**Further Monetary tightening**

- We expect the repo rate to remain unchanged at 8.50%.
- The reverse repo rate to remain unchanged at 6 %.
- CRR to rise by 25 bps to 9.00% effective in August.
- Bank Rate to remain unchanged at 6.0%.

The arguments supporting policy stance are in detail as under:

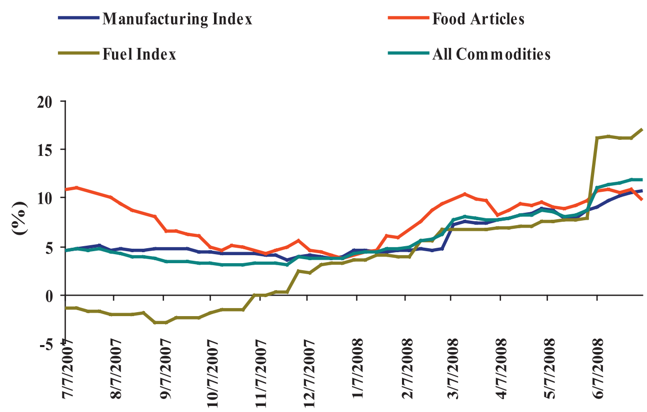
**Current concerns in India**

**Inflation: gradually eating pockets**

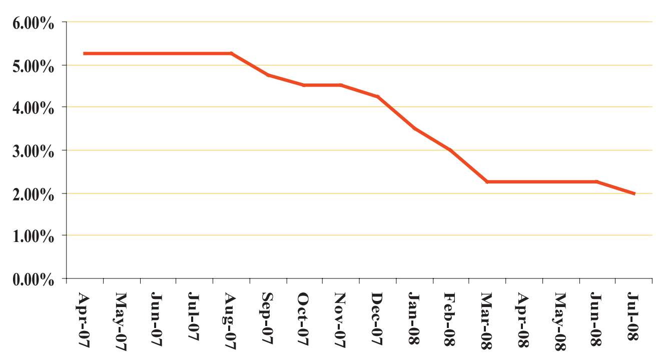
Inflation is no longer a worry of the poor countries; it has now the entire world in its grip. India follows suit with the other emerging nations reeling under imported inflation induced by supply side pressures. According to World Economic Outlook April 2008 published every quarter by the IMF, the global commodity prices are unlikely to cool off in the near term. In many countries, the driving force behind higher inflation is higher food and fuel prices. Oil prices have risen substantially above previous record highs in real terms, driven by supply concerns in the context of limited spare capacity and inelastic demand, while food prices have been boosted by poor weather conditions on top of continued strong growth in demand (including for bio-fuels). The IMF has revised its forecast for world inflation from 4.0% in CY 07 to 4.8% in CY 08.

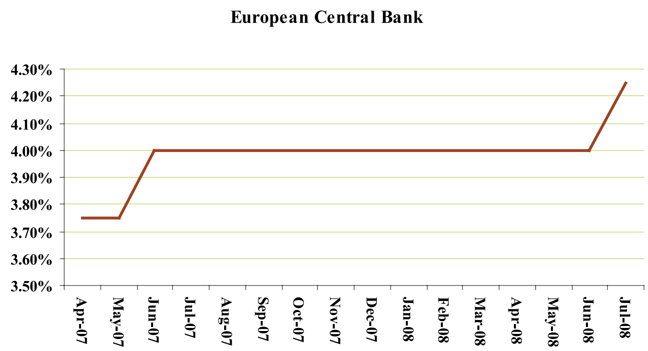
**Indian inflation Scenario**

Inflation has become nightmare not only for the bond- houses but an invincible enemy for the Central bank. Commodity prices have risen manifold since the beginning of FY 08.Crude oil the main culprit touched a historic high of $ 148. Metals index witnessed some decline in the beginning of FY 08 but has again spiked up since December. The metals price index includes the prices of copper, aluminum, iron ore, tin, nickel, zinc, lead and uranium. The prices of coal, iron ore and lead have increased by 120%, 64% and 55% yoy, respectively during FY 08. Global food prices have also been on the rise. The rice and wheat indices in March 08 have increased by 75% and 123%yoy. The Indian Meteorological department has already declared Maharashtra, Andhra Pradesh and Arunachal Pradesh under drought stricken areas. The persistent demand from nations for metals to enhance infrastructural and housing facilities will continue to pressurize the prices of steel, iron-ore and the likes. On the backdrop of rising prices inflation in India is expected to remain way above central banks comfort zone.




Federal Reserve

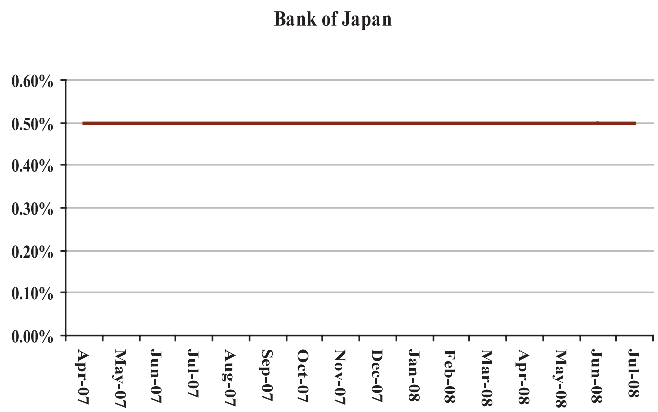




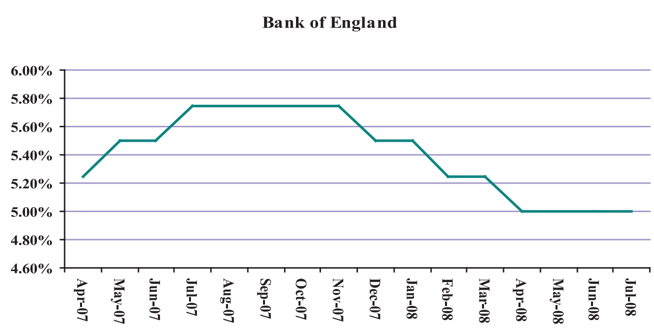

The supply side pressures may be diluted with the fall in consumption demand. This has become evident with the inflation figures at 11.89% for the weak ending July 12, 2008 indicate fall in the wholesale prices across several commodities. The 50 bps hike has begun to take toll on the financing cost of the corporates. The corporates are deferring consumption by bringing down their working capital requirements and shelving existing projects.

**Central bank reactions;**

The fear of high inflation had induced several central banks to keep their policy interest rates and reserve requirements high except for US Federal Reserve. The aggressive cuts in policy rates by the Fed in the recent months emanated from the priority of the US to combat the credit crisis and recession.



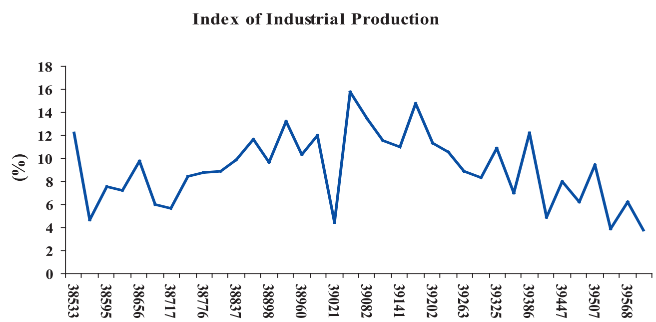

In India, the inflation threat remains high. The government and the central bank have taken slew of fiscal measures in terms of sharp reduction in import duties and export restrictions on several commodities. The shift in policy preference is apparent in government actions curbing inflation at the cost of growth, if required. Accordingly, the RBI has increased CRR 6 times since the monetary policy-April 2008 in tranches of 25 bps each to 8.75%. The RBI even went to the extent of hiking Repo rate by 50bps to 8.50%. The efficacy of monetary tools are questioned when it comes to taming inflation especially when it is induced by supply side pressure.



### Industrial performance

The poor industrial production for the month of May at 3.8% has emanated from the confluence of several factors. One high base effect has somewhat muted better than marginal industrial performance. Two, hike in repo rate and CRR announced on June 7, 2008 has slowed consumer demand and made the cost of funds for new and existing projects expensive.

In light of the facts repo rate hike in the forthcoming monetary policy will act as a dampener for industrial growth as the corporates will have no incentive to borrow at higher cost.Moreover, repo rate serves as an indirect tool for arresting industrial growth.




| Capital Investments | | | | | | (Rs. Crore) |
|---|---|---|---|---|---|---|
| | | Jun-07 | Sep-07 | Dec-07 | Mar-08 | Jun-08 |
| **Project investments added during the quarter** | Rs.crore | 250688 | 450800 | 465232 | 553787 | 498300 |
| **Project investments added during the quarter** | % | -8.6 | 79.83 | 3.2 | 19.03 | -10.02 |
| **Project investments shelved during the quarter** | Rs.crore | 22529 | 11871 | 40629 | 17896 | 43305 |
| **Project investments shelved during the quarter** | % | 110.66 | -47.31 | 242.26 | -55.95 | 141.98 |
| **Project investments outstanding at the end of the quarter** | Rs.crore | 4462638 | 4888418 | 5411733 | 6062750 | 6668471 |
| **Project investments outstanding at the end of the quarter** | % | 4.94 | 9.54 | 10.71 | 12.03 | 9.99 |
| ***Source: CMIE*** | | | | | | |

### Fiscal profligacy

The central government in its annual budget policy has projected the Gross fiscal deficit (GFD) for FY09 at 2.5% of GDP lower than FRBM target of 3.00%..However,the government may have to revise its estimates to 3-3.5% after taking into account following factors:

- Impact of agricultural debt waiver scheme: Under this scheme the governemt has waivered existing agricultural loans and disbursed fresh loans to the tune of Rs. 70,000 cr accounting for 1.3%of the GDP.

- possible loss of revenue due to lower tax buoyancy, loss of tax revenue following exemption of excise and customs duty on several commodities, additional expenses
- the Sixth Pay Commission recommendations: the outgo is estimated at Rs. 26,000 cr which is 0.5 of the GDP.
- possible surge in pre-election spending.
- and off-balance sheet items like food, fertilizer and oil bonds. The recoveries under oil, fertilizer and food is to extent of Rs. 2, 41,000 cr (4.5% of the GDP), Rs. 96,000 (1.8% of the GDP) and Rs.16, 200 cr (0.3% of the GDP).

Union Budget announced for 2008-09 has projected GDP to grow at 8.7%. In the background of the above mentioned factors the fiscal deficit will surpass the comfort trajectory of the central government.

Moreover, the recent tax buoyancy may be affected in FY 09 in case of a slowdown in the economy. In addition to this tax collection will be lower in view of sharp cut in import duties and export restrictions on several commodities and restructuring of the personal income tax structure.

**Money Supply**

Broad money (M3) growth has remained consistently higher than RBI's projected trajectory of 15% and 17.0 - 17.5% envisaged by the central bank in the FY 07 and FY 08. The stronger than expected money supply growth over a period of time carries the threat of fueling inflation in the long run.

The higher than expected M3 growth despite a series of CRR hike in tranches of 25 bps since the first quarter monetary policy emanated largely from a higher than expected GDP growth, strong remittances from abroad, and a shift of deposit mobilization from postal small savings to the banking system.

According to the table the money supply is way above RBI's projected trajectory. Thus, the RBI may consider using the MSS route further to absorb liquidity from the market depending on the market conditions. However, a declaration in this connection may not necessarily be associated with the scheduled policy meetings.

**Balance of payments**

India's BOP during FY 08 has been characterized by sharp rise in oil imports driven mainly by the surge in international crude prices while imports in terms of quantity showed subdued

Liquidity Monitor during the August-October 2008 (Rs. Cr.)

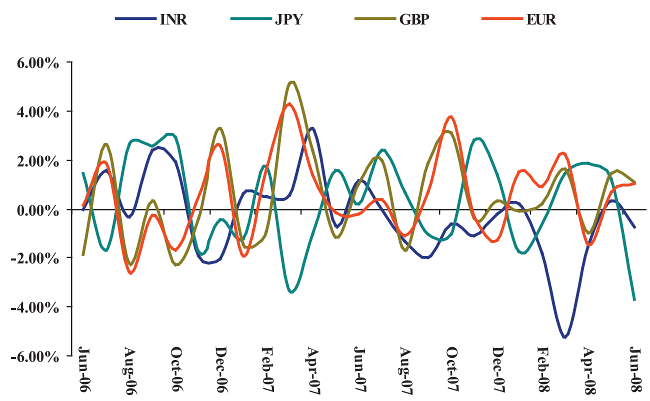
| | Inflow | Outflow |
|---|---|---|
| Government gross borrowings | | |
| Treasury Bills (including MSS) | | |
| of which:91 Day T-bill | 30,000 | 6000 |
| 182 Day T-bill | 4500 | 3000 |
| 364 Day T-bill | 18000 | 6000 |
| Coupon Payment | 27451 | 0.00 |
| G-sec Redemption | 10000 | |
| SDL Auction/redemption | 7579 | |
| G-sec (under normal Auction) | 0 | 24000 |
| G-sec (under MSS Auction) | 0 | |
| Advance tax collection | | 30000 |
| Net Inflow /outflow | 28530 | |

Note: estimated figures are subject to change growth, steady increase in invisible surplus led by remittances and significant increase in the capital inflows was led by FDI.

The widening of trade deficit for the Q4 resulted from high crude oil prices subsequently impacting import bills substantially and falling dollar in value terms cutting exports drastically. The trade deficit scenario is shaky given the fact that credit crisis in US, if does not deepen, is likely to prolong over a period of time.

**INR to appreciate**

Apparently, weakening US economic fundamentals impelled not only rupee but, Yen, Euro and Sterling appreciate vis-à-vis dollar. The RBI may be forced to intervene to bring back the rupee to its projected trajectory.




**Conclusion**

The RBI ideally will maintain a hawkish stance with a wait and watch policy. The plausibility of a repo rate in the existing condition may be less likely until the first dose of hike realize full impact on the investment demand of corporates and keeping in mind the poor industrial performance for the month of May.

The rise in CRR is possible as it is an inexpensive way of maintaining high reserve requirements. RBI has resorted to CRR on many occasions to level down growth to RBI's envisaged trajectory.

Reverse repo rate is tweaked by the Central bank only to narrow down the LAF corridor. Also, reverse repo rate beyond 6.0% without dismantling the bank rate can be seen as an anomaly, which the RBI would possibly like to avoid.

Repo rate to remain unchanged at 8.50%.

CRR to increase by 25bps to 9.00%.

Reverse Repo and Bank rate to remain unchanged at 6.00%, each.

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