

With the help of extraordinary macroeconomic and financial policy support the world economy has started showing the signs of stabilizing. However, the recession is not over yet and the recuperation is likely to be slothful. Following a disappointing first quarter, during which the global economy contracted almost as fast as during the fourth quarter of 2008, high-frequency data point to a return to modest growth at the global level. However, it is projected that the advanced economies as a group will still not show a sustained pickup in activity until the second half of 2010.

It is also forecasted that Global activity is likely to contract by 1.4 percent in 2009 and to expand by 2.5 percent in 2010, which is 0.6 percentage point higher than what was predicted in the April 2009 by WEO. For 2010 the higher annual average growth rate largely imitates carryover from a gain in growth during the final half of 2009. On a fourth-quarter-over-fourth quarter basis, real GDP growth is anticipated at 2.9 percent in 2010, compared with 2.6 percent in the April WEO forecast.

Going onward, the rapidity of recovery will depend on the stability between opposing forces. The downward drag exerted by the financial distress, the sharp drop of global trade, and the universal increase in uncertainty and collapse of confidence is progressively losing ground. Nevertheless, supportive forces are still very weak. Several housing markets have yet to bottom out. Importantly, financial markets remain weakened, bank balance sheets are not yet cleaned and institutions still need to be restructured. Reductions in policy interest rates, continual provision of generous liquidity, credit slackening, public assurances, and bank recapitalization have significantly lowered concerns about systemic failure and have supported intermediation. Consistent with these developments, financial stress indexes for developed and emerging economies have withdrawn since the beginning of 2009. However, the improvements are far from uniform across markets and countries. In particular, bank lending conditions are expected to remain tight and external

financing conditions constrained for a considerable time.

At the same time, commodity prices have rebounded ahead of the recovery. The recent rally in commodity prices has been strong and broad-based, reflecting improved market sentiment, U.S. dollar depreciation, and commodity-specific factors. In the oil market, prices have responded strongly to perceptions that market dynamics are shifting from significant oversupply to more balanced conditions. This owes in part to improving demand prospects but also Organization of Petroleum Exporting Countries (OPEC) members' strict observance of lower production quotas. Forward markets project oil prices at \$74.50 for 2010, not much above current levels, with high excess capacity expected to buffer growing demand.

In this setting, activity and credit growth are likely to remain subdued in many economies. Looking beyond 2010, it remains unclear how structurally weaker private consumption in the United States and other advanced and emerging economies that suffered asset price collapses will be compensated for by stronger demand elsewhere. Currently, expansionary macroeconomic policies and an inventory adjustment are supporting global activity but these are temporary forces.

Accordingly, GDP in the advanced economies is projected to decline by 3.8 percent in 2009 before growing by 0.6 percent in 2010. Although the projections are 0.6 percentage points higher than in the April WEO forecast growth in 2010 would still fall short of potential until late in the year, implying continuing increases in unemployment. Among the major economies, growth rates have been marked up mainly for the United States and Japan.

In the United States diminishing rate of deterioration in the labor and housing markets pointed by a high-frequency indicator. Also Industrial production is close to bottoming out; the inventory cycle is

whirling; and business and consumer confidence has improved. These developments are consistent with stabilization of output during the second half of 2009 and with a gradual recovery emerging in 2010.

In Japan signs of output stabilizing has been seen after following a dismal first quarter. Improved consumer confidence, advancement in inventory modification, aggressive fiscal policies, and strong performance by some other Asian economies are some of the reasons expected to lift growth in the coming quarters.

Also In the euro area, consumer and business survey indicators have been convalescing but the data on real activity show little signs of stabilization and thus activity is anticipated to reinforce more slowly than elsewhere. Though Macroeconomic policies are providing support but much of the adjustment in the labor market still lies ahead. Rising unemployment will impact on consumption and activity, as will the economy's heavy dependence on a still-ailing banking sector.

During the second half of 2009 emerging and developing economies are anticipated to recoup growth momentum, although with important regional differences. Low-income countries are also facing significant challenges of their own because official support has fallen and these economies are particularly defenseless to swings in commodity prices.

Growth projections in emerging Asia have been amended upward to 5.5 percent in 2009 and 7.0 percent in 2010. This upgrade owes to enhanced prospects in China and India, in part reflecting substantial macroeconomic stimulus; and a faster than-expected turnaround in capital flows. However, the current acceleration in growth is likely to diminish unless there is a recovery in advanced economies.

For Latin America, in 2009 growth projections have been reduced by 1.1 percentage points, primarily because production has been hit much harder by the

global trade slowdown than what was primarily expected. However, in 2010 the region is benefiting from increasing commodity prices, and the growth protuberances have been revised up by 0.7 percentage points.

The growth projections for central and Eastern Europe and the Commonwealth of Independent States (CIS) have been modified downward by 1.3 and 0.7 percentage points in 2009 and upward by 0.2 and 0.8 percentage points in 2010, respectively. Developments differ significantly across countries but numerous have been badly affected by the global financial crisis, with capital flows reversed and commodity exports sharply contracted, although the recent recovery of commodity prices is forecast to raise demand in key CIS economies.

Growth projections for emerging Africa and the Middle East have been revised downward by 0.3 and 0.5 percentage points in 2009, respectively, while those for 2010 are broadly unchanged. Both regions have been more negatively affected by the drop in global trade than previously expected, with Middle Eastern oil exporters using their financial reserves to prop up domestic demand.

Inflation pressures to remain low

Inflation pressures have unrelenting to ease with the continued weakness of the global economy. In May 2009 Year-over-year inflation moderated to 1.7 percent, down from approximately 6 percent in comparison with one year earlier. In the advanced economies, headline inflation fell below zero percent in May as oil prices remained far below levels one year earlier, in spite of their recent pickup. Core inflation is still running around 1½ percent, down from 2 percent one year earlier. Similarly, headline and core inflation in the emerging markets have moderated, falling below 4½ percent and to around 1 percent in May, respectively. However, growths have been uneven, with inflation falling more in China and the Middle East than elsewhere.

Despite upward pressure from recovering commodity prices, global inflation is expected to remain subdued through 2010, held back by significant excess capacity. Risks for sustained deflation are small, as core inflation and inflation expectations in most major economies are still holding in the 1–2 percent range. In the advanced economies, potential output growth rates have taken a hit, with activity in the housing and financial sectors slumping and a need for a reallocation of resources toward other sectors. Nonetheless, the weakness of demand implies a noticeable widening of excess capacity that will keep inflation close to zero percent in 2009. Inflation rates have been marked up by about ½ percentage point for 2010 from the April WEO forecast, owing to somewhat stronger demand and commodity prices than earlier projected. Unemployment rates will reach double digits in some countries, holding back wages and household spending and presenting significant policy challenges. In the emerging economies, stronger disinflation forces in some regions have prompted modest markdowns to the April projections for inflation, notwithstanding the upward revisions to output growth.

Risks have moderated but remain to the downside.

The risks to the outlook are still tilted to the downside, although tail risks have diminished noticeably. In the advanced economies, rising unemployment and a loss of confidence in the stability of the financial sector (possibly resulting from a larger-than-anticipated wave of corporate bankruptcies) could put renewed downward pressure on asset prices and potentially trigger a deflationary episode.

Moreover, rising questions about public debt sustainability in some countries could add to upward pressure on bond yields, with negative effects on the recovery of housing markets. Falling house prices are another important risk that could undermine confidence in bank capital bases. At the same time, a number of emerging economies remain quite vulnerable to

intensified financial stress, with potential feedback effects.

More generally, if higher unemployment and social discontent were to prompt governments to introduce trade and financial restrictions and roll back reforms to other sectors, there would be confidence and productivity which would suffer. However, there are also some upside risks, including a larger-than-expected drop in risk aversion and stronger internal demand dynamics in some major emerging economies.

Strong policy implementation remains key for a durable recovery.

While policies still have much work to do in dealing with the crisis, there will also be a need to increasingly shift from providing short-term support to laying the foundations for a return to strong medium-run growth. This will depend crucially on fostering stronger potential output growth, particularly in advanced economies, and rebalancing global demand. Financial, monetary, fiscal, and structural policies all have a role to play in this regard.

Financial policy

The policy priority remains restoring financial sector health. While major progress has been made in restoring bank solvency, it is not yet sufficient to stop the deleveraging. Accordingly, continued efforts to restore financial sector health, deployed in a multilaterally consistent way, will be key determinants of the durability of recent improvements in financial conditions and the strength of the recovery in the real economy. In the United States, addressing problem assets remains a key priority for putting the financial sector on a firmer

footing. Although many of the largest U.S. banks are again able to raise private capital and, in some cases, to repay government capital, major downside risks continue in the banking sector. In the European Union and elsewhere, authorities are also actively assessing banking system soundness by

conducting stress tests. While good progress has already been made, achieving credible recapitalization together with appropriate restructuring or resolution of financial institutions where needed, remains of overarching importance. Forceful and suitably transparent implementation of these steps would help rebuild confidence and reaccelerate credit growth.

Overall, short-term measures to support financial systems need to be consistent with long-term objectives to strengthen incentives and improve market discipline. Progress with respect to the latter will determine the extent to which the financial sector can effectively perform its role of allocating savings to competing projects and thereby sustain productivity growth.

Monetary and fiscal policy

Monetary policy should remain supportive until growth resumes and deflationary risks dissipate. Remaining room to cut policy rates should be exploited, while no conventional policy measures to support credit flows should continue to be explored. At the same time, exit strategies for withdrawal of exceptional conventional and no conventional monetary policy support should be developed and explained, so as to contain inflation fears.

Additionally, it would be helpful to develop tools to facilitate a smooth unwinding of the significantly expanded central bank balance sheets.

Rising concerns about fiscal sustainability underline the need for stronger medium-run fiscal policy frameworks. Although fiscal policy should stay supportive through 2010, plans should be made for rebuilding fiscal balances and ensuring sustainable debt paths after growth is firmly reestablished. Relevant reforms should aim at strengthening fiscal rules and institutions and reducing the buildup of future pension and health liabilities.

Commitments to raise statutory retirement ages in line with life expectancies and to slowdown health services costs through

efficiency improvements could help to achieve the latter objective.

In the emerging economies, macroeconomic policy has to strike a balance between the need to support demand and the risk of aggravating capital outflows and undermining fiscal sustainability. To this end, where underlying inflationary pressures are easing, central banks should reduce their policy rates cautiously to avoid a disorderly adjustment in exchange rates as well as large capital outflows.

Emerging economies also need to assess the soundness of their banking systems, especially where important segments of the corporate sector are struggling to meet payments, for example, because of sharply declining export revenues and loss of external financing.

Rebalancing global demand

Looking ahead of the next year, the crisis is likely, on the supply side, to have reduced the global economy's sustainable output. Falling investment and widespread bankruptcies are lowering the level and perhaps also the rate of growth of potential output. Moreover, rising cyclical unemployment may translate into higher structural unemployment as workers lose market attachment.

Turning to the demand side, public demand will have to recede and private demand increase. In countries such as the United States, which posted large current account deficits in the recent past, this, may require a shift from internal to external demand. By implication, the reverse will be required in countries that posted large current account surpluses.

The extent to which these supply and demand side developments will weigh on the recovery beyond 2010 depends on many factors. However, of critical importance will be the success of policies in rebuilding financial sectors in advanced economies and in supporting private

consumption in emerging economies with large current account surpluses.

Overview of Indian Economy

During the first quarter of the fiscal year 2009 the Indian economy has been showing signs of marked improvement as indicated by the performance of the various sectors. In April 2009 the Index of Industrial Production registered a positive growth of 1.4% year-on-year.

The Mining, Manufacturing and the Electricity Index also observed steady growth during this period. In April 2009 four of the six core sectors Coal, Cement, Steel & Electricity have fared better as compared to the same period last year. This is mainly due to the increase in construction activity that has aided double growth of cement sales this quarter and the increase in the demand for steel.

During the first quarter of the current fiscal year the services sectors, especially Trade, Transport, and Communication & Community Service also witnessed tremendous improvement. The capital inflows into India have increased with FIIs investing in Indian equities in the months of April and May 2009. The Indian rupee has also seen appreciation from around Rs. 52 in the month of March 2009 to around Rs. 46 in June 2009 reflecting the overall strengthening of the Indian rupee stemming mostly from the inflow of foreign funds into the Indian economy. The country has also seen increased savings and investment owing to the structural change in the economy.

However, this data may not be indicative of an early revival as there are continuing uncertainties in the global market that can cause a rapid reversal of the trends leading to a negative impact on the Indian economy.

Therefore, policy makers should remain cautious and actively monitor the events within and outside India to better manage the proposed transition into the high growth

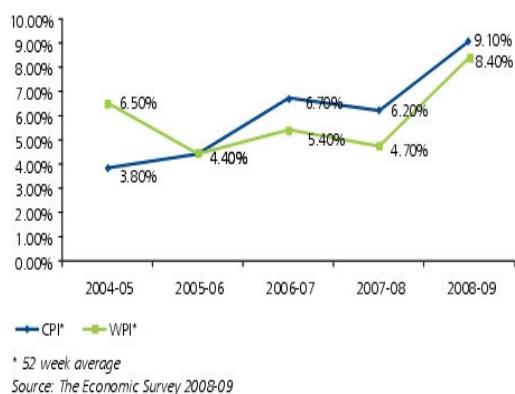
momentum that everyone is looking forward to.

The Monetary Sector

During the first half of the fiscal year 2008-09 saw that the monetary policy makers struggling with the problem of rising inflation with the WPI peaking at 12.8% in August 2008, this was instantaneously followed by an uniformly sharp decline, with the WPI inflation falling to unprecedented level of close to zero % by March 2009. During January 2008 to March 2009 this was largely driven by the rampant volatility in the global and domestic commodity prices. The growing oil and commodity prices with their consequent fall contributed to both the rise and the fall in prices.

In order to deal with the economic slowdown the RBI moved to signal a monetary stance. The repo rate (RR) was increased by 125 basis points in three tranches from 7.75% at the beginning of April 2008 to 9.0% with effect from August 30, 2008. However the reverse repo rate (R-RR) was left unchanged at 6.0%.

The cash reserve ratio (CRR) was augmented by 150 basis points from 7.50% at the beginning of April 2008 to 9.0% with effect from August 30, 2008. Bank rate remained at the same level of 6%. During FY 2008-09 the Prime Lending Rate (PLR) increased slightly from 12.8% to 13%. All these policy initiatives are coupled with a fall in commodity prices which resulted in the WPI reaching close to 0.8% at end-March 2009 on a year-on-year basis for all commodities. For 2008-09 the average WPI inflation was 8.4% as against 4.7% in 2007-08. In a contrast to the movement in the WPI, the Consumer Price Indices (CPIs) continued at a fairly high level throughout the fiscal year 2008-09. The average inflation on Consumer Price Index for Rural Laborers (CPI-RL) and for the year 2008-09 CPI for Industrial Workers (CPI-IW) was 10.2% and 9.1%, respectively.



Government take an active role in trying to bound start due to the ongoing economic slowdown which has seen the and revive the Indian economy through a series of fiscal initiatives to boost Government spending on infrastructure and other demand and employment generating projects. The result has been a burgeoning fiscal deficit which stood at 11.6% of GDP as of March 2009. Against this backdrop, fear surrounding its medium term non-sustainability has resulted in India's sovereign rating being recently revised downwards by several international rating agencies.

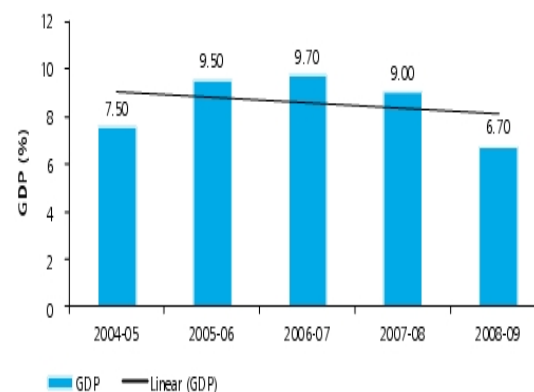
An additional concern arising from this fiscal deficit is the potential inflationary pressure which is likely to generate within the economy. A high inflation in the next fiscal will limit the Government's primary objective to fuel growth and revive the growth momentum within the economy.

GDP

In 2008-09 the Indian economy's GDP growth rate of 6.7% is a clear break down from the previous spurts in growth. This slowdown in growth is mainly due the fallout of the global recession on the Indian economy working through the fall in export demand, reversal in FII flows, slowdown in domestic investment as well as consumption and declining agricultural productivity. In 2008 in view of the enormity of the adverse economic developments, the projected drop from 9.0% last year to 6.7%

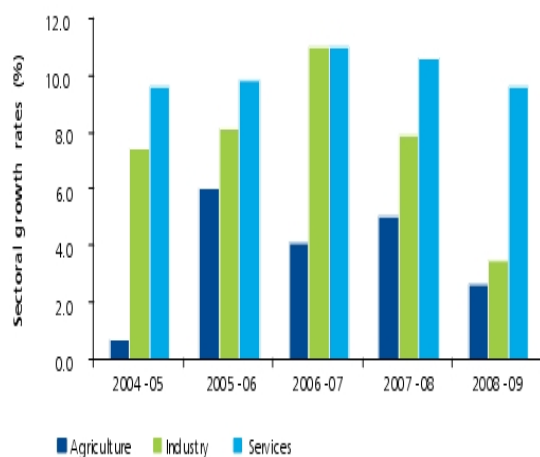
this year is modest compared to several other economies.

Figure 1: GDP at constant prices



In 2008-09 the decline in growth was stretched across all sectors except mining & quarrying and community, social and personal services. The growth in agriculture and allied activities decelerated from 4.9% in 2007-08 to 1.6% in 2008-09, mainly due to the high base effect of 2007-08 and due to a fall in the production of non-food crops including oilseeds, cotton, sugarcane and jute.

The manufacturing sector has been observed to have taken the maximum hit with a growth of 2.4%, down from 8.2% in FY2007-08. The main reason for this is the fall in exports followed by a decline in domestic demand, especially in the second half of the year. Rising cost of raw materials or inputs and the higher cost of credit reduced manufacturing margins and profitability.



During 2008-09 electricity and Construction sectors were down to 3.4% and 7.2%, respectively from 5.3% and 10.1% in 2007-08. The slowdown in electricity sector was due to capacity constraints and scarce availability of coal, particularly during the first half of the year.

The construction industry, consisting of different segments like housing, infrastructure, industrial construction, commercial real estate, etc. went through a boom phase with high growth rates until last year.

Subsequently, the rise in input cost and interest rates started impacting the industry. Services sector continued to contribute the largest share to the overall GDP with over 50%.

This sector has also shown creditable flexibility to resist the impact of the economic slowdown in India. During 2008-09 growth rates in the industrial sector fell sharply (at 3.5%) while industry and services maintained their moderate growth momentum.

** Source: Report by IMF and other financial institutions

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