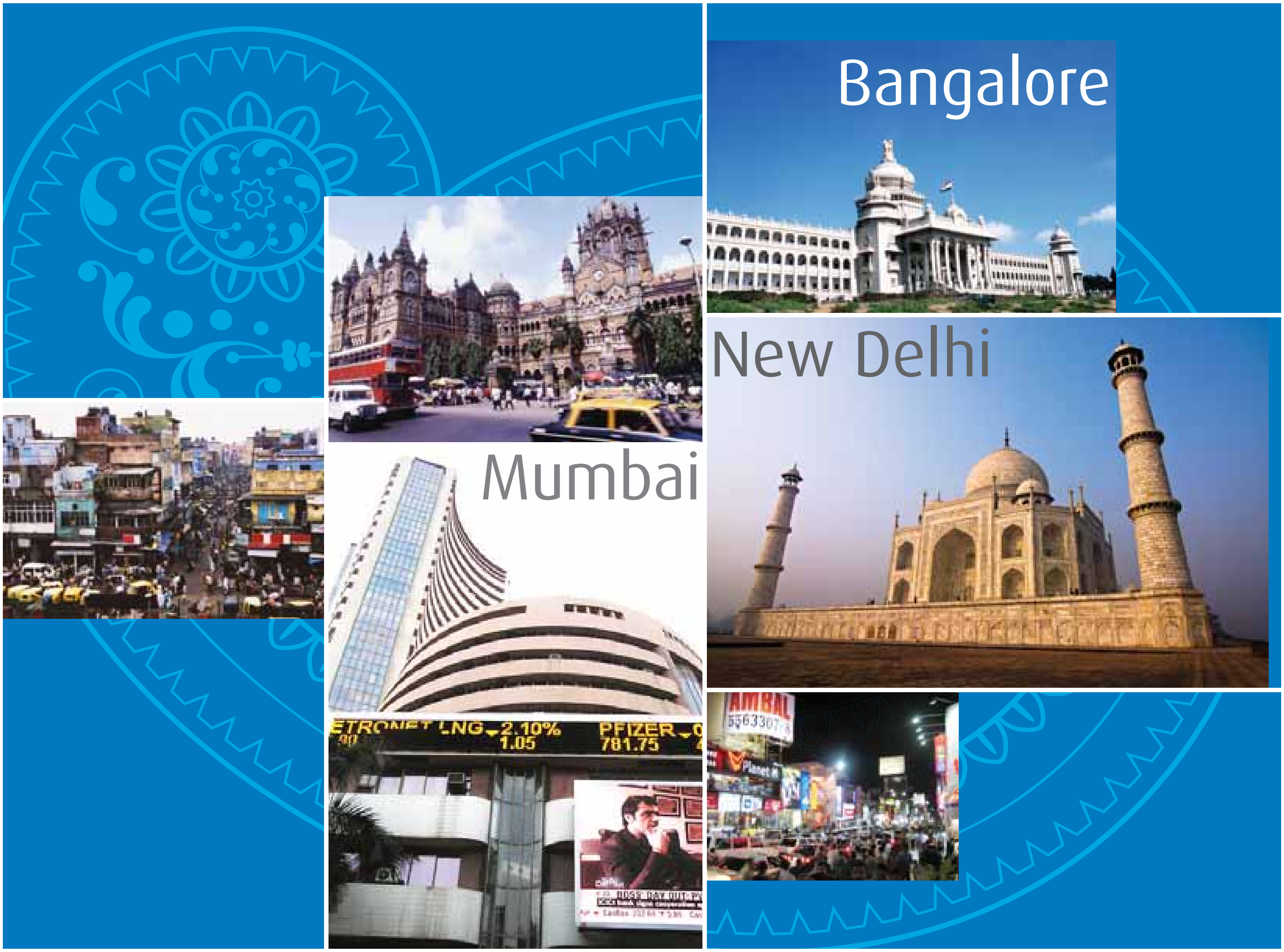

THE BMO CAPITAL MARKETS INDIA ECONOMIC UPDATE

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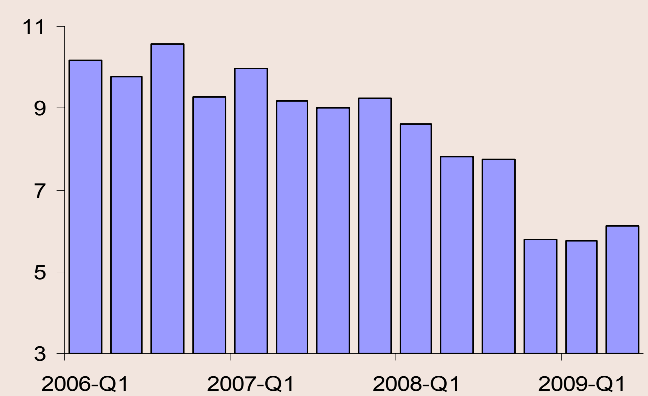
October 14, 2009

- India's economy slowed, but showed considerable resilience in the global economic crisis
- The lowest monsoon rains in almost 40 years will constrain growth this year
- Wholesale price inflation has rebounded and is set to rise rapidly
- Rebounding capital inflows are bolstering the balance of payments
- A deteriorating fiscal situation is a concern while monetary policy faces a dilemma

Economy Resilient But Not Immune to Global Crisis. India entered the global financial and economic crisis as one of the world's high-flyers with average growth of almost 9% in the five fiscal years (April-March) to FY2007/08 ranking among the best in the world. Notably, and unlike much of the rest of Asia, the strength was due to domestic demand, with net exportsconsistently acting as a drain on growth. Investment growth in particular ran in the mid upperteens, steadily increasing its percentage of GDP from the low 20s early in the decade to 34-35% in the last couple of fiscal years and laying the groundwork for robust medium-term growth. Of course, the economy hit a speed bump with the global economic crisis, which slowed GDP growth to 6.7% in FY2008/09 from 9.0% in FY2007/08. Manufacturing output was hard hit with growth slumping to 2.4% from 8.2% while, on the expenditure side, private consumption growth was slashed to less than 3% from 8.5%and investment spending skidded to 8.3%. A hefty fiscal stimulus propelled government spending 20% on the year, providing some offset. The downturn appears to have bottomed out, with growth improving modestly in Q1 of FY2009/10 (April-June) to 6.1% y/y from 5.8% the previous quarter. Manufacturing revived 3.5% y/y from -1.4% but signs of weakness continued with private consumption easing to 1.6%, investment slowing to 4.2% and government spending slowing for the April-May elections. Net exports ended up boosting growth as a 20% plunge in imports doubled the fall in exports.

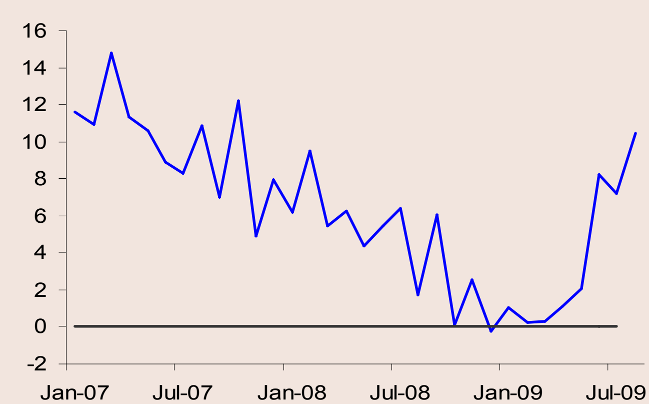
GDP Growth Has Eased...

Year-over-Year % Change



...But Industrial Production Rebounding

Year-over-Year % Change



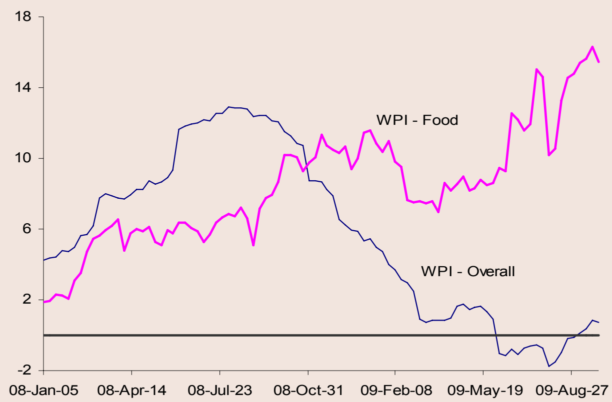
Signs of a Rebound Challenged By Weak Monsoons. Signs that the economy has turned a corner continue to emerge, most notably including a surge in industrial production growth from basically flat early this year to a 10.4% y/y rise in August. Nevertheless, overall growth this year will be constrained as the June-September monsoon rains, which provide about 80% of the country's rainfall, were 23% below the long run average, the worst since 1972. Summer grain production will be cut sharply due to drought-like conditions in many regions (60% of agricultural land is rainfed) while rural demand will also be dampened as agriculture employs 55% of the labour force.

Inflation on the Rise. The poor monsoons are also raising food prices and stoking inflation fears. The economic downturn and falling oil prices drove the wholesale price index (India's inflation benchmark) to negative territory in June-September from over 12% y/y a year earlier. But the WPI is positive again and up 7% since mid-February. Food prices (15% of the index) were up 15.5% y/y at the latest tick. The inflationary and socialimpacts of the monsoon will be cushioned by the buoyant food grain stocks built up from recent bumper crops and by importing essential commodities. Nevertheless, food prices will put pressure on the overall index just as it begins rising steeply as high oil prices drop out of the year ago base figures. Official forecasts of WPI inflation of 5% at the end of March 2010 are optimistic; it will likely come closer to 7.5%.

- Food prices account for about half of India's consumer price index (industrial workers), which was already up almost 12% y/y in July and August from 8.0% in April.

Wholesale Price Inflation Rising

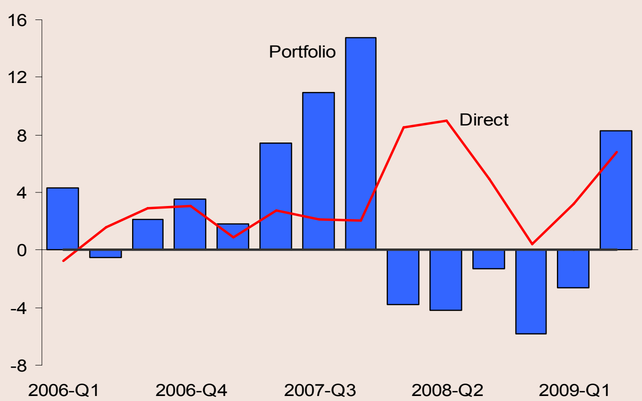
Year-over-Year % Change



But External Accounts Improving. More positively, recent trade trends are narrowing the current account deficit after a rise to $29.8bn (2.6% of GDP) in FY2008/09 from $17bn a year earlier. The $5.8bn deficit in April-June was down by a third from a year earlier, mostly due to a lower trade gap. Even more positively, capital inflows rebounded strongly, reflecting an increasing global risk appetite and investor pleasure with the stunning election results in May which saw a surprisingly strong showing for the Congress Party led by reform-oriented PM Manmohan Singh. The governing alliance is very near a majority and no longer has to rely on the anti-business Communists, who suffered major losses. The improved prospects for renewed and overdue economic reforms bolstered net foreign direct and portfolio investment, both of which exceeded the current account deficit. Given the strength of the stock market and exchange rate, the strong inflows seem to have continued, raising foreign reserves to $270bn from $242bn at the end of April.

Capital Inflows Rebounding

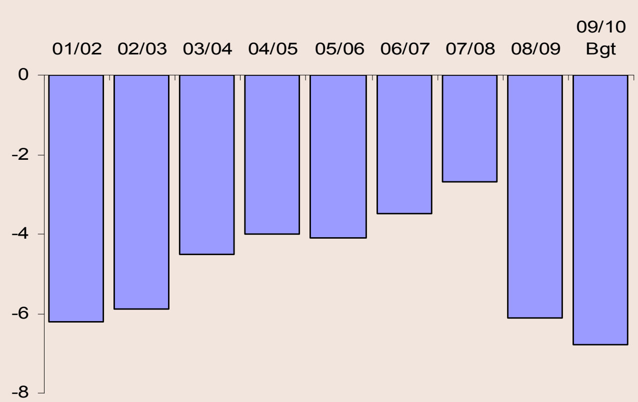
Net Foreign Direct and Portfolio Investment – US$ billions



Fiscal Challenges Mount. A key challenge for the government will be to tackle the rapidly worsening fiscal accounts. India's recent success has been in no small part due a fiscal responsibility law in 2003 which broke a pattern of large fiscal imbalances and narrowed the central government deficit from 5.9% of GDP inFY2002/03 to 2.7% in FY2007/08. The trend was disrupted last year by high oil prices, the global economic crisis and the adoption of fiscal stimulus measures in the latter part of the fiscal year, causing the deficit to soar to 6.1%. The government's continuing focus on fuelling the economy led it to target a further rise in the deficit to 6.8% of GDP in the FY2009/10 Budget, but the poor monsoons and subdued growth may widen it further. While the elimination of stimulus measures back budget projections that the deficit will fall to 5.5% in 2010/11 and 4% in 2011/12, political resolve will be critical to meet the targets. Much of the earlier fiscal gains came from rapidly rising revenues in good times, with relatively little done to contain expenditures, which include a wide variety of subsidies as well as more recent populist measures such as rural employment guarantees, debt relief for poor farmers and a 21% increase in civil servant

Fiscal Balances Deteriorating

Central Government Balance as % GDP



wages last year. This kind of spending may prove politically difficult to curtail. Having a strengthened government in place after recent elections should help, as should the report of the Thirteenth Finance Commission later this month which is meant to address medium term fiscal issues.

- Central government fiscal figures underestimate the fiscal imbalance as off-budget outlays (including large oil, food and fertilizer subsidies) and state government deficits likely pushed the general government deficit-to-GDP ratio into double-digits last year, among the highest in the world. Lower oil prices will reduce subsidies this year, but the deficit will likely remain near last year's level, pushing the general government's debt above 80% of GDP. (Compared to 62% for central government debt.)

India Economic Indicators

Fiscal Years Beginning April	07/08	08/09	09/10f	10/11f
GDP Growth (%)	9.0	6.7	5.8	7.5
Wholesale Inflation (%, pd avg)	4.7	8.4	2.3	6.5
Wholesale Inflation (%, pd end)	7.7	0.8	7.5	5.0
Central Govt Balance (% GDP)	-2.7	-6.1	-7.0	-6.2
Central Govt Debt (% GDP)	62.1	61.5	62.0	64.0
Trade Balance ($bn)	-91.6	-119.4	-106.0	-119.1
Current Account Bal ($bn)	-17.0	-29.8	-11.7	-18.3
% GDP	-1.7	-2.7	-1.0	-1.3
FX Reserves ($bn)	299.7	242.3	280.0	300.0

Monetary Policy Dilemma. Monetary policy was also aggressively loosened to support demand during the economic downturn. Since October, the central bank's repo rate (the benchmark lending rate) was cut 425 basis points to 4.75% while the reverse repo was cut 275 bps to 3.25%. The cash reserve requirement and the statutory reserve (government securities) requirement were also lowered to free up liquidity. Rates have been on hold since April as India's inflation began to rise and an accommodative stance remains likely for now given the poor monsoon and continued weak bank credit growth, which is now down to 12.6% y/y from double that a year ago and 17.3% in March. However, with prices expected to rise sharply and production rebounding, the Reserve Bank of India may need to tighten soon. Reserve ratios may be raised first, but India may also prove to be a relatively early rate hiker, with the first moves possible before the end of the fiscal year.

Economic Outlook. Monsoon-induced headwinds will likely restrain growth in FY2009/10 Q2-Q3 (July-December) and keep growth below 6% for the year as a whole. However, the substantial amounts of fiscal and monetary stimulus should still be feeding through by the year end and, combined with an improving external environment and assumed normal rains next year, spur a substantial growth boost to 7.5% in 2010/11. Inflation should moderate next year despite the stronger growth as a normal harvest helps contain food prices. On the external side, lower oil prices and improving exports should reduce the current account deficit this year to around 1% of GDP before an improving domestic economy and a commodity price revival leads to a modestly wider deficit in 2010/11.

- Prospects over the medium term will depend on maintaining strong savings and investment ratios. As in recent years, private investment will be boosted by sustainable fiscal consolidation. Even so, a return to the 9% pre-crisis economic growth may prove challenging given India's inadequate infrastructure and the need to eliminate lingering structural impediments. A renewed reform push under the newly strengthened Congress-led government would be useful, particularly in areas such as labour reforms, privatizations and opening up the economy to foreign investment.

NOTES

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