Decide with Confidence

Dun & Bradstreet

ECONOMY OBSERVER

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Industrial output, as measured by the Index of Industrial Production, after registering a low growth of 5.6% during Jan 08, recovered to 8.6% during Feb 08, exceeding our expectations. As per use-based classification, the Consumer goods segment registered a strong growth rate of 9.2%, primarily driven by the consumer non-durables segment. Although data suggests that the capital goods sector has witnessed a mild recovery, the sector's contribution to IIP growth remains low at 12%, as compared with an average contribution of 21% during the Apr-Feb 08 period. It is possible that the slowdown in capital goods production growth is indicative of a moderation in the corporate sector's capital expansion plans. Further, ECBs and FCCBs, which have been primarily used by corporates to meet import payments of capital goods, have also witnessed a slowdown to less than US$ 1 bn in Feb 08 from US$ 1.8 bn in Jan 08 and US$ 2.3 bn in Dec 07. While tight liquidity conditions in global markets are an important factor behind the decline in ECBs, slowdown in firms' capital expansion plans may have also played a role. As per the D&B Business Optimism Index, respondents from the capital goods sector were less optimistic with respect to demand conditions in the Apr-Jun 08 quarter as compared with the year ago quarter.

On the external front, the current account deficit (CAD) for Q3 FY08 widened to US$ 5.4 bn, i.e. to 1.7% of GDP as compared with 1.5% of GDP during the year ago quarter. However, when we consider the Current Account, net of Transfers, the deficit rises to as much as 5.2% of GDP. Private transfer inflows consisting primarily of inward remittances and local withdrawals/NRE deposit redemptions amounted to US$ 10.9 bn during Q3 FY08.

However, the main concern remains on the price front. Inflation, as measured by the WPI, rose to a three and a half year high of 7.4% during the week ended 29-Mar-08, spurred by a sharp increase in prices of primary articles and select manufacturing products such as metals. Although the RBI and the Government are taking measures to contain inflation, supply side constraints are expected to persist at least in the short term, thereby placing upward pressure on prices of food articles.

With inflation rising far above the RBI's threshold limit of 5%, a cut in interest rates can be ruled out. At the same time, with the slowdown in real economic activity, interest rates may not be increased. We expect a status quo to be maintained on interest rates. The RBI has already opted to raise the CRR by 50 basis points in two phases, effective 26-Apr-08 and 10-May-08.

Dun & Bradstreet's Macro Economic Forecasts

		ACTUALS	
	FORECAST	**Latest Period**	**Previous Month**
Inflation (W.P.I)	7.2%-7.4%(Apr-08)	6.75%(Mar-08)	4.85%(Feb-08
IIP Growth	5.5%-6.5%(Mar-08)	8.6%(Feb-08)	5.8%(Jan-08)
15-91-day T-Bills	6.9%-7.1%(Apr-08)	6.76%(Mar-08)	6.85%(Feb-08)
INR/US$	39.90-40.1(Apr-08)	40.36(Mar-08)	39.73(Feb-08)

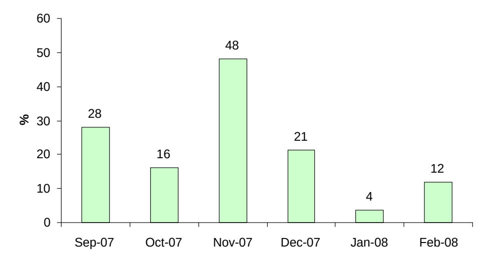
All figures are monthly averages

Real Economy

Contribution of capital goods to IIP growth at 12%

The Index of Industrial Production (IIP), after registering a low growth of 5.8% in Jan-08, recovered to 8.6% in Feb-08, backed by strong growth witnessed in the mining (7.5%) and electricity sectors (9.8%). However, the strong growth rates reported by mining and electricity sectors can be, in part, attributed to the low base of the previous year. The manufacturing sector registered a growth rate of 8.6% in Feb-08 as against 6.3% in the previous month.

Contribution of Capital Goods to IIP Growth



Source: CSO

As per use-based classification, although growth in capital goods sector picked up to 10.4% in Feb-08 (as compared with 2.3% in the previous month), the contribution of this sector to the overall increase in IIP still stands lower at 12% as compared with an average contribution of 21% during Apr-Dec 07. The slowdown in capital goods output growth reflects the impact of high interest rates on the corporate sector's capacity expansion plans.

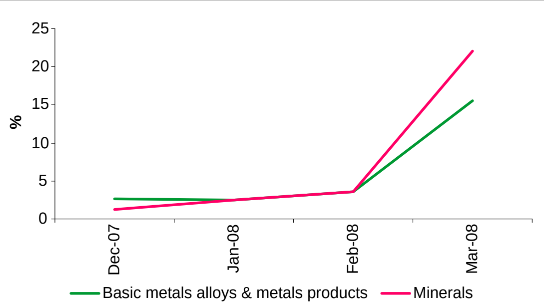
Consumer goods segment registered a growth rate of 9.2% as against 7.8% in the previous month, primarily driven by consumer non-durables which contributed almost 93.5% to the growth in this segment in Feb-08. Although growth in consumer durables picked up in Feb-08, it still remains low at 3.3% - indicative of the continued moderation in consumption growth. We expect the Index of Industrial Production to remain subdued and grow within the 5.5- 6.5% range during Mar-08.

Price Scenario

Upward pressure on food article prices to persist

Inflation, as measured by the WPI, continued its march northwards and surged to a three and half year high of 7.41% during the week ended 29-Mar-08, far above the RBI threshold limit of 5%. During the month of Mar 08, inflation was at an average of 6.75%, driven by a sharp increase in prices of primary articles and select manufactured products.

Inflation of Minerals & Metals (WPI)



Source: Ministry of Commerce

High prices of food products (edible oil, oil cakes), basic metal alloy and metal products pushed inflation in the manufacturing group to 6.28% during Mar 08 as compared with 4.37% during Feb 08. With a steep rise in prices of metals such as steel, the Basic metals alloys & metal products group contributed as much as 37% to the overall increase in manufacturing inflation. The sharp rise in steel prices, in turn was due to a 29% increase in iron ore prices. In fact, mineral group inflation rose to 22% as compared to 3.57% during Feb 08.

The WPI for primary articles increased to 8.27% during Mar 08 from 5.67% during Feb 08. The domestic production of food articles during the Rabi season is expected to be low. Further, supply side constraints in the domestic market have resulted in a surge in prices of food articles such as rice. With countries such as Thailand, China, Vietnam as well as India imposing either tariffs on exports or a complete ban on rice exports, international prices of commodities such as rice will also continue to be under pressure.

Other short term measures such as a cut in duties on refined oils are likely to have limited impact on domestic prices, given that supply side constraints in world markets have kept international prices high. As per a Food and Agriculture Organisation (FAO) report, with strong demand and utilisation needs higher than the overall cereal production in 2007, there has been a steep fall in global stockpiles of cereals. Thus, supply side constraints are expected to persist at least in the short term, putting an upward pressure on prices of food articles. We expect WPI inflation to average at around 7.2-7.4% during Apr-08.

Money & Finance

We expect a status quo to be maintained on interest rates

A moderation in industrial output growth, higher commodity prices and weak global markets continued to dampen the sentiment in domestic stock markets. The BSE Sensex declined by almost 11% since the end of Feb 08 (during the period 29-Feb-08 to 10-Apr-08). With global investor risk aversion to emerging markets increasing, the domestic stock markets witnessed net FII outflows amounting to US$ 0.17 bn. However, with a further reduction in the US benchmark rate by 75 basis points, some amount of foreign funds should continue to flow inward in the near future.

Monetary Indicators

	FY07	Jan-08	Feb-08	Mar-08
M3*	21.3	23.8$	21.15^	20.7#
Bank Credit*	28	22.5$	21.8^	21.6#
Non food Credit*	28.4	23.1$	22.4^	22.3#
Prime lending rate (%) (Min-Max.)	10.25-12.5	12.75-13.25	12.25-13.00	12.25-12.75
5 year G-sec yield (%)	7.9	7.5	7.6	7.62
Inflation (%)	5.4	3.95	4.76	6.75

**Figures are percentage Y-O-Y growth; $ As on Jan 18, 2008*
^As on Feb 29, 2008; #As on Mar 28, 2008
Source: RBI

Higher interest rates have resulted in a significant slowdown in bank credit to 21.6% (as on 28-Mar-08) as compared with near 30% levels witnessed during the corresponding period of the previous year. With inflation rising far above the RBI's threshold limit of 5%, a cut in interest rates can be ruled out. At the same time, with the slowdown in real economic activity, the possibility of a hike in rates is also low. We expect a status quo to be maintained on interest rates. The RBI has already opted to raise the CRR by 50 basis points in two phases, effective 26-Apr-08 and 10-May-08.

In the G-sec market, rising inflation rates and expectations of an increase in government borrowing in order to meet the Sixth Pay Commission recommendations resulted in the firming up of yields. The yield on the ten-year benchmark gilt rose to 7.91% on 28-Mar-08, up by 35 basis points as compared to 29-Feb-08. 15-91 day Treasury bill yield were in the range of 6-7.3% during the week ended 28-March-08. We expect 15-91 day T-bills yield to be in the range of 6.9-7.1% in Apr-08.

External Sector

CAD widens despite high net invisibles surplus

The appreciation of the rupee by almost 8.34% during Apr-Feb FY08 has adversely affected export realisations - evident from the divergence between exports growth in dollar terms and in rupee terms. While exports in dollar terms grew by 22.9% during the Apr-Feb FY08 period, in rupee terms, exports grew by just 8.9% during the same period. The decline in export earnings has affected a large number of exporters from sectors such as textiles & garments, agricultural products, engineering goods and chemicals. In order to soften the impact of rupee appreciation on exports, the Central Government announced an extension of certain incentives under the Annual Supplement 2008 to Foreign Trade Policy. Further, the exports target of US$160 bn for FY08 is unlikely to be achieved, given that exports would have to grow by as much as 68% during the month of March in order to attain this target. During the Apr-Feb FY08 period, exports (in dollar terms) have grown by an average of 22.9%. Imports, on the other hand, grew at a higher rate of 30.2% during Apr-Feb FY08. As a result, the trade deficit widened to US$ 72.47 bn during Apr-Feb FY08 as compared with US$ 49.32 bn during Apr-Feb FY07. The upsurge in the merchandise trade deficit, in turn, resulted in a substantial increase in the current account deficit for Q3 FY08 to US$ 5.4 bn (as compared with US$ 3.7 bn in Q3 FY07), despite a high net invisibles surplus emanating from high NRI remittances and software export revenues. Net capital inflows, arising primarily from External Commercial Borrowings (ECBs) and portfolio investment more than doubled to US$ 81.9 bn during Q3 FY08. In the forex market, an increase in oil importer-led dollar demand amidst surging global oil prices resulted in a fall in the value of the rupee to as low as 40.77/US$ on 17-Mar-08. We expect the rupee to remain in the range of 39.90-40.10 to a US$ during the month of Apr-08.

Highlights of Annual Supplement 2008 to Foreign Trade Policy (2004-09)

- Export target for FY09 set at US$ 200 bn
- Duty entitlement passbook scheme (DEPB) extended till May 2009
- Income tax benefit to 100% EOUs available under section 10B of Income Tax Act extended for one year, beyond 2009
- Interest rate subvention to sectors affected by rupee appreciation and to SMEs extended for one more year
- The custom duty payable under Export Promotion Capital Goods Scheme (EPCG) reduced from 5% to 3%

Source: Ministry of Commerce

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