

24<sup>th</sup> February, 2010

## HIGHLIGHTS

### Currency

- *We expect USD to remain volatile but the general tendency would be for more strength on the basis of likely risk-aversions in light of the debt sustainability issues in Greece. We expect EUR/USD to be in the range of 1.3200-1.3750 in the near term.*
- *Based on the lower than expected foreign inflows for the PSU disinvestment papers we feel that the recent USD-INR strength would be capped. For the near term we see the range at 45.80-47.20.*
- *For the longer period till end-March 2011, while there could be phases of appreciation bias, USD-INR could witness significant volatility. Any heightened fears of risk-aversion globally could lead to weakening trend in the INR against the USD. For FY11 as a whole we look for the USD-INR in a range of 44.50-47.50. We are out of consensus with the market which broadly expects a significant appreciation trend in INR to around 42.00.*

### Rates

- *FY11 fiscal deficit to come down to 5.6% of GDP or Rs 396,436 cr. Next year's net borrowing programme is expected to be less than this year's and should be close to Rs 3,36,971 cr. However, due to higher redemptions, the gross borrowing would be comparable to this year's.*
- *Despite the recent small relief rally in Gsec, bond yields are likely to maintain an overall bearish trend in the next few months on account of the large supply pressures and a likely normalization of monetary policy. With no support from MSS de-sequestering or OMO buybacks likely in FY11, the 10-year benchmark bond yield is expected to harden to around 8.25-8.50% during H1, 2010.*
- *Given the re-emergence of worries over the sustainability of global growth, we would expect RBI to move ahead with further monetary policy tightening in a cautious way. However, the course of normalization of monetary policy is expected to continue and in the next FY we look forward to another 75-100 bps of increase in CRR, while Reverse Repo could be increased by 100-150 bps. We pencil in a lower rise in Repo Rate by 50-100 bps. The removal of monetary accommodation is also likely to lead to the G-sec yield curve to flatten in FY 11.*

## India Macroeconomic Outlook

### India's recovery on track

- Advance estimate for FY10 pegs real GDP growth at 7.2%, beating market expectations
- Despite the drought and a 16% drop in kharif output, Agriculture and allied activities show a dip by 0.2%
- Financial segment in the services sector shows a growth of 9.9% as per the advance GDP estimate

Indian economy recovery remains on track with Advance estimate for FY10 GDP release indicating a growth of 7.2% (2004-05 base) for FY10 from 6.7% in FY09. Not surprisingly, the rebound has been driven by the industry and the services sector, which together recorded a growth of 8.5%, up from 7.7% last fiscal. The strength in these two sectors had been anticipated as monthly IIP, air passenger traffic, cargo handled at ports, cellular subscription, auto sales etc have been showing promising trends over the last few months. The PM's Economic Advisory Committee expects growth to pick up to 8.2% in FY11 and to 9% in FY12.

### Exhibit 1: Robust manufacturing and services growth pull up GDP advance estimate to 7.2%

Growth rates (%)	2007-08	2008-09 QE	2009-10 A
Agriculture, forestry & fishing	4.7	1.6	-0.2
Industry	9.3	3.1	8.8
Mining & quarrying	3.9	1.6	8.7
Manufacturing	10.3	3.2	8.9
Electricity, gas & water supply	8.5	3.9	8.2
Services	10.4	9.3	8.5
Construction	10.0	5.9	6.5
Trade, hotels, transport & communication	10.7	7.6	8.3
Financing, real estate, insurance, & business services	13.2	10.1	9.9
Community, social & personal services	6.7	13.9	8.2
GDP factor cost 2004-05 prices	9.2	6.7	7.2

Source: CSO, Kotak Mahindra Bank

The biggest surprise came from the much smaller than expected decline in the agriculture sector (including forestry and fishing), at -0.2%. Analysts had been calling for nearly a 4-6% decline in the overall agriculture sector (we were forecasting a 0.3% growth with 1999-00 as base), on the back of nearly a 16% drop in Kharif food grain production, as shown by the 1st Advance estimate released in

Nov. According to CSO, food-grain production is now expected to drop by only 8% due to expectations of a better rabi output. This along with a reasonable growth in horticulture crops and other allied activities has helped to limit the downside for the sector.

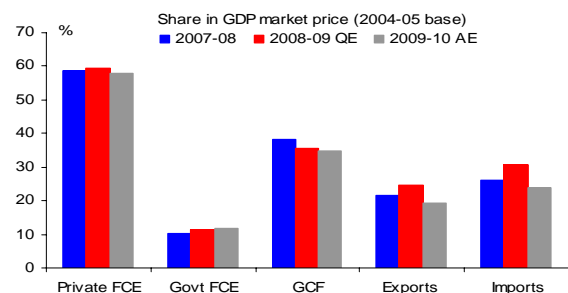
### Exhibit 2: A better rabi crop to offset partially the decline in Kharif output

		2007-08	2008-09 4th Advance estimate	2009-10	
				1st advance estimate	2nd advance estimate
Rice	Total	96.69	99.15	-	87.56
	Kharif	82.66	84.58	69.45	72.87
	Rabi	14.03	14.57	-	14.69
Wheat	Rabi	78.57	80.58	-	80.28
Coarse cereals	Total	40.76	39.48	-	34.27
	Kharif	31.89	28.34	22.76	22.77
	Rabi	8.87	11.14	-	11.50
Pulses	Total	14.76	14.66	-	14.74
	Kharif	6.40	4.78	4.42	4.21
	Rabi	8.36	9.88	-	10.53
Total foodgrains	Total	230.78	233.88	-	216.85
	Kharif	120.95	117.70	96.63	99.85
	Rabi	109.83	116.18	-	117.00

Source: Various media reports, Kotak Mahindra Bank

The expenditure side breakup of GDP reveals that private demand (consumption and investment demand taken together) is still somewhat weak, while government sector support has remained relatively strong. Even as growth in government consumption expenditure moderated to 8.2% from 16.7% last year, its share in the total GDP increased to 11.6% from 11.5% in FY09. Private consumption expenditure, on the other hand, is expected to grow by only 4.1% (from 6.8% in FY09) and its share in GDP is likely to come down to 58% from 59.5% in FY09. Gross Capital Formation (GCF) is seen to grow by 4%, helped by the boost to infrastructure spending and an end to inventory liquidation seen at the peak of the crisis.

### Exhibit 3: Share of private demand in total GDP has come down, while that of government has increased



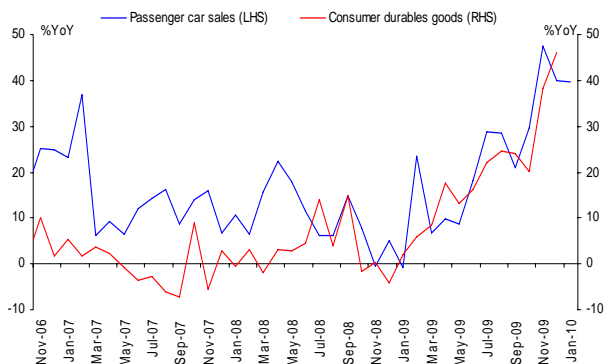
Source: CSO, Kotak Mahindra Bank

**Industrial recovery gathers momentum**

- **December IIP prints a record growth of 16.8%, belying market expectations of a 12.4% growth**
- **Consumer durables along with capital goods register very strong growth**

December IIP data surprised on the upside, with industrial activity recording a stupendous growth of 16.8%, beating expectations by a huge margin (Bloomberg consensus 12.4%, Kotak Bank estimate 12.3%). Taking the latest data print into account, industrial production has averaged 8.6% this fiscal as against 3.6% in the corresponding period last year. Alongside the support from a low base, an across the board improvement in activity was behind the spectacular performance of the industrial sector in December. While all three sub indices jumped on a monthly basis, the rise in the manufacturing index (11.6%) was the highest. Given the strength in Dec IIP and the low base of growth in January to March of 2009, the rest of this FY could see IIP in a range of 15-16%. Hence, for the year as a whole, IIP could average more than 10%, significantly higher than the average of 2.7% in the last FY.

**Exhibit 4: Passenger car sales show strong growth, pulls up consumer durable goods production**



Source: Bloomberg, Kotak Mahindra Bank

As per the 2 digit NIC Industry classification, 8 industry groups posted double digit growth in December, one more than in November. The continued strength in auto sales (Dec growth at 60.1%) possibly explains the more than 80% growth in transport equipment & parts in December. Machinery & equipment other than transport equipment was the other segment that saw a very strong growth in December (44.6%).

The strength in metal products as well as machinery and transport equipments in December was reflected in the sharp increase in the consumer durables and capital goods growth in December (46% and 38.8% respectively). We anticipate that the rise in the consumer durables growth could have been be on account of consumer advancing their purchase with expectations that prices could rise (rollback of excise duties in the forthcoming budget and recent hikes in prices of steel) or that the low interest rate regime would come to an end. The process was also possibly helped by the arrear payouts of the 6th Pay Commission in October 2009.

**Exhibit 5: Skewed nature of the manufacturing sector growth remain an area of concern**

Sub-segments of manufacturing sector	Weight	Dec-09	Apr - Dec 09
Food Products	9.08	-6.9	-7.4
Beverages, Tobacco and Related Products	2.38	0.5	-1.3
Cotton Textiles	5.52	2.6	3.3
Wool, Silk and man-made fibre textiles	2.26	3.8	12.1
Jute and other vegetable fibre Textiles (except cotton)	0.59	24.5	-15.3
Textile Products (including Wearing Apparel)	2.54	10.2	9.8
Wood and Wood Products; Furniture and Fixtures	2.70	10.4	8.7
Paper & Paper Products and Printing, Publishing & Allied Industries	2.65	4	2.2
Leather and Leather & Fur Products	1.14	-0.1	0.8
Basic Chemicals & Chemical Products (except products of Petroleum & Coal)	14.00	29.0	12.0
Rubber, Plastic, Petroleum and Coal Products	5.73	21.5	14.5
Non-Metallic Mineral Products	4.40	8.2	6.5
Basic Metal and Alloy Industries	7.45	5.8	4.5
Metal Products and Parts, except Machinery and Equipment	2.81	11.7	5.2
Machinery and Equipment other than Transport equipment	9.57	44.6	15.8
Transport Equipment and Parts	3.98	82.2	19.8
Other Manufacturing Industries	2.56	-9.4	8.7

Source: Bloomberg, Kotak Mahindra Bank

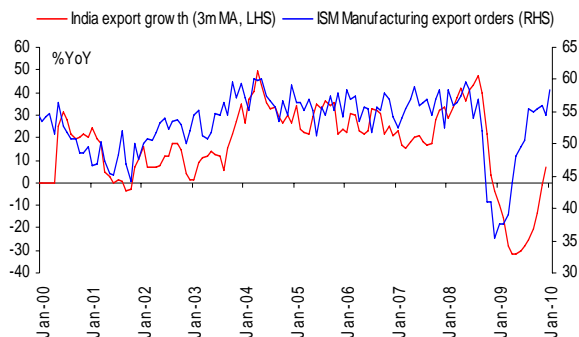
While the stupendous growth in several industries is encouraging, the unevenness in the industrial recovery continues to be an area of concern. In December, a little less than half of the manufacturing growth was contributed by only two industries (transport and machine equipment), which make up for only 17% of the overall manufacturing sector. Industries such as food products, beverage, tobacco & related products and Jute & other vegetable fibre textiles, which together account for

15% of the manufacturing sector are still seeing negative growths on a FYTD basis. In December, nearly a third of the manufacturing sector recorded growth below 5%. With many of these industries a part of the consumer non durable goods segment, it is not surprising that the later has been seeing rather muted growth (3.7% in Dec'09, FYTD average 1.8% vs. 6.8% last fiscal). In fact, in its January policy review the RBI cited its concerns over the emerging imbalances in the growth trajectory, even as it upped its FY10 growth forecast to 7.5%.

While there is a need for policy normalization, both on the fiscal and monetary front, policymakers must not be swayed in by the strength in the headline IIP. Rather, taking note of the still skewed nature of the recovery process, policymakers should be cautious while withdrawing policy accommodation. We thus think a more gradual approach in removing the policy stimulus would serve better as it would help to minimize the risk of derailing the ongoing recovery.

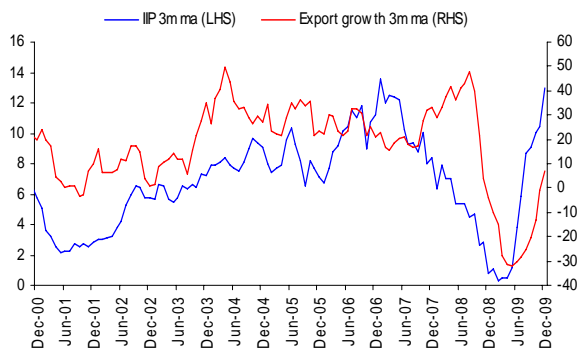
We had upped our GDP estimates for the current fiscal to around 6.9% from our earlier estimate of 6.0%, much ahead of the recent sharp increase in the IIP. This was because we were not expecting a very sharp contraction in the agricultural segment's growth even though the khariff food output was supposed to be lower by almost 16%. In the current FY the incomes of people sustaining on agriculture was also raised through the NREGA programme and other in income-generating flagship programmes of the government. We would tend to agree to the 7.2% GDP growth for FY10 (CSO's advance estimates) but would keep ourselves open to an upside bias originating from a better than expected rabi production and/or a steeper rise in the IIP growth.

**Exhibit 6: A recovery in the global demand has pushed up India's exports...**



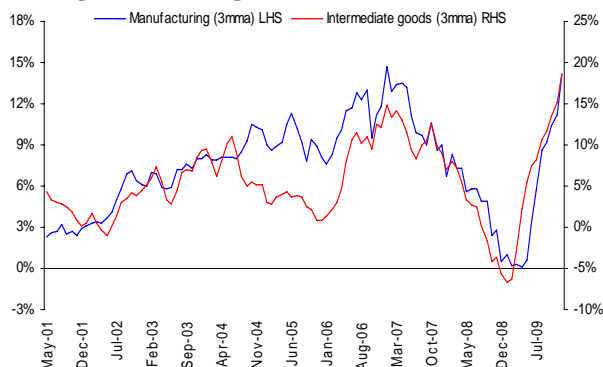
Source: Bloomberg, Kotak Mahindra Bank

**Exhibit 7: ...which bodes well for the manufacturing sector going forward**



Source: Bloomberg, Kotak Mahindra Bank

**Exhibit 8: Manufacturing and Intermediate goods production has bounced up sharply, with growth nearing historical highs**



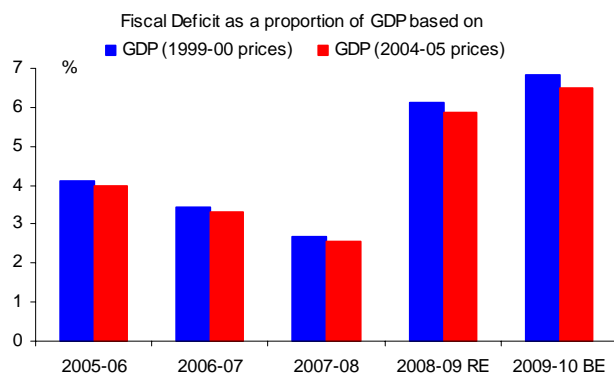
Source: Bloomberg, Kotak Mahindra Bank

## Lower Fiscal Deficit/GDP ratio but elevated gross borrowings of Centre

- FY10 fiscal deficit to GDP ratio likely to come at around 6.5% of GDP, lower than the BE of 6.8%, on account of a higher GDP due to re-basing to 2004-05 from the earlier 1999-00
- FY11 fiscal deficit to come down to 5.6% of GDP or Rs 396,436 cr
- Next year’s net borrowing programme to be less than this year’s and should be close to Rs 3,36,971 cr. However, due to higher redemptions, the gross borrowing would be comparable to this years

This year’s massive fiscal deficit (6.8% of GDP) was unavoidable, as in the absence of private demand; the government had to step in to support growth. However, with domestic recovery on track and conditions reviving globally as well, there is now immense pressure on the government to correct for its fiscal largesse. Thus the focus for this year’s Union Budget on the 26<sup>th</sup> of February would be the extent to which the government is able to show fiscal restraint and also assure the foreign investor community through a roadmap on fiscal consolidation based on some expected date for the rollout of the GST, the new direct tax code etc.

### Exhibit 9: A change in base year for GDP reduced fiscal deficit to GDP ratio



Source: CSO, Kotak Mahindra Bank

To start with, there would definitely be an advantage to the headline fiscal deficit/GDP numbers with the change in the GDP’s base year from 1999-00 to 2004-05. As a result of this base change, 2009-10 nominal GDP is being

projected (as per the advanced estimates) to be nearly 5.6% higher than with the previous base year. All else equal, this strong boost to the denominator would help to bring down the fiscal deficit to around 6.4% of GDP (BE is 6.8%). In this sense, achieving a target of 5.5% fiscal deficit/GDP could be easier for FY11. In the run up to the Union Budget, we take a closer look at the revenue and expenditure trends for the current year, our expectations for the next year and what it means for the Central government borrowing programme.

### 2009-10 BE likely to hold their ground: Revenue to get a fillip from direct taxes...

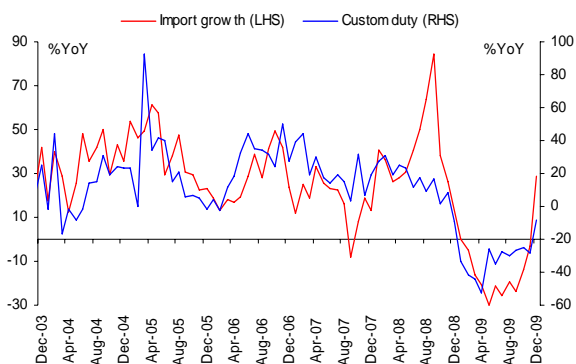
Current trends in total receipts (revenue receipts plus non debt capital receipts) broadly indicate that the government will most likely meet its BE of Rs619,842 cr. As per our calculations, buoyancy in direct taxes and divestment proceeds (not accounted for in the BE) would offset the shortfall in indirect tax collections and the revenue losses due to the postponement of the 3G auction to the next fiscal.

Data until Dec’09 shows that direct tax collections have been much more robust than budgeted, with corporate taxes growing by 16.8% and income taxes by 12.2%. Going by these trends, we expect direct tax collections to surpass the budget estimate of Rs 369,575cr and be closer to Rs 4,00,000 cr., in line with the revised estimates on direct taxes that were put out by the government in the past. In fact, the Finance Ministry is quite determined to meet its new direct tax revenue collection target and has tightened its collection machinery to prevent any loss in revenues on the direct tax account. To meet the revised target for direct tax collections, in a recently held meeting, the CBDT (Central Board of Direct Taxes) decided on several measures which included (i) monitoring the advance tax payments of top companies and persuading them not to defer such payments as self-assessment tax for the next fiscal, (ii) monitoring the tax paid out by loss-making companies liable to minimum alternate tax (MAT) at an enhanced rate of 15 per cent, and persuading them to make such payment as advance tax during the current financial year, (iii) monitoring tax deducted at source (TDS) deposits by private

deductors as well as state governments and local bodies.

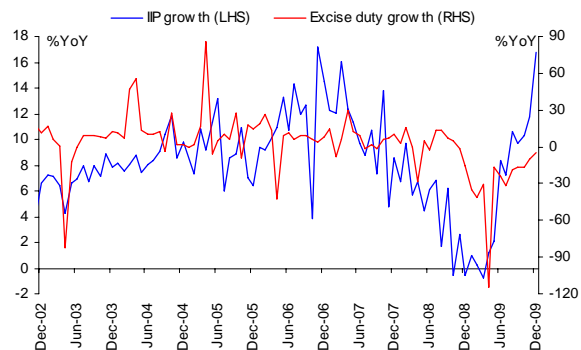
In case of indirect tax collections, the dismal trends, which started in the latter half of FY09, have continued well into FY10. While the reduction in the excise tax rates has seen the excise tax collections fall by 29.2% on an FYTD basis, the steep decline in imports has weighed significantly on customs collections, which has declined by 18.2% on a FYTD basis. However, this near Rs 25,000 cr of shortfall in indirect tax collections from the BE is expected to be met out of the higher than budgeted collections in direct taxes. Further, the loss in revenues to the extent of Rs 35,000 crore due to postponement of the 3G auction to the next fiscal is likely to be made up by the PSU divestment proceeds, estimated at Rs 25,000 cr in this FY. The Centre has already raised around Rs12,000 cr by diluting its stake in NHPC, Oil India and NTPC and it expects to raise another Rs 12,000 – Rs15,000 cr by the end of this fiscal through divestment in REC, NMDC Ltd and SJVNL. However, the final amounts garnered would depend on the conditions in the equity market and the response from the FIIs to the above stake sales.

**Exhibit 10: Recovery in imports to bode well for custom tax collections**



Source: RBI, CGA, Kotak Mahindra Bank

**Exhibit 11: Drop in production and excise tax cuts weighed on excise tax collections**



Source: Bloomberg, CGA, Kotak Mahindra Bank

**Spending restrains by Ministries to avoid any slippage on the expenditure side in FY10**

In early December the government had sought Parliamentary approval for additional expenditure of Rs30,942cr (included Rs 3,459cr on food subsidy and Rs 3,000cr on the fertilizer subsidy). The additional cash requirements were however only Rs 25,725 cr, and the remaining was to be financed through savings of different ministries and also enhanced government receipts. However, recent comments by a finance ministry official indicated that savings of various ministries could add up to almost Rs 25,000 - Rs 30,000 cr. Thus this supplementary demand for funds is unlikely to have any negative implications for the borrowing programme of the Central Government.

In the Apr –Dec period, the government has spent only 69.3% of its total expenditure estimates, much less than the 79.5% seen during the same time last fiscal. However, the biggest difficulty is to estimate the expenditure pattern in the rest of the financial year as there could be some lumpiness of expenditures in Q4. Moreover, there are still some hazy areas so far as meeting of the under-recoveries of the oil marketing companies are concerned. While the under-recoveries of the oil marketing companies are estimated at around Rs 30,000 crore we are still not sure whether the government would give or cash payouts or would issue oil bonds against these. Initial understanding was that of Rs 12,000 crore cash payment, that could lead to some slippages in the fiscal deficit.

On the plan expenditure side, once again barring the 2008-09 period, we have observed that the actual plan expenditure in the preceding few years has fallen short of the BE. Given this and the fact that only 64.6% of the budget allocations for plan expenditure have been utilized till Dec'09 as against 70.2% last fiscal; we estimate a marginally lower outflow on the plan expenditure side. Taking into account our estimates for the major expenditure items alongside our expectation that some ministries could have seen lower spending as opposed to the BE (as was also voiced by a Finance Ministry official), we do not immediately sense any large slippage on the expenditure side.

### No risk to FY10 BE of fiscal deficit

Based on our analysis, we expect the absolute fiscal deficit for FY10 at close to budget estimates (Rs 401,617cr against a BE of Rs 400,996 cr), while the fiscal deficit/GDP ratio is likely at 6.5% of GDP, lower than the BE of 6.8%, mainly on account of a higher GDP number due to selection of a new base year. A risk to our estimates comes if our assumptions of expenditure curtailment and/or the buoyancy in direct tax collections are proved incorrect. Further, with the recent changes in the financial markets globally and a bias for the equity markets to stay weak, there could be a possibility of lower than expected receipts through the PSU divestment route. This could thus open up a scope for a higher slippage in the fiscal deficit. Even as the government had been indicating that there would be no need for additional borrowings for this FY, we keep ourselves open to this risk. However, any additional fund requirements of this year could be managed through the use of “cash management bill” rather than borrowings through the dated securities.

### Exhibit 12: No risk of a fiscal slippage in 2009-10

	2006-07	2007-08	2008-09 RE	2009-10 BE	2009-10 F*
<b>Total receipts</b>	440,814	585,759	574,438	619,842	619,190
% of GDP	10.3	11.8	10.3	10.0	10.0
<b>Total expenditure</b>	583,387	712,671	900,953	1,020,838	1,020,807
% of GDP	13.6	14.4	16.2	16.5	16.5
<b>Fiscal Deficit</b>	<b>142,573</b>	<b>126,912</b>	<b>326,515</b>	<b>400,996</b>	<b>401,617</b>
% of GDP	3.3	2.6	5.9	6.5	6.5

Source: CSO, CGA, Kotak Mahindra Bank

### Next fiscal to see improvement in revenue collections ...

In the coming fiscal 2010-11, we think that cyclical buoyancy in taxes on the back of better growth performance, a rollback of excise duties and service taxes and 3G auction receipts would boost overall revenue collections. On the tax revenue side, direct tax collections, both corporate and income taxes should continue to see healthy growths on the back of good prospects for economic growth and rising incomes. On the indirect taxation side, excise tax collections is expected to rise on account of an expected increase in the excise duties closer to the pre-crisis days. Custom tax collections is also likely to be helped with a likely rebound in both oil and non oil imports as the Indian economy shows stability in growth as well as a possible increase in customs duties in certain areas.

A roll-back in the excise and custom rates should also enable a seamless integration of the taxation system into the Goods and Service Tax (GST) later this year (the deadline shifted to Oct'10). Apart from the boost in tax revenue, government receipts are likely to get further enhanced by the nearly Rs 25,000 of revenue expected to be garnered from the 3G auction (now likely to be in Dec'10) and around Rs 30,000 cr from PSU divestment (depends on the course of the equity markets in next FY).

### Exhibit 13: Receipts to show cyclical rebound next fiscal

In Rs cr

	2008-09 RE	2009-10 BE	2009-10 E	2010-11 E
<b>A Revenue Receipts (10+11)</b>	<b>562,173</b>	<b>614,497</b>	<b>589,965</b>	<b>707,479</b>
<b>1 Direct Taxes (2+3)</b>	<b>344,600</b>	<b>369,575</b>	<b>399,944</b>	<b>464,147</b>
2 Corporate Tax	222,000	256,725	261,960	303,318
3 Income Tax	122,600	112,850	137,984	160,829
<b>4 Indirect Taxes (5+6+7)</b>	<b>281,359</b>	<b>269,477</b>	<b>244,249</b>	<b>289,211</b>
5 Customs Tax	108,000	98,000	82,131	98,755
6 Excise Tax	108,359	106,477	97,118	112,863
7 Service Tax	65,000	65,000	65,000	77,593
<b>8 Other Taxes</b>	<b>1,990</b>	<b>2,027</b>	<b>2,400</b>	<b>2,822</b>
<b>9 Gross Tax Revenue (1+4+8)</b>	<b>627,949</b>	<b>641,079</b>	<b>646,593</b>	<b>756,180</b>
<b>10 Tax Revenue (Net)</b>	<b>465,970</b>	<b>474,218</b>	<b>478,285</b>	<b>559,347</b>
<b>11 Non-Tax Revenue</b>	<b>96,203</b>	<b>140,279</b>	<b>111,680</b>	<b>148,132</b>
<b>B Non-Debt Capital Receipts (12+13)</b>	<b>12,265</b>	<b>5,345</b>	<b>29,225</b>	<b>34,938</b>
12 Recovery of Loans	9,698	4,225	4,225	4,938
13 Other Receipts (Disinvestments)	2,567	1,120	25,000	30,000
<b>C Total Receipts (A+B)</b>	<b>574,438</b>	<b>619,842</b>	<b>619,190</b>	<b>742,417</b>

Source: CGA, Kotak Mahindra Bank

### Expenditure would also head higher, though at a slower pace

The expenditure side had been augmented significantly in the course of the last couple of years. Some of the expenditure increases such as through the 6<sup>th</sup> Pay Commission and the Farm Loan waiver were thought of earlier than the economic crisis. Along with this, increases in expenditure in response to the economic crisis have increased the expenditures as a % of GDP by nearly 2.2%. The area where the outlay was increased significantly was the NREGA programme, implying that most of the expenditure increases supported consumption rather than investments.

Some of these expenditures would be automatically vacated in FY11. There are no further expenditures to be incurred for 6<sup>th</sup> Pay Commission arrears and only around Rs 15,000 crore are remaining under the farm loan debt waiver scheme. However, despite the absence of these one off expenditure items, overall expenditure is unlikely to moderate sharply as a large part of our expenditure is structural in nature. Nearly a third of our expenditure is on two items – interest payments and subsidies, which are unlikely to see any reduction in the next fiscal. In FY11, interest payments are expected to increase by around Rs 25,000 cr –Rs 28,000 cr, reflecting the increased interest cost of the huge government borrowings. The subsidy bill would also move higher, on account of the higher MSP prices (would increase the carrying cost of food-grains and thus the food subsidy bill). The fertilizer and the oil subsidy bills could also be at the risk of a sharp increase if the international crude oil prices rise. However, the government has now de-controlled fertilizer prices other than that of urea. Subsidies will now be provided on the basis of nutrient content from April 1, 2010 rather than on a per-bag basis. Further, the price of urea has been hiked by 10%, the first rise since 2002. These measures are expected to contain the rise in the fertilizer subsidy bill, but the extent of containment is not yet clear. But more significantly, the above decision provides a clear intent of the government to correct for the fiscal imbalance and could also clear the path for selective implementation of the Kirit Parikh committee report on de-regulating the oil sector.

Furthermore, defense expenses are also seen to go up, though by a lesser magnitude than that seen in the last two years (was due to the pay commission arrears). Overall, we see non plan expenditure rising by 11.6% next year to Rs 779,104cr from this year's BE of Rs 695,689cr (11.0% of GDP as against BE of 11.2% of GDP in 2009-10). We estimate plan expenditure to rise by 11.4% next fiscal, which would translate into an incremental outlay of around Rs 37,000 cr over our FY10 estimate to meet the targets of the 11<sup>th</sup> Five Year Plan.

#### Exhibit 14: Expenditure growth to moderate in FY11

Items	2008-09 RE	2009-10 BE	2009-10 E	2010-11 E
<b>A Non Plan Expenditure (1+2+3+9)</b>	<b>617,996</b>	<b>695,689</b>	<b>697,910</b>	<b>779,104</b>
1 Interest Payments	192,694	225,511	225,511	253,941
2 Defence Expenditure	114,600	141,703	143,924	157,302
3 Subsidies (4+5+6+7+8)	129,243	111,276	117,735	138,609
4 Food	43,627	52,490	55,949	63,485
5 Fertilizer	75,849	49,980	52,980	64,896
6 Petroleum	2,876	3,109	3,109	3,527
7 Interest	4,063	2,601	2,601	3,174
8 Other subsidies	2,827	3,096	3,096	3,527
9 Others	181,459	217,199	210,740	229,252
<b>B Plan Expenditure</b>	<b>282,957</b>	<b>325,149</b>	<b>322,897</b>	<b>359,749</b>
<b>C Total Expenditure (A+B)</b>	<b>900,953</b>	<b>1,020,838</b>	<b>1,020,807</b>	<b>1,138,853</b>

Source: CGA, Kotak Mahindra Bank

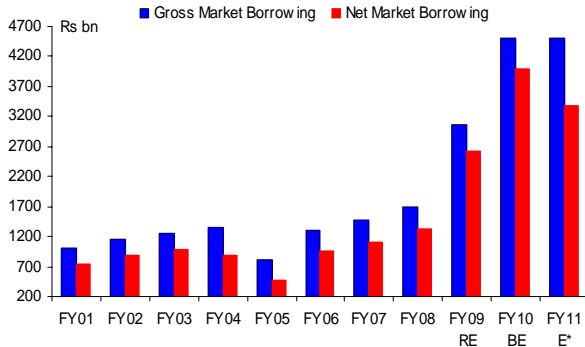
Our calculations on the expenditure side does not consider any adjustment of the off-balance sheet items such as the oil bonds, fertilizer bonds into the main budget. We would wait for the suggestions on these in the report of the 13<sup>th</sup> Finance Commission to take a view. However, this is a factor that could lead to a bloating of the expenditure side.

#### Fiscal deficit unlikely to see a significant correction

Our estimates for 2010-11 revenue and expenditure would result in a resource gap of Rs 396,436 cr or 5.6% of GDP, which would have to be funded through resources generated either externally or domestically. We think that in the next fiscal, external financing together with domestic financing other than market borrowings could help to fund nearly 15% of the fiscal deficit (was around 1% this year as per BE), leaving Rs 3,36,971 cr of the deficit to be financed via market borrowings. This is nearly Rs 61,000 cr less than this year's net borrowing by the government. However, with around Rs 1,14,000 cr of redemptions due next year (Rs 53,136 cr in FY10), the gross borrowing would not be materially

different from this year's and we estimate next year's gross borrowing at Rs 4,51,294 cr.

**Exhibit 15: High redemption pressure leads to an almost unchanged gross market borrowing for FY11**



Source: Budget documents, various issues, Kotak Mahindra Bank

Despite a comparable figure for gross borrowing and a lower net borrowing, managing next year's borrowing programme could be a challenging. While RBI's OMO buyback and MSS de-sequestering (adding up to nearly Rs 1,46,000 crore) helped in the conduct of the borrowing programme in a "non-disruptionary" manner in FY10, the absence of support from these two channels may lead to spikes in the Central Government bond yields. Even after assuming a respectable growth in aggregate deposits (17%) and a high holding of SLR (core) by banks (28.5%), we estimate that the supply of bonds (Centre + State) would overstep demand by around Rs 64,000 cr.

**Exhibit 16: Supply of bonds could outstrip demand in the next fiscal (Rs cr)**

	Demand	Supply	balance of gilts	FY10E	FY11 E
1	<b>Demand for SLR securities (2 to 3)</b>			<b>343,132</b>	<b>402,884</b>
2	required from banks			182,725	227,384
3	from insurance companies, PFs, MFs			160,407	175,500
4	<b>Supply of SLR securities (5 to 7)</b>			<b>513,395</b>	<b>466,971</b>
5	Net market borrowing of center			397,957	336,971
6	T-bills financing			0	0
7	Net State Government issuances			115,438	130,000
8	<b>Demand-Supply (1-4)</b>			<b>-170,263</b>	<b>-64,087</b>
9	To be met through				
10	MSS			88,077	0
11	Outright OMOs			58,715	0
12	Private placements			0	0
14	<b>Total</b>			<b>146,792</b>	<b>0</b>
13	<b>Gap</b>			<b>-23,471</b>	<b>-64,087</b>

Source: Kotak Mahindra Bank

Overall, we feel that there is possibly some scope for improvement in the overall revenue chain while curtailing expenditures could continue to pose some challenge. Even as the fiscal deficit as a proportion of GDP could correct lower, it could be difficult to see a very aggressive correction as the cyclical buoyancy in revenues is unlikely to kick in to the same extent as it was when growth had topped 9%+.

However, it is heartening to see the government's commitment to initiate measures that point towards fiscal consolidation such as the de-controlling of the fertilizer segment. This also provides some scope of an announcement for implementation of the Kirit Parikh committee report on de-regulating the oil sector in the Budget.

The other issues that are likely to find mention in the budget documents are

- a. roadmap for implementation of the GST and the revenue sharing formulae between the Centre and the States and a likely estimate on the benefits to the revenue chain that can come through the implementation of the GST,
- b. roadmap for implementation of the Direct Tax code and the likely implication of this on revenues,
- c. clear plans for disinvestment in the PSU enterprises in the coming fiscal,
- d. the public-private partnership for infrastructure projects is yet to take off in any sincere way and should once more find a mention in the budget documents
- e. agriculture could emerge as a big focus in the budget and there could likely be some announcement to increase the productivity of this sector with a view towards food security
- f. the outlays for the various flag-ship programmes such as the NREGA are likely to increase but the percent increases are expected to be way below the previous year's rise.

**Bond yields to stay under pressure on supply concerns**

- Following the RBI's policy meeting on the 29<sup>th</sup> of January, bond yields have hardened significantly
- Bond yields are likely to stay under pressure as Centre's borrowings is unlikely to be much different from last FY

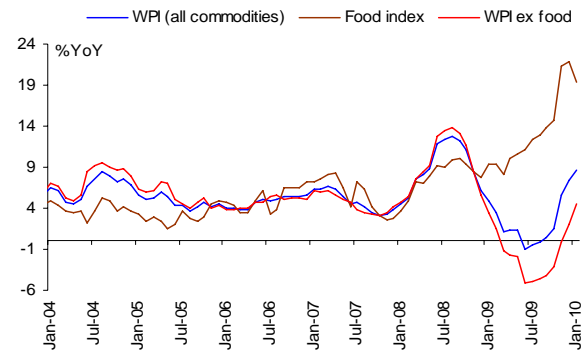
Following the RBI's monetary policy meeting on the 29<sup>th</sup> of January, Indian government bond yields hardened significantly. Even though the central bank hiked the CRR by 75 bps and left the interest rates unchanged, its tone was visibly hawkish as it highlighted the need to normalize policy environment in light of the ensuing growth and inflation dynamics. Markets were quick to price in aggressive rate hikes, which exerted upward pressure on Gsec yields.

Rate hike expectations were further strengthened as inflation and industrial production data surprised on the upside, and this further weighed on the bond market. Following the spectacular performance of the Industrial sector (December IIP rose by 16.8% YoY), the headline WPI in January climbed to 8.6% YoY, breaching the revised 8.5% end-March inflation target of the RBI. Even though food prices were expected to soften due to the arrival of the Kharif output, the extent was much less than anticipated. Further, prices of commodities other than food also firmed up, and the WPI ex-food accelerated to 4.5% from 2.1% in December. With inflation risks on the upside, not only due to a pass through of food inflation into a more generalized inflation but also due to a spillover of a stronger growth on to inflationary expectations, markets started to pencil in inter-meeting hikes by the RBI, even though recent comments by the RBI tended to rule out any inter-meeting action. The OIS rates thus moved higher with the 5 year OIS moving from around 6.88% to over 7.10%. Yield on the benchmark 10-year Gsec (6.35% Gsec 2020) also moved up from around 7.58% levels to around 7.90% levels while those on the 2 year benchmark Gsec went up from around 5.2% to around 6.2% levels.

The bond market also remained cautious ahead of the Union Budget on the 26<sup>th</sup> Feb. For the current

FY the government has mostly ruled out any additional borrowing. The broad market consensus for the next year is for a stable or a slightly higher gross borrowing programme for the Centre. With almost 70% of the gross borrowing programme likely to be front-loaded into the first half of the year, this could create a pressure of Central bond supplies of around Rs 12,000 crore to Rs 14,000 crore in each week in H1.

**Exhibit 17: Strong inflationary concerns persist**



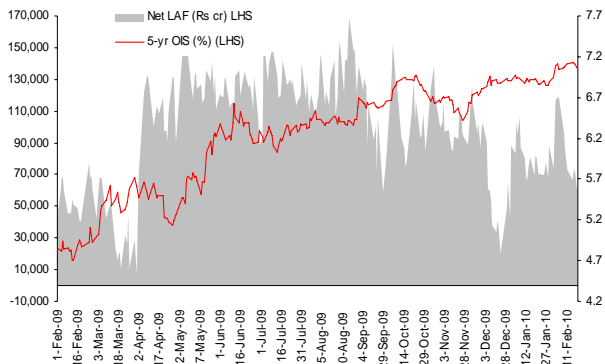
Source: Ministry of Commerce & Industry, Kotak Mahindra Bank

*Despite the recent small relief rally in Gsec, bond yields are likely to maintain an overall bearish trend in the next few months on account of the large supply pressures and a likely normalization of monetary policy. With no support from MSS de-sequestering or OMO buybacks likely in FY11 (Refer back to Exhibit 16), the 10-year benchmark bond yield is expected to harden to around 8.25-8.50% during H1, 2010.*

There could be factors that are likely to prevent a sharper increase in the bond yields. First, RBI's removal of monetary accommodation is expected to be very gradual. Second, there are some concerns raised once more in terms of the sustainability of global recovery. This and any further risk-aversion on the basis of the debt sustainability issues in the European economies could lead to a lowering of the international crude oil prices and also in the US 10-year Treasury yields. Both these variables are seen to be closely correlated with India's 10-year yield. **Further, with expectations of more liquidity tightening measures via CRR increases and policy rate increases in India, we expect the G-sec yield curve to flatten in India.**

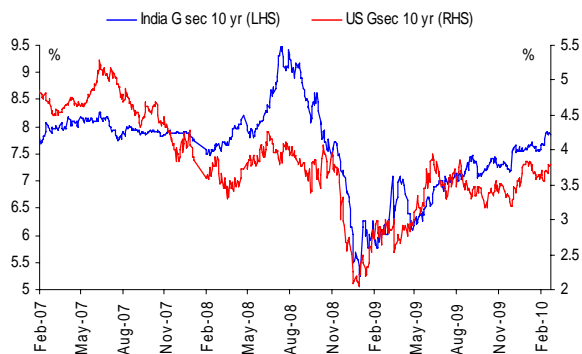
Rates market indicators

**Exhibit 18: With the first phase of CRR hike coming into effect, systemic liquidity has reduced by approximately Rs 20,000 – Rs 30,000 cr**



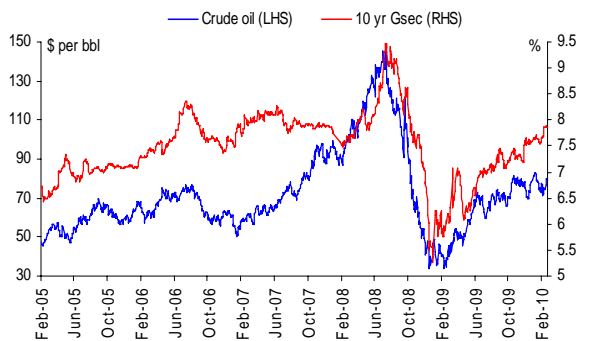
Source: Bloomberg, Kotak Mahindra Bank

**Exhibit 19: 10-yr G-sec yield in India and the US are closely correlated**



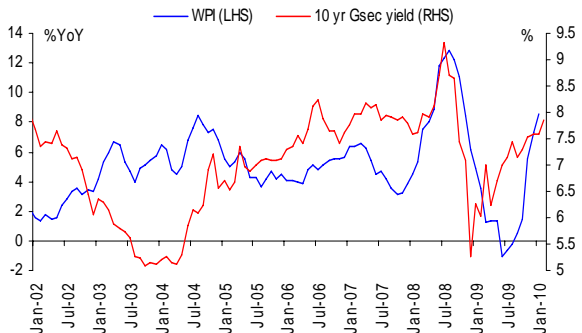
Source: Bloomberg, Kotak Mahindra Bank

**Exhibit 20: International crude oil prices have a close correlation with the 10-year yield through the inflation chain**



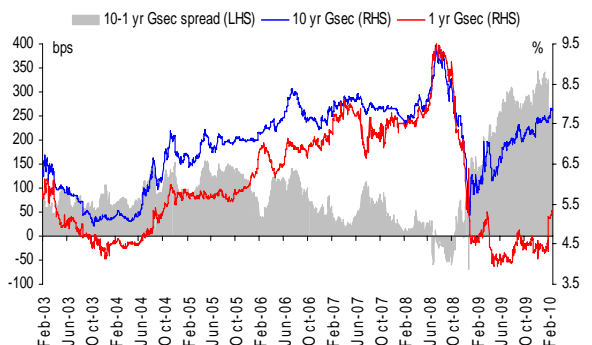
Source: Bloomberg, Kotak Mahindra Bank

**Exhibit 21: Correlation of the WPI inflation with 10-yr G-sec yields has been reinstated due to rising expectations of monetary policy tightening**



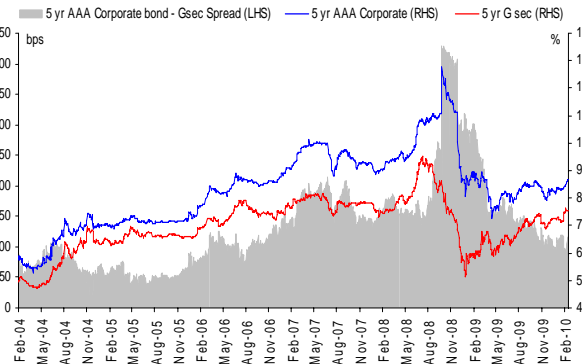
Source: Bloomberg, Kotak Mahindra Bank

**Exhibit 22: Yield curve flattened with a sharper increase in the shorter end; the flattening trend is expected to continue**



Source: Bloomberg, Kotak Mahindra Bank

**Exhibit 23: Spread of the 5-yr AAA corporate bond over the underlying have come off significantly in the recent times**



Source: Bloomberg, Kotak Mahindra Bank

## RBI begins with policy normalization as it hike CRR; interest rate hikes to follow next

In its Third Quarter Review of Monetary Policy 2009-10, the RBI surprised the markets by delivering a 75 bps increase in the CRR to 5.75% of NDTL (50 bps effective from 13<sup>th</sup> Feb 10 and another 25 bps from 27<sup>th</sup> Feb 10) as against consensus view of 50 bps. The normalization process of monetary policy has been set in motion with RBI admitting that the current policy rates “are more consistent with a crisis situation than with a fast recovering economy”. However, RBI preferred to keep all policy interest rates unchanged as it recognizes the possible downside risks to growth out of the global economic conditions and the fact that the recovery till now is still skewed.

### Exhibit 24: RBI increases its projections for both GDP growth and inflation

FY10 RBI Projections				
	As of Jul'09	As of Oct'09	Jan'10	Latest data
Real GDP	6.0% (upward bias)	6.0% (upward bias)	7.50%	7.2% (FY10)
WPI Inflation	5.0%	6.5% (upward bias)	8.50%	8.56% (Jan'10)
Money supply (M3) growth	18.0%	17.0%	16.5%	17.0% (29 Jan'09)
growth (adj for non SLR Investments)	20.0%	18.0%	16.0%	14.5% (29Jan'09)
Deposit growth	19.0%	18.0%	17.0%	17.1% (29Jan'09)

Source: RBI documents, Kotak Mahindra Bank

On the other hand, RBI's fears of rising inflationary expectations emerging are reflected in the following:

- Despite expectations of better rabi production and large food-grain stocks, food prices are unlikely to ease significantly due to (i) the seasonal moderation has not been significant and has been limited to vegetables and (ii) higher international food prices would limit the use of food imports to contain domestic food prices.
- Food inflation can spill over to other segments of the economy through upward adjustments in wages. Core inflation moved up in Dec'09 to 2.1% YoY (-0.5% in Nov'09) while the contribution of non-food items of inflation was higher in December than earlier, an indication that inflationary pressures are starting to spill over to other segments of economy.

- Firming global commodity prices could also put an upward pressure on domestic prices.
- RBI's quarterly inflation expectations survey shows a rise in household inflationary expectations.

*Consequently, with fears of sustainability of the recovery receding to a large extent, the need for “managing the recovery” and anchoring inflation expectations emerged strongly in the monetary policy statement.*

The larger-than-expected dose of CRR increase was also possibly motivated by RBI's expectations of a large amount of foreign capital inflows going forward. “India's improving growth prospects, combined with persistently high levels of global liquidity, may result in a significant increase in net inflows over the coming months. Depending on how these are handled, there will be implications in terms of a combination of exchange rate appreciation, **larger systemic liquidity** and the fiscal cost of sterilization”.

*In terms of RBI's own calculations (as was indicated in the press conference), the liquidity position is likely to stay comfortable in the weeks ahead, even after factoring in the CRR increases. Based on this the RBI appeared confident that the lower end of the interest rate corridor (the Reverse Repo rate) will remain as the operative rate. However, the current LAF amount stands at around Rs 60,000 crore (after the first round of 50 bps increase in CRR) and another round of 25 bps is likely to reduce this to around Rs 48,000 crore to Rs 50,000 crore. With the recent rounds of PSU disinvestments not having been effective in bringing in large amounts of FII flows, there could be a chance for the overnight rate to operate briefly at the upper end of the interest rate corridor at the time of the advance tax outflows in the 2<sup>nd</sup> week of March.*

Given the re-emergence of worries over the sustainability of global growth, we would expect RBI to move ahead with further monetary policy tightening in a cautious way. *In the next FY we look forward to another 75-100 bps of increase in CRR, while Reverse Repo could be increased by 100-150 bps. We pencil in a lower rise in Repo Rate by 50-100 bps.*

## Sovereign debt concerns in Europe throw global asset markets into frenzy

- The escalation of the Greece debt problems has seen risk aversion return as a driver of global asset markets, bringing to a temporary halt the ‘recovery chasing returns’ play in the markets
- The recent pledge by European government to bailout Greece, should the need arise, has helped calm market jitters
- However, with a solution still appearing remote and with other peripheral European economies also facing large debt problems, risk sentiment is likely to oscillate

Over the last few weeks, risk aversion has returned as the key driver of global asset markets. This has resulted in a correction in global equities, a rally in government bonds, a stronger Dollar, and widening credit and sovereign spreads. At the core of this recent bout of risk aversion has been the sovereign debt crisis like situation in Greece, which has brought into focus the deteriorating fiscal position of several European nations (Spain, Ireland, Portugal, Italy, U.K) and fuelled concerns of a full fledged European sovereign debt crisis.

### Exhibit 25: Greece a class apart from the other EU member states

	GDP (%)		General government borrowing (% of GDP)			General government gross debt (% of GDP)		
	2009F	2010F	2009F	2010F	2011F	2009F	2010F	2011F
Portugal	-2.9	0.3	-8.0	-8.0	-8.7	77.4	84.6	91.1
Ireland	-7.5	-1.4	-12.5	-14.7	-14.7	65.8	82.9	96.2
Italy	-4.7	0.7	-5.3	-5.3	-5.1	114.6	116.7	117.8
<b>Greece</b>	<b>-1.1</b>	<b>-0.3</b>	<b>-12.7</b>	<b>-12.2</b>	<b>-12.8</b>	<b>112.6</b>	<b>124.9</b>	<b>135.4</b>
Spain	-3.7	-0.8	-11.2	-10.1	-9.3	54.3	66.3	74.0
Belgium	-2.9	0.6	-5.9	-5.8	-5.8	97.2	101.2	104.0
France	-2.2	1.2	-8.3	-8.2	-7.7	76.1	82.5	87.6
Germany	-5.0	1.2	-3.4	-5.0	-4.6	73.1	76.7	79.7
Euro zone	-4.0	0.7	-6.4	-6.9	-6.5	78.2	84.0	88.2
EU-27	-4.1	0.7	-6.9	-7.5	-6.9	73.0	79.3	83.7

Source: European Commission, Kotak Mahindra Bank

The so called PIIGS economies (Portugal, Ireland, Italy, Greece and Spain) entered the downturn with high fiscal deficits and current account deficits, which has made the process of adjustments in this post crisis period much more difficult. In February 2009, ratings agencies had slapped rating downgrades on Portugal, Greece, Ireland and Spain on concern that these economies would lose their

competitiveness in the worsening economic climate, with no option of currency devaluation.

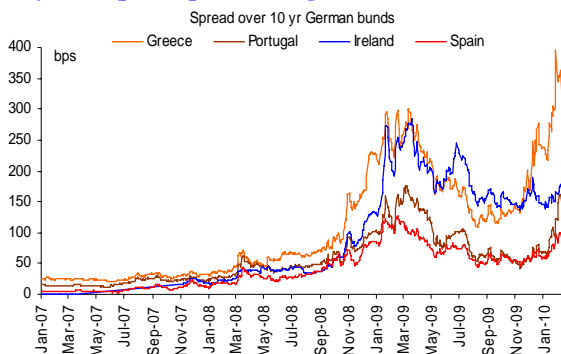
However, Greece is a class apart in terms of the scale of its problem as well as its resolve (rather lack of it) to take corrective action. At the time the New Greek government assumed office in October (elected on a mandate of higher spending), it estimated that the country’s fiscal deficit would jump to 12.7% in 2009 – the highest amongst the EU member states and up from 3.7% committed by the previous government. This is also more than 4 times the 3% limit specified under the Growth and Stability pact. This huge upward revision to the earlier reported data alongside indications that the Greek government may have used derivative instruments (currency swaps) in the past to give an illusion of a lower debt, raised concerns over the reliability of the data furnished by the government. In its November forecasts, the EC estimated that the Greek government debt could rise from over 110% in 2009 to 135% by 2011 (Italy and Belgium the only other two EZ member states with debt expected to exceed 100% of GDP in 2010).

These shocking revelations led to intense pressure from all corners (EC, other EU member states) on the Greek government to not only correct for its fiscal largesse, but also improve the quality of statistics reported by it. The EU initiated infringement proceedings against Greece for the false data furnished by it and has been closely monitoring the developments on the fiscal front.

A series of ratings downgrade have also followed - Fitch was the first to lower its rating on Greece in October to A- from A and then again to BBB+ in December. S&P and Moody’s soon followed, lowering their ratings for the country to BBB+ (from A-) and A2 (from A1) respectively in December. While even at the current sovereign ratings, Greece debt is eligible as collateral with the ECB (minimum rating required currently is BBB-), further rating downgrades if no corrective steps are taken, and/or reversion of ECB collateral rules to the pre crisis level (A- by at least one rating agency) by the end of the year, could spell further troubles for the Greece economy in the months to come.

Even though the Greek government responded to austerity calls, until recently, it lacked the conviction needed to bring about any noteworthy correction in its fiscal position. The first plan presented by the government lacked decisive action as it focused mainly on limiting tax evasion, improving tax collections to bring about the fiscal correction. Subsequent pressure from the EC has seen the government outline new measures last month, which included substantial spending cuts and tax-boosting measures to bring the deficit lower than 3% of GDP by 2012. However, with a timeline on the measures to be implemented this year absent (EC has asked for clarity on this and has given a deadline of 16<sup>th</sup> Mar'10) and the strong public outcry over measures such as public wage freeze, withdrawal of several tax benefits etc, the ability of the Greek government to rein in its fiscal deficit in a decisive manner remains a big question mark.

**Exhibit 26: European sovereign debt concerns have seen yields spike up in the region**



Source: Bloomberg, Kotak Mahindra Bank

The developments on Greece’s government balances front had been weighing on the markets for a considerable time, evident from the high spread between Greek bonds and German bunds. The more recent concerns have to do with the *possibility of a default by the Greek government, as it needs to raise nearly EUR 54bn this year, of which, more than EUR 20 bn is needed in April and May itself, to honour the bonds maturing during that time.*

Further, what spooked markets and the investor community was the possibility of the crisis engulfing the other fiscally unsound EU member states, and in turn endangering the stability of the EMU. However, it must be noted that the remaining PIIGS government have taken aggressive steps to bring their deficits under control. Market fears were also compounded by the “tough” talk by EU officials and their constant dismissal of a plan to bailout Greece, should the need arise. As the fragility and vulnerability of the common monetary union came into the limelight, investors rushed to the safety of the Dollar, shunning all risky assets.

The already dented investor sentiment was further soured as President Obama outlined a plan for stricter banking regulation in what came to be known as the ‘Volker Rules’. Further, the second round of policy tightening by the Chinese central bank via another 50 bps RRR hike (similar measures taken in India) stoked fears of a slowdown in the Chinese economy, and in turn on the prospects of the global recovery currently underway.

For the time being, markets have taken some comfort from last week’s pledge by the other European governments to support Greece. However, EU member states continue to stress on the need for Greece to take more deficit control steps and have given the government time until Mar 16<sup>th</sup> to outline its plans to bring down this year’s fiscal deficit to 8.7% of GDP. Even then, it is unclear as to the kind of support and steps the other EU member states would take, in the event that the Greece government is unable to solve its fiscal problems.

With markets expected to closely track the progress of the Greek government, risk appetite is likely to remain shaky in the near term. In our opinion, the 16<sup>th</sup> March deadline as well as April and May, when the Greek government would need to tap the international market remain the biggest risk events in the coming months.

## Currency market outlook

- We expect USD to remain volatile but the general tendency would be for more strength on the basis of likely risk-aversions in light of the debt sustainability issues in Greece. We expect EUR/USD to be in the range of 1.3200-1.3750 in the near term.
- Based on the lower than expected foreign inflows for the PSU disinvestment papers we feel that the recent USD-INR strength would be capped. For the near term we see the range at 45.80-47.20.
- For the longer period till end-March 2011, while there could be phases of appreciation bias, USD-INR could witness significant volatility. Any heightened fears of risk-aversion globally could lead to weakening trend in the INR against the USD. For FY11 as a whole we look for the USD-INR in a range of 44.50-47.50. We are out of consensus with the market which broadly expects a significant appreciation trend in INR to around 42.00.

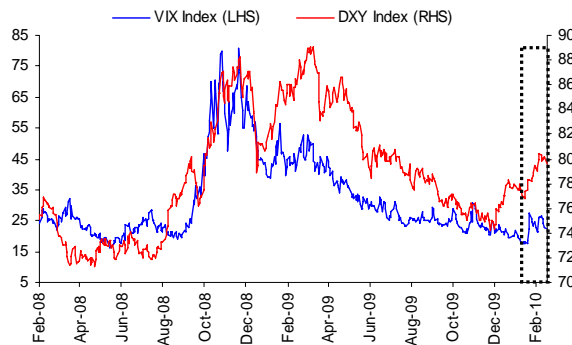
### Dollar stages a comeback – first on risk aversion and now on Fed moves

The last few weeks had seen ‘risk’ emerge as the underlying driver of currency markets, and the ‘recovery trade’ came to a halt, at least temporarily. Not surprisingly, the safe haven appeal of the Dollar and Yen has seen these currencies strengthen, while commodity and emerging market currencies have been shunned by investors. The DXY Index rose from its mid January lows to a high of 80.441 in early February, appreciating by more than 4.8%. During this time, the Yen strengthened by 2.2% while the EUR weakened by 5.7%, AUD by 6.8% and Asian currencies as a block by 1.6%.

The pledge by the EU member states to support Greece did see the common currency reverse some of its losses against the Dollar. However, these gains were short lived as the Euro fell sharply against the greenback following the surprise move by the Fed last week, wherein the central bank raised its discount rate (the rate at which the Fed lends to depository institutions through its discount window) by 25 bps to 0.75% and also reduced the maximum maturity of primary credit to overnight from the

current 90 days. Markets took this as a signal that Fed would hike rates, sooner than later, resulting in a strong Dollar rally. In fact, the EUR/USD broke past 1.35 and fell to a low of 1.34.

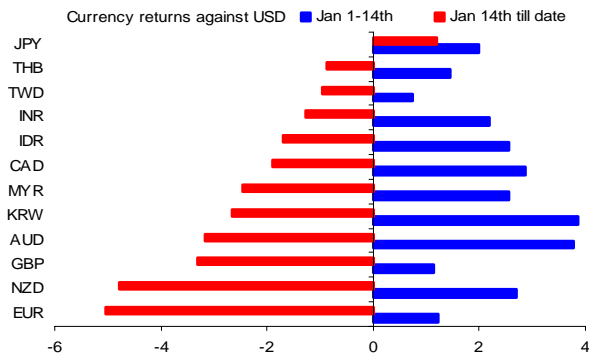
**Exhibit 27: Dollar has strengthened as risk aversion made a comeback**



Source: Bloomberg, Kotak Mahindra Bank

Markets have now pared their expectations of a Fed hike and are largely viewing the discount rate hike as more a step towards normalization of Fed’s lending facilities, as also emphasized by the Fed. While this has seen the Dollar pare some of its gains, it continues to trade with an upward bias as sentiment for the euro remains shaky on account of the uncertainty surrounding Greece.

**Exhibit 28: The euro has weakened sharply as Greece debt concerns have haunted global asset markets**



Source: Bloomberg, Kotak Mahindra Bank

In our view, the increase in the discount rate is a step closer towards an eventual exit from the accommodative monetary policy as the central bank has started to wind down the unconventional policy measures taken to address the financial crisis. We have long been of the view that the Fed would lead

the rest of the developed country in raising rates, and the recent developments (Fed policy action and the fiscal mess in Europe) have only strengthened our expectations. With a possibly stronger recovery underway in the US than in the rest of the G3 sphere, the Fed would find it easier to move its policy rate. On the other hand, ECB and for that matter even BoE could find it difficult to tread the path as the region's ongoing debt problems would weigh on the already weak growth profile. Having said this, we believe that rate hikes by the Fed are unlikely to happen before the fag end of 2010 as the still large unutilized capacity along with tight credit conditions would warrant the continuation of monetary accommodation, especially in an atmosphere where immediate inflation fears are absent.

The Dollar is thus expected to remain strong in the medium term and also possibly for most part of the 2010 as we do not immediately see a conclusive solution to the debt sustainability issues in the European region. Further, in the event that fiscal austerity is followed, there is a risk for growth in the European region to crumble, thereby pushing back further the chances of fiscal consolidation as the revenue side suffers severely.

*Currency pairs are likely to stay volatile and we now expect EUR/USD to trade in the region of 1.3200-1.3750 in the medium term, with scope for further dollar strength in the longer period.*

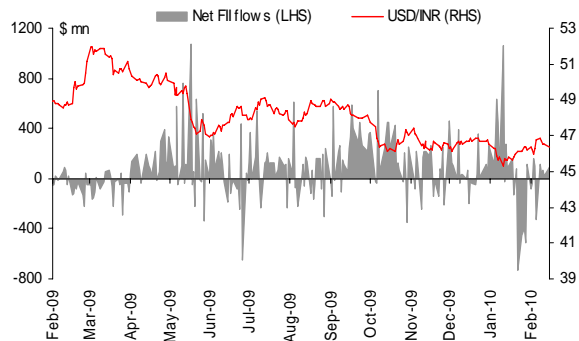
**Indian Rupee weakens on global risk aversion**

The recent bout of risk aversion that gripped global markets did not leave the Indian asset markets unscathed. While FIIs had pumped in more than USD 1.4bn into Indian equity markets at the start of the year (till 15<sup>th</sup> Jan), they pulled out more than USD 1.6bn in the latter half of the month. The Sensex also fell by more than 10% from its one year peak seen in early January and the INR depreciated by more than 2% from its mid-January levels. USD/INR traded at a high of 46.81 in the course of the last one month.

USD has once again emerged as the key driver of the currency (Exhibit 30). The recent bout of USD strength thus led to a depreciation pressure on INR.

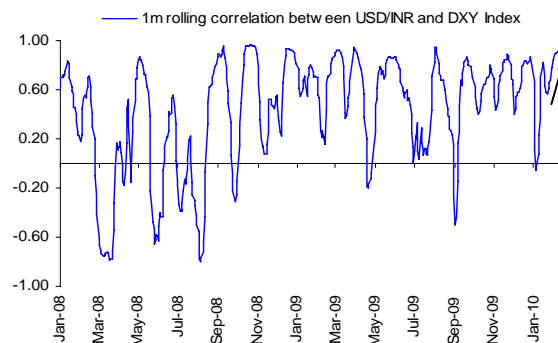
This is unlike the trends seen at the start of the year, wherein expectation of policy tightening by the RBI and positive outlook for flows had supported the currency. The 1-month correlation between USD/INR and the DXY Index has jumped from around 0.10 levels at the start of the year to around 0.90 levels currently.

**Exhibit 29: Souring global sentiment has seen a reversal in FII flows from the country**



Source: Bloomberg, Kotak Mahindra Bank

**Exhibit 30: The Dollar-USD/INR correlation starting to strengthen once again**



Source: Bloomberg, Kotak Mahindra Bank

In the near term, the Rupee is likely to take cues from the Dollar as the sovereign debt concerns and Fed policy action would dominate sentiment in the FX markets. Domestically, the upcoming Union Budget to be presented next week would also dictate the near term USD/INR trajectory.

The recent spate of the Rupee weakness highlights the risk to a unilateral appreciation path for the Rupee. This is even more so the case in the current year, as uncertainty remains high on the global

policy, regulatory and the fiscal front, which would have a significant bearing on the currency markets. Any stringent regulatory requirements and/or sharp removal of policy support could see risk appetite recede and drag USD/INR higher. These risks aside, the medium to long term path of USD/INR would depend upon the Dollar trajectory and the incremental capital flows that the economy receives.

According to our Balance of Payments projections for 2010-11, we see an overall surplus of USD 34.7bn. The current account deficit is expected to widen, as invisible receipts would not be able to make up for the larger trade deficit. Trade deficit would widen as the strong domestic growth along with higher oil prices would see imports surge while export growth would be modest as external demand remains weak. On the capital account, we expect the improvement seen in this fiscal to continue. Alongside the continued strength in equity flows, debt flows are likely to pick up, as a rising domestic interest rate environment would see Indian companies tap the international capital markets for funds at a lower cost. Although we have penciled in around USD 26bn of FII flows 26bn in FY11, the uncertain policy environment, both globally and domestically, along with the recent trends in FII flows (USD -245mn in FYTD) could result in much lower FII inflows.

*Based on the lower than expected foreign inflows for the PSU divestment papers we feel that the recent USD-INR strength would be capped. For the near term we see the range at 45.80-47.20.*

*For the longer period till end-March 2011, while there could be phases of appreciation bias, USD-INR could witness significant volatility. Any heightened fears of risk-aversion globally could lead to weakening trend in the INR against the USD. For FY11 as a whole we look for the USD-INR in a range of 44.50-47.50. We are out of consensus with the market which broadly expects a significant appreciation trend in INR to around 42.00.*

Exhibit 31: Balance of Payment trends in 2010-11

	FY09	FY 10 e	FY 11 e
<b>CURRENT ACCOUNT</b>			
<b>I. MERCHANDISE TRADE DEFICIT</b>	-118,650	-120,000	-141,200
Exports	189,001	170,000	183,600
Imports	307,651	290,000	324,800
<b>II. INVISIBLES</b>	89,923	86,000	100,000
<b>Total Current Account (I+II)</b>	<b>-28,727</b>	<b>-34,000</b>	<b>-41,200</b>
As a proportion of GDP	-2.4	-2.6	-2.7%
<b>CAPITAL ACCOUNT</b>			
<b>1. Foreign Investment (a+b)</b>	<b>3,467</b>	<b>54,000</b>	<b>53,000</b>
a) Foreign Direct Investment	17,498	25,000	27,000
b) Portfolio Investment	-14,030	29,000	26,000
<i>of which FIIs</i>	-15,017	27,000	24,000
<b>2. Loans (a+b+c)</b>	<b>8,669</b>	<b>11,500</b>	<b>15,000</b>
a) External Assistance	2,637	5,000	2,000
b) External Commercial Borrowings	7,941	4,000	9,000
c) Short Term to India	-1,909	2,500	4,000
<b>3. Banking Capital</b>	<b>-3,245</b>	<b>3,000</b>	<b>5,000</b>
<i>of which : Non-Resident Deposits</i>	4,290	4,000	3,500
<b>4. Rupee Debt Service</b>	<b>-100</b>	<b>-100</b>	<b>-100</b>
<b>5. Other Capital</b>	<b>-1,545</b>	<b>-3,000</b>	<b>3,000</b>
<b>Total Capital Account (1to5)</b>	<b>7,246</b>	<b>65,400</b>	<b>75,900</b>
as a proportion of GDP	0.6	5.0	4.9%
C. Errors & Omissions	1,402	-1,000	
<b>D. OVERALL BALANCE</b>	<b>-20,080</b>	<b>30,400</b>	<b>34,700</b>

Source: RBI, Kotak Mahindra Bank

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