7.6	10.4	9.5	11.4	10.3	10.0
India	1.4	1.5	0.1	-1.1	-1.3	-1.7
Indonesia	4.0	3.4	1.5	1.1	2.5	1.8
Korea	1.0	2.0	4.1	2.1	0.9	0.5
Malaysia	8.4	12.8	12.6	15.1	12.8	10.9
Philippines	-0.5	0.4	1.9	2.3	3.0	2.3
Singapore	13.4	24.1	24.4	28.5	30.8	30.5
Taiwan	8.7	9.8	5.7	4.6	6.9	6.7
Thailand	5.5	5.6	4.2	-2.1	-2.1	-2.7
Interest Rates (Prime Lending Rate, %, Period End)						
China/[2]	5.3	5.3	5.6	5.6	6.4	6.9
Hong Kong	5.0	5.0	5.0	7.8	8.0	8.3
India	10.8	10.3	10.3	10.3	10.5	10.8
Indonesia/[2]	18.3	15.1	13.4	16.2	15.1	12.9
Korea/[3]	5.5	5.2	3.5	5.5	5.0	4.7
Malaysia	6.4	6.0	6.0	6.2	6.8	6.6
Philippines	8.5	10.3	11.3	10.8	10.8	10.8
Singapore	5.4	5.3	5.3	5.3	5.5	5.3
Taiwan/[4]	7.3	3.3	3.5	3.7	4.2	4.2
Thailand	6.5	5.6	5.6	6.6	7.5	7.5
Interest Rates (3-Month Interbank Rate, %, Period End)						
China/[6]	1.7	1.7	1.7	1.7	2.3	2.8
Hong Kong	1.5	0.1	0.3	4.2	4.7	5.2
India/[5]	5.6	4.3	5.3	5.8	6.5	6.5
Indonesia/[6]	13.6	7.1	6.7	11.8	10.4	8.1
Korea/[7]	4.9	4.4	3.4	4.1	4.6	4.3
Malaysia	3.0	2.9	2.8	3.2	3.7	3.4
Philippines/[5]	5.2	6.5	7.8	5.2	5.2	5.2
Singapore	0.8	0.7	1.4	3.3	3.0	2.5
Taiwan/[8]	1.8	1.2	1.4	1.7	2.2	2.4
Thailand/[9]	1.8	1.0	1.0	2.5	3.8	3.8
USD Exchange Rate (Period End)						
China	8.28	8.28	8.28	8.07	7.70	7.50
Hong Kong	7.80	7.76	7.77	7.75	7.80	7.80
India	48.14	45.63	43.45	45.03	45.50	45.00
Indonesia	8,940	8,418	9,272	9,825	9,100	8,800
Korea	1,186	1,193	1,035	1,008	947	935
Malaysia	3.80	3.80	3.80	3.78	3.64	3.45
Philippines	53.3	55.5	56.3	53.0	50.0	48.5
Singapore	1.74	1.70	1.63	1.66	1.57	1.52
Taiwan	34.8	34.0	31.7	32.8	33.0	32.5
Thailand	43.2	39.6	38.9	41.0	37.0	36.0
Australia	0.57	0.75	0.78	0.73	0.72	0.69

(1) Composite Consumer Price Index (2) Exclude GST for 2000-2002 (3) 1-Year Working Capital Rate (4) 5-Year National Housing Bond Yield
(5) Taiwan First Commercial Bank Prime Lending Rate before 2003, Base Lending Rate since 2003 (6) 91-Day Treasury Bill Rate (7) 3-Month Time Deposit Rate
(8) 91-Day Yield on Certificates of Deposit (9) 90-Day Money Market Middle Rate (10) 3-6 Month Time Deposit Rate
Dated as of Nov. 24, 2006 E = Morgan Stanley Research Estimates * GDP and CPI for Asia Pacific includes Asia Ex-Japan and Australia

The Retail Revolution – The Macro Story

Nov. 22, 2006

Domestic Private Sector Is Rushing to Announce Retail Plans

Even as the government continues to delay the decision to allow FDI in multi-product retail chains, the fast-emerging Indian retail sector is becoming widely recognized amongst domestic entrepreneurs and investors as one of the biggest opportunities in India. Apart from existing players (such as Pantaloon) ramping up their retail chain store operations, many large business groups, including Reliance Industries, Birla group, and Bharti Enterprises, have announced their intention to cumulatively invest over US$10 billion over the next five years to capture a share in the fast-growing pie of the organized retail sector. In addition, various foreign players such as Walmart and Tesco have announced their intentions to enter the domestic market via a joint venture with a domestic Indian player. Major consumer spending items currently form part of the addressable market for the retail chain stores format and include food and grocery, general merchandise (such as furniture and furnishings), and apparels. While growth estimates for the organized retail sector vary, forecasts by our Consumer analyst, Hozefa Topiwalla, indicate that India's organized retail market is likely to grow from the current US$4 bn (2.1% of total relevant consumer spending) to US$ 64 billion (10.8%) by F2015.

It's Not Just About the New Shopping Ambience

Until 2002, even consumers in India's top cities, such as Mumbai, had no choice but to purchase their daily food and consumables from small-scale mom & pop stores. Meaningful introduction of organized retail chains across the major metros has started only over the past 3-4 years. Prior to this, the Indian consumer had access to a limited variety of goods and the quality of available goods was poor. The existing distribution system is completely fragmented with mom & pop shops that operate with little use of technology. Inventory management is inefficient and the fragmented structure implies that they have little negotiating power, while purchasing goods from wholesale traders.

However, the shopping experience for Indian urban consumers is now changing completely. What is triggering this change? On the demand side, rising per capita income of the fast-emerging middle-aged population and easier access to credit are triggering a change in consumption patterns. On the supply side, the private sector is responding with investments, taking advantage of the positive support from capital markets. Retail shopping space is also growing exponentially. Mall space has increased to 54 million square feet (mn sq. ft) currently from 2.2 mn sq. ft four years back.

Exhibit 1

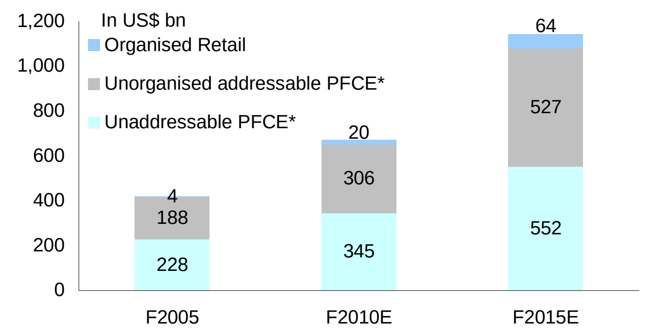
India's Retail Sector: Basic Facts

- India's *relevant* private final consumption expenditure (PFCE) is estimated to be about US$221 (28% of GDP) billion as of F2006. Note we are excluding part of PCFE such as rent, fuel & power from the relevant spending estimate.
- Currently, Indian retail distribution is completely fragmented with about 12 mn players operating from small shops and handcarts.
- Organized retail sector is currently just about 2.2% of the total relevant PFCE Overall PFCE is estimated to have grown at 11.6% over the last three years.
- Organized retail sector is estimated to be growing at 15-20%.
- Wholesale and retail trade sector currently contributes to about 13% of GDP and employs about 40 million people.
- Food and beverages account for 38% of the total retail spending.

Source: CSO, Morgan Stanley Research Estimates

Exhibit 2

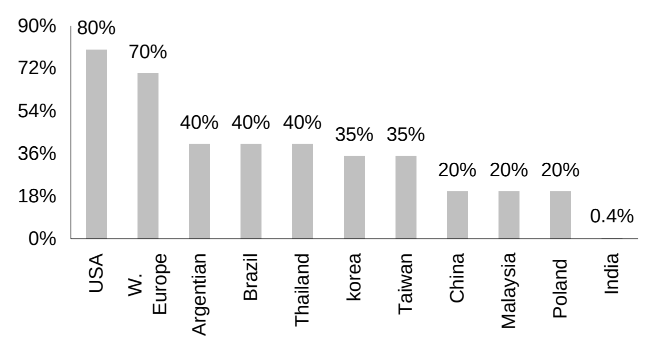
Organized Retail Opportunity



Source: CEIC, CSO, ACNielsen, Morgan Stanley Research
* PFCE = Private Final Consumption Expenditure; E= Morgan Stanley Research Estimates

Exhibit 3

Penetration of Organized Retail



Source: FDI In Retail Sector (ICRIER), Morgan Stanley Research

According to Images Retail, the space is likely to rise further to 88 mn sq. ft by the end of 2007.

In the first phase of the retail revolution, the focus of entrepreneurs has been largely on capturing the consumers' attention and providing them with a new shopping experience. There has been little effort on reforming the back-end of the supply chain. However, going forward the rising scale of organized retail distribution network and increasing competition will force players to focus on reforming the whole supply chain to improve productivity and provide an attractive deal to customers.

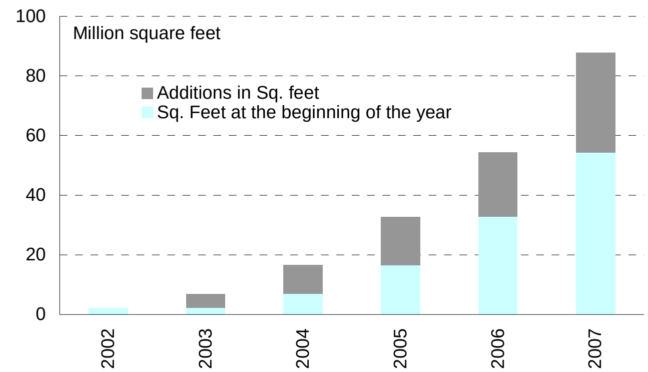
Restructuring the Supply Chain

The retail revolution, involving an increase in input of capital, technology and new management practices, can potentially reform each and every part of the retail business chain over the next few years. It will restructure: (a) retail distribution via higher asset turnover and better inventory management; (b) intermediary and logistics management; and (c) production management in the case of both agriculture and manufacturing. Although, total spending through organized retail chain store format is likely to be only about 10% of the addressable market by F2010, the impact of this trend on productivity across the retail food chain can be more than proportionate, in our view.

***Transformation in retail distribution*:** Currently, Indian retail distribution is completely fragmented with about 12 million players. The majority of these are very small players operating from small shops (below 50 square feet in size) and handcarts. These retail outlets are spread across the country in over 5,000 towns and 600,000 villages. In the absence of complete data related to the distribution of current mom & pop retail shops, distribution of fast-moving consumer goods (FMCG) distribution could be used a proxy, in our consumer analyst's view. Data from AC Nielsen indicates that the top six cities contribute around 19% of FMCG consumption, whereas the top 23 towns represent around 29%, and the top 301 towns about 48%. In our view, large retail companies are likely to be more aggressive in the top 20-30 towns. Penetration in the smaller towns is not likely to begin in a hurry. Apart from obvious improvement in consumer satisfaction, retail chain store distribution will help improve efficiency in distribution via higher asset turnover and better inventory management.

Exhibit 4

Growth in Mall Space



Source: Images Retail, Morgan Stanley Research

Reducing large inefficiencies in the agriculture related supply chain: This segment suffers from maximum inefficiency currently. Cumulative wastage in this supply chain is estimated to be about US$11 billion, or 9.8% of agriculture component of GDP. Over the years, owing to government intervention in the input and output pricing, there has been little incentive for farmers to improve efficiency. Moreover, in the past few years, public investment in agriculture as a percentage of GDP has also been gradually declining. The archaic infrastructure for reaching the agricultural produce from farm-gate to consumers has meant huge losses in transit and large markups in pricing due to extra layers of intermediation. Until recently, most states controlled the marketing of agricultural produce through the Agricultural Produce Marketing Committee (APMC) Act. Not surprisingly, due to this lack of government support on infrastructure and restrictions on private sector participation, the agricultural sector has only been growing at an annual average of 1.8% over the past five years.

However, the outlook for the agricultural sector is finally improving as state governments have started implementing legislative reforms. Thirteen states and three union territories have amended the APMC Act allowing private sector participation in direct purchases of agricultural produce from farmers. We believe that the rise in presence of the organized retail sector will accelerate reform in the agriculture sector. Farmers will be incentivised to adopt improved management techniques to increase efficiency, better quality output and also provide the needed variety to consumers. As scale builds up, increased commercial opportunity should also attract the private sector in agriculture logistics management, reducing the number of intermediaries. The plans announced by some of the likely large retail players reflect the potential food-chain restructuring that could take place.

Indeed, certain large players have already begun participating and investing in this area. For instance, ITC – a large Indian FMCG company – has initiated an effort to place computers with Internet access in rural farming villages (known as e-choupals[1]). Via these kiosks, the company provides the farmers with a more transparent pricing mechanism and secure operating framework. The company has been able to procure agricultural products are at a lower cost and farmers are able to increase their realizations.

SME manufacturing will get a major demand boost and also face pressure to increase efficiency: The development of the organized retail sector should also result in restructuring of small and medium scale manufacturing. We believe that some of the large players in the retail business will encourage the emergence of efficient small and medium-sized suppliers of modern retail goods. Two major segments in the small and medium scale manufacturing sector that could get a boost from the emergence of the retail chain stores are textiles & clothing and food processing industries. In industries such as fast moving consumer goods, where India already has a large organized sector presence in the supply chain (via MNC's and domestic companies), efficiency will come from better inventory management and responsiveness to customer feedback.

However, in the near term, the organized retail chain stores could rely on imports for certain segments such as toys, select types of general merchandise and electronics goods. Unlike India, China's organized retail sector is being developed before a globally competitive SME sector has been developed. Moreover, China has already built economy-of-scale advantages in certain goods where it will be difficult for Indian players to compete in the near term. Success of Indian players will also be dependent on the government's support in improving infrastructure and enabling tax legislations.

Intermediation/Logistics: One of the key hurdles to Indian agriculture and small/medium scale manufacturing sector productivity growth has been the lack of infrastructure support from the government. In 2005, infrastructure spending was US$28 billion in India (3.6% of GDP) compared with US$201 billion in China (9.0% of GDP). The IMD World Competitiveness Year Book (2006) ranks India 47th among 61 nations in terms of distribution efficiency. The reason for this poor score is inadequate investment in infrastructure and the fragmented nature of the logistics industry. We believe that development of the organized retail sector could trigger a change in this industry as manufacturers and retailers rely on outsourcing to third-party logistics providers and also create economies of scale advantages for warehousing and transportation.

Macro Impact – More Positive than Negative

The emergence of the organized retail sector is likely to have a transcending impact on India's macro. Some of the key macro implications are summarized as follows:

Productivity growth and inflation: The obvious positive effect of the emergence of organized retail trade in the competitive market will be an increase in productivity and reduced inflation in the economy. The productivity benefit will stem from the aforementioned supply chain changes and the increased disintermediation in the system. For instance, according to a study by the McKinsey Global Institute, the retail sector contributed to nearly one-quarter of the productivity growth jump in the United States from 1987-95 to 1995-99. The productivity benefit will likely be shared with the consumers (lower end-product prices) – hence leading to lower inflation.

Trade balance and export competitiveness: Initially, due to supply-side constraints and lack of economies of scale in select goods, increased demand could lead to an increase in imports from other countries and a wider trade deficit. Our discussion with the existing retail chain store players indicates that currently, chain stores that cater to the middle class segment of the population already have an import content of about 15%. Chain stores that cater to the upper middle class and higher income population tend to have an even higher proportion of import content. Over the next few years, as the small and medium scale sector further builds scale and capabilities to manufacture, it could be able to substitute imports of some of these goods as well as improve their revenues from exports of agricultural and manufactured products. We believe this trend will be further supported if the FDI in retail is allowed.

Employment trend: The retail and wholesale trade sector contributes to 13% of GDP and employs about 40 million people (9% of workforce). It is the third-largest employer after the agriculture and manufacturing sectors. The sensitivity of this retail sector restructuring on the lower middle class population is indeed very high. A large of number of households depend directly on this sector for their livelihood. A majority of these mom & pop shops are very small in size (below 50 square feet) and are being used as a last resort employment opportunity by many of the low skilled working-age population. In many ways, it has been acting as a safety net for a specific section of the poor.

[1] "Choupal" is a Hindi word that translates into meeting place.

Over the next two-three years, the development in the retail sector may not have significant impact on the existing mom & pop shops. However, in the medium term, as the reach of chain stores increases, some adverse impact on mom & pop shops is inevitable. We believe that not allowing FDI in the retail sector is hardly a solution to prevent the adverse effect, as the domestic private sector will still be a force to reckon with. In our view, opposition to evolvement of organized sector retail chain stores is no less legitimate than opposition to the removal of protection provided to many sectors in the early 1990s liberalization program. The liberalization program of the 1990s also forced a major restructuring of the workforce. Restructuring of an economy that is still at a developing stage in today's globalizing, competitive world is inevitable. Embracing such a change is less difficult for a country such as India whose population has a median age of 24 years.

The issue of employment should be assessed not only from the perspective of welfare of specific segment of lower middle-income group (LMIG) population dependent on mom & pop shops but also from the viewpoint of welfare of the overall LMIG population. Although a specific section of the LMIG already employed in mom & pop shops may be adversely affected, the emergence of the organized retail sector will create new jobs for a different section of the lower middle class in low-end modern retailing distribution, small-scale manufacturing, packaging, construction, infrastructure and transport sector. Moreover, we believe that the lower middle-class also stands to gain from the higher productivity (in the form of lower inflation) benefit that the organized retail sector offers. The quality of employment will also see a vast improvement as larger institutions will be able to provide better social security, training and growth opportunities. Indeed, increased organized sector activity should help increase aggregate tax to GDP that would allow the government to initiate measures for direct intervention for reducing the adverse impact on any specific section of the population.

Pace of Change Will Depend on Government's Response

While we believe that the emergence of the organized sector will itself be a trigger to restructuring of the supply chain, the government's response in enabling this transition will be a key factor in determining the pace of the improvement. Some of the areas where a supportive role from the government will be important:

Infrastructure investments: Although we expect some push for infrastructure investments from the private sector as it attempts to build an organized supply chain, there is clearly a need for a strong response from the government in building the infrastructure needed for quick transition in the supply chain. We believe that the primary responsibility for development of infrastructure lies with the government. These projects by their very nature are long-gestation and low ROE projects, highly dependent on government regulations. The response of the government on infrastructure development will determine Indian producers' (SMEs and farmers) capability to compete with other developing economies such as China in filling up the shelves of the organized retail format. Although infrastructure spend is finally picking up as a percentage of GDP, the pace needs to be more rapid.

Foreign direct investment: In January 2006, the government approved new FDI norms for the retail sector and allowed up to 51% FDI in single-brand retailing. However, the decision to allow foreign direct investment in the multi-product retail chain stores has been delayed and remains a politically sensitive issue. There are some political groups that are opposing this decision due to its perceived implications for the mom & pop shops. We believe that not allowing foreign players is hardly resolving the issue as the domestic private sector is continuing to ramp up retail chain stores in any case. Indeed, if participation of foreign players is allowed in partnership with domestic players, it can help the sector evolve in a more efficient manner as these foreign players bring technology and expertise. Increased presence of the foreign players can also potentially help Indian manufacturers participate in the international goods outsourcing market – an area where India has struggled to compete with China. We believe that if the government desires to be conservative, it could allow FDI with certain restrictions. The entry of foreign players could be restricted by limiting the geographical distribution and the quantum of stores that can be opened in a particular region. The government could screen the entry of foreign players on the basis of minimum investment requirements. Foreign players could also be required by the government to have a minimum domestic sourcing requirement or even have a reciprocal goods outsourcing requirement.

Agriculture sector: One of the key reasons for the low growth in the agriculture sector over the past few years has been the gradual decline in the government's capital spending on the sector to 0.5% of GDP in F2006 from 1.2% in F1982. Although the government has finally started initiating measures on improving agricultural productivity, the pace of the change is still slow. The government needs to make a concerted effort to increase capital investment in the agriculture sector and improve the effectiveness of current spending. In addition, the government also needs to support an acceleration in agriculture productivity growth in the sector (via a better fertilizer pricing policy and improved irrigation facilities) and also help diversify the agriculture product mix (via provision of better storage facilities, encourage the development of the food processing industry and provide proper crop insurance products). Finally, the government also needs to further liberalize trade in the agriculture commodities so that farmers become more commercially oriented towards export markets.

Legislative Reforms: The government needs to create an enabling environment in many areas to ensure swift development of the sector.

Various states are yet to implement legislative reforms in property related laws such as the Urban Land Ceiling Act, Stamp Duty laws and Rent Control Act. These laws have been slowing property development in the country and hence have been one of the factors resulting in rising property prices (and hence rentals). These high prices could prove to be a major hurdle for the organized sector retail players in acquiring the necessary real estate.

In addition, the government also needs to ensure quick implementation of the reform in the inter-state trade-related taxation law. Currently, the central government charges 4% sales tax on all inter-state sales of goods. This regime encourages companies to set-up storage facilities in each state to avoid being taxed on these movements. This proves to be a disincentive to the development of a nation-wide distribution system, especially via third-party logistics providers. Indeed, the government has announced a road-map wherein the levy on output by the central government (central sales tax) will be merged in common nation-wide rate by April 2009.

This note forms part one of our three-part series on the retail sector titled "The Retail Revolution". The second and third part of the series focused on the impact of the emergence of organized retail on the agriculture sector (November 25) and small and medium manufacturing (November 30).

RBI Adopts Wait and Watch Policy Stance

Nov. 1, 2006

Reverse Repo Unchanged, Repo Hiked by 25 bps
In its mid-term review of monetary policy, the Reserve Bank of India (RBI) left the reverse repo rate unchanged at 6% and announced a 25 basis point hike in the repo rate to 7.25%. The reverse repo is the rate at which the RBI absorbs excess liquidity. The reverse repo rate had become the key short-term policy rate since 2002, in line with the sharp rise in forex reserves. The repo rate is the rate at which the RBI injects liquidity into the money market. As and when excess liquidity winds down, the relevance of the repo rate increases (Exhibits 1 and 2).

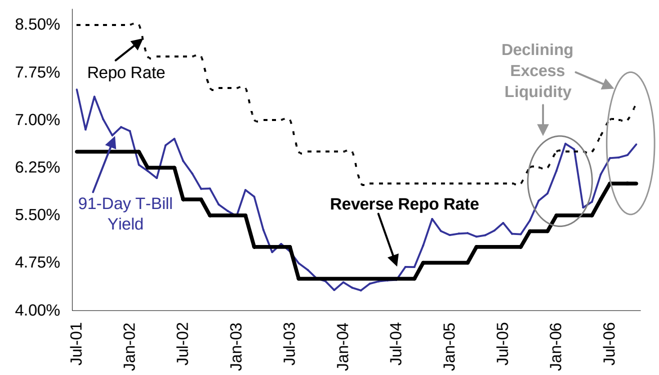
Trend in Excess Liquidity Is the Key
Excess liquidity stock levels have been driven largely by capital inflows, apart from the domestic liquidity absorption rate. Since F2003, rising capital flows (40% of which are portfolio equity flows) had caused a huge increase in forex reserves, resulting in excess liquidity. Foreign capital inflows not absorbed (excess liquidity) by the domestic economy were sterilized by the Central Bank in the form of short-term paper issued in the money market (reverse repo and monetary stabilization bonds) to control money supply.

A sharp slowdown in foreign exchange reserves accretion (due to lower inflows of portfolio equity investments or otherwise) results in a decline in excess liquidity. This would mean that the RBI would have to start injecting liquidity into the system instead of absorbing excess liquidity. In effect, the relevant short-term policy rate would then become the repo rate instead of the reverse repo rate. Hence, for the money market, short-term rates would effectively transition to 7.25% as the floor rate.

What Does RBI's Policy Move Mean for the Interest Rate Outlook?
If the excess liquidity stock is high, at above US$20 bn, the reverse repo rate (the rate at which the RBI absorbs liquidity) is the relevant rate. In that environment, the short-term market rate will remain close to the reverse repo rate and hence ward off pressures on the banking system to raise its lending rates.

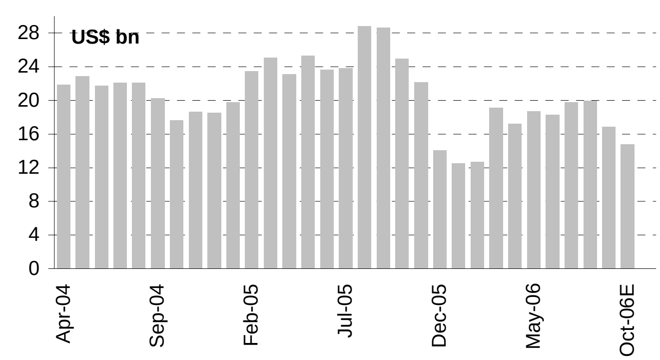
However, the bad news is that excess liquidity stock is declining and the risk of repo rate coming into play is rising. In that context, the move to hike the repo rate by 25 basis points has raised the risk of a sharper indirect rate hike in the future. Indeed, the recent decline in excess liquidity stock has already pushed the 91-day T-bill rate to 6.7% (significantly

Exhibit 1
Short Rates Trend



Source: RBI, Morgan Stanley Research

Exhibit 2
Stock of Excess Liquidity[1]



1. Net Reverse Repo Position + Outstanding Amount under Market Stabilization Scheme + Central Government's Surplus with the Central Bank. Source: RBI, Morgan Stanley Research

higher than the reverse rate of 6%). A similar (albeit temporary) shock was felt by the market in January-February 2006, when excess liquidity had shrunk to US$12.5 bn (see Exhibit 1). If the current declining liquidity trend continues, short rates will effectively transition to the repo rate of 7.25%, raising the cost of borrowing.

Monetary Policy – Wait-and-Watch Stance with a Pro-Growth Bias
The RBI's July monetary policy statement had led us to believe that its bias was increasingly tilting towards maintaining stability, even if that implied paying the necessary price of lower growth. However, today's policy statement seems to have shifted the bias back towards a pro-growth with a 'wait and watch' stance. We believe three factors have permitted and/or driven this stance:

a) Conducive global conditions: A change in market expectations regarding the peak of the Fed rate cycle has clearly raised market hopes of a possible pause in policy rates. Since the last monetary policy announcement by the RBI in July, the US interest outlook appears to have changed. The Fed has skipped rate hikes in two consecutive meetings and the Fed Funds Futures, which were discounting a 5.4% rate in December 2006 at the time of the last monetary policy announcement by RBI, are now discounting a rate of 5.25%. Many other Central Banks have also paused after steadily hiking rates over the last two years. This trend has reduced the pressure from global factors on the RBI to hike rates.

b) Waiting for past measures to work their way through: Over the past few months, credit growth has started decelerating, as a result of (i) the lagged impact of the steady rise in real interest rates increasing supply constraints on banks' balance sheets (i.e. low deposit growth) and (ii) the RBI's measures to control aggressive credit by increasing risk weights for banks lending to certain sectors. Indeed, there has historically been a significant lag in the trend in bank credit growth compared with the real 10-year yield trend as financial intermediaries tend to be slow to reflect this trend in lending rates (Exhibit 3). The Central Bank has chosen to pause and gauge the impact of the above-mentioned factors over the next few months. We believe that the RBI is wary of getting over-cautious in its efforts to dampen credit growth lest it result in a sharper-than-expected slowdown.

c) Limited utility of reverse repo as a policy tool: The final factor that has driven this decision is the limited utility of the reverse repo rate as a monetary policy tool. There are two reasons for this. First, a higher reverse repo rate would imply higher sterilization costs for excess liquidity. Second, and more importantly, higher rates (i.e. higher return on excess liquidity) would have then attracted more arbitrage money and, in turn, may have defeated the purpose of reverse repo as a policy tool.

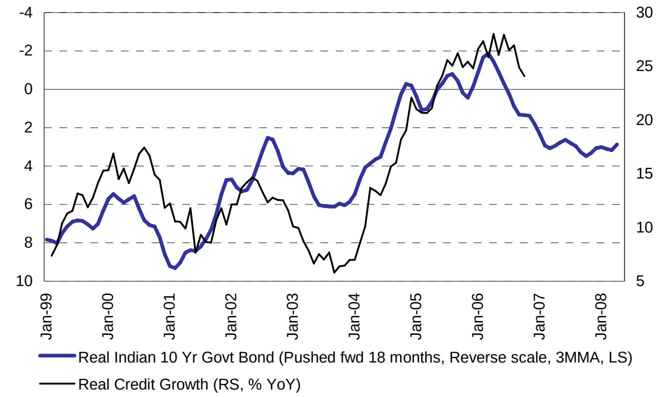
Risks of Pro-Growth Policy Bias

While our base case scenario assumes that there will be a soft landing in credit growth and debt-funded GDP growth, the underlying macro-stability risks have increased as a result of the pro-growth bias in the monetary policy announcement. There are five key reasons for the same.

One, the mix of incremental credit disbursement remains biased towards funding consumption and less productive sectors (see Exhibit 6). Additionally, the cost of credit is just

Exhibit 3

Indian 10-year Real Interest Rates Vs Real Credit Growth



Source: RBI, Morgan Stanley Research

Exhibit 4

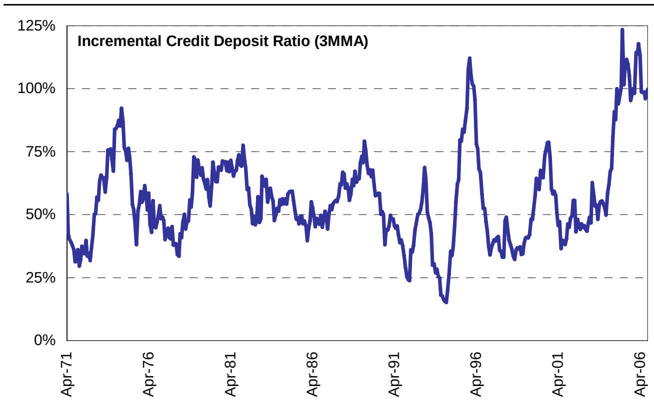
Policy Measures by RBI to Address its Concerns

Date	Measure
Oct '04	- Risk weight on housing loans increased to 75% from 50% - Risk weight on consumer credit (including personal loans and credit cards) increased to 125% from 100%
July '05	- Risk weight on capital market and commercial real estate exposures increased to 125% from 100%
Oct '05	- General provisioning requirement for 'standard advances', with the exception of banks' direct advances to agricultural and SME sectors, increased to 0.4% from 0.25% - RBI limits banks' exposure to capital markets at 40% of net worth of a bank compared to 5% of total loans earlier.
April '06	- Risk weights on commercial real estate increased to 150% from 125% - Increase in general provisioning requirement for 'standard advances' in specific sectors (commercial real estate loans, residential mortgages of greater than Rs. 2 Mn in value, personal loans and capital market exposures) to 1% from 0.4% on a phased basis over the fiscal year ended March 2007.

Source: RBI, Morgan Stanley Research

Exhibit 5

Incremental Credit-Deposit Ratio (3MMA)



Source: RBI, Morgan Stanley Research

beginning to rise and the banks' credit risk pricing curve remains relatively flat.

Two, although credit growth will likely slow due to the lagged effect of past measures, the pace of the slowdown could be slower than estimated.

Three, the stretched banking sector balance sheet has been a key source of concern for the RBI. Although credit growth has moderated to 29.3% from its peak of 33%, it remains significantly higher than deposit growth of 19.7%.

Four, the low interest funded credit consumption is resulting in deterioration in the current account deficit, which in turn is offsetting the capital inflows into the country and weighing on the accretion of forex reserves.

Five, the dependence on less-stable foreign capital flows (and rising forex reserves) to fund credit growth is already high. These less stable capital flows into EM/India have invariably gone through cycles, driven by rates and risk appetite in the developed world. We believe that any slowdown (not necessarily outflow) in capital inflows due to a change in the global environment could result in a decline in excess liquidity and result in a disruptive rise in interest rates.

Exhibit 6

Segmental Breakdown of Non-food Bank Credit

	% YoY		% Contribution to Credit Growth	
	As on Jun-06	**As on Mar-06**	**As on Jun-06**	**As on Mar-06**
Non-food Gross Bank Credit (1 to 6)	**44.6%**	**40.5%**	**100.0%**	**100.0%**
1. Agriculture and Allied Activities	**36.8%**	**37.6%**	**11.6%**	**11.6%**
2. Industry (Small, Medium and Large)	**26.6%**	**28.6%**	**25.7%**	**30.1%**
-- Small Scale Industries	21.7%	21.0%	4.0%	3.9%
-- Infrastructure	28.3%	37.7%	5.4%	7.3%
3. Services	**207.1%**	**57.4%**	**8.4%**	**4.3%**
-- Transport Operators	193.8%	67.7%	2.5%	1.6%
-- Professional and Others	218.1%	21.2%	3.2%	0.7%
4. Personal Loans	**47.2%**	**44.4%**	**28.4%**	**26.8%**
-- Housing	54.3%	44.8%	16.5%	14.2%
-- Advances against Fixed Deposits	23.0%	16.9%	1.5%	1.2%
-- Credit Cards	199.2%	59.3%	1.2%	0.8%
-- Education	138.7%	96.5%	1.6%	1.2%
-- Consumer Durables	-1.5%	-3.3%	0.0%	-0.1%
5. Trade	**70.0%**	**40.5%**	**7.9%**	**5.8%**
6. Others	**88.7%**	**75.8%**	**17.9%**	**21.3%**
-- Real Estate Loans	102.4%	100.6%	3.3%	3.3%
-- Non-Banking Financial Companies	45.4%	37.6%	2.1%	2.1%

Source: RBI, Morgan Stanley Research

Exhibit 7

Policy Signals by the RBI

Monetary policy dated:	Signal
April '03	RBI cuts bank rate by 25 bps; mentions that further significant movement will be difficult
April '04	Benchmark rates unchanged; RBI highlights that international rates may rise, but domestic factors warrant stability
Oct '04	Repo rate increased by 25 bps, transitioning to a rising rate environment
April '05	Monetary policy tightening continues; repo rate increased by an additional 25 bps
Jul '05	Monetary stance unchanged; however, RBI maintains status quo on rates
Oct '05	RBI cautions on inflation pressures, credit risks, widening current account deficit and asset bubbles; repo rate increased by an additional 25 bps
Jan '06	RBI re-iterates that global and domestic concerns are threatening macroeconomic and price stability; repo rate increased by an additional 25 bps
April '06	RBI maintains status quo on rates; adopts balanced approach with an equal focus on maintaining growth momentum and price stability.
Jun '06	RBI raises repo and reverse repo rate by 25 basis points between policy announcements; decision driven by changing global interest rate conditions.
Jul '06	Policy rates hiked by another 25 basis points; prompted by rising concerns that are threatening macroeconomic stability
Oct '06	Reverse repo rate left unchanged at 6%. Repo rate hiked by 25 bps to 7.25%

Source: Morgan Stanley Research

2008: The Year of Payback

Dec. 4, 2006

Summary

India has witnessed one of its strongest growth cycles over the last three years. However, we believe that a significant part of the acceleration in growth was borrowed from future growth. As cyclical factors supporting growth reverse over the next two years, GDP growth is likely to decelerate. After recording a growth of 8.5% in F2007 (fiscal year-ending March 2007), we expect India's GDP growth to moderate to 7.3% in F2008 and 6.9% in F2009. Our growth estimates are premised on the view that India is heading for a soft landing in its growth cycle, as the cost of capital is rising and macro stability parameters are at worrying levels restricting policy makers' ability to allow the strong growth trend to continue.

India has seen strongest growth cycle in recent history

India has achieved strong economic growth of 8.2% pa over the past three years versus 6.2% pa in the preceding ten years. This compares with average economic growth of 10.3% pa for China and 5.3% pa for Emerging ASEAN countries in the past three years. Although we believe that some acceleration is warranted due to structural factors, the greater part of growth has been a result of the sharp rise in capital flows in response to an increase in global risk appetite. The global liquidity spillover into India has allowed the government to pursue relatively loose monetary and fiscal policies, which have supported the acceleration in cyclical growth.

Debt-funded Domestic Demand was Key Growth Driver

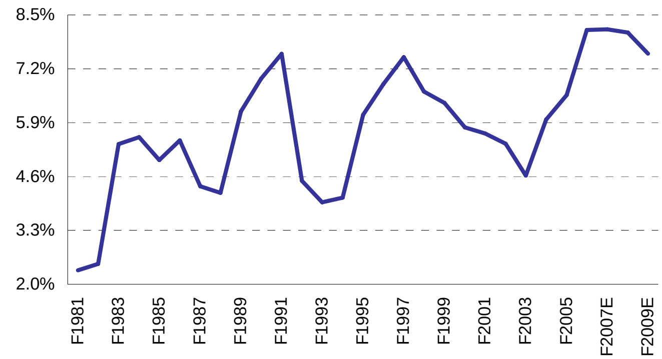
A large part of the acceleration in growth has been driven by domestic demand, which, in turn has been supported by a sharp rise in bank credit, in our view. Bank credit growth had accelerated to a new high of 33% as at end June 2006, making the current credit cycle the longest in the past 35 years. Indeed, during the quarter ended June 2006, the government also borrowed aggressively to fund acceleration in its expenditure growth. The government is continuing to pursue the policy of "borrowing from the future". Apart from this aggressive leveraging trend supporting growth, the government had also protected domestic demand by choosing not to pass on the full cost of higher oil prices.

But Credit the Cycle Has Reversed

We believe the credit cycle has reversed due to the lagged effect of the steady rise in real rates over the past few months, increasing supply constraints in banks' balance sheets (i.e. low deposit growth) and the Reserve Bank of India's measures to

Exhibit 1

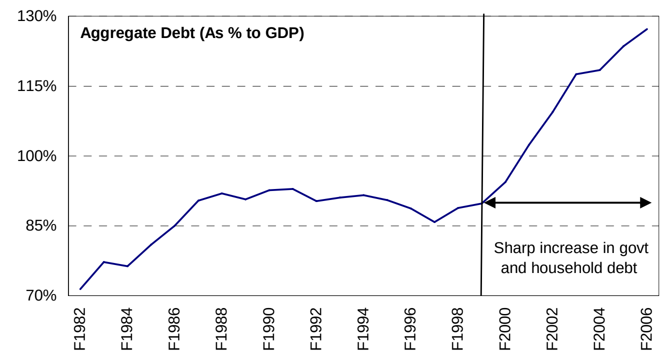
India: GDP Growth (Three-Year Moving Average)



Source: CSO, Morgan Stanley Research; E= Morgan Stanley Research Estimates

Exhibit 2

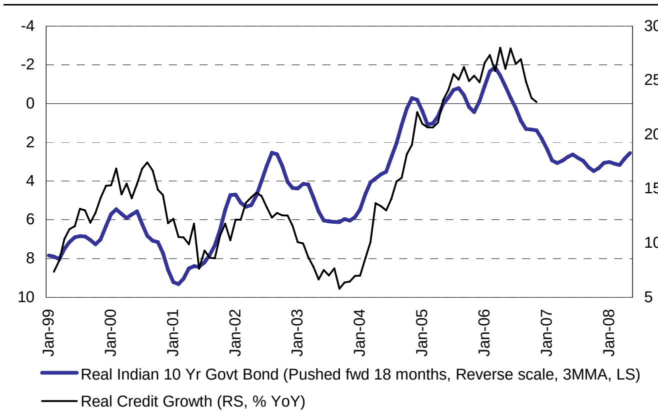
India: Aggregate Debt to GDP[1]



Source: RBI, Morgan Stanley Research 1. Note debt stock figures are understated as they do not include external borrowings by corporates and lending by non-banking financial entities

Exhibit 3

Indian 10-year Real Interest Rates Vs Real Credit Growth



Source: RBI, Morgan Stanley Research

control aggressive credit by increasing risk weights for banks lending to select sectors. As regards government spending, the Finance Ministry has also clarified that the spike during the quarter ended June 2006 was due to the bunching up of expenditure, and they expect it to slow down. We believe the acceleration of growth during the quarters ended June and September 2006 is unsustainable. Hence, even as the support from corporate capex remains positive, the weaker trends in the other three drivers, including external demand, government spending and household spending, should result in a slow down in growth.

Pressure on Macro Stability Indicators

Given that various macro stability indicators have already reached worrying levels, policymakers' ability to let the strong growth trend to continue appears limited. Headline wholesale price inflation (WPI) at 5.5%, is threatening to cross the RBI's tolerance range of 5-5.5%. The banking sector's balance sheet is already stretched with the gap between credit (+28% YoY) and deposit (20.7%) growth continuing to remain high. Excess liquidity without an adequate supply response in the form of absorption of investments has also resulted in higher asset prices. Property prices have risen 100-300% in major cities in the past two years. On the external front, the current account balance turned into a deficit of US$ 6.1 billion (3% of GDP) during the QE-June 2006 and recent monthly trade data indicate a further deterioration.

F2008 and F2009: Pay Back Years

We believe that debt-funded consumption growth, which has been at the heart of the above-trend GDP growth over the past three years, will be hit by the rise in the cost of capital and the soft landing of the credit growth cycle. We expect GDP growth to decelerate from an average of 8.1% over the three years ending F2007 to 7.3% in F2008. We believe the payback period for the high debt funded growth that India had enjoyed is likely to continue through to F2009. As a result, we expect overall growth to moderate to 6.9% in F2009.

Exhibit 4

GDP Growth Forecasts (% YoY)

	Share in Total	F2006	F2007E		F2008E		F2009E
			Old	New	Old	New	
Agriculture	20%	3.9%	2.1%	2.2%	3.5%	3.7%	3.0%
Mining	2%	0.9%	4.6%	3.8%	4.7%	4.7%	4.8%
Industry	24%	9.5%	9.2%	10.0%	7.0%	7.9%	7.3%
Services	54%	10.0%	9.4%	10.3%	7.9%	8.4%	8.1%
Overall	**100%**	**8.4%**	**7.8%**	**8.5%**	**6.8%**	**7.3%**	**6.9%**
		C2005	**C2006E**		**C2007E**		**C2008E**
Overall		**8.2%**	**8.4%**	**8.9%**	**6.8%**	**7.5%**	**6.9%**

Source: CSO, Morgan Stanley Research; E= Morgan Stanley Research Estimates

Strong GDP Growth in F2Q07

Nov. 30, 2006

GDP Growth was at 9.2% in F2Q07

The Central Statistical Organization (CSO) announced that GDP growth in the quarter ended September 2006 (QE Sep-2006) was at 9.2% YoY as compared with 8.9% registered in QE Jun-2006. This was ahead of our and consensus expectations of 8.5% and 8.9% respectively largely on account of stronger than expected growth in trade, hotels, transport and communications segment (+13.9% in QE-Sep 2006 vs. 13.2% in previous quarter). The services segment growth accelerated to 10.9% in QE Sep-2006 as compared with 10.2% in the previous quarter. The industrial segment accelerated to 10.9% in QE Sep-2006 from 10.2% in the previous quarter. The agriculture segment growth decelerated, in line with expectations, to 1.7% in QE Sep-2006 from 3.4% registered in QE Jun-2006.

Manufacturing Segment Growth Accelerated to Yet Another New High

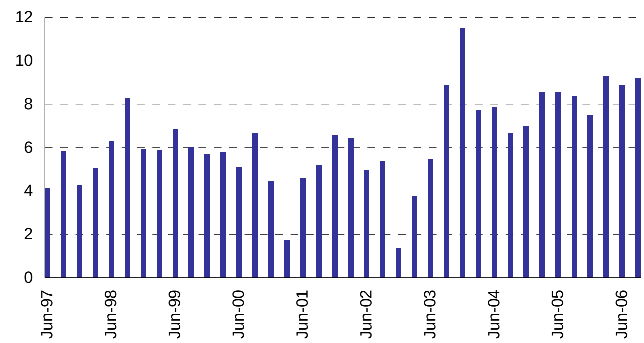
The manufacturing segment growth accelerated a new high (since quarterly data has been made available) of 11.9% in QE Jun-06. This compares with 11.3% recorded in the previous quarter. This was also reflected in the aggregate corporate sales growth (for the MS universe – 87 companies – excluding energy) which also accelerated to a new high of 26.1% YoY during the QE-Sep 06 from 25.2% during the previous quarter.

What Drove the Strong Growth?

In our view, the key driver of the strong growth appears to be domestic demand driven which in turn has been driven by debt funded consumption growth. Indeed, bank credit growth averaged 31% YoY during the quarter ended September 2006 as compared with 31.9% in the previous quarter. During the quarter, external demand also witnessed a rebound – with export growth accelerating to 25.4% YoY during the quarter from 18.6% during the QE-June 2006. However, this was partially offset by government expenditure growth decelerating to 5% in the QE-Sept 06 from 44% in the previous quarter.

Exhibit 1

Quarterly GDP Growth Trend (% YoY)



Source: CSO, CEIC, Morgan Stanley Research

Exhibit 2

Quarterly GDP Growth (F1Q2005-F2Q2007, YE March)

% YoY	FY2005				FY2006				FY2007	
Sector	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Agriculture and allied activities	**3.9**	**0.4**	**-0.7**	**1.7**	**3.4**	**3.2**	**2.6**	**5.2**	**3.4**	**1.8**
---Agriculture	3.5	-0.2	-1.2	1.5	3.4	4.0	2.9	5.5	3.4	1.7
---Mining & Quarrying	8.2	6.0	5.7	3.7	3.1	-2.6	0.0	3.0	3.4	3.1
Industry	**7.0**	**7.9**	**11.6**	**8.9**	**10.9**	**8.7**	**8.9**	**9.5**	**10.2**	**10.9**
---Manufacturing	6.6	8.3	9.2	8.1	10.7	8.1	8.3	8.9	11.3	11.9
---Electricity, gas & water supply	4.9	7.9	3.1	1.4	7.4	2.6	5.0	6.1	5.4	7.7
---Construction	8.9	6.8	20.8	13.5	12.4	12.3	11.5	12.0	9.5	9.8
Services	**10.1**	**8.4**	**9.4**	**11.4**	**9.8**	**10.0**	**9.4**	**10.9**	**10.6**	**10.9**
---Trade, hotels, transport & communication	10.6	11.2	9.7	11.0	11.7	11.0	10.2	12.9	13.2	13.9
---Financing, insurance, real est. & busi. Services	8.8	7.5	9.7	10.7	8.8	10.5	8.9	10.5	8.9	9.5
---Community, social & personal services	10.7	4.8	8.5	12.7	7.3	8.0	8.4	7.6	7.4	6.9
GDP at factor cost	**7.9**	**6.7**	**7.0**	**8.6**	**8.5**	**8.4**	**7.5**	**9.3**	**8.9**	**9.2**

Source: Central Statistical Organization (CSO), Morgan Stanley Research

The Credit Cycle Has Reversed

Nov. 10, 2006

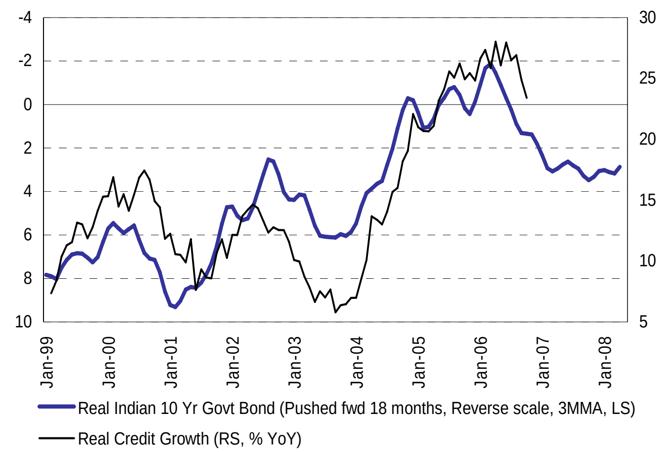
Credit growth slows to 28.6%: Latest data released by the Reserve Bank of India (RBI) indicates that credit growth has slowed to 28.6% as of end-October. Growth in credit has slowed by 4.5% points over the past four months after peaking at 33.1% (on July 1). The 12-month moving average of nominal credit growth that had been accelerating for 30 straight months has also reversed.

Past measures working their way through: We believe that three factors have driven the slowdown. (i) the lagged impact of the steady rise in real interest rates (ii) increasing supply constraints on banks' balance sheets, i.e. low deposit growth, and (iii) the RBI's measures to control aggressive credit by increasing risk weights for banks lending to certain sectors. (See Exhibits 3, 5 and 6 on the following page).

Real interest rate trend predicting further slowdown: Indeed, there has historically been a significant lag in the trend in bank credit growth compared with the real 10-year yield trend as financial intermediaries tend to be slow to reflect this trend in lending rates. As the chart alongside indicates, the trend in the real 10-year yield is predicting a further slowdown in credit growth in the coming months.

Base case of soft landing materializing: We maintain our base case view that credit growth will slowdown to 20% by March 2007 (see our note titled "The Coming Credit Slowdown" dated June 13, 2006). We believe that debt-funded consumption growth, which has been at the heart of the above-trend GDP growth over the past three years, will be hit by the rise in the cost of capital and the soft landing of the credit growth cycle.

Exhibit 1
Indian 10-year Real Interest Rates Vs Real Credit Growth



Source: RBI, Morgan Stanley Research

Strong IP Growth in September

Nov. 10, 2006

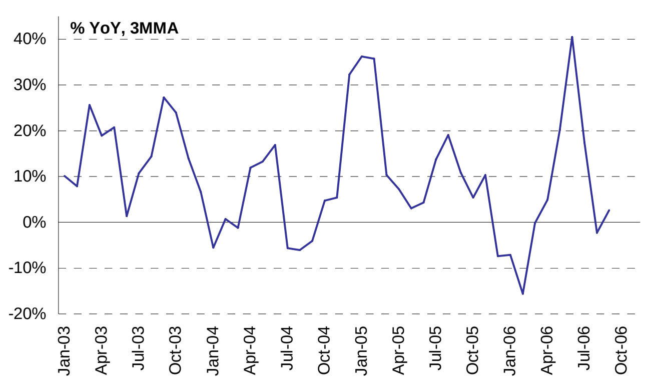
Industrial production growth at 11.5% in September-06: Growth accelerated from 9.9% (revised upwards from 9.7%) registered in August-06. The acceleration in September was ahead of our expectations of 10-10.5% and consensus expectations of 9.8%.

All three major segments register acceleration: The mining segment registered an increase of 3.9% as compared with a decline of 1.2% in August and the electricity segment grew at 11.3% versus 4.1% in the previous month. Manufacturing segment growth marginally accelerated to 12% from 11.4% in the previous month. Chemicals, basic metals, machinery & equipment and food products were the key segments driving the strong growth in manufacturing sector.

Sharp deceleration in capital goods offset by strong growth in basic goods: The capital good production growth slowed sharply to 2.2% from 13.9% registered in the previous month. However, this was more than offset by an acceleration in the basic goods segment growth to 11.3% in Sept-06 from 4.8% in Aug-06. The consumer goods segment growth slowed to 12.5% as compared with 15% in the previous month. Within consumer goods, durables growth decelerated to 12.6% from 19.7% in the previous month and the non-durables segment growth decelerated to 12.5% from 13.2% in August.

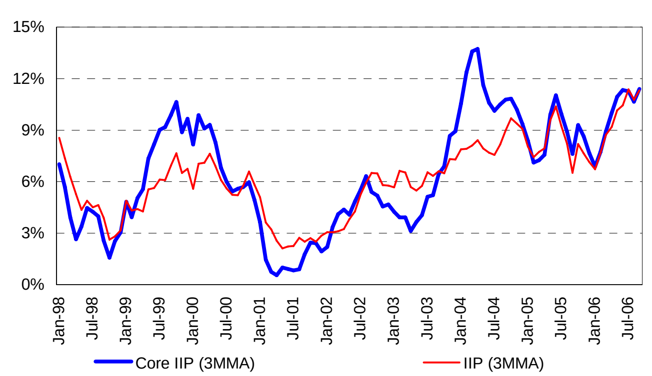
Early indicators point to moderation in IP growth in October: The early indicators (cement dispatches and automobile sales) registered a deceleration in growth in the month of October.

Exhibit 1
Central Government Expenditure



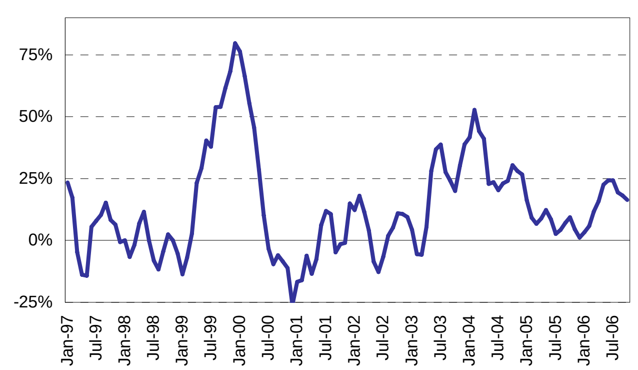
Source: Ministry of Finance, Morgan Stanley Research

Exhibit 2
IIP Vs Core IIP* (3MMA, % YoY)



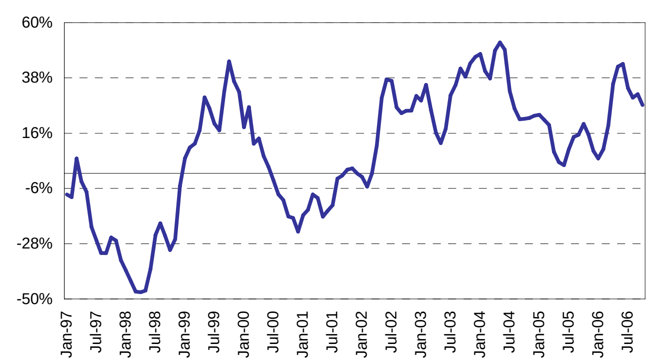
Source: CSO, Morgan Stanley Research

Exhibit 3
Passenger Car Sales (3MMA, YoY)



Source: SIAM, CMIE, Morgan Stanley Research

Exhibit 4
Commercial Vehicle Sales (3MMA, YoY)



Source: SIAM, CMIE, Morgan Stanley Research

Trade Deficit Widens Further

Nov. 28, 2006

Import growth accelerates to thirteen-month high: Import growth accelerated to 36% YoY in October from 25% in September and 12% in August. This was driven by sharp acceleration in oil import growth to 55% in October, up from 26% in September. Non-oil import growth also accelerated to 28% from 24% in the previous month.

Export growth slows to 11%: This compares with 22% in September and 21% in August. Other Asian countries also reported deceleration in export growth to 18% in October compared with 22% in September (9% in October vs. 15% in September – excluding China).

Monthly trade deficit widens to yet another new high of US$6.2 billion (8.9% of GDP, annualized): Owing to imports growing on a high base (+34% YoY in the same month in the previous year), the monthly trade deficit widened to a new high of US$6.2 billion (8.9% of GDP, annualized). This compares with US$5.3 billion (7.6% of GDP, annualized) in the previous month. Monthly trade deficit growth increased 110% in October on a YoY basis; this compares with the 31% growth rate in September. The trailing three-month trade deficit widened to 7.2% of GDP as of October.

Exhibit 1

India: Trade Data Trend

	Oct-05	Aug-06	Sep-06	Oct-06
Exports (US$ mn)	8636	10380	10300	9620
---YoY Growth	36%	21%	22%	11%
Imports (US$ mn)	11584	13870	15600	15800
---YoY Growth	34%	12%	25%	36%
Trade Balance (US$ mn)	**-2948**	**-3490**	**-5300**	**-6180**
---YoY Growth	29%	-8%	31%	110%

Source: Ministry of Commerce, Morgan Stanley Research

Exhibit 2

Trade Deficit vs. IP Growth

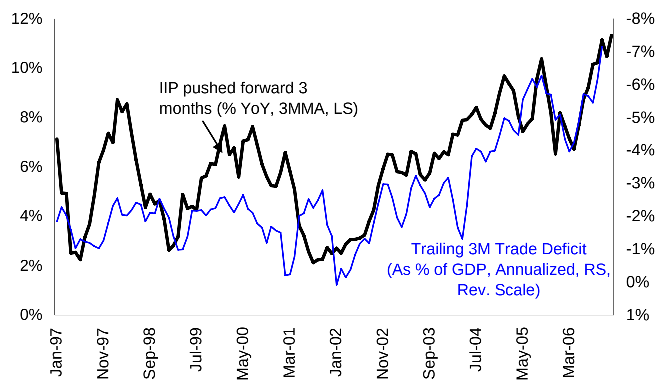


Exhibit 3

India's Exports vs. US ISM New Orders Index

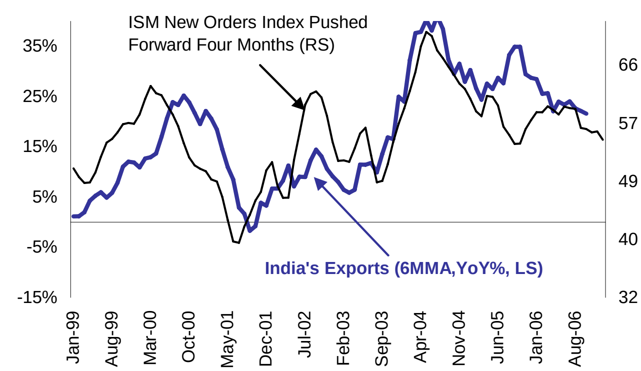


Exhibit 4

Export Growth (3MMA, % YoY)

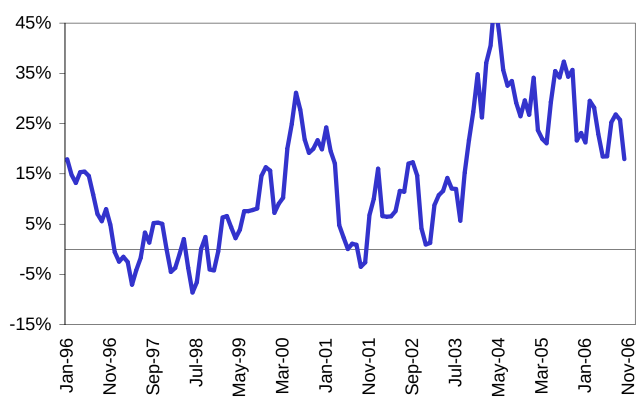
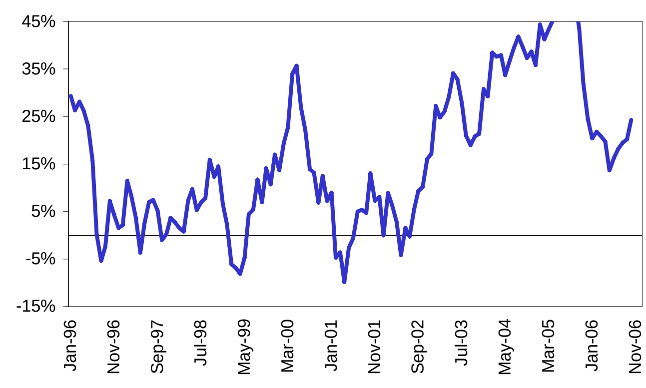


Exhibit 5

Import Growth (3MMA, % YoY)



Source: Ministry of Commerce, CSO, RBI, CMIE, CEIC, Morgan Stanley Research

Tax Collection Growth Stays Strong

Nov. 30, 2006

Tax collections grew at 26% in October: This compares with 27% registered in the previous month. Year to date, tax collections have grown by 30% ahead of the full-year government budget estimate (BE) of 19%. Corporate tax collections grew at 33% in October as compared with 35% in the previous month. Personal income tax collection also accelerated to 48% in October from 18% in the previous month. Tax collection on domestic production, i.e. excise duties, decelerated to 6% in October from 9%. Customs duty collections decelerated to 24% in October from 31% in September. Other tax collections (primarily service taxes) grew by 43% in October.

Revenue expenditure declined by 11% in October: Growth in revenue expenditure declined 11% YoY in October. This compares to growth of 44% and 5% in quarters ended June and September respectively. Fiscal YTD revenue expenditure has grown at 17% ahead of the full-year government budget estimate (BE) of 11%.

Moderating expenditure growth coupled with strong tax collections leads to improvement revenue/fiscal deficit: On a year-to-date basis, both revenue and fiscal deficit registered declines of 4% and 5% respectively, as compared with the full-year BE of a decline of 8% and growth of 2%, respectively).

Exhibit 4

Government Finances: Summary

(% Change YoY)	Fiscal Year to Date (April - Oct 2006)	F2007 BE*
Corporate Profits	47%	28%
Personal income	28%	17%
Total Direct Taxes	**40%**	**24%**
Excise Duties	7%	6%
Customs Duties	31%	20%
Total Indirect Taxes	**18%**	**11%**
Other Taxes	58%	48%
Total Tax Collections	**30%**	**19%**
Total Revenue Receipts	**27%**	**16%**
Total Revenue Expenditure	**17%**	**11%**
Revenue Deficit	**-4%**	**-8%**
Fiscal Deficit	**-5%**	**2%**

*BE = Government Budget Estimates, Source: Ministry of Finance, Morgan Stanley Research

Exhibit 5

India: Gross Tax Collection (% YoY)

	Monthly					Fiscal Year to date						Required Growth in rest of the yr
% YoY	Oct-06	Sep-06	Aug-06	Jul-06	Jun-06	Oct-06	Sep-06	Aug-06	Jul-06	Jun-06	F2007	
Direct Taxes on company profits	33%	35%	26%	NM	22%	47%	49%	71%	81%	50%	28%	17%
Direct Taxes on personal incomes	48%	18%	10%	40%	21%	28%	24%	27%	32%	29%	17%	10%
Total Direct Taxes	41%	31%	17%	173%	22%	40%	40%	49%	56%	41%	24%	14%
Excise Duties	6%	9%	9%	6%	12%	7%	7%	7%	6%	7%	6%	6%
Customs Duties	24%	31%	34%	35%	44%	31%	33%	33%	33%	32%	20%	4%
Total Indirect Taxes	13%	18%	19%	17%	24%	18%	18%	19%	19%	20%	11%	5%
Other Taxes	43%	52%	57%	53%	90%	58%	64%	66%	69%	81%	48%	32%
Total	26%	27%	22%	43%	26%	30%	30%	32%	35%	32%	19%	11%

NM=Not Meaningful; RE= Revised Government Estimates, BE= Government budget estimates Source: Ministry of Finance, Morgan Stanley Research

Chart-Scan

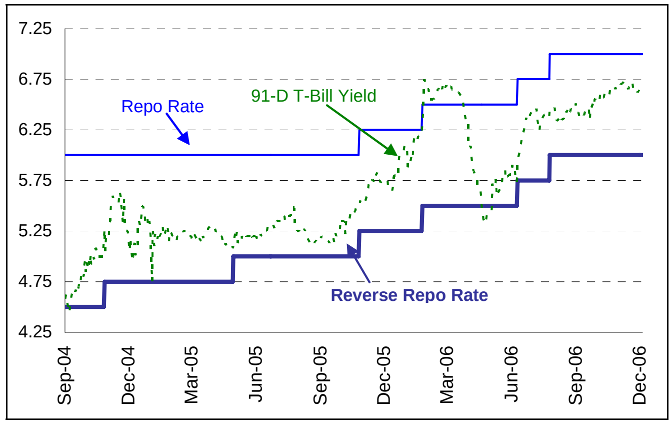
Interest Rate Scenario

Exhibit 1
Nominal 10-Year Government Bond Yield Movement

Source: Morgan Stanley Research

Over the past month, the nominal 10-year government bond yield has declined by 30 basis points to 7.4% currently in line with softening global bond yields

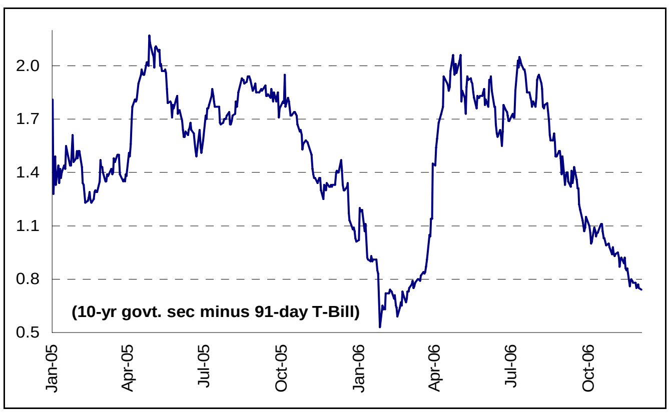
Exhibit 2
Short Rate Movement



Source: Morgan Stanley Research

However, the short-end of the yield curve has remained largely stable, with the 91-day T-bill yield almost unchanged at 6.65%.

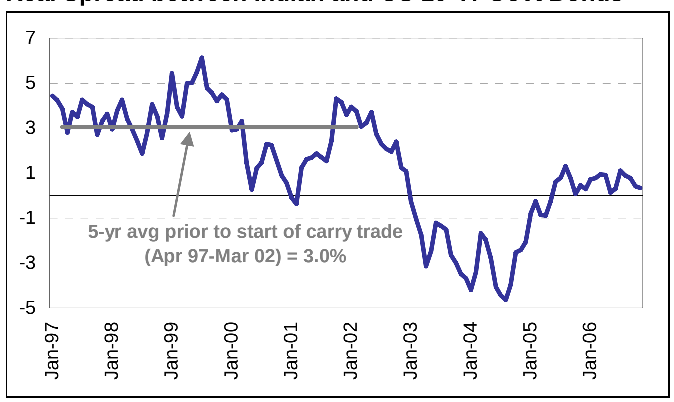
Exhibit 3
Government Bond Yield Curve



Source: Morgan Stanley Research

Owing to falling yields at the long end, the government yield curve has flattened significantly to 75 basis points currently from 115 basis points at end-September and 200 basis points in mid-July.

Exhibit 4
Real Spread between Indian and US 10-Yr Govt Bonds

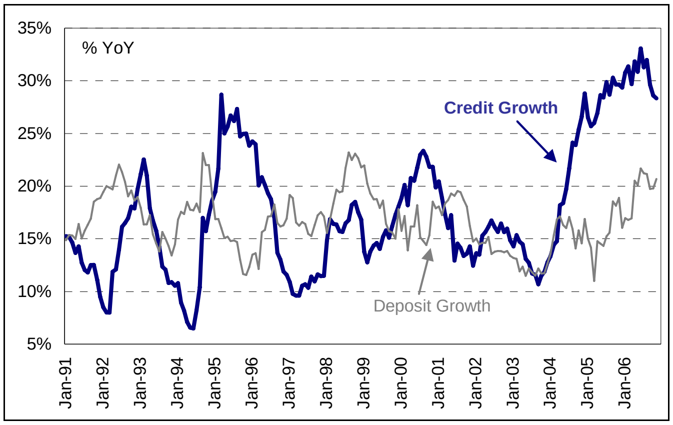


Note: Computed using WPI for India and core CPI for US. Source: Morgan Stanley Research

The real spread between Indian and US 10 Yr Government bond yields decreased to an average of about 30 basis points in November from 40 basis points in October, 80 basis points in September and 89 basis points in August.

Monetary Indicators

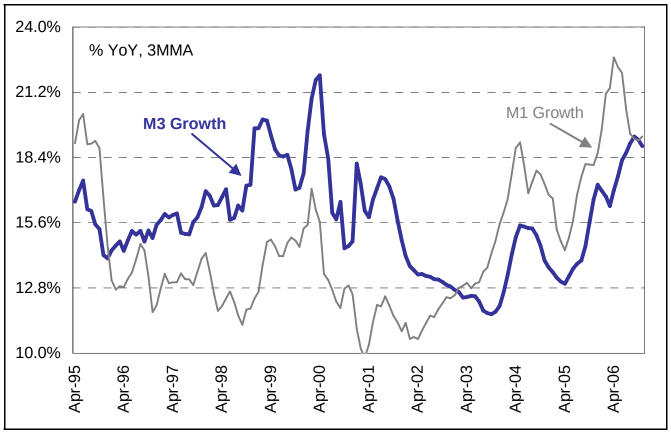
Exhibit 5
Credit and Deposit Growth



Source: RBI, Morgan Stanley Research

Credit growth decelerated to 28.4% in November 2006 from 28.6% in October and the peak of 33% in June. Overall deposit growth accelerated to 20.7% in November from 19.8% October.

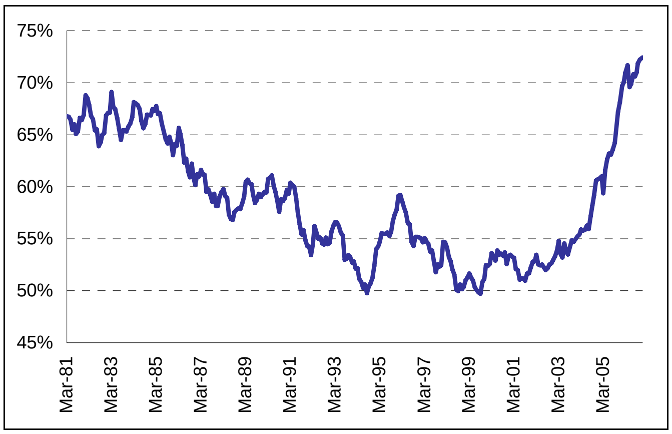
Exhibit 6
Money Supply Growth



Source: RBI, Morgan Stanley Research

M3 (broad) money supply growth remained steady at 18.7% in November. M1 (narrow) money supply decelerated to 18.7% in November from 19.9% in October.

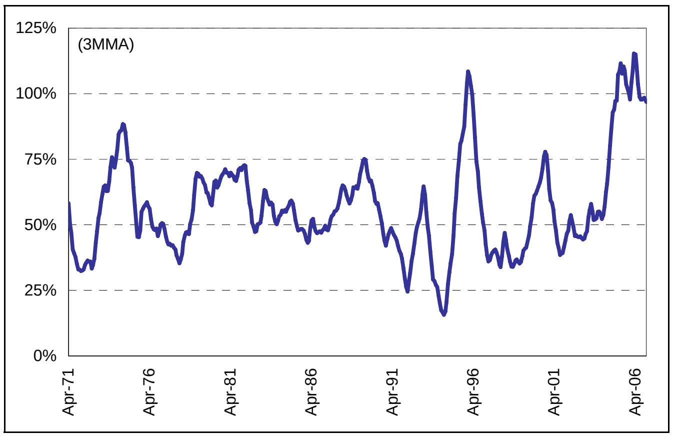
Exhibit 7
Credit-Deposit Ratio



Source: RBI, Morgan Stanley Research

The credit-deposit ratio increased to another new high of 72.4% in November from 72.2% as of October.

Exhibit 8
Incremental Credit-Deposit Ratio

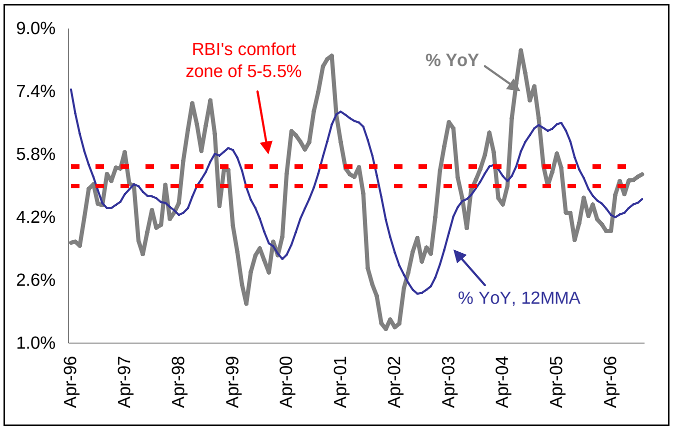


Source: RBI, Morgan Stanley Research

The 12-month trailing incremental credit ratio was at 93.4% in November. This compares with 97.2% in October and 99.7% in September.

Inflation Scenario

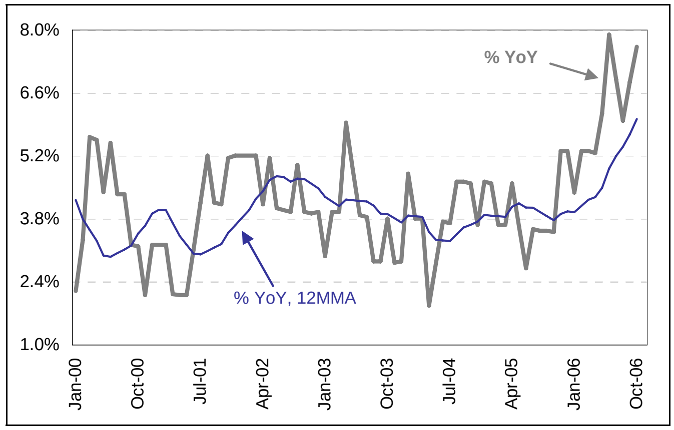
Exhibit 9
Wholesale Price Inflation (% YoY)



Source: RBI, Morgan Stanley Research

Headline wholesale price inflation (WPI) accelerated to 5.45%, close to RBI's maximum tolerance level of 5-5.5%. We believe the pressure on headline WPI is only likely to rise further due to increases in global commodity prices (other than oil) in the last few months and due to the potential impact of a base effect building in.

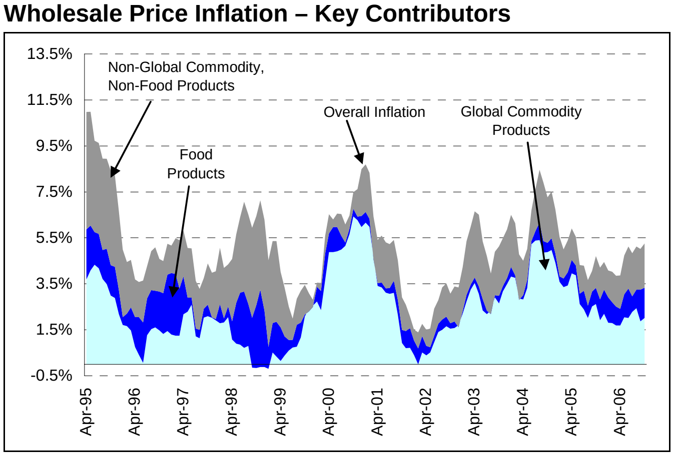
Exhibit 10
Consumer Price Inflation – Industrial Workers (% YoY)



Source: CEIC, Morgan Stanley Research

Inflation as measured by the new CPI Index (base 2001) has witnessed a significant rise in the recent months. CPI for industrial workers has increased to 7.6% as of October 2006 (last data point available) as compared with 4.4% at the start of the year.

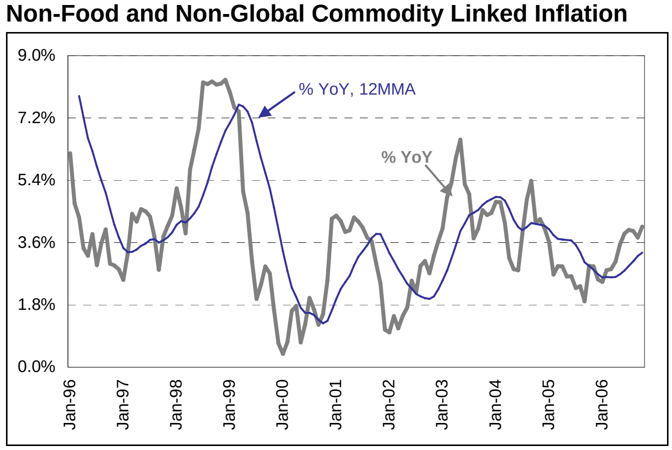
Exhibit 11
Wholesale Price Inflation – Key Contributors



Source: CEIC, Morgan Stanley Research

Food-product-linked inflation stayed high at 8.6% in October, as compared with 8.9% in September.

Exhibit 12
Non-Food and Non-Global Commodity Linked Inflation



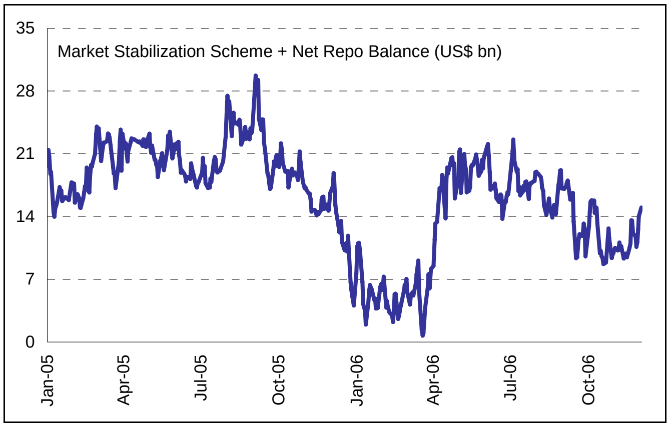
Source: CEIC, Morgan Stanley Research

The WPI components excluding food and global commodities (akin to core inflation) moved up to 4.1%, in October (last available data point) from 3.7% in September.

Liquidity and Capital Flows

Exhibit 13

Trend in Excess Liquidity Balances

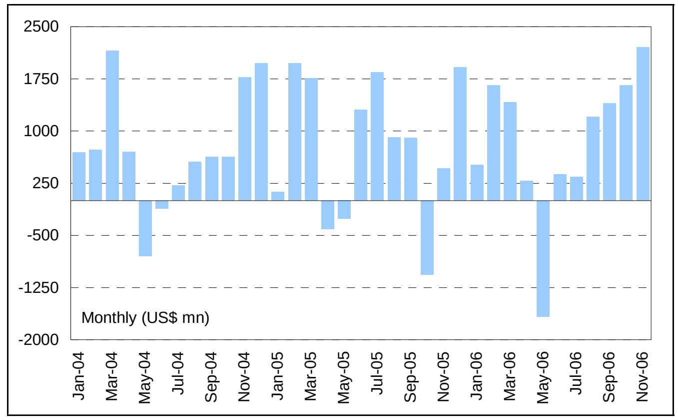


Source: Morgan Stanley Research

The net repo balance and funds absorbed under the market stabilization scheme have increased to US$15 billion currently from US$10 bn as of end-October.

Exhibit 14

Portfolio Investment Flows

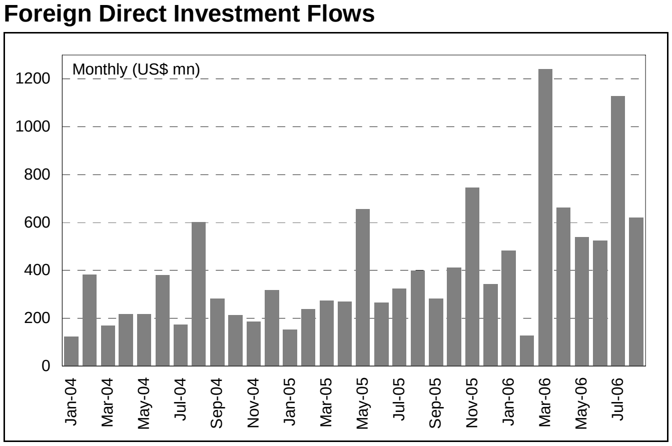


Source: CEIC, Morgan Stanley Research

Net portfolio flows (equity and debt) increased to US$2.2 bn, in November from US$1.7 bn in October. This compares with a monthly average of US$0.8 bn in the previous fiscal year.

Exhibit 15

Foreign Direct Investment Flows

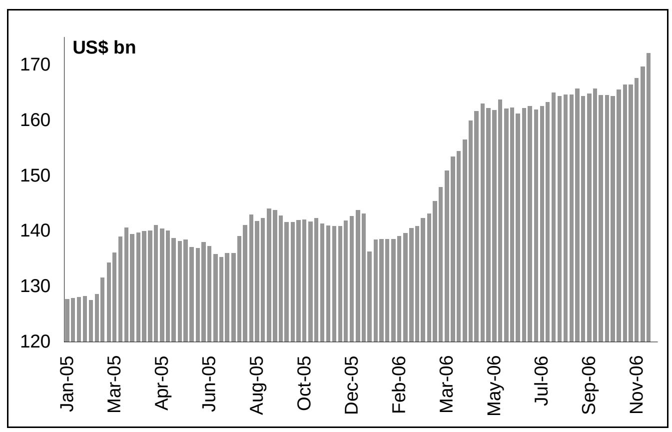


Source: RBI, Morgan Stanley Research

FDI inflow in August (last available data point) was US$0.6 bn, above monthly average of US$460 mn in F2006.

Exhibit 16

Forex Reserves Trend

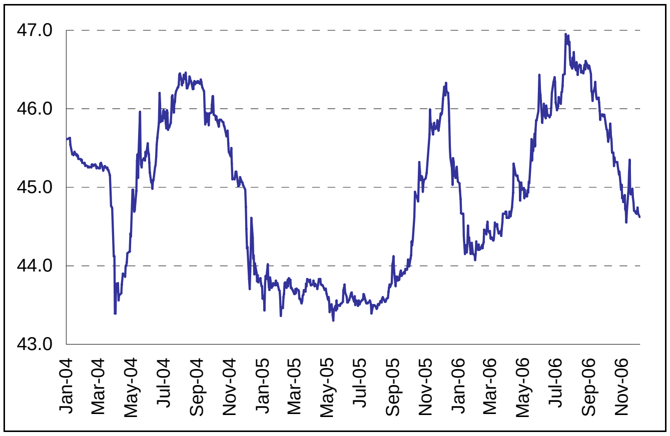


Source: RBI, Morgan Stanley Research

The stock of foreign exchange reserves have increased by US$ 5.7 bn in the month of November to US$ 172 bn. On a trailing three-month basis, forex reserve accretion is running at US$ 7.6 bn (an annualized rate of US$30 bn), as compared with US$23 billion in May 2006.

Currency Movement

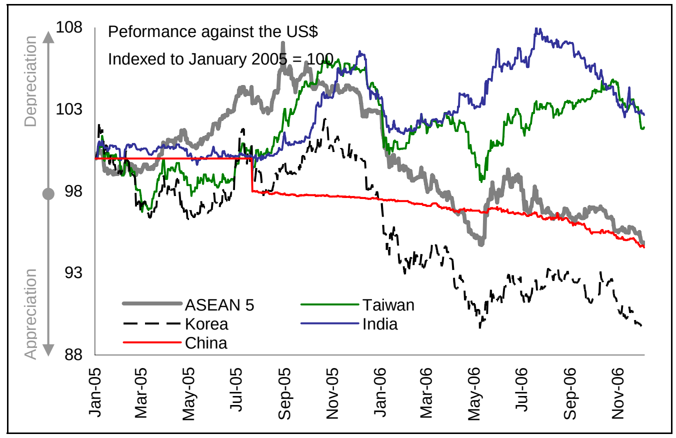
Exhibit 17
Indian Rupee Movement versus US$



Source: Morgan Stanley Research

The Indian rupee registered an appreciation of 0.6% against the US$ in November. This was the third consecutive month of appreciation (+1.9% in October and +1.4% in September).

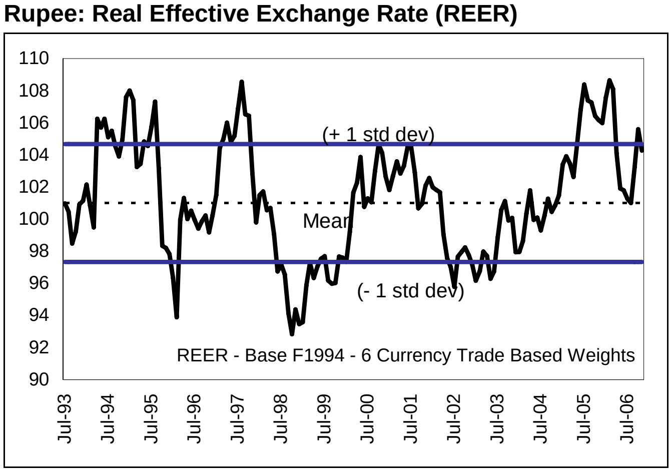
Exhibit 18
Performance of Major Asian Currencies versus US$



Source: Morgan Stanley Research

In November, the rupee underperformed the ASEAN 5 (appreciation of 0.7% against the US$), the New Taiwan dollar (appreciation of 2.7%), and the Korean Won (appreciation of 1.4%).

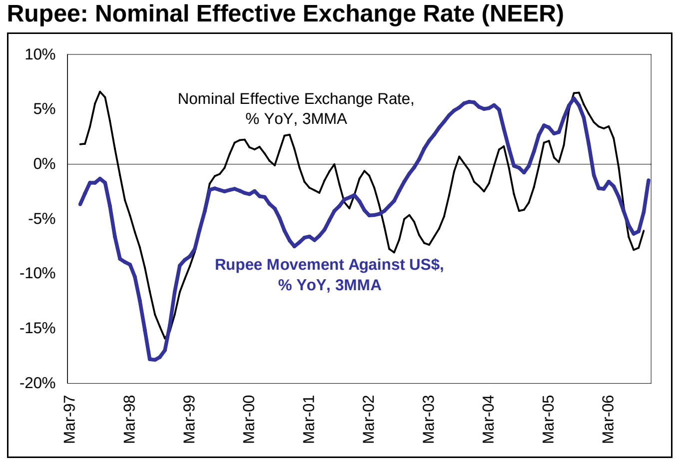
Exhibit 19
Rupee: Real Effective Exchange Rate (REER)



Source: RBI, Morgan Stanley Research

On a REER basis (trade-weighted exchange rate adjusted for inflation differentials with trade partners), owing to the recent appreciation, the rupee has moved to 3.2% above the 10-year mean as of November.

Exhibit 20
Rupee: Nominal Effective Exchange Rate (NEER)



Source: RBI, Morgan Stanley Research

On a trailing 12-month basis, the rupee has depreciated by 3.8% against major trading partners (NEER), while it has depreciated by 1.4% against the dollar.

Monthly Indicators

	Oct-05	Nov-05	Dec-05	Jan-06	Feb-06	Mar-06	Apr-06	May-06	Jun-06	Jul-06	Aug-06	Sep-06	Oct-06	Nov-06
Interest Rates														
10-Year Govt Bond	7.1%	7.1%	7.1%	7.1%	7.3%	7.4%	7.5%	7.6%	7.9%	8.3%	8.1%	7.7%	7.7%	7.5%
91 Day T-Bill	5.4%	5.7%	5.8%	6.2%	6.6%	6.5%	5.6%	5.7%	6.1%	6.4%	6.4%	6.4%	6.6%	6.7%
Government Bond Yield Curve	1.7%	1.4%	1.3%	0.9%	0.7%	0.9%	1.8%	1.9%	1.7%	1.9%	1.7%	1.3%	1.0%	0.9%
1 Yr AAA Corporate Bond	6.2%	6.3%	6.9%	7.2%	7.8%	8.6%	7.5%	7.6%	8.1%	8.0%	7.9%	8.0%	8.0%	8.1%
1 Yr Bank Deposit Rate	5.5%	5.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.3%	6.3%	6.3%	6.8%	6.8%	6.8%	6.8%
Monetary Aggregates														
Forex Reserves (US$bn)	142.3	140.9	136.3	138.6	140.8	150.9	159.9	161.8	162.1	163.3	164.6	164.5	166.4	172.1
Money Supply, M3 (YoY)	16.9%	17.3%	17.5%	16.2%	16.5%	16.3%	18.2%	18.3%	18.3%	19.2%	19.5%	19.2%	18.8%	18.7%
Money Supply, M1 (YoY)	17.9%	18.0%	19.9%	20.9%	22.6%	20.6%	24.9%	21.3%	19.9%	20.1%	18.2%	19.2%	19.5%	18.7%
Credit Growth (YoY)	29.6%	29.7%	29.4%	30.8%	31.4%	29.7%	31.8%	30.9%	33.1%	31.3%	32.0%	29.7%	28.6%	28.4%
Deposit Growth (YoY)	18.1%	18.9%	16.0%	17.0%	16.8%	16.9%	20.5%	20.1%	21.7%	21.2%	21.2%	19.7%	20.7%	20.7%
Credit Deposit Ratio	67.2%	68.1%	69.7%	70.1%	71.0%	71.7%	69.6%	69.9%	70.8%	70.6%	71.0%	71.9%	-	-
Incremental Credit Deposit Ratio	100.1%	98.1%	114.4%	113.7%	117.9%	113.3%	98.8%	98.5%	98.7%	96.0%	98.5%	99.7%	-	-
Inflation														
WPI YoY	4.7%	4.2%	4.5%	4.1%	4.0%	3.9%	3.9%	4.8%	5.1%	4.8%	5.1%	5.2%	5.2%	5.3%
-- Food (Wt. 15.4%)	4.6%	5.9%	6.9%	7.2%	5.9%	5.3%	4.7%	6.5%	8.3%	4.4%	5.3%	8.9%	8.6%	-
-- Global Commodity (Wt 37.1%)	7.1%	5.2%	5.9%	4.9%	4.8%	4.6%	4.6%	5.5%	5.4%	6.1%	6.6%	5.1%	5.4%	-
-- Others (Wt. 47.5%)	2.9%	2.9%	2.5%	2.5%	2.8%	2.8%	3.0%	3.6%	3.9%	4.0%	3.5%	3.6%	4.1%	-
CPI (Industrial Workers) YoY	3.5%	5.3%	5.3%	4.4%	5.3%	5.3%	5.3%	6.1%	7.9%	6.9%	6.0%	6.8%	7.6%	-
Foreign Trade														
Trade Balance (US$bn)	-2.9	-3.9	-2.7	-3.4	-2.5	-2.0	-4.0	-3.8	-3.8	-4.0	-3.5	-5.3	-6.2	-
Exports YoY	36.3%	4.2%	28.9%	30.8%	28.9%	24.9%	14.6%	15.8%	25.1%	34.8%	20.5%	21.9%	11.4%	-
Imports YoY	34.2%	21.9%	17.3%	21.9%	26.2%	14.6%	18.3%	8.1%	22.4%	24.2%	11.7%	24.8%	36.4%	-
Port Traffic YoY	2.0%	5.2%	14.2%	4.6%	3.9%	5.2%	-3.0%	6.6%	14.2%	6.5%	5.4%	6.6%	-	-
Growth Indicators														
IIP (YoY)	9.8%	6.0%	5.7%	8.5%	8.8%	8.9%	9.9%	11.7%	9.0%	12.7%	9.7%	11.4%	-	-
-- Manufacturing	10.9%	7.0%	6.4%	9.4%	9.2%	10.1%	11.0%	13.3%	10.7%	13.8%	11.4%	12.0%	-	-
-- Mining	-0.1%	-2.1%	-0.1%	2.0%	3.8%	2.0%	3.4%	2.9%	4.7%	4.8%	-1.2%	3.9%	-	-
-- Electricity	7.7%	3.4%	3.4%	6.4%	9.1%	3.4%	5.9%	5.0%	4.9%	8.9%	4.1%	11.3%	-	-
Passenger Cars (YoY)	2.3%	0.0%	1.3%	8.5%	7.7%	19.1%	21.0%	27.7%	24.3%	20.9%	13.2%	20.4%	15.5%	-
Commercial Vehicles (YoY)	22.6%	7.1%	-3.1%	13.8%	18.1%	23.4%	63.6%	38.6%	28.4%	34.9%	15.5%	14.1%	11.0%	-
Two-wheelers (YoY)	26.6%	2.1%	3.7%	14.7%	16.6%	18.2%	12.6%	20.4%	23.4%	19.7%	3.5%	19.1%	10.3%	-
Cement Dispatches (YoY)	8.0%	4.2%	13.5%	14.2%	16.4%	16.3%	13.4%	8.2%	13.7%	13.5%	3.2%	16.9%	9.0%	-
Steel Production (YoY)	8.9%	5.0%	3.5%	2.1%	1.8%	5.3%	8.3%	7.9%	6.0%	15.6%	6.8%	-	-	-
Government Finances														
Revenue Receipts (YoY)	22.0%	15.5%	9.2%	33.0%	25.0%	-1.9%	NR	NR	26.8%	36.4%	17.5%	31.6%	9.4%	-
-- Tax Collections	15.5%	11.2%	15.7%	39.2%	31.5%	14.7%	NR	NR	26.2%	42.8%	22.0%	27.4%	26.1%	-
Revenue Expenditure (YoY)	23.3%	35.5%	24.9%	8.3%	-6.4%	12.2%	40.2%	74.1%	20.2%	-18.6%	0.3%	38.1%	-11.2%	-
Total Receipts (YoY)	13.8%	-10.9%	2.9%	7.2%	-4.8%	-3.6%	NR	NR	25.9%	32.9%	16.3%	30.6%	10.7%	-
Total Expenditure (YoY)	8.8%	32.1%	-36.7%	8.2%	-6.5%	-1.3%	38.2%	70.0%	16.9%	-18.5%	-1.0%	28.1%	-9.8%	-
Revenue Deficit (YoY)	32.1%	67.8%	-31.7%	-24.0%	-51.6%	-69.4%	14.2%	120.3%	-34.9%	-65.1%	-78.2%	9.1%	-138.1%	-
Fiscal Deficit (YoY)	NR	NR	NR	NR	NR	NR	12.5%	109.1%	-18.3%	-62.3%	-51.7%	69.7%	-92.2%	-

Source: RBI, Ministry of Commerce, CEIC, CSO, SIAM, CMA, Ministry of Finance, Morgan Stanley Research

Macro Forecasts Summary

Years Ending March 31	F2002	F2003	F2004	F2005	F2006	F2007E	F2008E	F2009E
National Income								
GDP at Factor cost Rs bn	19,781	20,526	22,260	23,937	25,953	28,148	30,213	32,306
GDP (at current mkt prices) Rs bn	22,813	24,497	27,602	31,214	35,315	40,039	44,802	49,822
GDP (US$bn)	478	506	601	694	798	888	1,036	1,159
Growth rates								
Gross domestic product	5.8%	3.8%	8.5%	7.5%	8.4%	8.5%	7.3%	6.9%
Agriculture and Allied activities (incl. mining)	5.8%	-5.6%	9.6%	1.2%	3.6%	2.4%	3.8%	3.2%
Manufacturing, Constn, Electricity	2.8%	6.8%	7.9%	8.9%	9.5%	10.0%	7.9%	7.3%
Services	7.1%	7.3%	8.2%	9.9%	10.0%	10.3%	8.4%	8.1%
Money and Banking								
Money Supply (M3) growth (avg)	15.7%	12.9%	12.6%	14.3%	15.4%	18.0%	16.0%	15.0%
Bank non-food credit (avg y-y increase)	11.8%	16.3%	16.2%	25.0%	30.8%	30.0%	24.0%	24.0%
Interest rates								
91-Day T-Bill Yield (year-end)	6.2%	5.8%	4.3%	5.2%	6.1%	6.8%	6.5%	6.5%
Bank Rate (year-end)	6.5%	6.3%	6.0%	6.0%	6.0%	6.0%	6.3%	6.3%
Prices								
Wholesale price index (avg y-y increase)	3.6%	3.4%	5.4%	6.4%	4.4%	5.2%	4.8%	4.5%
Consumer price index (avg y-y increase)	4.3%	4.0%	3.9%	3.8%	4.4%	6.5%	4.3%	4.3%
External sector								
Current account								
Exports (US$bn)	44.7	53.8	66.3	85.2	104.8	124.3	142.8	164.2
Imports (US$bn)	56.3	64.5	80.0	118.9	156.3	189.8	219.2	254.3
Trade balance (US$bn)	-11.6	-10.7	-13.7	-33.7	-51.6	-65.6	-76.4	-90.0
Exports as % of Imports	79.4%	83.4%	82.9%	71.7%	67.0%	65.5%	65.2%	64.6%
Invisibles, net (US$bn)	15.0	17.0	27.8	31.2	40.9	51.2	61.3	70.5
Current account balance (US$bn)	3.4	6.3	14.1	(2.5)	(10.6)	(14.4)	(15.1)	(19.6)
Current account Balance as a % of GDP	0.7%	1.3%	2.3%	(0.4%)	(1.3%)	(1.6%)	(1.5%)	(1.7%)
Capital account								
Debt creating capital inflows (US$bn)	2.3	-1.8	-2.1	6.2	5.8	9.0	7.8	7.8
Foreign investment (US$bn)	8.1	6.0	15.7	15.3	20.2	18.5	17.5	17.5
Total capital -net (US$bn)	8.6	10.8	16.7	28.0	24.7	33.1	25.9	25.9
Capital inflow as a % of GDP	1.8%	2.1%	2.8%	4.0%	3.1%	3.7%	2.5%	2.2%
Reserves								
Foreign currency reserves (US$bn)	54.1	75.4	111.6	140.1	154.5	173.6	184.9	191.1
Foreign currency reserves as no. of months imports	10.9	13.2	15.9	14.1	11.9	11.0	10.1	9.0
Exchange rate								
Average exchange rate (USD/INR)	47.7	48.4	45.9	45.0	44.3	45.1	43.2	43.0
Year end exchange rate (USD/INR)	48.7	47.6	45.0	43.7	44.5	43.7	43.0	43.0
External debt								
External debt (US$bn)	98.8	105.0	111.7	123.2	125.2	137.2	146.5	155.8
External debt as a percentage of GDP	21.1%	20.4%	18.2%	17.2%	15.8%	15.0%	14.1%	13.4%
Short term debt as a proportion of total	2.8%	4.4%	4.0%	6.1%	7.0%	8.6%	9.1%	9.5%
Debt service ratio (Payments over currents receipts)	13.9%	15.1%	16.3%	6.1%	10.2%	7.2%	7.4%	7.1%
Public Finance								
Fiscal deficit (Rs bn)								
-----Central government	1410	1451	1233	1252	1463	1562	1837	2043
-----State government	960	1021	1231	1093	1140	1321	1523	1644
-----Consolidated Deficit **	2264	2350	2319	2347	2632	2916	3397	3728
Fiscal deficit (As % of GDP)								
-----Central government	6.2%	5.9%	4.5%	4.0%	4.1%	3.9%	4.1%	4.1%
-----State government	4.2%	4.2%	4.5%	3.5%	3.2%	3.3%	3.4%	3.3%
-----Consolidated Deficit **	9.9%	9.6%	8.4%	7.5%	7.5%	7.3%	7.6%	7.5%

** Individual Central and State deficits may not aggregate to Consolidated Deficit due to adjustments relating to inter-government transfers.
E = Morgan Stanley Research estimates   Source: RBI, CSO, Budget Documents, Morgan Stanley Research

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