



Decide with Confidence

Dun & Bradstreet

# ECONOMY OBSERVER

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With inflation touching the 12% mark for the week ended 26-Jul-08, price control would continue to remain the key concern for policy makers in the months to come. The surge in global oil prices led to the increase in domestic fuel prices, exerting upward pressure on prices of other commodities. Given that the second round impact of hike in domestic fuel prices is yet to unfold, headline inflation is likely to surge further.

In view of the sharp rise in the domestic inflation and money supply continuing to grow far above the RBI's target level, the RBI reiterated its monetary tightening stance in the first quarter review of monetary policy. In line with D&B expectation, the RBI increased the repo rate by 50 basis points to 9% (with effect from 29-Jul-08) and CRR by 25 basis points to 9% (effective from the fortnight beginning 30-Aug-08). While the full impact of the inflation control measures undertaken by the RBI and the Government will be realised after December 2008, growth in industrial output has already displayed some signs of moderation.

High interest rates coupled with rising input costs adversely impacted the profit margins of corporates – as was evident from the Q1 results of some of the companies. Overall, industrial growth – measured in terms of IIP - during the first quarter of FY09 averaged at 5.23% as compared with an average growth of 10.28% during the corresponding quarter of the previous fiscal. Against this backdrop, the recent hike in key policy rates will exert further pressure on bank's lending rates, thereby raising the costs of investible funds. Further, high interest rates would have a dampening impact on demand in interest sensitive sectors. Rising input costs and falling profit margins along with the moderation in demand (particularly in interest sensitive sectors) may lead to deferment of capacity expansion plans by domestic companies. As such, growth in capital goods sector has already begun to witness a significant decline on account of fall in investment demand.

Further, growth in six core infrastructure industries witnessed significant moderation during the current fiscal – as is evident from an average growth of 3.5% during Q1 FY09 vis-à-vis 6.4% during Q1 FY08. Going forward, a decline in growth of infrastructure sector coupled with a reduction in capacity expansion by the domestic companies could possibly weigh down the overall economic growth.

### Dun & Bradstreet's Macro Economic Forecasts

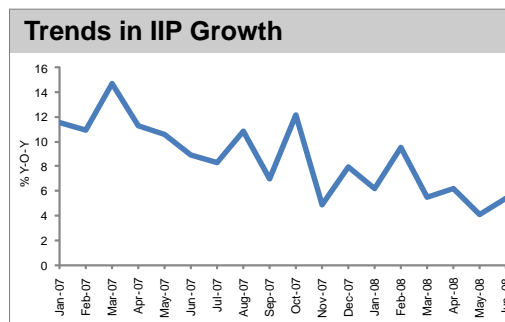
	FORECAST	ACTUALS	
		Latest Period	Previous Month
<b>Inflation (W.P.I)</b>	12.20%-12.40%(Aug-08)	11.95%(Jul-08)	11.49%(Jun-08)
<b>IIP Growth</b>	5.00%-6.00%(Jul-08)	5.41%(Jun-08)	4.07%(May-08)
<b>15-91-day T-Bills</b>	8.90%-9.10%(Aug-08)	8.68%(Jul-08)	7.46%(Jun-08)
<b>INR/US\$</b>	42.20-42.40(Aug-08)	42.84(Jul-08)	42.82(Jun-08)

*All figures are monthly averages*

## Real Economy

### Industrial production growth slows down during Q1 FY09

Data for Index of Industrial Production (IIP) and core infrastructure industries for the month of Jun-08 corroborates the adverse impact of high interest rates and rising raw material costs on industrial production. While the IIP grew at a lower rate of 5.41% during Jun-08 as compared to 8.9% during Jun-07, the index of six core infrastructure industries grew merely by 3.4% during Jun-08 as compared to 5.2% in Jun-07. Infact, the growth in IIP has almost halved to average at 5.2% during Q1 FY09 as compared to 10.3% during Q1 FY08, indicating a moderation in the growth momentum during the current fiscal. The manufacturing sector, which accounts for around 80% of the total IIP basket, grew merely by 5.9% during Jun-08 as against 9.7% during Jun-07.



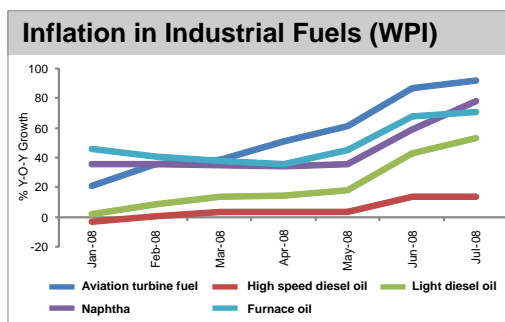
Source: CSO

As per use-based classification, the growth of consumer non-durables (12.24%) gained momentum, taking the growth in consumer goods sector to double-digit level of 10.04% during Jun-08. The consumer goods sector contributed as much as 55.5% to growth in IIP. Consumer durables sector grew by 3.49% during Jun-08 as compared to -3.56% in corresponding month of the previous fiscal. The capital goods sector, however, registered a low growth of 5.61% in Jun-08, taking the average growth in production of capital goods for Q1 FY09 to 6.79% as compared to 18.79% in Q1 FY08. The declining trend in the capital goods production is indicative of moderation in investment activity across industries. This would have bearing on future industrial production and thereby economic growth. The recent hike in policy rates by the RBI has put further pressure on lending rates leading to increase in cost of capital for the corporates. This might lead to deferment of their capacity expansion plans and a further slowdown in capital goods sector. We expect IIP to have grown within the 5-6% range during Jul 08.

## Price Scenario

### Inflation breaches 12% mark

Inflation, as measured by WPI, breached the 12% mark for the week ended 26-Jul-08. Primarily driven by rising prices of manufactured products and the fuel group, inflation averaged at 11.95% during Jul-08. Elevated global oil prices continued to spur inflation in industrial fuels like Aviation turbine fuel (91.69%), Naphtha (77.82%) and Furnace oil (70.68%); causing the prices of Minerals oil to rise and contribute nearly 16.26% to the headline inflation. In fact, if we exclude the Minerals oil category from the WPI basket, the average inflation rate for Jul-08 would drop to around 9.84%.



Source: CSO

Within manufactured products, inflation in textiles, chemicals and chemical products rose substantially during Jul-08, together contributing as much as 15.51% to the headline inflation. Prices of basic metals alloys & metal products continued to surge due to rising prices of minerals like iron ore. Inflation in food products, although continuing to be at double digit level during Jul-08, witnessed some moderation on account of a downward shift in the inflation of food articles. Growth in prices of fruits and vegetables slowed down to 1.97% in Jul-08 as compared with 5.95% during the previous month. Further, the revival of monsoon which led to better prospects for kharif output helped to contain inflation in food grains (cereals, in particular) to 5.50% during Jul-08 vis-à-vis 6.18% during Jun-08.

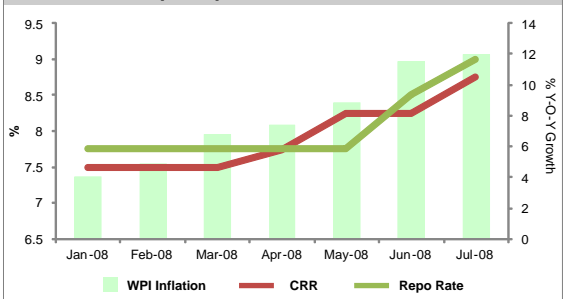
To contain building inflationary pressures, the RBI increased repo rate by 50 basis points and CRR by 25 basis points to 9% each. While these monetary tightening measures will help contain inflation expectations, given that the current rise in prices is mainly supply driven, they are likely to have only a limited direct impact on curbing inflation in the short run. Nevertheless, the fiscal measures initiated by the Government to augment supply and contain inflationary pressures are expected to yield results around December. We expect WPI to average between 12.20-12.40% during Aug-08.

## Money & Finance

### RBI announces hike in repo rate and CRR

In line with D&B expectations, the RBI increased the repo rate by 50 basis points to 9% (w.e.f. 29-Jul-08) and CRR by 25 basis points to 9% (w.e.f. 30-Aug-08). The earlier monetary tightening measures have exerted upward pressure on bank's lending rates, in effect moderating growth in bank credit to 25.80% (as on 18-Jul-08) vis-à-vis 26.26% in the previous month. The recent hike in the repo rate will lead to further increase in bank's lending rates, in turn raising the cost of investible funds. Interest rates on deposit have also increased from 8.25-9.00% (as on 20-Jun-08) to 8.75-9.50% (as on 25-Jul-08). This is likely to have a positive impact on deposit growth.

**Changes in Key Policy Rates & Inflation (WPI)**



Source: RBI

In the gilt market, the higher than expected rise in policy rates affected investor sentiment, leading the yield on the ten-year benchmark gilt to rise by a steep 33 basis points to 9.40% on 29-Jul-08. Call rates surged beyond the LAF corridor to 9.60-9.70% (on 23-Jul-08) following the cash outflow as a 25 basis point hike in CRR became effective on 19-Jul-08. 15-91 days Treasury bill yields were in the range of 7.93-9.36% for the week ended 01-Aug-08.

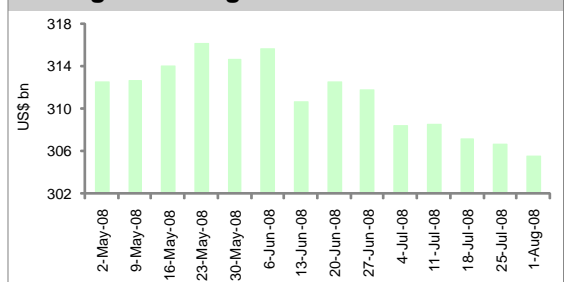
During the current fiscal, the RBI increased CRR by 125 basis points in total (excluding the recent 25 basis points hike w.e.f. 30-Aug-08), enabling the absorption of excess liquidity from the banking system. In spite of this, money supply continued to grow at 20% (as on 18-Jul-08) – far above the RBI's target. In view of the high growth in money supply and rising domestic inflation, we expect further policy rate hikes in the forthcoming monetary policy announcement. We therefore expect 15-91 days Treasury bill yields to remain high in the 8.90-9.10% range during Aug-08.

## External Sector

### Forex reserves deplete by US\$ 10.2 bn

Sharp rise in imports amidst surging global oil prices widened the trade deficit to US\$ 30.4 bn, in Q1 FY09, 41.7% higher than the US\$ 21.5 bn in Q1 FY08. However, the trade deficit narrowed slightly to US\$ 9.8 bn during Jun-08 (vis-à-vis US\$ 10.8 bn during May-08), on account of an impressive growth in exports and some moderation in the growth of non-oil imports. Exports in dollar terms grew substantially by 23.5% (y-o-y) during Jun-08, as compared to 12.9% (y-o-y) in May-08. In rupee terms as well, exports grew impressively by 29.7% (y-o-y) in Jun-08 as compared to 16.6% (y-o-y) in May-08, indicating the positive impact of rupee depreciation. While rising international oil prices

**Foreign Exchange Reserves**



Source: RBI

caused the oil imports to grow by 53.4% during Jun-08, growth in overall imports (in dollar terms) slightly moderated to 25.9% (y-o-y) as compared to 27.1% (y-o-y) in May-08. This was due to the moderation in growth of non-oil imports to 13.9% in Jun-08 as against 17.4% (y-o-y) in May-08. With international crude oil prices beginning to descend, growth in the value of oil imports is likely to moderate.

Further, in the wake of moderation in international crude oil prices (owing to the slowdown in US oil demand) the demand for dollar has moderated, leading to the appreciation of rupee against USD during Jul-08. Rupee appreciated by almost 2% to 42.4 per USD on 12-Aug-08 as compared to 43.27 per USD on 01-Jul-08. Foreign exchange reserves declined by almost US\$ 10.2 bn to US\$ 305.47 bn as on 1-Aug-08 as compared to 315.7 bn as on 6-Jun-08. This could be partially attributed to FII outflows from the equity markets. FIIs have been net sellers in equities to the tune of US\$ 2.34 bn during this period. Given the moderation in oil-importer led dollar demand backed by moderating international crude oil prices we expect the rupee to remain in the range of 42.20-42.40 to a US\$ during the month of Aug-08.

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

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