



Decide with Confidence

Dun & Bradstreet

ECONOMY OBSERVER

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View from the top

In its quarterly review of the 2007-08 monetary policy, the RBI has raised the cash reserve ratio (CRR) by 50 basis points to 7% and terminated the cap of Rs 30 bn on absorption of liquidity from the banking system through the Reverse Repo window, which had been in place since Mar 07. It has left its benchmark Repo and Reverse Repo rates unchanged.

The steps are on the expected lines, with a clear focus on liquidity management so as to ensure that excess liquidity does not result in inflation. The hike in the CRR is expected to lead to an outflow of close to Rs 160 bn from the banking system. The removal of the cap on the Reverse Repo window will lift the overnight call money rates from the sub-1% levels prevailing for over two months.

Policy measures during 2007

Date	Reverse Repo Rate	Repo Rate	CRR
31-Jan-07	6%	7.50% 25 bp	5.50%
13-Feb-07	6%	7.50%	6.00% 50 bp in 2-stages
30-Mar-07	6%	7.75% 25 bp	6.50% 50 bp in 2-stages
24-Apr-07	6%	7.75%	6.50%
31-Jul-07	6%	7.75%	7% 50 bp

Source: RBI

The earlier CRR hikes had resulted in banks instantly raising their prime lending rates. However, unlike earlier occasions, the current CRR hike might not trigger lending rate increases as banks are flush with liquidity even after the outflow. Banks might however realign deposit rates to neutralise the CRR hit. Some of the major banks have already announced cuts in their peak deposit rates.

With the two measures, an absolute reduction in liquidity is inevitable. Consequently, short term market interest rates that were showing distinct signs of softening may well stop their decline, and even firm up a little.

Rise in domestic short term market interest rates will however further increase the difference between Indian interest rates and international rates. Even though the RBI has been intervening in the currency market to contain its appreciation and the Government has put up stiff restrictions on overseas borrowings, a higher arbitrage possibility and consequently greater inflow of foreign funds into India will increase the prospects of the rupee hardening further. This along with a general weakness of the US Dollar against major international currencies will call for the RBI's continued presence in the currency market to contain any major appreciation.

Key Economic Indicators

	Forecast	Latest Period	Previous Month
W.P.I	4.5 - 4.8%(Aug-07)	4.4%(July-07)	4.3%(June-07)
IIP Growth	9.50%(July-07)	9.8%(June-07)	11%(May-07)
91-day-T-Bills	6.5 - 7%(Aug-07)	4.5%(July-07)*	7.4%(June-07)*
INR/US\$	40.20 - 40.50(Aug-07)	40.42(July-07)	40.77(June-07)

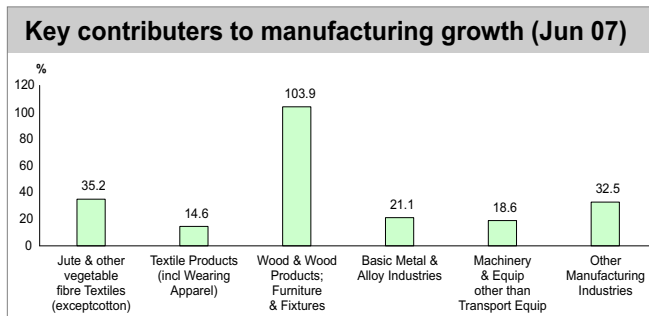
all figures are monthly averages, (y-o-y)
* end of the month

Real Economy

Industrial production growth slows down

Agricultural output is likely to witness an impressive growth in the current financial year, given the satisfactory progress of the South-West monsoons; the cumulative rainfall during the 2007 season (up to July 25) was 4% above normal as compared with 14% below normal during the year-ago period.

The industrial sector is however beginning to feel the pinch of higher interest rates. This is evident from the slowdown in industrial growth for the third month in a row in June; the Index of Industrial Production registered a growth of 9.8% (y-o-y) in Jun 07 as against 10.9% in May 07. Weak consumer demand and rising input costs has forced many manufacturers, particularly in the auto sector, to scale down production. The recent appreciation of the rupee vis-à-vis the US Dollar has dented external demand as well. As a result,



Source: CSO

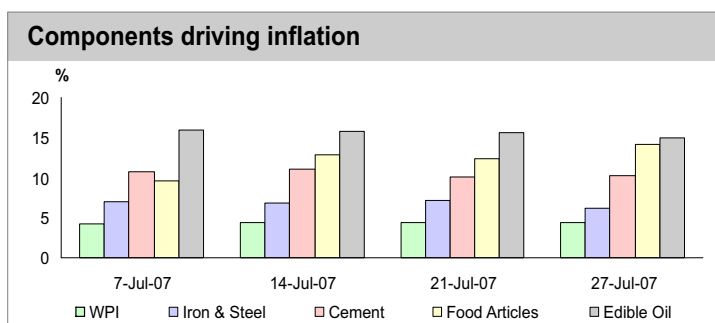
the manufacturing sector witnessed a slowdown in growth to 10.6% in Jun 07 from 11.7% in May 07. Within the manufacturing sector, growth in consumer goods decelerated to 4.2% with consumer durables growing by a mere 0.7%. Corporate profitability seems to have decelerated in recent months as high interest rates, higher input costs and an appreciating rupee have weighed down the performance of the sector.

However, production data points toward continued buoyancy in investment activity; the production in the capital goods sector grew by a remarkable 29% in Jun 07. Machinery and Equipment (excluding transport equipment) grew by an impressive 18.6% during the same period. We expect growth in industrial production to further decelerate to 9.5% in Aug 07 as the impact of higher interest rates on credit demand becomes more pronounced.

Price Scenario

Inflation within targeted range: Risks persist

Recognising the persistence of upward pressures on inflation, the RBI in its quarterly review has reiterated its commitment towards containing inflation within 5% during FY08. With money supply in the economy growing at rates (around 21%) much higher than the targeted rate of 17.5%, the focus of the policy review is on liquidity management, so as to ensure that excess liquidity does not create inflationary demand pressures. Data on domestic inflation, as measured by the WPI, indicate that supply side constraints have also continued to play a role in raising price levels.



Source: Ministry of Commerce

As per the latest WPI data, inflation for the week ended 27-Jul-07 rose by 4.45% mainly driven by a rise in prices of food articles and some manufactured products. While prices of food articles have gone up by as much as 9.1% y-o-y, prices of cement and edible oils have increased by 10.2% and 14.9%. Consumer inflation, as measured by the CPI, is rising faster than the WPI since these products tend to form a bulk of the consumer's consumption basket. The CPI (IW) stands at 5.69% for the month of June 07 while the CPI (AW) stands at 7.8%. Although consumer inflation seems to have moderated as compared with previous months, it could rise again in the months to come.

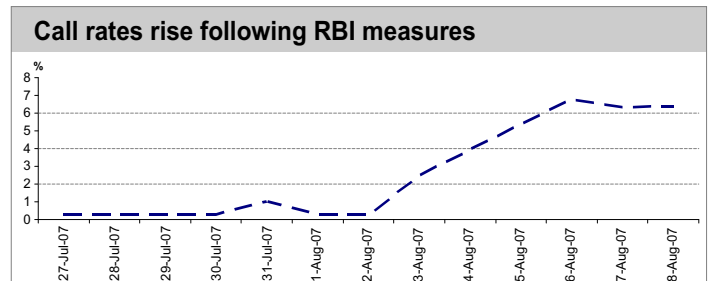
Given the policy measures taken by the RBI and the Government to absorb excess liquidity and the reiterated commitment towards inflation management, WPI inflation is expected to continue to remain within the targeted band in the short term. However, supply side constraints, particularly as reflected in higher prices of food articles (both domestic as well as global) and higher international crude oil prices along with excess liquidity, pose a risk to the inflation outlook. We expect the WPI to average at around 4.5-4.8% in Aug 07.

Money & Finance

Call rates stabilise

With growth in money supply at 21.7% (as of 20-Jul-07) - much higher than the targeted rate of 17.5%, liquidity management continues to be at the forefront of the RBI's monetary stance. The RBI, in its quarterly monetary policy review, has hiked the Cash Reserve Ratio by 50 basis points to 7%, thereby sucking out about Rs 160 bn from the money market. It has also withdrawn the ceiling of Rs 30 bn from the daily Reverse Repo auction.

The measures taken at the policy review are expected to stabilise overnight rates and keep these rates within the LAF corridor. Call rates which had fallen to below 1% levels during the weeks prior to the policy review rose to 6% levels following the removal of the ceiling on the reverse repo auction on 6-Aug-07.



Source: RBI

Foreign exchange reserves have increased by almost US\$ 26 bn during Apr-Jul 07, which is about half of the entire reserve accretion during FY07. The measures announced by the Central Bank may strengthen interest rates in the economy and the consequent rise in interest arbitrage opportunities could further increase foreign fund inflows in coming months. Strong foreign fund flows on all accounts FDI, FII, and ECBs has enhanced liquidity levels in the system and put upward pressure on the rupee. The RBI's intervention in the forex market, in order to keep a check on the rising rupee, has in turn, increased the supply of rupees in the market.

15-91 day Treasury bill yields have been hovering around the 1.3-4.5% range during the month of July. In view of the recent policy announcements and the subsequent decline in liquidity levels, we expect short-term interest rates to tighten and average at around 6.5-7% in Aug 07.

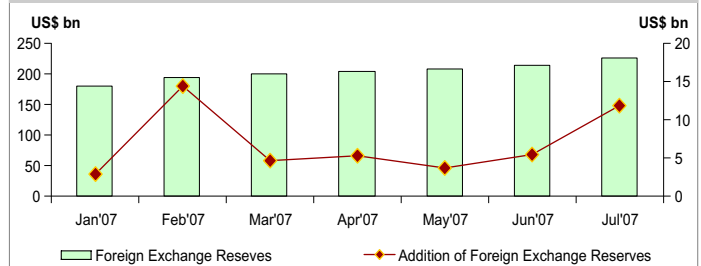
External Sector

Growth in exports continues to decelerate

The impact of the rupee's appreciation on India's export competitiveness was further evident with the release of export data for Jun 07; exports slowed down to 14% (y-o-y) in Jun 07 as compared to 18% in May 07. Imports, however, grew by 37% in Jun 07 (y-o-y) as against 26% in May 07. The resultant trade deficit for Apr-Jun 07 was estimated at US\$ 20.6 bn as against US\$ 11.8 bn in the year-ago period.

Aided by sustained capital inflows, the rupee touched a nine-year intra-day high of 40.20 towards the end of Jul 07. The RBI has expressed its concern towards rupee appreciation by actively intervening in the currency market via dollar purchases. The RBI bought US\$ 4.43 bn in May 07 and a further US\$ 3.2 bn in Jun 07, taking the cumulative dollar purchases to US\$ 9.7 bn during Apr-Jun 07. In effect, forex reserves increased by US\$ 12 bn (m-o-m) to US\$ 225 bn in Jul 07. Another move towards stemming the currency appreciation has been the imposition of capital controls to reduce dollar inflows. ECBs above US\$ 20 mn have now been allowed only for foreign currency expenditure for permissible end-uses and are required to be parked abroad. Lately, External Commercial Borrowings (ECBs) and FDI have been a major source of accretion to foreign exchange reserves. Net overseas borrowings by Indian companies climbed almost six-fold to US\$ 16.1 bn in FY07 as against US\$ 2.7 bn in the previous fiscal. We expect the average value of the rupee to average at around 40.20 - 40.50 during Aug 07.

Forex reserves piling up



Source: RBI

Please send your feedback to Yashika Singh - Leader, Economic Analysis Group

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