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India: Economic and Business Outlook Mid-year review 2005-06



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Mid-year review 2005-06

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Overview: Sustaining momentum

A Mid-year Review is an opportunity to take stock of the way things are and modify our outlook on indicators that are not behaving as anticipated earlier in the year. For us, however, this poses a dilemma. We are effectively doing this anyway on a monthly basis in *EcoView*, our publication on trends in the Indian and the global economy. What can we conceivably add to our readers' understanding of the state of the economy in a mid-year document?

We, therefore, decided to try a different approach. Month after month, as we attempt to keep abreast of developments, questions emerge that we think deserve considered, carefully analysed responses. Also, patterns become visible, providing answers to questions we have faced in the past but have not been able to address to our satisfaction. Both these channels inspire our monthly theme articles. But, in a year as full of economic news as this, 12 months are not enough! So, this year's Mid-year Review is essentially an anthology of theme pieces, addressing issues that we think are particularly relevant in today's circumstances. We thought this would give this publication more shelf life. We hope you enjoy it as well as find it useful.

Four themes have been explored. The first is an analysis of what appears to be an incredibly healthy configuration of outcomes - high industrial growth, low inflation and rising profitability. Using aggregated data from the corporate sector, we offer an explanation of how this configuration emerged. This leads naturally to questions about its sustainability. We argue that much of it is due to structural changes on the supply side, which means that it is likely to have long-lasting effects.

The second looks beyond this positive scenario to assess what is clearly the dominant source of risk to economic performance, not just in India but globally - oil prices. It is clear by now that the world economy has become far less vulnerable to high oil prices than even as recently as a decade ago. Despite rising energy intensity, India is also showing the same tendency, which points to the significance of buffers, or offsetting forces prevailing in the economy. It has become rather difficult, even hazardous, to rely on past experience to project the future impact of oil prices! Keeping this in mind, we nevertheless attempt a few simulations about the likely impact of this oil scenario on growth and inflation. It will be adverse, though not

necessarily large; the question to which we have not provided an answer is when it will set in. As of now, the offsetting factors seem to be getting the better of oil prices.

The third theme is of immediate topical interest. The Reserve Bank of India will release its quarterly review of the economy on October 25, based on which it will decide whether or not to raise interest rates. This decision will be made in the context of a general tendency among global central banks towards higher rates. Looking at the overall liquidity situation in the context of the demand for funds and the likely inflation scenario, we are of the view that there is no immediate cause for the RBI to raise rates.

Finally, we examine the fiscal situation of the Central government at the half-way mark of FY06. Based on revenue and expenditure performance so far this year, we carry out simulations, which reflect the relatively buoyant performance of the industrial sector and come to the conclusion that there will be a mild slippage in the fiscal deficit, driven by a small shortfall in revenues. Of course, expenditure adjustments or slippages are always possible, so the end result is still unpredictable. However, at this point in the year, a dramatic failure to meet the target is clearly not on the cards.

In addition to these themes, we provide an exhaustive summary of the state of the global economy, a feature that we have recently added to *EcoView*. By and large, while the risks from oil are obvious, there are very few dark clouds as far as short-term performance of the US as well as Asian economies are concerned. With India's increasing global integration, our own fortunes are clearly increasingly dependent on what is happening in other countries. At this point, we all face the common risk from oil, but otherwise, the positives visible on the Indian front are also evident across much of the global economy.

We conclude this special issue with a summary check of variables that we consider leading indicators of economic performance beyond the current year. While this is by no means a rigorous exercise (we will gradually incorporate this approach into *EcoView*), the weight of evidence clearly points to sustainability. We do not want to underplay the visible risks, but we would also like to emphasise the strength and endurance of the positive drivers.

Macroeconomic outlook: 2005-06

Parameter	Forecast		Rationale
Growth	Agriculture	2.5	Uneven monsoons have weakened agricultural prospects. But growth momentum in industry and services is expected to continue.
	Industry	7.5	
	Services	8.5	
	Total	7.0	
Inflation	WPI-Average	5.1	Adverse base effect in second half of the current fiscal and pressures from oil prices will push the overall inflation to 6 per cent by March 2006.
	WPI-Year end	6	
Interest rate	10-year G-sec	7.25- 7.5	Yields expected to harden by year-end due to rising inflation and up-tick in global rates.
Exchange rate	Re/US\$	43.5-44	FII inflows and the worsening trade deficit (due to higher oil bill and industrial recovery) likely to offset each other and rupee expected to trade in a narrow band
Fiscal deficit (% of GDP)	Fiscal deficit	4.6	Expenditure pressures and overoptimistic revenue targets will lead to fiscal slippage.

Source: CRISIL

Indian manufacturing: Will the troika of robust growth, low prices and zooming profits last?

Introduction

With GDP growth expected to be 7 per cent in 2005-06, the Indian economy will witness 3 consecutive years of above-7 per cent growth. This feat was earlier achieved in the mid nineties (1994-95 to 1996-97) following the launch of economic reforms in India. After that, not only was the growth lower it was more volatile too. Between 1997-98 and 2002-03, the average GDP growth fell to 5.2 per cent with manufacturing growth sliding to 4.3 per cent (from 12.6 per cent per annum in the preceding 3 years).

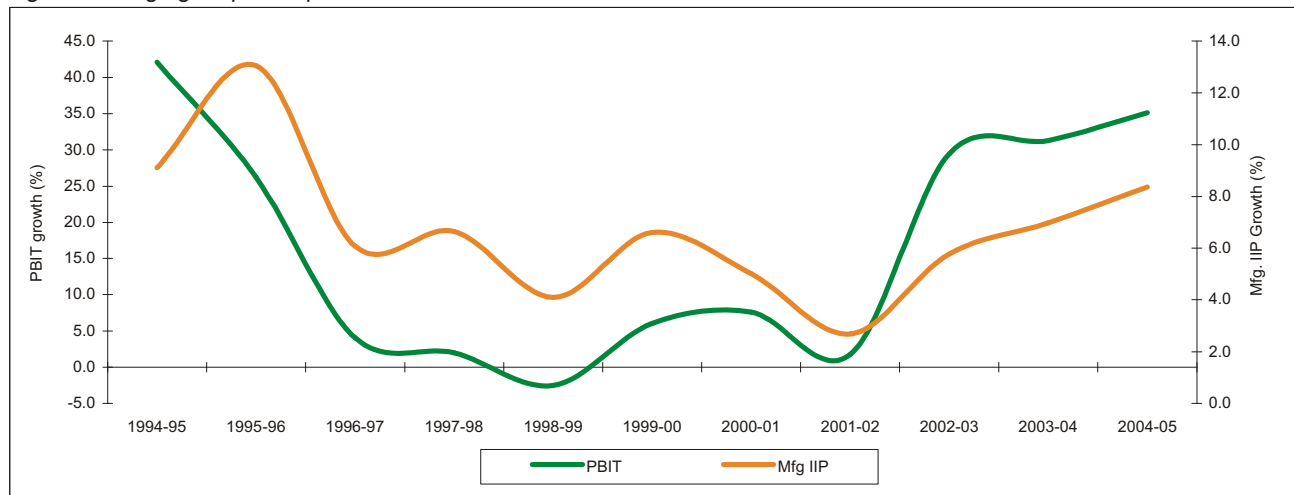
The manufacturing sector started looking up in July 2002 and has consolidated its position every passing year since then. It registered an average growth of 8 per cent between July 2002 and August 2005. The performance of the industrial sector, particularly the manufacturing sector, is clearly the highlight of current growth revival. Along with the pick-up in growth, corporate profitability too zoomed (Figure 1). The average PBIT grew at 32 per cent per annum between 2002-03 and 2004-05 as against a mere 3 per cent per annum in the preceding 5 years.

products. The low pricing power is evident from the benign inflation in the manufacturing sector, which currently is below 2 per cent. So not only did the weak monsoons and oil shock fail to dent industrial recovery, corporate profits too zoomed despite high input costs and low output prices. This piece examines the nexus between growth, inflation and profitability in the manufacturing sector to assess the sustainability of current bullish trends.

Did buoyant manufacturing demand increase the pricing power?

The manufacturing sector has witnessed low inflation in the post reform period. In the last 10 years, inflation in the manufacturing sector averaged around 4 per cent in comparison to 7.1 per cent in the non-manufacturing sectors (fuel and primary articles). The low inflation in the manufacturing sector was a consequence of increased competition due to lower taxes and tariffs and freer imports. The recent pick-up in manufacturing activity since 2002-03 also saw firming up of inflation (Figure 2). By July

Figure 1: Surging corporate profits

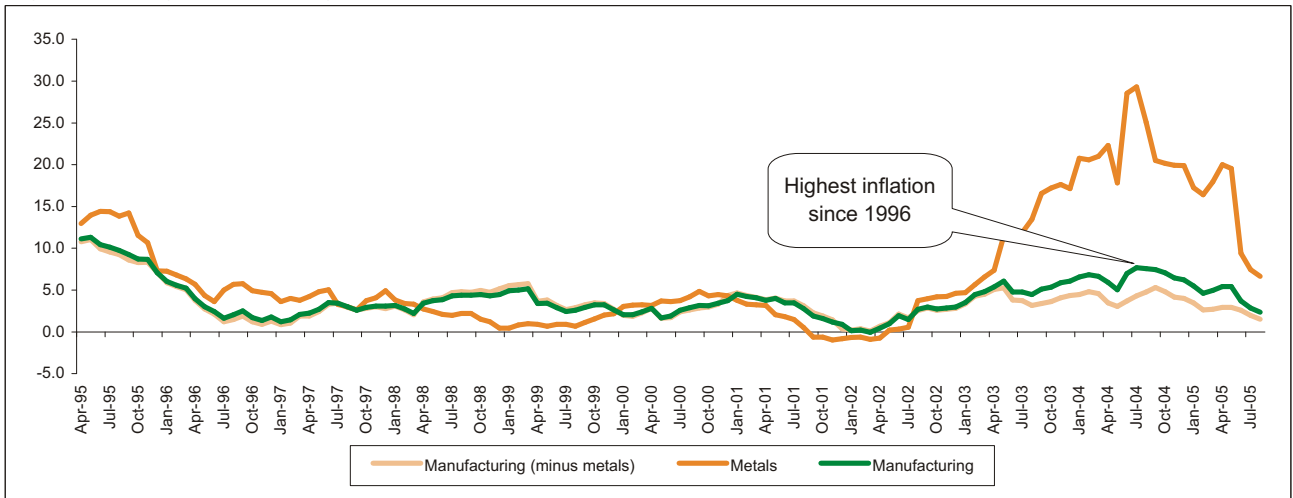


Source: Prowess and Central Statistical Organisation

What is interesting is that the surge in corporate profitability has come despite the reduced ability of the manufacturers to pass on the steep increases in raw material costs (specifically fuel and metals) in the final

2004, the manufacturing inflation had touched 7.7 per cent.

Figure 2: Rising manufacturing inflation?



Source: Ministry of Industry

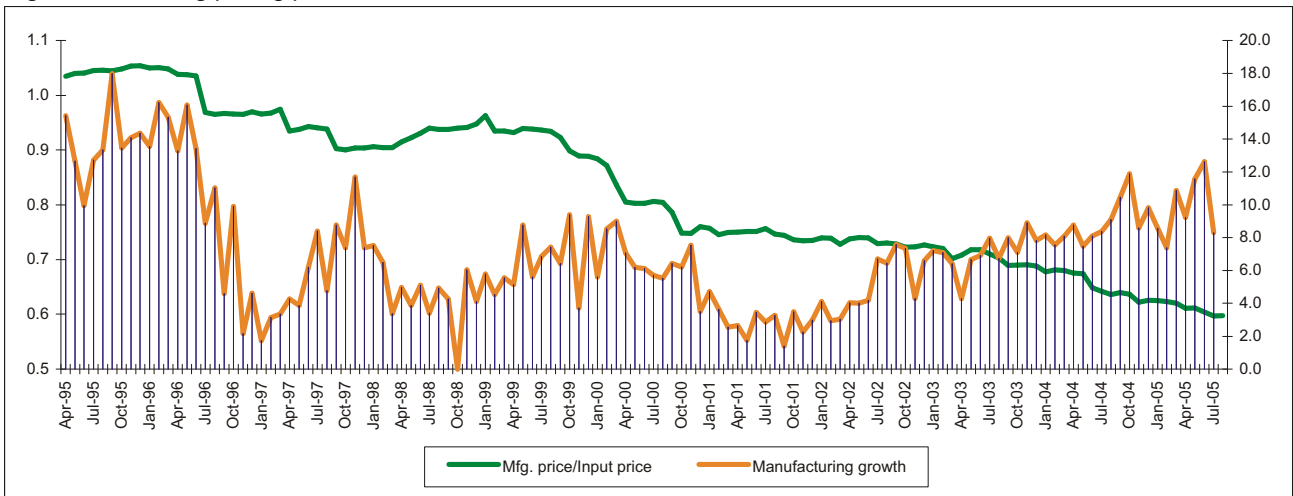
Although the spike in manufacturing inflation coincides with the up-tick in manufacturing activity, it does not imply increased pricing power generally associated with rising demand. The pick-up in manufacturing inflation was largely limited to the metals group, where inflation touched almost 30 per cent. Excluding the metals from the manufacturing sector yields a relatively low inflation in the manufacturing sector. Metals and fuel are two key inputs for the manufacturing sector. Although fuel and metal prices rose by 10.1 per cent and 20.2 per cent, respectively, in 2004-05, inflation in the manufacturing sector excluding metals was only 4 per cent in fiscal 2005. This fell to 2.6 per cent in the first quarter of fiscal 2006, although inflation in the fuel and metals groups remained high at 10.8 per cent and 14.0 per cent, respectively.

Figure 3 tracks the pass through of input costs, by plotting the ratio of output prices in the manufactured sector (manufactured prices minus metals) to input prices (prices in the metals and fuel). What is notable is that unlike the previous phases of industrial recovery, the recent phase (beginning 2002-03) has witnessed a continuous decline in the pass through ratio. This suggests a rather low pricing power.

Low pricing power fails to dent manufacturing margins

The reduced pricing power has not adversely impacted the margins in the manufacturing sector. On the contrary, margins have improved since 2002-03. The key financial ratios documented in Table 1 help in understanding the reasons behind this.

Figure 3: Shrinking pricing power



Source: Prowess and Central Statistical Organisation

Table 1: Financial ratios of manufacturing companies

	Mar-00	Mar-01	Mar-02	Mar-03	Mar-04	Mar-05
	As % of net sales					
PBDIT	13.1	11.7	12.3	13.3	14.4	14.7
PBDT	8.1	7.1	8.0	9.9	11.8	12.7
PBIT	9.4	8.4	8.7	9.9	11.0	11.6
PAT	3.2	2.8	2.7	4.4	6.0	6.9
Raw material expenses	41.0	40.6	43.1	45.5	45.7	47.1
Salaries and wages	5.9	5.7	5.6	5.3	4.9	4.4
Interest payments	4.6	4.3	4.0	3.1	2.3	1.7
Operating profit	5.2	4.2	4.9	6.7	8.0	8.7
	Per cent growth					
PBDIT	9.9	6.8	7.4	25.6	24.2	22.4
PBDT	14.7	4.5	15.1	43.8	37.7	28.4
PBIT	7.0	7.0	5.9	31.7	28.4	26.4
PAT	15.1	5.7	-3.1	88.6	58.5	37.8
Raw material expenses	21.3	18.0	9.1	22.2	15.6	23.6
Salaries and wages	9.7	15.2	0.4	8.3	7.8	7.1
Interest payments	3.3	11.2	-4.3	-9.7	-16.6	-8.1
Operating profit	16.2	-2.8	19.5	58.8	37.1	30.6
Net sales	18.4	19.3	2.6	15.7	15.2	19.9

Source: Prowess

All the financial ratios show improvement between 2002-03 and 2004-05. The increase in costs of inputs like fuel and metals is clearly reflected in the rising ratio of raw material expenses to net sales. This notwithstanding, all the profitability ratios show marked improvement. This has been made possible by savings on interest costs and productivity/efficiency improvements. Between 2001-02 and 2003-04, about 20 per cent of the increase in profits of companies in the manufacturing sector can be attributed to lower interest costs, while the remaining 80 per cent was due to improved productivity.

The lower interest costs benefited the manufacturing companies in two ways - first it reduced their interest expenditure, and second, it helped in sustaining the demand for manufactured products by facilitating a consumption boom. Increased competition led to efficient utilisation of labour and capital by the corporates, which further helped them in improving margins in the face of their inability to pass on the input price increases in the output prices.

Outlook

Will this benign nexus between growth, inflation and profitability in the manufacturing sector be sustained? The recent manufacturing recovery has been primarily driven by increased demand - both domestic and external. With the manufacturing sector operating at high capacity utilisation levels, fresh investments will be critical for sustaining the growth momentum. Some evidence of a

pick-up in investment activity (RBI 2005) is indeed a positive development in this regard.

The companies have until now succeeded in improving their margins without fully passing on the input cost increases to their final products. This has been made possible by the soft interest rate regime and productivity improvements. With interest rates hardening, though moderately, the impact of declining rates is clearly waning. Sustaining increases in productivity gains, once the initial slack in the system has been used up, becomes more and more difficult. Further, with a continuing scenario of high fuel and metal costs, companies may either have to raise prices or see margins fall.

Oil prices, therefore, remain a critical supply side worry as their remaining at high levels can trigger inflationary pressures, firm up interest rates, trim corporate profits and consumption and slow down industrial activity. Over the medium run, the inadequacy of physical infrastructure will emerge as a critical supply side bottleneck for sustaining high growth in the manufacturing sector.

These risks notwithstanding, we should not underestimate the very significant contribution of productivity improvements in the industrial sector to this very healthy scenario of high growth, low inflation and high profitability. To the extent that this process still has some way to go, it provides a comforting buffer against emerging risk factors.

Oil shock: How vulnerable are we?

High and volatile oil prices not only trigger inflationary expectations but are also regarded as a harbinger of economic slowdown. The impact of high oil prices varies across economies depending on the degree to which they are net importers and the oil intensity of the economy. The impact is generally more severe for oil importing developing countries.

Oil prices have been on an upward spiral since 2002. The first half of the current fiscal saw them spiralling to new highs. During August and September, crude prices had been hovering around \$65 a barrel. This is, of course, the highest ever level when measured in current prices. Nominal oil prices as indicated by West Texas Intermediate (WTI) spot prices almost touched \$70 a barrel on August 30, 2005. Obviously, we cannot compare dollar prices of even a few years ago with today's dollar prices without correcting for inflation. In Figure 4, we display the "real" price of crude oil over the past 3 decades using two major inflation gauges, US CPI and US PPI. The figure shows the monthly average price of WTI deflated by the US Producer Price Index at 1995 prices and US Consumer Price Index at 1995 prices. Having adjusted for US inflation, we have a clear comparative picture of the severity of the recent price surge.

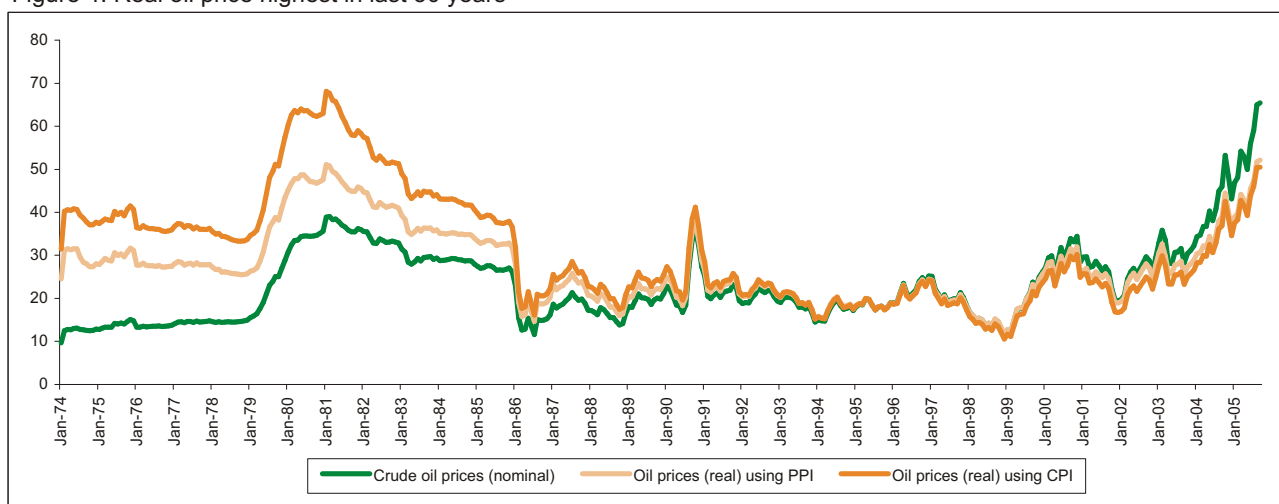
At the current juncture the real price of oil after correcting for inflation (based on US PPI using 1995 dollars as the base) is the highest level ever reached. The real price of around \$51 per barrel was last attained in January 1981.

In that period, the real price of crude remained above \$40/barrel from November 1979 until December 1982. However, using the US CPI to deflate the oil prices, the real oil prices are lower than the peak achieved during January 1981.

Oil impact on growth

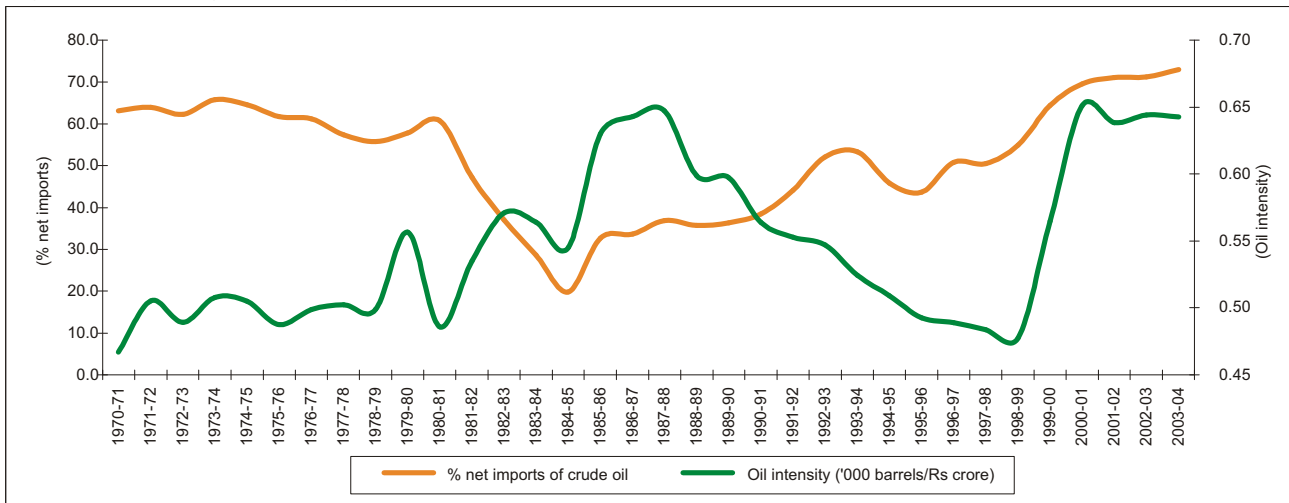
The vulnerability of the Indian economy to international crude oil prices can be gauged using two indicators, the first being the share of imports in total availability of crude oil in the country. The following chart shows the rising share of imports in the total crude oil basket of country in the last two decades - the contribution by imports in total crude oil basket currently stands at around 70 per cent. The other indicator is the oil intensity - the following chart also displays the trend in oil intensity of the Indian economy (measured in terms of '000 barrels per year/ Rupees crore worth of GDP in 1993-94 prices) over the last 3 decades. It is not surprising that a country at this level of per capita GDP shows a significant increase in oil intensity, which is very clear until the late 1980s. However, during the 1990s, there was a distinct reversal of trend, which, in turn, appears to have reversed in the upward direction in recent years. If the recent pattern is an indicator of a significant structural shift, which it may well be, given the fact that two-wheelers, automobiles and commercial vehicles have seen very rapid growth in these years, India's exposure to rising oil prices is clearly on the increase.

Figure 4: Real oil price highest in last 30 years



Source: Energy Information Administration, Bureau of Labour Statistics

Figure 5: Increasing vulnerability to oil shock



Source: Energy Statistics, Central Statistical Organisation

Given the increasing vulnerability to oil shocks, the spiralling oil price is the most critical risk to industrial performance. Thus far, the Indian economy seems to have ducked the adverse impact of high oil prices. But the continuation of the current scenario of high and volatile oil prices will eventually trim corporate profits and mute industrial activity. If oil prices continue to surge, it will tend to put downward pressure on the manufacturing sector (and also the transport sector, which comes under services). We try to quantify the manufacturing and transport growth under different scenarios of oil prices, and hence, its impact on the overall GDP growth rate.

High oil prices create a supply side risk for the manufacturing sector as it raises the input costs. Past experience demonstrates a negative correlation between oil prices and manufacturing sector growth. During FY84 to FY03, the correlation coefficient between manufacturing growth (3 year moving average) and international crude oil prices (3 year moving average) is -0.40. The relationship, however, weakened after FY03, as the manufacturing sector has remained buoyant despite rising crude oil prices.

A similar negative relationship exists between oil prices and the transport sector growth. During FY84 to FY03, the correlation coefficient between transport growth (3 year moving average) and international crude oil prices (3 year moving average) is -0.52.

Based on respective oil price elasticity, we have calculated manufacturing and transport growth under alternative oil price scenarios (Table 2). Further, we also

give the resultant GDP growth in different scenarios. However, the GDP growth captures just the direct impact of fall in output in the sectors and does not capture the indirect impact of falling manufacturing and transport sector growth on other sectors in GDP, or consumption spending and overall demand situation in the economy.

Table 2. Oil price scenarios (2005-06)

Crude US\$/barrel	Manufacturing	Transport	GDP growth
60	8	8.5	7
70	7.6	7.5	6.9
80	7.3	6.9	6.8
90	6.7	6	6.6
100	6.1	5.4	6.5

Source: CRISIL Estimates

Oil price impact on inflation

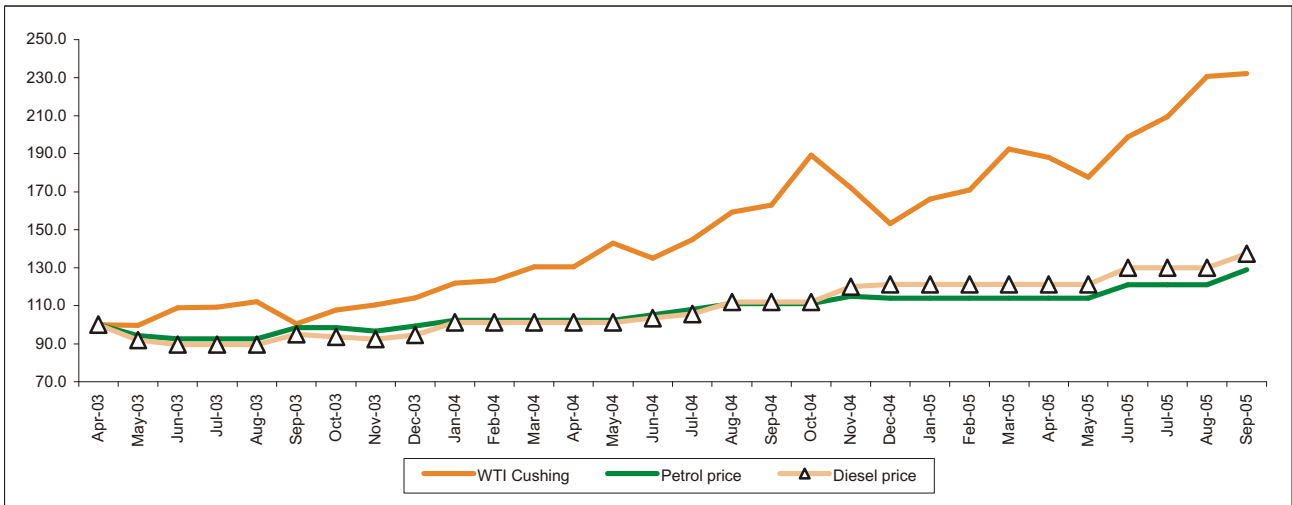
The following figure plots the international oil prices with domestic petrol and diesel prices. The figure clearly shows that the international crude price increases have not been fully transmitted to the domestic sector. During August, international crude oil prices touched new highs. Crude oil prices indicated by WTI Cushing were at an all-time high level of \$69.9/barrel as on August 30. It averaged \$65/barrel during August and September compared with \$59/barrel during July 2005. Domestic oil prices, however, have not been raised during August. However, in September, petrol prices were hiked by Rs 3 per litre and diesel prices by Rs 2 per litre, but this was not enough to neutralise the losses of oil companies. The 7 per cent hike in petrol and diesel prices has pushed up inflation by 0.25 percentage points. But this would just be the first round impact. Going forward, it may trickle down

to manufacturing inflation by raising the cost of production of manufactured products, though signs of this happening are not visible yet.

Despite high oil prices, the manufacturing sector managed a healthy performance as it has benefited from the possibilities thrown open by the reforms and increased competition. Reduced cost of borrowing and

low interest rates have allowed it cushion its margins against steep raw material price increases (see section on industry). But clearly, these buffers cannot last indefinitely. Persistence of high oil prices beyond a point is bound to adversely impact growth in the manufacturing sector. When this impact will manifest itself is the question that needs to be addressed.

Figure 6: Domestic petroleum prices do not reflect global volatility



Source: Energy Information Administration, Infraline

Interest rate: What is in store?

Leading central banks across the globe have begun to moderate their accommodative monetary policy stance in response to inflationary pressure/expectations. Will the RBI also follow suit? We examine current monetary and liquidity conditions and ask whether these warrant an upward revision in interest rate by the RBI.

Global interest rates

As high global crude oil prices persist, uncertainty has dominated the market sentiments in most economies. Short-term interest rates in the US continued to move up with the Fed undertaking its eleventh consecutive hike in September 2005 keeping the target rate at 3.75 per cent. However, back home, comfortable liquidity conditions kept the call money rates close to the reverse-repo rate of 5 per cent for majority of the period.

Table 3: Short-term interest rates (per cent per year)

Country	April	July	September	October
US	3.12	3.49	3.79	3.85
Euro Area	2.13	2.13	2.14	2.18
Japan	0.02	0.02	0.02	0.02
China	2.1	2	4.38	1.95
Hong Kong	2.21	3.54	3.95	4.23
India	5.1	5.47	5.1	5.1
Singapore	2.13	2	2.21	2.34
South Korea	3.49	3.49	3.79	3.98
Russia	13	13	13	13
South Africa	7.05	7.1	7.05	7.05
Malaysia	2.82	2.88	2.9	2.91

* As on last reporting Friday of the month/ Data for October as on 8 October

Source: Economist

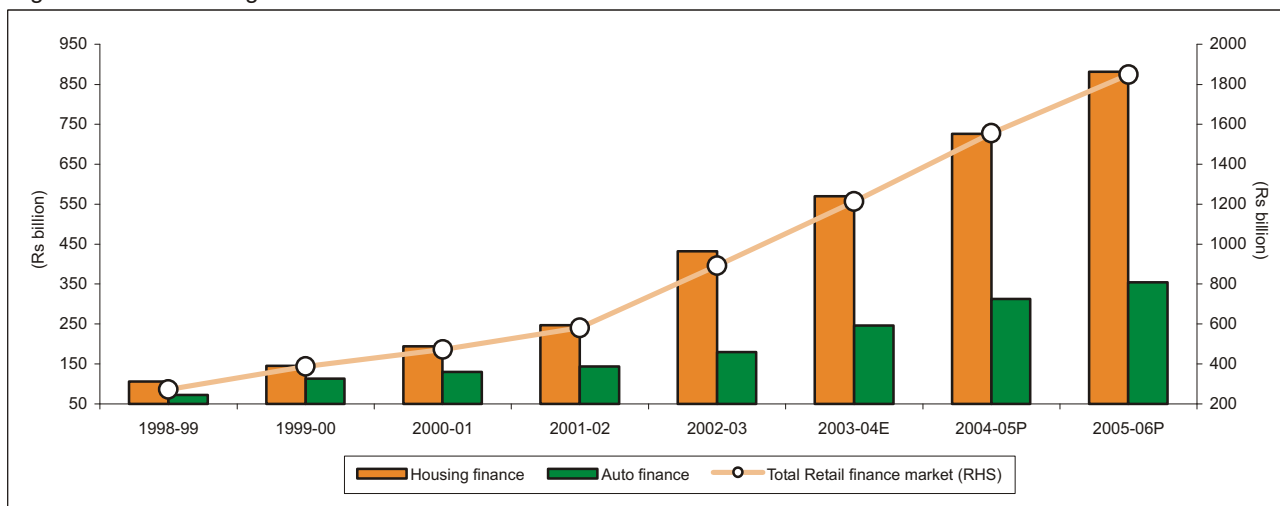
Credit offtake

Increased activity was witnessed during the year in the credit market as the commercial credit offtake continued to remain strong and broad based. The demand for commercial credit remained buoyant in line with the upbeat industrial activity in the economy. The broad-based industrial recovery supported the demand for bank credit, which has been rising since June 2004 and has Year-on-year growth of gained momentum since then. Bank credit reached a peak of 34 per cent in August FY06 as against 24.3 per cent for the same month in FY05.

Apart from the priority sector, which accounted for about 40 per cent of incremental credit deployed during FY05, credit absorption was led by infrastructure and housing sectors. The infrastructure sector with an output growth of 4.9 per cent during the year, recorded a 52 per cent increase in credit offtake from the banking sector. Sectors as diverse as petroleum, construction, gems and jewellery, and cotton textiles recorded strong growth in credit offtake in FY05. Bank credit offtake continued to display strong momentum with total credit to industry during April 2005 increasing by Rs 12,065 crore.

With credit growth (Y-o-Y) of consistently above 30 per cent during first half of the fiscal, commercial banks have been funding the credit expansion by liquidating their stock of government paper. But even now the current share of banks' securities eligible for SLR stands at around 36-40 per cent of their NDTL (net demand and time liabilities), which is significantly higher than the

Figure 7: Retail credit growth



Source: CRIS INFAC

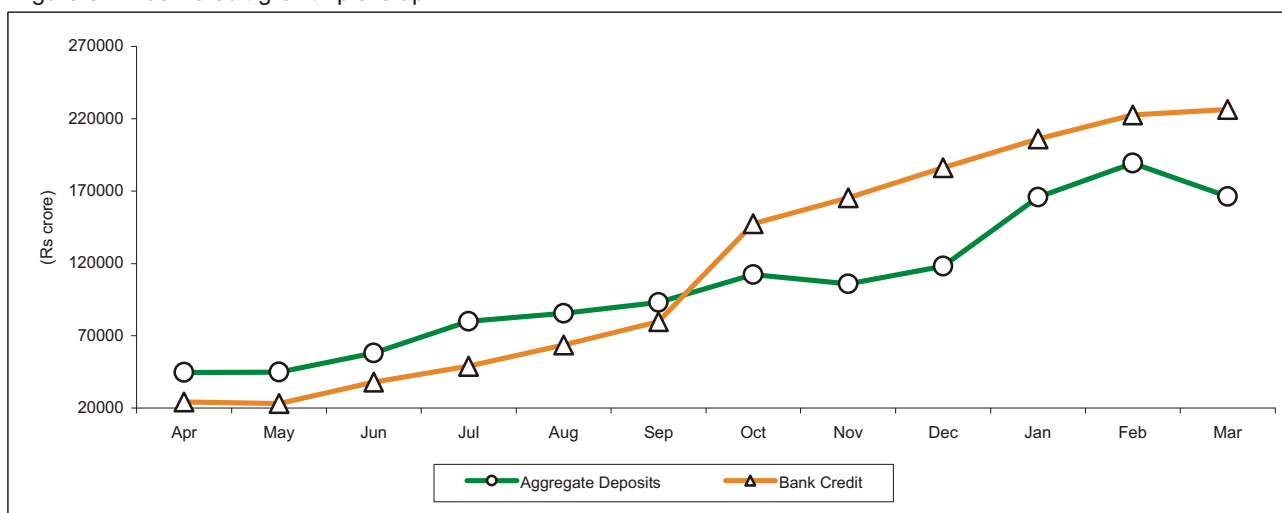
statutory minimum requirement of 25 per cent. Therefore, funding of credit growth by reduction in the stock of government paper held by the banking sector is still within the statutory requirement and need not be interpreted as a cause of concern.

Bank deposits

On the deposits front, the credit-deposit ratio has been consistently rising. It increased from 55.8 per cent during April 2004 to well above 65 per cent during September 2005. The increase in aggregated deposits during the

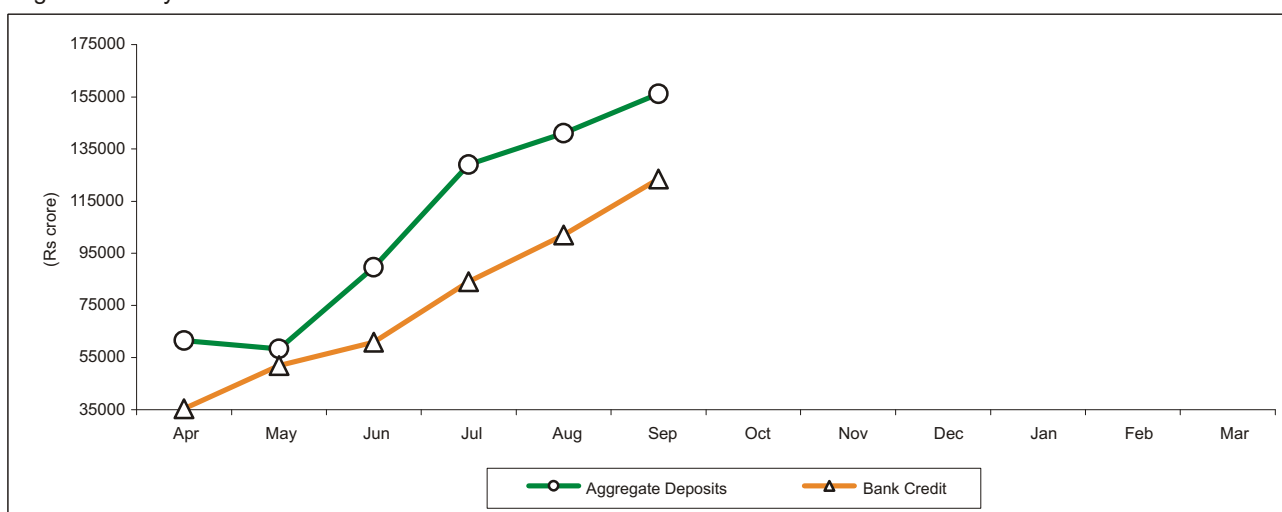
fiscal remained well above that of total bank credit. The aggregate deposits for the week ending September 16, 2005, increased by Rs 1,56,138 crore as against an increase of Rs 1,23,429 crore in bank credit. The situation was, however, different during the corresponding period last fiscal as bank credit increased by Rs 79,690 crore as against an increase of Rs 79,047 crore in aggregate deposits. Therefore, going forward, the increased growth in deposits is expected to support the rapid credit expansion without exerting significant pressure on liquidity.

Figure 8: FY05 - credit growth picks up



Source: Reserve Bank of India

Figure 9: The year so far



Source: Reserve Bank of India

Liquidity conditions

Considering the latest available data (Table 4) for the period commencing July 23 to August 12, 2005, the central bank's foreign currency assets increased by Rs 19,348 crore from Rs 6,412 crore during April to July 22, 2005, thus driving up the liquidity during the period to Rs 35,118 crore. The increased activity on the Liquidity Adjustment Facility (LAF) front by the RBI further indicates the existence of surplus liquidity in the system.

As noted above, since one of the key drivers of the liquidity in the domestic financial market is RBI's foreign

currency assets, global financial market trends cannot be ignored. Thus, a look at the global liquidity trends is in order. The figure below shows that despite the US Federal Reserve raising its target short-term rate consecutively now for the eleventh time (to 3.75 per cent) in September 2005, there has been hardly any deceleration in share of foreign exchange reserves across central banks, thereby helping them support credit expansion in their respective economies. This perhaps is indicative of the fact that despite hardening of short-term interest rate in the US there is no immediate threat to capital inflow.

Table 4: Liquidity drivers (net flow during the period)

(Rs crore)

	2005-06		2004-05		
	July 23- Aug 12, 2005	Apr 1- July 22, 2005	Oct 30 -Mar 31, 2005	May 15 - Oct 29, 2004	Mar 27- May 14, 2004
A. Drivers of liquidity	35118	-4890	43734	-24471	37170
1 RBI's foreign currency assets (adjusted for revaluation)	19348	6412	83662	-4614	37919
2 Currency with the public	-1307	-14802	-25896	6639	-20021
3 Others (residual)	17077	3500	-14032	-26496	19272
3.1 Surplus cash balances of the Centre with the Reserve Bank	5972	6053	-7721	-18481	15355
B. Management of liquidity	-24633	-740	-31852	37960	-40148
4 Liquidity impact of LAF repos	-26565	8845	-11875	66040	-12095
5 Liquidity impact of OMO (net)	-66	-2069	-1853	-769	-277
6 Liquidity impact of MSS	1998	-7516	-9124	-27311	-27776
7 First round liquidity impact due to CRR change	0	0	-9000	0	0
C. Bank reserves (A+B) #	10485	-5630	11882	13489	-2978

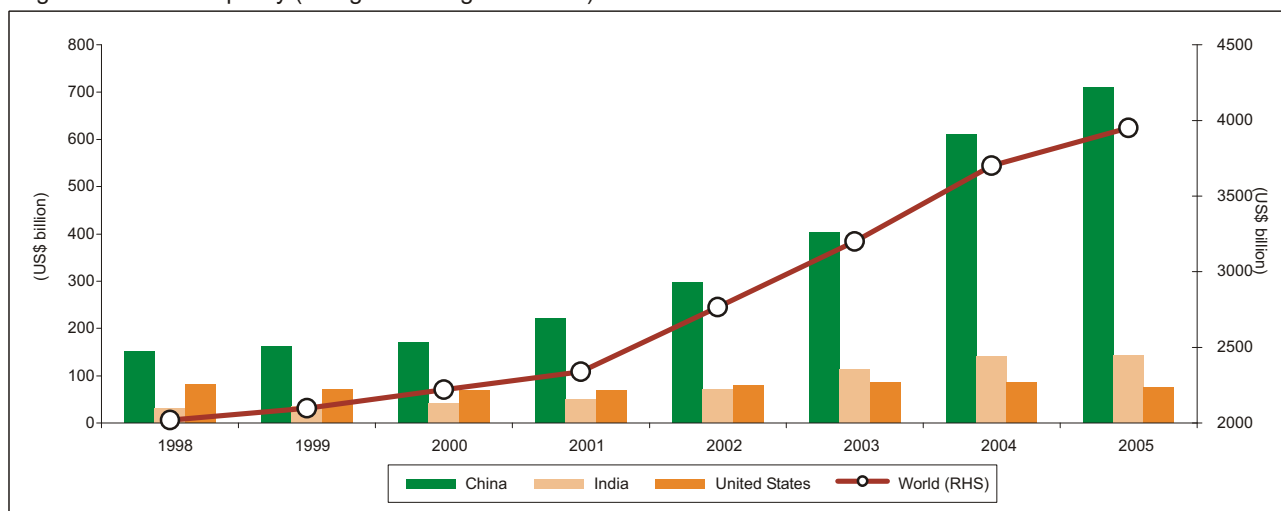
Note: '+' : Indicated injection of liquidity

'-' : Indicates absorption/ leakage from the banking system

#: Includes vault cash with banks and adjusted for first round liquidity impact due to CRR change

Source: Reserve Bank of India

Figure 10: Global liquidity (foreign exchange reserves)



Source: IMF, Reserve Bank of India, Federal Reserve, and People's Bank of China

Summing up

Increased deposit growth together with buoyant capital inflows are expected to provide a cushion against the credit and oil related demand in the economy.

Consequently, there does not exist significant pressure on liquidity. Also, the Central government has already met more than 70 per cent of its market borrowing requirement of the current fiscal.

Moreover, triggered by consumption demand, the current economic upturn has entered a phase whereby there are clear signs of a pick-up in investment demand. This is happening after a lull of nearly 8 years. Inflation may rise a bit, but given the existing level of oil prices, the economy is certainly doing reasonably well on this front.

All things considered, an increase in the interest rate by the RBI is unwarranted at this stage.

Government finances: Stress is evident

The fiscal situation has been a cause of concern for over a decade now. In response to its inability to enforce fiscal discipline, the government enacted the Fiscal Responsibility and Budget Management Bill to impose legislative ceilings on deficits. Despite healthy revenues, it failed to meet the committed deficit targets in FY05. This year too the revenue position thus far has been healthy, thanks to booming industry and corporate profits. But the emerging fiscal scenario suggests that expenditure overshooting together with over-optimistic revenue targets will result in fiscal slippage.

Receipts

Total receipts during FY06 were budgeted to be 2 per cent lower than last year's collection. Receipts crunch is expected to come about on the capital receipts front because of the switching off of the disinvestment of public sector units (PSUs) and end of the states' debt swap scheme. As the total receipts data is not comparable across years, it is more meaningful to focus on the revenue receipt performance. Within total receipts, the revenue receipts were up by 18.7 per cent during the first 5 months of the current fiscal compared to the target of 15 per cent for the whole fiscal. In it, tax revenue net to Centre was higher by around 28 per cent during the first 5 months of current fiscal compared to 21.6 per cent targeted for the whole fiscal.

Gross tax revenue was up by 23.2 per cent during the first 5 months compared to the corresponding period of the previous fiscal. Under direct tax collection, corporate tax mop up, at Rs 13,337 crore during the first 5 months of current fiscal, was 120 per cent higher than that during the corresponding period of the previous fiscal. On the other hand, advance payment of personal income tax has declined by about 10 per cent compared to the first 5 months of the previous fiscal. Under indirect taxes, customs duties overshadowed the excise performance. The customs duty collections reflect impressive growth in imports. Custom duties collections during the first 5 months of the current fiscal grew at around 29 per cent compared to the corresponding period of the previous fiscal. On the other hand, excise collections posted a growth of just 6.3 per cent during the same period. However, the budgeted rate of growth in customs and

excise for FY06 stood at -5.5 per cent and 20.7 per cent, respectively. Other taxes, which mostly include service taxes, were also very buoyant growing at 87.6 per cent during April-August FY06.

Table 5: Tax performance (Rs crore)

	Apr-Aug 2005-06	Apr-Aug 2004-05	Yr-on-yr % change
Corporation tax	13337	6059	120.1
Income tax	13879	15399	(-)9.9
Customs duty	25526	19775	29.1
Excise duty	31363	29504	6.3
Other taxes	8772	4677	87.6
Total	92877	75414	23.2

Source: Crisil Marketwire

Expenditure

On the expenditure front, both Plan and non-Plan expenditure overshoot the target during the first 5 months. Plan expenditure has grown by 28.5 per cent during the first 5 months of the current fiscal compared to the corresponding period of the previous fiscal. However, the target rate of growth in Plan expenditure for the whole fiscal is just 8.6 per cent. Similarly non-Plan expenditure grew at 6.6 per cent during the first 5 months of the current fiscal, though the target rate for the whole fiscal stood at 1.2 per cent.

There were big spending initiatives on the social and infrastructure sectors in Union Budget FY06. Even the outcome budget presented by the government during August re-emphasised the same. Schemes such as the National Rural Health Mission, Sarva Shiksha Abhiyan, Sampoorna Grameen Rozgar Yojana, National Food for Work Programme, Swarnajayanti Gram Swarozgar Yojana, Integrated Child Development Services, Accelerated Rural Water Supply Programme, Central Rural Sanitation Programme, Backward States Grant Fund and Accelerated Irrigation Benefit Programme have been allocated around Rs 45,000 crore during FY06. A number of schemes, including the Rs 2,800-crore National Urban Renewal Mission, the Rs 1,500-crore scheme for Basic Services for the Urban Poor, the Urban Infrastructure Development Scheme for Small and Medium Towns, and the Integrated Housing and Slum Development Programme, however, are yet to be approved by the

Table 6: Central government finances during April-August FY06 (Rs crore)

	April - August FY06	FY06BE	Share of Budgeted
Revenue receipts	81,169	351,200	23
Tax revenue (net)	58,482	273,466	21
Non-tax revenue	22,687	77,734	29
Non-debt capital receipts	3,292	12,000	27
-Recovery of loans	3,281	12,000	27
-Other receipts	11	0	-
Total receipts	84,461	363,200	23
Non-Plan expenditure	123,453	370,847	33
-On rev A/C	116,663	330,530	35
Interest payments	44,770	133,945	33
-On capital A/C	6,790	40,317	17
Loans disbursed	968	1,576	61
Plan expenditure	47,336	143,497	33
-On rev A/C	38,878	115,982	34
-On capital A/C	8,458	27,515	31
Loans disbursed	1,593	4,076	39
Total expenditure	170,789	514,344	33
Fiscal deficit	86,328	151,144	57
Revenue deficit	74,372	95,312	78
Primary deficit	41,558	17,199	242

Source: Controller General of Accounts

Cabinet. Further, the expenditure outgo on account of the Employment Guarantee Scheme will put pressure on this year's finances depending upon the speed and scale of its implementation.

Hence, an increase in expenditure has offset the gains of higher tax revenue, pushing up the overall fiscal deficit to Rs 86,328 crore till August 2005, which at 57 per cent of the Budget estimate is much bigger than 38.2 per cent during the corresponding period a year earlier. Following the spurt in expenditure and lower capital receipts, there has been an increase in borrowings. Domestic market borrowings stood at Rs 73,239 crore, which implies that 66 per cent of the budgeted annual borrowings were carried out in first 5 months. During last fiscal only 22 per

cent of the budgeted market borrowing were carried out in the first 5 months.

However, as per the calendar issued by RBI in March 2005, the GOI Borrowing Programme for H1FY06 was set at Rs 83,000 crore. The actual borrowing during the first half of the current fiscal was marginally lower at Rs 81,000 crore. The GOI Market Borrowing Programme for second half (H2) of FY06 has been placed at Rs 58,000 crore.

The following table documents the growth in revenue and expenditure required to meet the budgetary targets. To meet the annual targets, total receipts will have to grow by 3.5 per cent during the rest of FY06 (September 2005 to March 2006). At the start of the year, the target growth for the whole fiscal was (-2.0) per cent. However, the revenue receipts have seen a fall in target growth rate over the months. The target growth rate for FY06 was 15.1 per cent, which has fallen to 14 per cent for the period September 2005 to March 2006. The target growth in net tax revenue has fallen from 21.6 per cent for the whole FY06 to 20 per cent for September 2005 to March 2006.

On the expenditure front, both Plan and non-Plan expenditure growth during the first 5 months has overshoot the target growth rate for the whole fiscal, which means some curtailment in expenditure is required to keep expenditure figures at the budgeted level.

Outlook

Given the disproportionate dependence of tax collections on industrial performance, the revenue performance of the government critically hinges on the level of industrial activity. If the average tax/industrial GDP observed in FY05 is assumed, we get a revenue shortfall of Rs 11,429 crore for industrial growth of 7.4 per cent, which we have projected for FY06. We expect the fiscal deficit at 4.6 per cent of GDP in 2005-06 as against the budgetary target of 4.3 per cent.

Table 7: Growth required to meet the budgetary targets (% y-o-y)

	Revenue					Expenditure		
	Revenue receipts	Tax revenue (net)	Non-tax revenue	Non-debt capital receipts	Total receipts	Non-Plan expenditure	Plan expenditure	Total expenditure
April 05 to Mar 06	15.1	21.6	-3.2	-81.6	-2	1.2	8.6	3.2
May 05 to Mar 06	14.8	21.1	-3.3	-80.8	-1.3	1.4	8.8	3.4
June 05 to Mar 06	14.1	20.3	-3.5	-77.2	0.6	1.4	10.1	3.8
July 05 to Mar 06	14.1	20.6	-3.5	-77.2	0.5	0.6	9.3	2.9
Aug 05 to Mar 06	14.2	20.9	-4.5	-75.3	2.4	-0.3	3.9	0.8
Sept 05 to Mar 06	14	20	-4.6	-73.2	3.5	-1.2	1.9	-0.4

Source: Prowess and Central Statistical Organisation

Global economy: Bullish amidst threats?

Summary

- | China grows at a higher-than-expected 9.5 per cent for the first half. Gives in to pressure to appreciate yuan, if only by 2.1 per cent, and discontinue pegging to the dollar.
- | US growth happens alongside house price bubble and massive current account deficits with eleventh consecutive rise in Fed Fund interest rates.
- | Global oil price boom transforms into an oil shock, as market tightens further
- | EA and UK exhibit weakness and their growth forecasts are revised downwards for the year
- | Germany and Japan show some signs of recovery

Concerns

- | *Oil price shock:* Frequent supply disruptions and unfading demand for oil, compounded with the already tight market, in the first 9 months of the year. Primarily, lack of refining capacity and poor spare capacity through the year, worsened by geo-political issues and adverse climatic conditions in Gulf of Mexico ensured that prices remain above \$55 per barrel mid-June onwards (EIA). Release of additional barrels of oil, to the tune of 1 million barrels per day in the year ending September, has done little to cease price hikes or volatility. This is because OPEC releases heavy crude, whereas consumers have been demanding light, sweet crude, which is easier to refine. Speculation about future uncertainty of supplies has increased the market's vulnerability to even transitory events and thereby stimulates upward price pressures that may not be justified by prevailing market fundamentals.
- | *Global imbalances:* Uneven growth of investments and savings in the world have caused large current account imbalances. In brief, on one hand, Asia's trade surpluses and corporate savings have been widening over the months due to the surge in external demand, in particular from the US consumer. On the other hand, these surpluses and savings have been increasingly invested in US government bonds, with the underlying expectation of security of funds and returns. This has prevented the dollar from falling and hence re-financed the US trade deficit. Partly, subdued domestic demand and low levels of investment in Asian countries,

besides the fear of reoccurrence of the 1997 crisis, have boosted this action. Oil producing nations have also placed their large oil-export surpluses in the US, rather than investing in the domestic economy, due to the fear of a fall in oil prices and an end to these surpluses. Weakness in EU growth has also diverted the flow to the US. Hence, continued export-led growth of Asian countries, high oil prices, saving and investment habits of nations are unlikely to reverse the flows to a great extent in the near term. Fundamental fiscal and financial reforms in domestic economies and reduced dependence on US as a consumer of Asian exports will ensure a gradual balance of these flows.

- | *House price bubble:* The soaring housing market has given a boost to the world economy. Prices in US have been rising fast though they have been sliding in Australia and Britain. However, the dangers associated with slowing of the housing boom, especially in the US, are rather big, since most purchases have been made with the perspective of making profits. This and low interest rates have left consumers highly indebted and vulnerable to interest rate hikes, amidst inflation arising from oil prices. This has weighed on domestic savings. Also, many jobs created in the economy over the last 4 years have been in the construction, real estate, lending and brokerage. The sudden cooling off of the market can be a substantial drag on the economy via lost employment and consumer spending.

Review of developments

US economy

- | Economic growth for the first half averaged 3.6 per cent on the year. It is largely attributed to the consumer-spending boom, exacerbated by the house price boom and increase in fixed investments, particularly equipment and software. Importantly, the investment growth although robust, has declined in the second quarter from that in the first. Although productivity has declined in the second quarter from the first, it continues to support growth, growing at 3.6 per cent in Q2.
- | CPI inflation remained above 3 per cent for most of the year, but has picked up since July on the back of rising oil prices. Energy index has correspondingly displayed double-digit inflation, trending upwards, whilst the core inflation has sustained at around 2.1 per cent.

- | Labour market started exhibiting signs of recovery from June onwards, consistently tightening to around 4.9 per cent. Due to the hurricane, however, the rate has moved back to 5.1 per cent in September.
- | Fed maintained its accommodative policy stance, pushing six more 0.25-point hikes in interest rates this year.
- | Current account deficit stands at 6 per cent of the GDP at the end of Q2, owing largely to the unstable trade deficit. It contracted to \$195.7 billion in Q2FY05 from \$198.7 billion in Q1 owing to a fall in the large trade deficit of \$173.3 billion.
- | Hurricane Katrina and subsequently hurricane Rita are likely to slow the pace of economic growth. These have given fresh impetus to inflationary expectations on account of oil supply disruptions and thereby push-up in prices. This is likely to be reflected in the core inflation of the near term. The unemployment rate has again increased to 5.1 per cent. Expectations of a pause on interest rate increments arise on account of high risk emanating from too much or too little tightening. As a result, consumer spending is likely to fall in the near term, alongside a gradual fall in house prices. A slowdown from the previous year is inevitable, but the economy would witness solid growth.
- | Labour market trend rate has been fairly flat in both economies, with unemployment slackening at 8.8 per cent in the Euro Area, and 4.7 per cent in UK for the first half of the year.
- | Deposit facility, main refinancing operations and marginal lending facility were held constant at 1 per cent, 2 per cent and 3 per cent, respectively, in the Euro Area, although demand and investment both remain weak. UK short-term interest rates were maintained at 4.75 per cent, until increased poor performance compelled Bank of England to cut rate by 0.50 basis points.
- | Current account has been worsening since March with a deficit of €2.1 billion in June, owing to higher imports that primarily reflect higher oil prices and increasing capital import volumes. The 12-month cumulated surplus of the Euro Area current account fell to €15.5 billion, as compared with €47.3 billion a year earlier. UK's current deficit, on the other hand, has improved in Q2, on account of reduction in trade deficit; from €7.3 billion to €3.1 billion.
- | Given the recent oil price developments, inflation above 2 per cent is likely to curb further domestic demand.

Euro Area and the UK

- | GDP growth in both economies have been rising at a slower than anticipated rate. Euro Area exhibited weakness, growing at an average of 1.3 per cent in the first half. Industrial production (excluding construction) and manufacturing have generally been weak and deteriorating over the first 6 months. UK exhibited similar performance, growing at an average of 1.8 per cent in the first half, deteriorating in the second quarter. This is attributed to slowing consumer demand as the housing boom retreats, alongside poor performance of the manufacturing sector, which has gone into recession.
- | Harmonised Index of Consumer Prices (HICP) inflation in the Euro Area has remained controlled at 2.1 per cent all through, and core inflation has also been low, around an average of 1.5 per cent. In UK by contrast, inflation has been increasing over the months, and breached the targeted rate of 2 per cent in July, worsening to 2.4 per cent in August. The largest upward affect came from the transport sector, clearly reflecting the pressure of crude oil prices.
- Germany has slid back to 0 per cent growth in the second quarter, from recession in previous quarters as unemployment has begun to fall from the high levels and corporate profits and export performance have shown a turnaround. These positive signals could translate into a sustained upward trending growth in the medium term.

Japan

- | Real GDP increased at a modest 1.4 per cent average indicating an unexpected gradual recovery, as exports and economic activity picked up, albeit domestic demand remained subdued. Industrial production has been deteriorating in the first half, although it has picked substantially in August, to 1.6 per cent.
- Unemployment has remained at an average of 4.5 per cent over the first 7 months of the year, although trending downwards since April.
- | Japan's current surplus has been decreasing at a consistent rate since February, standing at 1,087 million yen on June end. Exports have picked up over the year though it has not contributed much to growth.

- A conducive, reform-oriented political-economic environment is likely to propel consumer demand in the medium term. This will be complemented by signals of healthy recovery exhibited by banks and positive business environment, from the stalemate that last after the stock bubble burst. A consistent recovery, but for high oil prices, is likely to result in further growth in GDP.

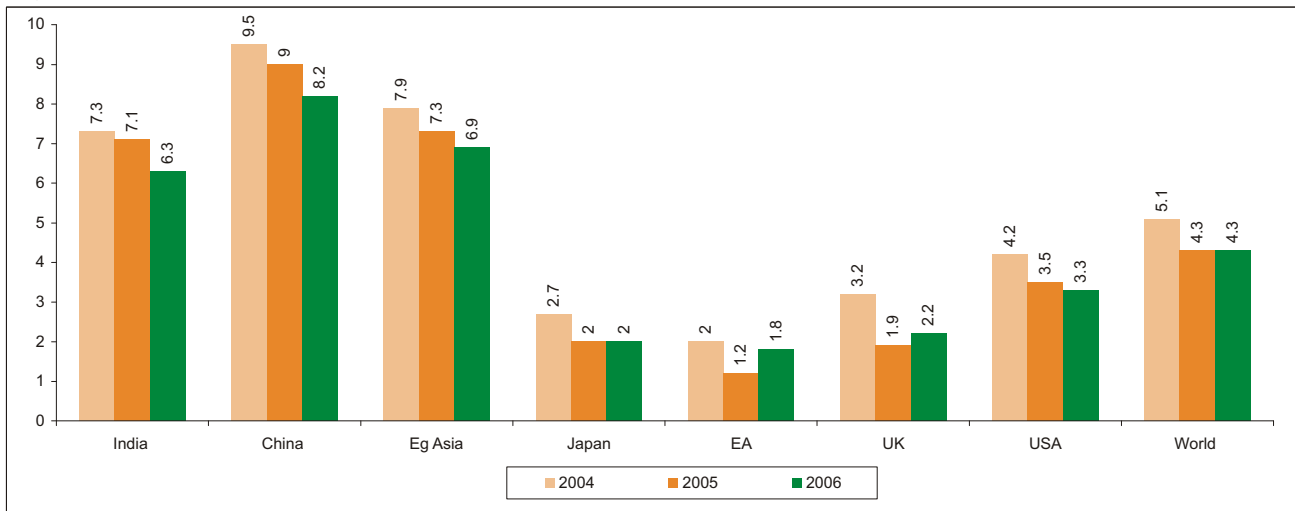
China

- Chinese growth of 9.5 per cent for the first half has been a combination of export-led and investment-led growth, more than consumption-led.
- The domestic demand remains low compared to external demand (that followed a high export and low import pattern), which has transformed to massive current account surpluses. In the first half of this year (Jan-June), the total value of import and export was \$645.0 billion, 15.9 percentage points lower on the corresponding period last year.
- Inflation has been declining through the year, and was an average 2.1 per cent for the first 8 months.

Persistent asymmetry in the expansion of demand and allocation of resources is causing further imbalances and the monetary policy stance of countries is becoming more differentiated. These are the two major risks to the global economy, posing a downside threat on the whole.

- India and China have been the star performers of the Emerging Asia region during the first half of the year. Since impact of higher oil prices is still not fully passed on to the consumer, the end impact on the domestic economy remains understated in India. Yet, soaring imports are weighing on the current account surplus, owing partially to high oil prices, estimated to be at an average of \$60-62 (North Sea Brent) for 2005 (CRIS-INFAC). The impact of the global performance primarily permeates through the trade link - in particular through backward and forward linkages with China and US as our major destination for exports and imports. Also as the East Asia region is growing as a destination for Indian exports, their linkage with the two countries also undermines demand for our exports.

Figure 11: Real GDP forecast



EA: Euro Area

Eg. Asia: Emerging Asia

Source: IM F, September 2005

Outlook

- Until late, global oil prices haven't made much of a dent on the growth of US and China indicating that underlying forces of economic growth were significantly stronger. Yet, the affects of high oil prices have shown up in gradual increases in inflation in other countries.

Leading indicators portray optimism

The latest available data shows a continuation of robust industrial growth this fiscal as well. Would this upturn be sustained for the rest of the fiscal? We look at some of the leading economic indicators to ascertain the likely future prospects this fiscal.

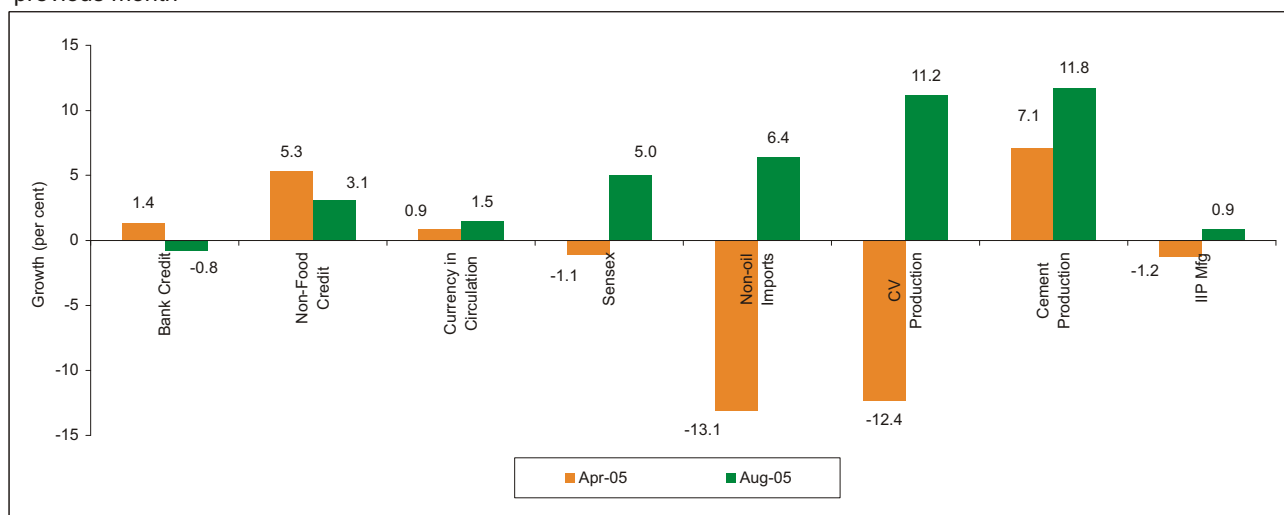
Activity relating to financial and credit markets is expected to rise or fall in consonance with activity in real sectors. This may be discerned by looking at the cyclical components of monetary variables. An upturn in these indicators suggest continuation of growth in the economy and vice versa. Although in some cases monetary variables may lead the real sector activity, usually these variables witness an upturn both in response to current business conditions as also expectations. A number of monetary variables closely linked with the level of real sector activity are bank credit, non-food credit and currency in circulation. Except bank credit, the cyclical component of the monetary variables that have been tracked has shown a growth in April 2005 as also in August 2005. The negative growth in the cyclical component of bank credit and decline in the growth of the cyclical component of non-food credit in August as compared to April, though, appears to be somewhat discouraging; this mixed pattern may indicate a less robust growth momentum. However, let us not forget that the impact of monsoon is yet to be captured by the monetary variable - food credit - which is perhaps why bank credit shows negative growth in August 2005.

Another set of variables that are considered to be leading indicators relate to production of select industries like cement and commercial vehicles. In the absence of a suitable variable, which can capture the construction activity, cement is used as proxy to reflect investment spending. Similarly, growth in commercial vehicle sales reflects heightened economic activity as enhanced production leads to greater movement of raw material and finished goods across markets and production sites. The cyclical component of both cement and commercial vehicle production shows improvement during August 2005 as compared to April 2005. Further, in view of the ongoing infrastructure projects such as the mega road projects under the NHDP programme and the boom in the housing construction sector, the consumption of cement is unlikely to nosedive for a while.

In addition to production of cement and commercial vehicles another real sector variable that is considered as leading economic indicator is non-POL import. As non-POL import includes both import of raw material and import of capital goods, an increase in its cyclical component is indicative of both increased production as well as investment activity in the economy. The non-POL import in August 2005 shows a healthy month-on-month growth of 6.4 per cent.

Finally, we consider the behaviour of stock prices and the business confidence index, both of which are considered

Figure 12: Leading economic indicators: Growth rate of cyclical components for April and August 2005 over the previous month



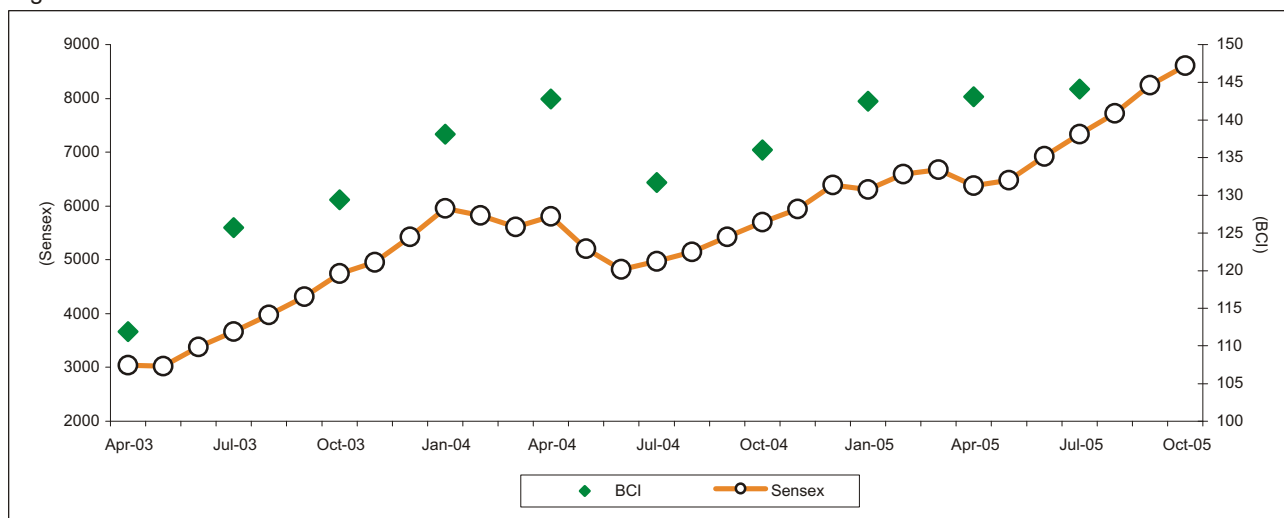
Source: RBI, BSE, Ministry of Commerce, CSO

to be a barometer of the economy and hence are forward looking indicators. While there have been some ups and downs, the growth in the BSE Sensex this fiscal has remained fairly strong. The BSE Sensex not only crossed the psychological barriers of 8000, it came very close to the 9000 mark recently. On a month-on-month basis its cyclical component recorded a growth of 5.0 per cent in August 2005 as compared to - 1.1 per cent in April 2005.

NCAER's Business Confidence Index (BCI) is a leading indicator for industrial growth. The BCI, which in April 2005 was 143.1, increased to 144.1 in July 2005. This is also the highest level BCI has reached since December 1995.

To conclude, the picture that emerges from the analysis of leading indicators is one of sustained improvement in monetary conditions and real sector activity this fiscal. This means outlook would remain reasonably optimistic.

Figure 13: BSE Sensex and Business Confidence Index



Source: NCAER, BSE

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