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Dun & Bradstreet

# ECONOMY OBSERVER

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In line with D&B's forecast, GDP is expected to grow by 8.7% during FY08 as compared with a growth of 9.6% in the previous year. A decline in demand due to higher interest rates and the appreciation of the rupee are expected to result in a moderation in economic growth during FY08. The impact of a tight monetary policy on consumer demand is also expected to be displayed by way of a decline in contribution of consumption to GDP to 67.1% from 68.4% in the previous fiscal and 70.2% in FY06. There is however evidence that growth is becoming increasingly investment-led. The contribution of investment to GDP is estimated to have risen to 32.6% in FY08 from 30.6% in FY07. Further, industrial production data shows an increase in capital goods production growth; the capital goods sector grew by 20.2% during Apr-Dec 08 as compared with 18.6% in the previous year. We expect industrial growth to remain in the 7-8% range during Jan 08 and growth in GDP to moderate to 8.5% during Q3 FY08.

On the monetary front, non-food credit offtake has declined to 22.6% (as on 25-Jan-08) from 30% levels witnessed at the beginning of this fiscal. However, with the increasing interest rate differential between India and the US, strong capital inflows have followed, pushing money supply to as high as 23.8%. With the 125 basis points cut in the US Fed rate (during Jan 08), real interest rates in the US have turned negative. In such a scenario, we do expect foreign fund flows to continue; the quantum of flows, however, will depend on the risk appetite of global investors given the current dampened sentiment in global markets.

However, despite the US Fed rate cut, the RBI maintained a status quo on policy rates in its credit policy review on fears of increasing inflationary pressures. The WPI has started to inch upwards and has crossed the 4% mark during the week ended 26-Jan-08. The fuel group, which had been witnessing deflation or a marginal rise in prices during the current fiscal until November contributed 13.7% to the increase in WPI during Jan 08, primarily due to a rise in prices of industrial fuels. An upward revision in administered prices of fuels such as petrol and diesel is expected in the near future. Further, high international prices of certain commodities as well as global crude prices will exert inflationary pressures on domestic prices. Therefore, inflation management will be at the forefront of the RBI's monetary policy during the next few months.

### Dun & Bradstreet's Economy Forecast

	FORECAST	ACTUALS	
		Latest Period	Previous Month
Inflation (W.P.I)	4.00%-4.20%(Feb-08)	3.91%(Jan-08)	3.53%(Dec-07)
IIP Growth	7.00%-8.00%(Jan-08)	7.62%(Dec-07)	5.06%(Nov-07)
15-91-day T-Bills	6.80%-7.00%(Feb-08)	6.74%(Jan-08)	7.40%(Dec-07)
INR/US\$	39.40-39.60(Feb-08)	39.37(Jan-08)	39.44(Dec-07)

*All figures are monthly averages*

## Real Economy

### We expect GDP growth to moderate to 8.5% during Q3 FY08

Mounting pressures of high interest rates and an appreciating rupee, which led to a slowdown in demand, coupled with high input costs have weighed down the Indian economy as is manifested in the growth estimates of 8.7% (AE) for FY08. This indicates a considerable moderation in the growth momentum, especially in comparison with the recent upward revision of GDP growth estimates for FY07 to 9.6%.

% Contribution to GDP			
	2005-06	2006-07	2007-08E
Consumption	70.2	68.4	67.1
Investment	29.2	30.6	32.6
External Sector	-2.8	-4.2	-4.1
Others	3.5	5.1	4.4

*All figures are calculated at constant prices  
Source: CSO*

Despite favourable monsoons, a decline in the area sown under rabi crops seems to have contained agriculture growth to 2.6% in FY08. It is the 12.1% growth of trade, hotel, transport & communication sector that drove the services sector growth to 10.7% in FY08. Industry experienced a considerable slow down and is estimated to grow by 8.9% during FY08.

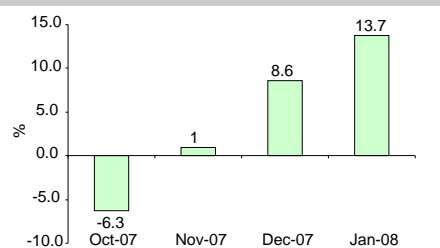
In the current scenario of moderating growth, consumption has slowed due to the elevated level of interest rates and investment has displayed a robust performance - as is reflected in its rising contribution to overall growth in real GDP during the past few years. Although tight monetary conditions led to a decline in the share of consumption in overall GDP in FY08, investment remains strong, reaffirming the sustainability of the growth momentum. A robust investment cycle and capacity building is evident in the 16.6% growth in IIP for capital goods sector during Dec 07. An overall IIP growth of 7.6% in Dec 07, though lower than last year, is an improvement over Nov 07. The double digit growth of 10.6% by the consumer non-durables sector led the consumer goods sector to grow at 8.7% and contribute around 35% of the increase in IIP growth in Dec 07. Given the current domestic scenario of high interest rates, a strong rupee and lower export realisations, we expect growth in IIP to remain in the range of 7-8% during Jan 08. Further, we expect GDP growth to have moderated to 8.5% during Q3 FY08.

## Price Scenario

### Inflation crosses the 4% mark

Inflation, measured by the Wholesale Price Index, has started to inch upwards and has breached the 4% mark, for the first time in four months. A rise in prices of manufactured products coupled with increasing domestic fuel prices spurred inflation for the week ended 26-Jan-08 to 4.11%. A closer look at the data reveals that prices of the unregulated industrial fuels such as naphtha, bitumen, furnace oil, etc, have been on the rise since Nov 07. Industrial fuel prices increased, on an average, by more than 30% during Jan 08. As a result, fuel group prices contributed 13.7% of the total increase in the inflation in Jan 08 as compared with a contribution of 8.6% in Dec 07.

#### Rising Contribution of Fuel Group to Inflation



*Source: Ministry of Commerce and Industry*

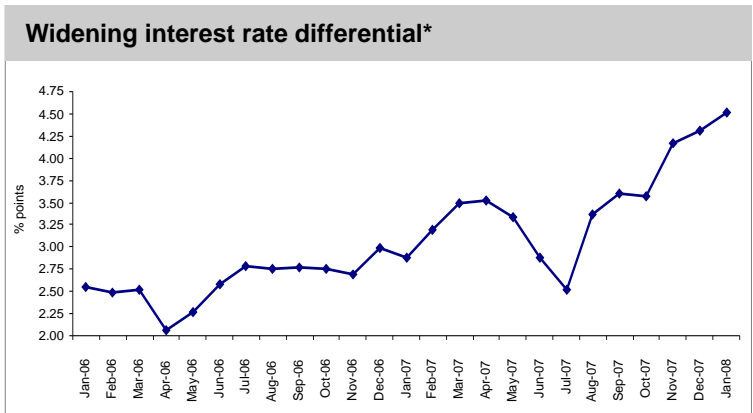
The manufacturing group, which accounts for almost two-thirds of the WPI basket witnessed a 3.95% increase in prices during Jan 08. Within the manufacturing group, high edible oil and oil cake prices pushed inflation in the food products group, to 5.58%. Prices of primary articles, on the other hand, continued to moderate and stood at 3.94% in Jan 08, down from 4.41% in the previous month. This group's contribution to overall inflation, (WPI stood at 3.91% during Jan 08), has declined to 22% from 26.8% in the previous month.

Containing inflation will be at the forefront of the RBI's monetary policy due to the following: high international prices of commodities such as edible oil and wheat are expected to exert inflationary pressures on domestic prices; domestic fuel oil prices which are largely regulated have not yet felt the full pass-through of high global crude oil prices and an upward revision in petrol and diesel prices is expected in the near future; money supply continues to grow at higher than targeted rates. We expect WPI inflation to average at around 4.0-4.2% during Feb 08.

# Money & Finance

## We continue to expect a hike in the Cash Reserve Ratio

In response to a scenario of rising inflationary pressures, the RBI, in its credit policy review, maintained a status quo on its key rates, despite the successive rate cuts by the US Federal Reserve. International prices of certain commodities such as wheat, edible oils as well as fuel prices are high and are expected to exert pressures on domestic prices in the near future. Further, money supply continues to grow at 23.8% (as of 18-Jan-08), far above the RBI target rate of 17.5%. Strong capital inflows, spurred by the increasing US-India interest rate differential have resulted in increased liquidity levels in the market over the last couple of years.



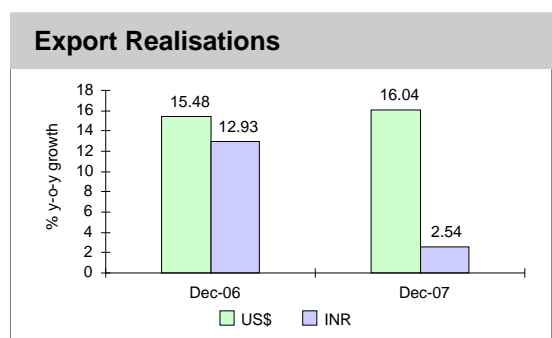
\* Difference between Yields on the 5 Year US G-sec and 5 Year India G-sec  
Source: RBI; US Federal Reserve

However, in the last month, concerns over the impact of the US sub-prime crisis and the possibility of a US recession, dampened the sentiment in global stock markets. Domestic stock markets also witnessed FII outflows amounting to as much as US\$ 3.23 bn and the BSE Sensex declined by as much as 13.06% in January 08. With the reduction in the US benchmark rate by 125 basis points, the interest rate differential has widened even further and US real interest rates have turned negative. We could therefore expect more capital inflows in the near future; however, the extent of flows would depend on the risk appetite of global investors in the current scenario. With the sustained high growth in money supply, we continue to expect the RBI to hike the Cash Reserve Ratio in the near future. 15-91 day Treasury bill yield were in the 6.2-7.4% range during the month of January. We expect 15-91 day T-bills yields to average at around 6.8%-7.0% in Feb 08.

## External Sector

### Rupee to remain in the range of 39.4-39.6 to a US\$

The impact of the rupee appreciation continues to display itself in the increasing divergence between export realizations in rupee terms and in dollar terms. Although, exports in dollar terms grew by 16.04% (y-o-y) in Dec 07, in rupee terms, exports grew by a mere 2.54% as compared with 12.9% in Dec 06. At the same time, the growth of imports slowed down to 18% (y-o-y) as compared to 26% in Dec-06 driven primarily by a significant moderation in the growth of non-oil imports, which grew by just 15.34% in Dec-07 as against 31.81% in the corresponding month of the previous year. As a result, the trade deficit widened to US\$ 57.82 bn during Apr-Dec 07 as compared to US\$ 42.85 bn during Apr-Dec 06.



Source: Ministry of Commerce

The rupee did not make significant gains during Jan 08 owing to RBI intervention in the forex market at regular intervals and a weak trend witnessed in domestic stock market. Although domestic stock markets witnessed net FII outflows during Jan 08, we expect this to be temporary and that capital inflows will continue. The RBI will therefore continue to intervene in the forex market, at regular intervals. We expect the rupee to remain in the range of 39.4-39.6 to a US\$ during the month of Feb 08.