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## Proposed Reforms to Corporate Defined Benefit Plans: Few Worries for the Markets

*A host of reforms to US corporate defined benefit pension plans are on the table. Few of them are likely to have any meaningful impact on the US equity or debt markets. We offer our own views on the elusive ideal solution to the problem of volatility in pension assets and liabilities*

In recent years, corporate defined benefit (DB) pension plans have moved sharply from overfunded to underfunded status. On the asset side, the decline has been caused mainly by the large drop in the equity market since its peak in March 2000. On the liability side, the present value of liabilities has increased sharply because the discount rate used to calculate present value has declined with falling interest rates.

The sharp swing in the value of assets versus liabilities creates two difficulties. Earnings volatility increases, while at the same time the volatility of the gap between assets and liabilities creates volatility in required cash contributions.

This is not all. Further problems with DB plans have become clear in recent years:

- The exposure of the federal Pension Benefit Guaranty Corporation (PBGC) has increased as plans have become underfunded and as the health of certain sectors—especially the airline, auto and steel industries—has deteriorated.
- The fact that premium assessments are not explicitly tied to the expected losses that are likely to be incurred by the PBGC creates a moral hazard problem.
- Accounting rules that allow assumed pension fund returns to influence reported corporate earnings increases the volatility of this measure of profits.
- Actuarial assumptions as to the prospective return on a diversified portfolio of equities and bonds may be unrealistically high for some companies.

The underlying problem is the volatility of the value of pension fund assets versus the present value of the plans' liabilities. This creates sharp swings in the adequacy of pension fund assets relative to liabilities when measured at any specific time.

Ultimately, the pension fund system reflects a tension between the desire to minimize contributions by holding a significant proportion of the assets in equities, which have higher long-run expected returns, and the fact that the prices of these assets are more risky over the short term. A pension plan holding risky assets will be subject to sharp swings in the asset-liability gap.

### *The Elusive Ideal Solution*

The ideal solution to this problem of volatility would simultaneously 1) reduce the volatility of the gap between assets and liabilities, thus reducing the volatility of cash contributions; 2) reduce the impact of the volatility of the pension plan on corporate earnings; 3) result in a smooth and predictable contribution schedule; and 4) minimize the size of required contributions.

Unfortunately, some of these objectives are mutually exclusive. Volatility could be reduced by shifting to an immunized portfolio (in which each liability was matched by an asset of the same duration), but this would prevent companies from minimizing contributions. Meanwhile, reducing the impact of pension fund returns on earnings is difficult in practice.

In our view, the elusive 'ideal' solution is one that is comprehensive; does not flow pension fund earnings through the income statement (because these earnings are not readily accessible to the corporation and because this increases earnings volatility); offers better disclosure and increased transparency; simplifies smoothing techniques to make them more transparent and easier to understand; and makes PBGC premiums risk-based, to avoid the problems of moral hazard.

*Continued on page 2*

A longer version of this paper was written at the request of the Committee on Investment of Employee Benefit Assets. A survey of its members was a critical source of information.

## Proposed Reforms to Corporate Defined Benefit Plans: Few Worries for the Markets

Continued from page 1

### Proposed Reforms: A Negligible Impact on Equities and Bonds

Several proposals currently under debate could result in significant changes to current US pension fund accounting and contribution rules. These proposals focus on three goals: keeping measured liabilities closer to actual liabilities; encouraging companies to keep assets in closer alignment with actual liabilities; and increasing transparency and disclosure about pension fund exposures.

Regulatory changes designed to achieve these goals tend to make equities less attractive as pension fund assets. While in principle these changes could affect companies' willingness to maintain their DB plans and could spark meaningful shifts in portfolio composition (and thus equity and bond prices), we think the impact would in fact be negligible.

First, the DB plans that would be affected by these changes hold a relatively small share of the total US corporate equity and bond markets. Corporate DB plan holdings of equities and mutual fund shares were only about 6% of the total value of the US equity market at year-end 2002, while the share of the US bond market (Treasuries, agencies, corporate and asset-backed securities) is even smaller.

Moreover, a survey of member companies in the Committee on Investment of Employee Benefit Assets suggests that these companies do not expect to make particularly large portfolio shifts away from equities. The survey results imply a reduction in equity exposure of about 16%. Applied to total corporate DB plan fund holdings of about \$1.6 trillion, this implies a reduction in equity holdings of about \$250 billion, compared to a total US equity

market capitalization of about \$12 billion at year-end 2002.

Third, the price elasticity is relatively low, meaning that equity sales by pension funds would not prompt a large decline in the equity market. Sales by DB plans would occur slowly, and there are offsetting impacts. A fall in equity prices would tend to lead to less equity issuance, which would dampen the price impact. If pension funds were to increase their demand for bonds and extend the duration of their bond holdings, this would tend to flatten the yield curve, which could provide some lift to the equity market.

We also think the impact on the fixed income market would be very small. If we assume that all the equities that are sold were invested in bonds, the increase in demand would represent only about 1.5% of total outstanding Treasury, agency, corporate and foreign bonds. The impact of such a shift on long-term interest rates is also likely to be modest.

The impact would, however, be significantly greater if DB plans sponsored by state and local governments also shifted their own asset allocations—but we do not expect them to do so.

### Some Unintended Consequences

If DB plans shift their portfolios away from equities into bonds, one consequence will be lower expected returns and higher expected contributions over time. However, this increased burden is not likely to be particularly large. We think the excess return on equities is currently about two percentage points above high-grade

corporate bonds. Thus, a shift of \$250 billion into bonds from equities would reduce expected returns by about \$5 billion per year.

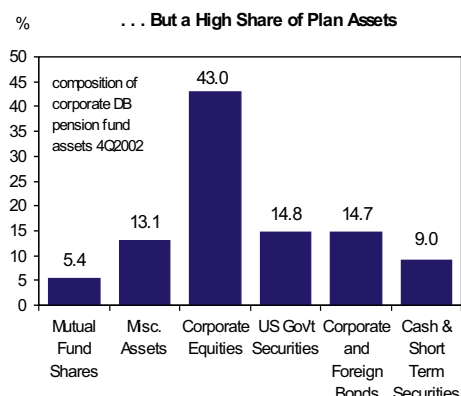
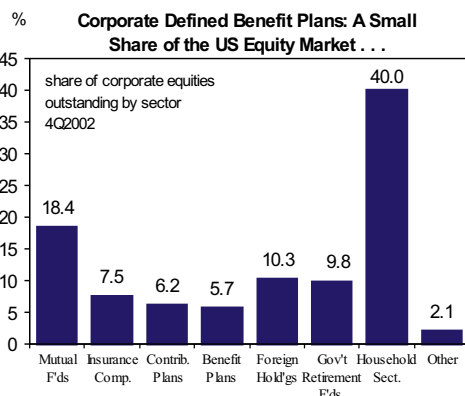
Some of this increased cost could be offset by the planned increase in the duration of pension fund bond portfolios. Given the fact that the yield curve is normally upward sloping, longer durations would tend to raise the long-run rate of return on fixed income assets.

An increase in annual funding cost of \$5 billion, however, would be large enough to have consequences on employment, wages, profits and the willingness of plan sponsors to continue to keep their plans open to new employees. At first, corporate sponsors would bear the costs in the form of lower profits. But over the longer run, corporations could be expected to shift this burden onto workers in order to remain competitive—in the form of lower employment or wages and/or the loss of pension benefits.

At the margin, the proposed changes would exacerbate the decline in the DB pension system and increase the burden on households in their retirement planning. DB plan sponsors are well-suited to undertake equity investments because the duration of their liabilities is usually quite long. While equities are riskier than bonds, the likelihood that equities will underperform bonds declines markedly as the investment horizon lengthens. If one can take a long-run view—appropriate when the pension fund liabilities are of long duration—then there is an excellent case for equities as a core asset holding. ■

Further information on the topics in this report is available on the GS Financial Workbench<sup>sm</sup>. For access, please go to [www.gs.com/ceoconfidential](http://www.gs.com/ceoconfidential)

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## Economic Benefits and Political Challenges as the EU Expands

*The inclusion of ten more dynamic economies in the European Union will boost momentum in the under-performing region. The addition of ten new governments to the EU's governing structures will add new and generally more liberal—but also relatively inexperienced—players to the existing structures, complicating decision-making*

### ***New Members: Poorer, Faster-Growing and More Liberal***

Scarred by the inefficiencies of central planning and government interference in people's lives, policies in the EU's new members have generally been more liberal during the last 10-15 years than in the EU. Central Europe has moved rapidly to wean the population from government dependency, through tax reforms and the implementation of comprehensive pension reforms. Privatization has gone further than in most of Western Europe, including the transfer of ownership of the financial and power sectors, and including sales to foreign owners.

More needs to be done to reduce the region's excessive budget deficits, and a remaining few old industries, including steel and coal, still need to be restructured. But on balance, reforms have moved rapidly to unleash the region's 75 million people from the reins of state control.

With cheap but well-educated labor, supportive governments, liberalization of trade with the EU and a clear end-target of EU membership, foreign companies have directed more than EUR100 billion of FDI into the region over the last decade. Autos, banks, consumer goods and breweries have moved aggressively into Central Europe.

New investment and foreign management have helped the manufacturing sector clock impressive average productivity growth rates of 10% or more in recent years. This has provided solid growth in incomes for some and has also provided the foundation for a real appreciation of the exchange rates, thus narrowing the income gaps between the accession countries and the old EU when measured in euros.

### ***Enlargement to Boost Growth . . .***

While the potential growth effect of EU enlargement is substantial for the newcomers, it is modest for the old members. Five channels should boost growth: the smooth functioning of the

Single Market; labor mobility; increased trade; official transfers; and FDI flows.

If fully implemented, the addition to potential growth in the old members could be about 0.4% per year during the first few years, almost all of which would come from the smooth functioning of the Single Market. Labor mobility and increased trade also could fuel growth, while official transfers and FDI flows would marginally drain growth. The biggest beneficiaries would be those countries, including Sweden and Germany, having the greatest trade interaction with Central Europe.

But politics stand in the way of reaping the full benefits. The Single Market is still poorly implemented throughout the old members, particularly in Italy and France, and labor mobility has been delayed by up to seven years for domestic political reasons in all but the UK and Ireland. The positive effect of trade integration has already been underway for several years.

New members would benefit through all five channels for a potential total of about 5% per year in the early years of enlargement, if starting from scratch and if the full set of benefits were triggered by membership alone. The trade effect would contribute about 40% of the total, but it has of course been in full effect for several years. Implementation of the Single Market would contribute about 20% of the total, with FDI inflows, official transfers and labor mobility providing the rest. The latter would be marginal at best and indeed negative for some of the countries. As a result, the near-term effect is likely to be more like 1.0%-1.5% per annum.

### ***. . . But Complicate Decision-Making***

Central European policymakers have expressed concern about committing their countries to the EU's ways. Many identify more easily with US and UK policy approaches than with those of Continental Europe. Outside the economic sphere, this was most recently illustrated in the

region's support of—and participation in—the invasion of Iraq.

One important area of friction is Central Europe's desire to join the currency union as soon as possible, preferably without first spending two years in ERM-2. Accession countries have gone a long way to satisfy Maastricht's five criteria on the budget deficit, public debt, inflation, interest rates and currency stability. Most of the countries now meet most of the criteria, although none has brought the budget deficit below Maastricht's 3% of GDP threshold.

Recently, however, the EU Commission and the ECB have shifted the focus to the need for real convergence, i.e. a concern that real income levels are too low to cope within EMU. A realistic date for EMU membership is now around 2010. Needless to say, shifting focuses causes trouble among policymakers in the accession countries.

At the institutional level, the EU's three governing structures (the Commission, the Council of national ministers and the European Parliament) will be expanded, adding to the complexities of decision-making.

In 2002, the European Council established a 'Convention on the Future of Europe' with a mandate to increase transparency by consolidating the Council's many treaties. The resulting draft Constitution redefines the relative powers of the EU vis-à-vis the national administrations and within the many EU institutions, streamlines the decision making processes and attempts to facilitate an evolution toward greater central decision-making.

Among the contentious issues are the relative power of member states, where Germany is set to gain additional votes, particularly relative to the two medium-sized members Spain and Poland, and attempts to harmonize legislation, including for taxation. ■

## How Big a Role Is Washington Playing in the US Corporate Finance Adjustment?

By boosting cash flow, changes to the tax code allowing accelerated depreciation have helped the US corporate sector's financial adjustment. But they play only a small part in a bigger story. Over the past three years, firms have engineered a more radical turnaround, arresting the build-up of debt on their books. We think these achievements will last beyond the end of the temporary tax measures, and we expect that the cumulative improvement in corporate creditworthiness will continue to underpin the performance of corporate bonds.

In an attempt to lift investment spending, the Bush Administration modified the tax code allowing a sizeable first-year depreciation bonus (30%, subsequently raised to 50%) for assets other than real estate put into service after Sept. 11, 2001, and before 2005. Although the total amount eventually amortized for IRS purposes remains unchanged, companies are able to front-load the depreciation charges. This front-loading distorts aggregate corporate finances in three ways. First, book profits are lower. Adjusting for depreciation distortions, quarterly corporate pre-tax profits have been on average 1.5% of GDP higher (on an annualized basis) than the headline numbers. Second, tax payments are smaller. Since the end of 2001, tax payments have fallen from 36% of pre-tax profits (in line with the 1990s average) to 28%. Third, D&A charges are higher. As a percentage of gross capex, D&A averaged 76% between 1960 and 3Q2001. Since then, the average has jumped by two standard deviations to 101%.

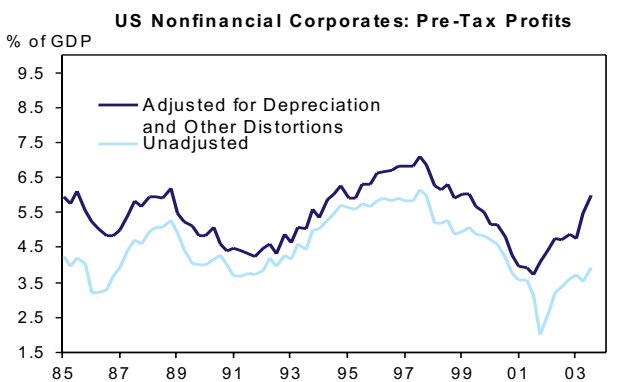
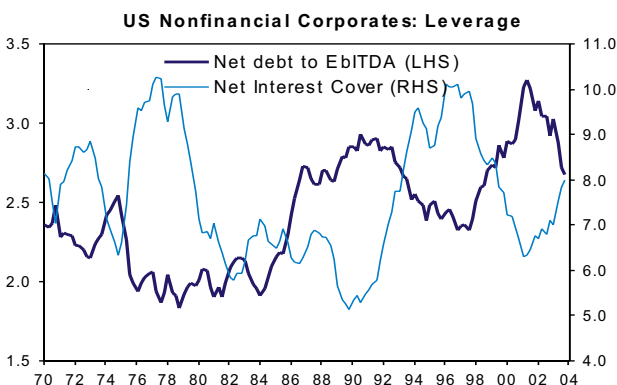
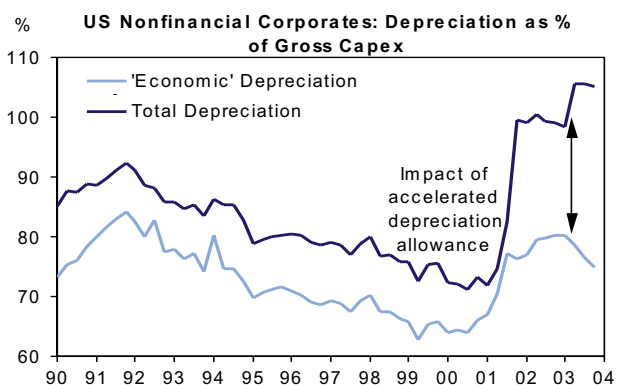
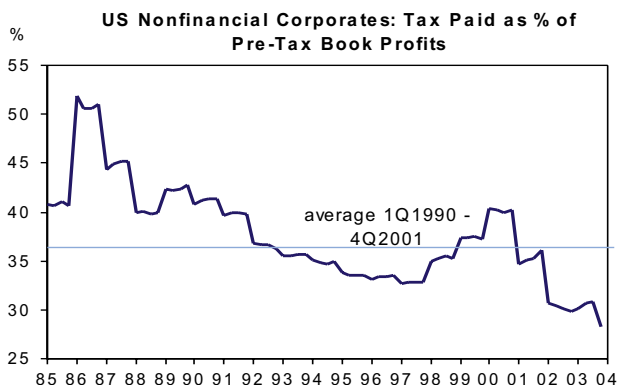
### The Impact on Corporate Finances

The 'financing gap' is the difference between corporates' 'internal funds' (retained profits after taxes but pre-D&A charges) and gross spending on fixed capital and inventories; it is roughly equivalent to 'free cash flow' net of dividend payments. A shrinking gap is typically associated with improving creditworthiness and tends to be associated with narrower corporate bond spreads. Estimates by the Bureau of Economic Analysis indicate that the depreciation allowance has raised internal funds by \$15.1bn (0.1% of GDP) in 2001, \$31.2bn (0.3% of GDP) in 2002 and \$36.6bn (0.4% of GDP) in 2003. We calculate that this has shaved around 15bp off aggregate nonfinancial lower-quality 'fair value' credit spreads. Between 2001 and year-end 2003, triple-B rated corporate spreads fell by close to 100bp, and by 300bp from their peak in October 2002.

### How Genuine Is the Improvement in Creditworthiness?

Deferred tax payments are only a small part of the story. Largely by compressing unit labor costs, US nonfinancials have boosted adjusted pre-tax profits from a low of 3.7% of GDP in 3Q2001 to slightly above 6.0% at the end of last year, a healthy level for this stage of the economic cycle.

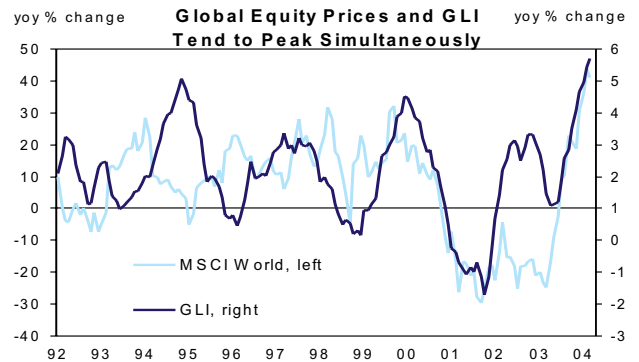
Even adjusting for the accelerated depreciation, the financing gap has swung from 3.0% of GDP in 2000 to zero in 2003—an impressive correction by historical standards. Leaving aside the equally important contributions from stronger economic activity, a significant decline in asset price volatility and lower bond yields, we estimate that the drop in external borrowing requirements has lowered 'fair value' corporate spreads by around 125bp. Further, stronger cash generation has been used to increase liquid holdings and issue less debt. As a result, the stock of gross liabilities has stabilized, allowing the ratio of net debt to EBITDA to fall from 3.1 times to 2.7 times. Though the financing gap may widen again once the tax effects fade at the end of the year, we think credit spreads are likely to remain low. ■



Source: US Federal Reserve; Goldman Sachs.

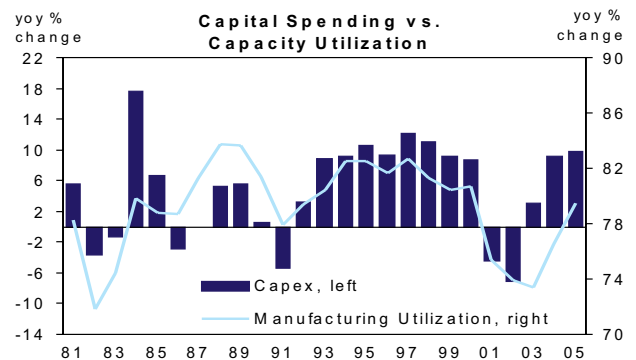
### Our Leading Indicator Suggests Growth Momentum Has Stabilized

- Our Global Leading Indicator (GLI) now offers an even earlier view on the global industrial cycle. Our earliest reading for April has hit a record on the year-on-year reading, but the monthly indicator suggests that the sharp fall in global growth momentum that began in January may have stabilized.
- Our GLI is well correlated with the outperformance of cyclical equity markets as well as with turning points in global equity prices.



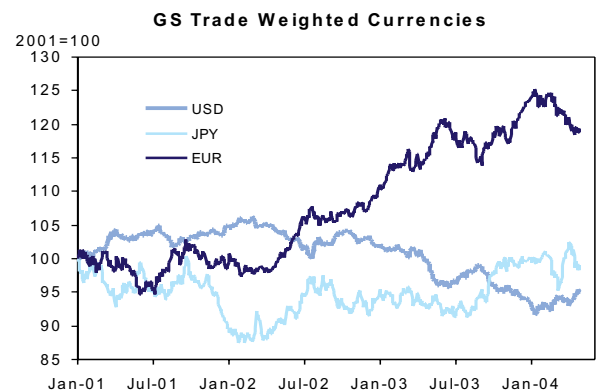
### Favorable Outlook for Capex Should Boost Industrials

- Despite the risk of an industrial deceleration in the US in the second half of the year, capital expenditures are forecast to rise by some 9% this year and 10% next.
- Rising capital expenditures are boosting capacity. Capacity utilization for the US manufacturing sector fell to a 20-year low in 2003, but it is expected to rise to a more neutral level (80%) by the end of 2004.



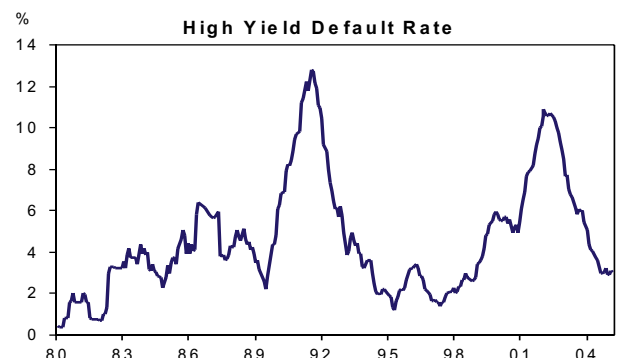
### Euro Still Bearing the Brunt of the US Dollar Adjustment

- The dollar has depreciated about 40% against the euro, 20% against the yen and about 9% in trade-weighted terms since early 2002. Over the last month, though, the dollar has recovered by about one percent on a trade-weighted basis.
- We estimate that the dollar is now about 10% undervalued against the euro but reasonably close to fair value against the yen. The main driver is the broad balance of payments deficit in the US. Euroland and Japan have much healthier positions by comparison.



### Strong Economic Data Drive the High Yield Default Rate Down Sharply

- The credit market has recently seen spreads going marginally tighter and a credit curve flattening. High yield is outperforming on the back of strong economic data, driving default rates down.
- We continue to look for spreads to move sideways for the remainder of the year. Issuance has been low, especially in Europe.



Source: Goldman Sachs.

**THE WORLD IN A NUTSHELL**

	Outlook	Key Issues
<b>United States</b>	The long-term prospects for the US economy are excellent. The three biggest drivers of industrial growth—capital spending, consumption and inventory building—are all surging. However, the near-term outlook for trade improvement is much cloudier, consumer spending is likely to slow, and the growth impulse from rising inventory accumulation is likely to ease. The second half of this year is likely to see an industrial deceleration, with GDP growth slowing to 3%.	Strong job market and inflation data, along with a change in tone at the Fed, have put the question of an early rate hike back on the table and put pressure on our forecast of no tightening until 2005. Our forecast depends critically on the slowdown in economic growth that we expect to materialize very soon. We expect consumer spending to slow as fiscal policy shifts from stimulus toward restraint, gasoline prices rise and mortgage refinancing activity drops sharply.
<b>Japan</b>	We have raised our real GDP forecasts to 3.0% for FY2004 and 3.2% for FY2005 and are much more bullish than the consensus. The Tankan survey confirms a strong recovery in the economy in the first quarter. Strength in large manufacturers is trickling down to non-manufacturing and smaller corporations, while higher expected inflation is likely to speed up consumer spending and capex.	Elements of a sustainable, domestic-driven recovery now appear in place. Deflationary pressures are steadily abating, driven by higher basic material prices and a narrowing of the supply/demand gap. Bank lending is beginning to recover and foreign investors are strong buyers of Japanese equities. The Bank of Japan will not discontinue its monetary easing policy until inflationary signs become firmer.
<b>Europe</b>	The better tone of business surveys in April, especially in Germany, alleviates fears that Euroland could miss the recovery. Industrial activity is gaining momentum after a sluggish start to the year. The recent easing of euro strength against the dollar has helped. We think the ECB will remain on hold, balancing improving business sentiment against weakness in the consumer sector and poor Q1 GDP data.	EU enlargement on 1 May will have a greater economic impact on the new entrants than on the 'old' members. Most of the positive impact on existing members will come through integration of the Single Market, labor mobility and trade integration, but the first two have been impaired by policy steps or weak implementation. The boost from trade has already been underway for several years.
<b>Non-Japan Asia</b>	Singapore announced a move to a 'modest and gradual' appreciation of the Singapore dollar nominal effective exchange rate, meaning that at least five Asian central banks have recently shifted FX policy due to rising inflation. Inflation pressure continues to build up in China, driven by an investment boom. The domestic demand recovery is spreading throughout Asia.	China's recent steps to restrain buoyant investment demand are unlikely to be effective. Sources of investment funding have become more diversified and plentiful despite slower growth in bank credit. We continue to see currency appreciation as the most appropriate way to combat rising inflation pressures. Strong domestic demand and exports will keep the economy on a solid growth path.
<b>Latin America</b>	Argentina has announced measures to boost investment in capital goods and infrastructure. These may promote investment but are also likely to increase permanent spending and harm the medium-term fiscal outlook. Mexico's trade deficit is declining, but FDI inflows remain high enough to fully finance it, introducing a bias towards appreciation for the currency.	Colombia has made great progress on the macroeconomic and domestic security fronts and has been one of Latin America's best emerging debt performers in the year to date, receiving generous capital inflows at the same time. Future spread compression hinges critically on decisive progress in addressing the fiscal finances.
<b>Central and Eastern Europe, Middle East and Africa</b>	Yield convergence in the countries that join the EU on 1 May has stalled. High fiscal deficits and slow nominal convergence make Eurozone entry unlikely before the end of the decade. A recent survey we conducted of a broad selection of European portfolio investors reveals increasing skepticism among fund managers on the prospect of the newcomers joining EMU anytime soon.	With the exception of Slovakia, reform momentum in Central Europe has generally declined in recent years despite the push from the EU accession process. Political realities give little reason to expect an improvement in the next one to two years. It may be hard for these countries to achieve the full potential growth benefits of EU membership without accelerating the pace of reform.

KEY ECONOMIC AND MARKET FORECASTS					
	GDP (%)	Consumer Prices (%)	3M Rate Forecasts* (%)	Bond Yields** (%)	Exchange Rate Forecasts
<b>US</b>	2003: 4.5 2004: 3.3	2003: 2.1 2004: 1.3	3m: 1.2 12m: 1.3	Current: 4.4 12m: 3.9	-- --
<b>Japan</b>	2003: 3.3 2004: 3.0	2003: (0.5) 2004: (0.1)	3m: 0.1 12m: 0.2	Current: 1.5 12m: 1.9	3m \$/JPY: 100 12m \$/JPY: 95
<b>Euroland</b>	2003: 2.0 2004: 2.4	2003: 1.9 2004: 2.0	3m: 2.1 12m: 2.4	Current: 4.2 12m: 4.5	3m EUR/\$: 1.20 12m EUR/\$: 1.30
<b>UK</b>	2003: 3.2 2004: 2.8	2003: 1.7 2004: 2.0	3m: 4.5 12m: 5.2	Current: 5.0 12m: 5.0	3m GBP/\$: 1.76 12m GBP/\$: 1.78
<b>Non-Japan Asia</b>	2003: 8.2 2004: 8.0	2003: 3.3 2004: 3.6	3m: 3.8 12m: 3.8	Current: 5.0	3m \$/KRW: 1110 12m \$/KRW: 1050
<b>Latin America</b>	2003: 4.3 2004: 3.3	2003: 6.8 2004: 5.5	3m: 6.0 12m: 6.8	Current: 8.0 12m: 10.1	3m \$/MXN: 10.80 12m \$/MXN: 11.50
<b>Central and Eastern Europe</b>	2003: 4.2 2004: 4.1	2003: 4.7 2004: 5.2	3m: 5.6 12m: 6.1	Current: 7.4 12m: 8.0	3m EUR/PLN: 4.60 12m EUR/PLN: 4.55

\* 3-Month Rates: Euroland: average of Germany and France; Non-Japan Asia: Korea; Latin America: Mexico; Emerging Central Europe: Poland.

\*\* Bond Yields: US: 10-year Treasury note; Japan: 10-year JGB; Euroland: average of Germany 10-year Bund and France 10-year OAT; UK: 10-year Gilt; Non-Japan Asia: Korea 10-year sovereign; Latin America: Mexico 5-year sovereign; Emerging Central Europe: Poland 5-year sovereign.

## India: Realizing the BRICs Potential

*Continued from page 8*

### Easing the Infrastructure Bottlenecks.

The fast-growing services sector still faces some notable infrastructure constraints, notably in the power supply and communications infrastructure. Fortunately, both are witnessing significant change. The power sector could see \$46 billion investment during 2002-2007, translating into 91% growth against the previous five-year period, when investment fell short.

The services sector is also an important user of information and communications technologies. Liberalization of the telecom sector and the rapid increase in the use of fixed-line and mobile phones have contributed to a dramatic drop in telecom costs. International outgoing call tariffs plunged by 71% from 1995 to 2003.

### Is India the 'Next China'?

In our view, India's long-run growth potential is largely underappreciated. Increasingly, however, we hear the question 'Is India the next China?'

China and India have some important similarities. Both have witnessed strong

growth over the past decade, although China's growth performance has clearly outshone India's. Both countries have massive labor force potential and strong diasporas to participate in economic development. At 20 million, India's diaspora is second in size only to China's 55 million. Its combined income is \$160 billion, or 35% of India's GDP.

But the broad similarities end there. The economic orientation of the two countries represent two different approaches to development, one led by manufacturing and the other by services.

Comparisons between the two countries' current economic environment are misplaced. From a point in 1986 where China's and India's per capita incomes were equal at \$275, China's per capita GDP has more than tripled, while India's has crawled up to \$494. China's export sector is nearly six times that of India. Much of China's improvement comes on the back of the country's reform program—largely focused on the external sector—which began in earnest in 1978. India's liberalization and reform began about a decade later, and the country is still about 10-15 years behind China in the reform process.

Approaches to investment have also been different historically. Investment rates over the past decade have averaged roughly 22% in India against China's 36%. At 5.1% of GDP against China's 36.2% of GDP, cumulative FDI plays a much smaller role in India.

Despite the different routes to growth that the two 'economic giants' may follow, the prospects for sustained and accelerating reform are encouraging. While there is still much scope for reform, healthy progress in liberalization; broad-based political support for economic and structural reforms; and long-awaited infrastructure development all suggest that India could be setting up the necessary conditions to support the type of long-term growth path we project. If these important conditions continue to strengthen, India may well realize its potential as the sleeper success story of the BRICs. ■

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# India: Realizing the BRICs Potential

*India could be a bigger growth story than China over the long run*

Last fall, in *Dreaming With BRICs: The Path to 2050*, we laid out growth paths for today's largest emerging markets: Brazil, Russia, India and China (BRICs). We painted a broad picture of shifts in global economic power over the next half-century and suggested a dramatic change in the world economy, with China and India becoming the world's first and third largest economies by roughly 2040.

One highlight of our findings was the remarkable, and largely underappreciated, growth potential for India. While investors and corporations have focused on China, India could be a bigger growth story over the long run. On our projections, India will become one of the world's three largest economies in less than 30 years. It is also the only BRICs economy to sustain above-5% growth until the middle of the century.

Two factors underlie India's sustained growth potential: the scope for it to 'catch up' with developed economies and its favorable demographics. Yet these factors are not new, and India bulls have been disappointed in the past. What has changed to account for our optimism now?

We think fundamental changes in the economy and its governance support India's ability to meet our BRICs projections. India's service-led growth strategy is benefiting from domestic and global demand. Globally competitive firms are emerging from the country's historically protected private sector, and broad-based reform is fostering

infrastructure development and greater openness.

To experience the long-term growth path we envisage, it is crucial that India, like the other BRICs, maintains steady progress in strengthening the key conditions for growth. Chief among these are openness to trade and investment; sound macroeconomic policies; strong institutions and infrastructure; and high education levels. These conditions are essential if India is to deliver the kind of sustained higher productivity growth that has eluded it in the past.

### *Progress Led by the Private Sector*

India's economy is less open than most of the other BRICs: trade amounts to 31% of GDP compared to 52% in China. Still, India is making encouraging moves towards more openness. Trade has roughly doubled from just 15% of GDP in 1980.

Alongside liberalization, one of the most exciting developments is private sector initiative. Globally competitive firms are raising the bar for internationally competitive products and strong corporate governance. Increased confidence has led top Indian companies in both manufacturing and services to join the global scene, seeking markets—and M&A targets—abroad. 2003 saw 75 cross-border acquisitions by Indian firms, up from 36 deals in 2002.

### *Macro Policy*

Conservative monetary and exchange rate policies can be seen as attempts to compensate for the loose fiscal policy that is India's main macroeconomic policy management challenge.

**Monetary Policy.** Compared to other developing countries, India has been able to maintain a moderate level of inflation. Inflation rates have mostly remained below 10%. Interest rates have fallen steadily over the past several years, and the bank

rate—the key policy signaling rate—is at a historically low 6%.

**FX Policy.** India's FX reserves, which have reached \$110 billion from just \$1 billion in 1991, provide an important buffer for crisis prevention. Although the Reserve Bank of India does not have an exchange rate target, the currency has been managed so that it depreciated nominally by 6.5% a year on average through the 1990s. Over the past year, the rupee has reversed its path and appreciated by 5%. We expect the rupee to strengthen further to 42.0 against the dollar in 12 months.

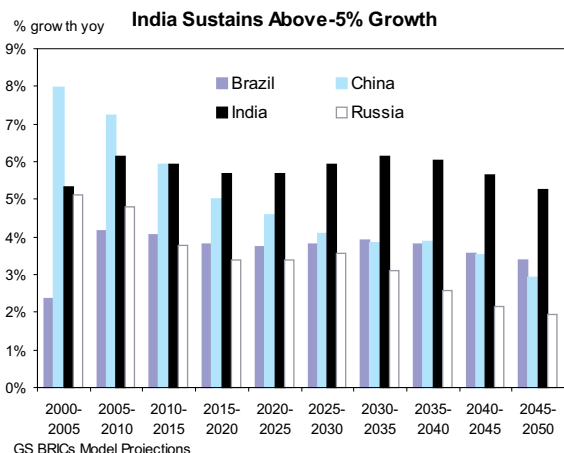
**Fiscal Policy.** India's fiscal deficit has been running at 10% of GDP for the past six years. The government's Tenth Plan (for 2002-2007) aims to reduce the fiscal deficit to 6.8%.

Progress on privatizations and divestitures would ease the deficit significantly, but process has been slow, and actual divestment has historically fallen short of targets. Raising the tax revenue to GDP ratio (currently at 10% of GDP) would help reduce the burden as well.

### *Services Focus Calls for Education and Infrastructure Gains*

Infrastructure and education are two other crucial conditions to keep India on a steady growth path. Looking at our BRICs model, if India could match China in the quality of its infrastructure and education, growth rates over the next five years could jump from an average of 6.1% to 8.1%, hitting the government's target of 8% growth.

**Broadening Education.** The country has seen well-known success in tertiary education on the back of public investment in higher education. However, at a broader level, low levels of education, particularly at the secondary level, are a major obstacle to achieving long-term growth potential. As of 2000, the proportion of the population over the age of 15 with no schooling was 44% (down from 72% in 1960), compared with 18% in China, 16% in Brazil and just 1% in Russia.



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