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Dun & Bradstreet

# ECONOMY OBSERVER

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## View from the top

The signals from the macroeconomic data seem to point towards the possibility of no change in key interest rates in the upcoming quarterly credit policy review by the RBI scheduled for July 31st.

With clear focus to control inflation, the RBI increased its key rates three times since December last year. Various measures taken by the RBI and the government to dampen credit availability and spending have started yielding results and more rate rises may not be needed if this trend continues.

Consequent to the impact of hardening interest rates, as reflected in slower credit off take, overall industrial production growth in the economy though still robust, has moderated a little. The buoyancy in manufacturing, especially consumer durables that has been visible over the last couple of years show distinct signs of easing down.

With inflation rates contained in the targeted range and moderating industrial production numbers, the scales are tilted in favor of maintaining the status quo on monetary policy.

The only reason for a tighter stance could be to curb the surge in liquidity levels in the economy. The money supply growth rate is much above the targeted range and the current liquidity build up in the economy could breed inflationary expectations in coming months.

However, the current liquidity levels are mainly driven by large foreign funds inflow and RBI's intervention in foreign exchange market. In this context, a rate hike will not be an effective measure to curb the money supply growth rate. Any rise in interest rate will induce further capital inflows seeking arbitrage advantage due to larger interest rate differentials and might not help in mopping up the surplus liquidity. Besides with call money rates plummeting to below 1% level, it will further widen the current deviation between the money market rates and the policy interest rates thus weakening the ability of the RBI to influence money supply levels.

We thus expect the RBI to keep its main policy rates unchanged though some policy tightening later in the year cannot be ruled out at this moment.

### Key Economic Indicators

	Forecast	Latest Period	Previous Month
W.P.I	4.5%(July-07)	4.3%(June-07)	5.15%(May-07)
IIP Growth	10.5%(June-07)	11.1%(May-07)	12.4%(Apr-07)
91-day-T-Bills	7.0-7.5%(July-07)	7.4%(June-07)*	7.6%(May-07)*
INR/US\$	40.7-40.9(July-07)	40.77(June-07)	40.78(May-07)

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

## Real Economy

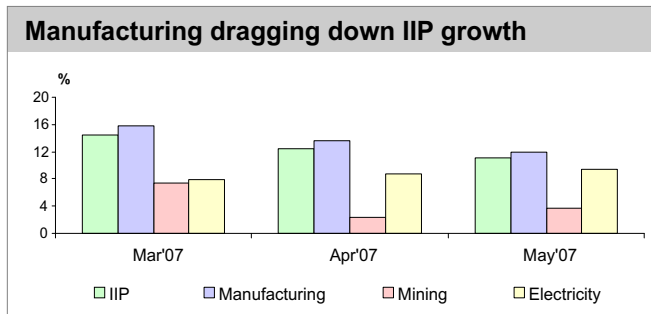
### Rate hikes are beginning to work

The impact of RBI's monetary tightening is beginning to show in a significant deceleration in consumer durables production which saw overall industrial growth decline. The Index of Industrial Production for May 07 slowed down to 11.1% from 12.4% in Apr 07. Though still robust, this moderation in industrial production was primarily owing to a slowdown in manufacturing growth to 11.9% as against 13.67% in the previous month. Lower consumer goods spending in the face of higher interest rates was evident in the consumer durables sector, which recorded a significantly lower growth of 2.6% in May 07 as against 17.5% in the year-ago month.

There is however some encouraging indication that growth is becoming investment-led. Output of capital goods rose 23% in May 07 higher than the 21.4% growth in the same month last year. The index of infrastructure industries also grew by 8.7% in May 07 compared to 7.2% in the same month last year.

Slower growth in consumer durables production, which has strong forward linkages with other sub sectors, could indicate slower growth in industrial production in the coming months. Declining exports growth rates and higher interest rates could moderate overall industrial demand in the economy. Any further buoyancy in industrial production will be determined largely by interest rate stance taken by the RBI.

We expect the IIP to register a growth rate of around 10.5 % in June 07.

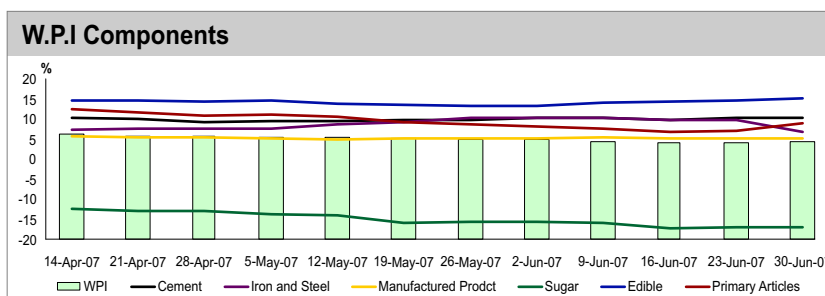


Source: CSO, D&B Research

## Price Scenario

### Inflation levels stay in the targeted range

RBI's monetary policy, government's fiscal policies and domestic currency strength has helped in moderating inflationary pressures in the economy. Though inflation as measured by the Wholesale Price Index has inched up a little to 4.27% (for the week ended 30-Jun-07) for the second consecutive week, after witnessing a decline for almost two months, it is well within the targeted range of 4-4.5%.



Source: RBI, D&B Research

While the demand side pressures have moderated following monetary measures, rise in prices of food and primary articles show that supply side constraints still persist. Prices of food articles have registered a growth rate of 7.7% y-o-y. Prices of certain key commodities such as cement, iron & steel and edible oils have also risen significantly by 10.3%, 6.7% and 15% respectively.

The current inflationary trend is affecting retail prices more than the wholesale prices as it is concentrated in essential commodities and thus might fuel inflationary expectations. The Consumer Price Index for Industrial Workers (CPI-IW) growth rate stood at 6.61% in May 07 while the CPI-AL grew by 8.2% during the same month.

Inflation is expected to continue to remain in the targeted band in coming months as various measures taken by the RBI and the government should yield results, and given the high base effect of the previous year. However monetary policy can only target demand side pressures on inflation by dampening aggregate demand; supply side concerns, particularly about prices of primary articles and rising international crude oil prices, continue to pose a risk. Given that international prices of certain commodities like edible oil and wheat are also high, inflationary pressures on these commodities is likely to continue in the near future.

We expect the WPI inflation rate to average at around 4.5% in July 07.

# Money & Finance

## Credit off take slows down

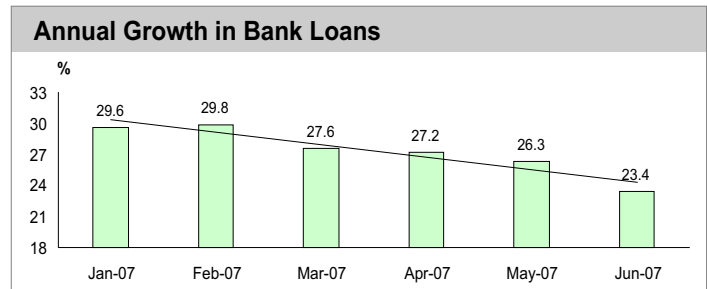
The impact of monetary measures taken by the RBI to curtail credit availability and spending in the economy has started showing. Bank credit growth rate has declined to 23.4% y-o-y (as of 29-Jun-07) from 30% levels witnessed during the early part of the year. The credit-deposit ratio has also declined to 70.83% compared to 74% at start of the year.

Continued strong foreign capital inflows, largely to cash on relative interest advantage

of Indian assets, have pushed up the liquidity levels in the economy. Money supply growth rate has started to inch up again and stood at 21.7% for the week ending 23-Jun-07. A large part of this surge in liquidity has also been driven by RBI's intervention in the foreign exchange market to halt rupee appreciation by buying dollars.

Excess liquidity, in turn, has pushed down call rates in the inter-bank money market to less than 1% level. With the interest rate corridor of 6.0-7.75% set by the RBI's reverse repo and repo rates, there is a wide deviation between money market rates and the policy interest rate. 15-91 day Treasury bill yields have been hovering around the 5.5-7.5% range during the month of June.

We expect short-term interest rates to average at around 7.0-7.5 % in July 07.



Source: RBI

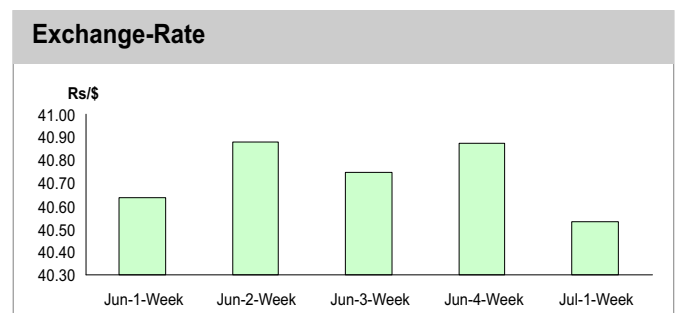
## External Sector

### INR run hits exports growth

The rise in the domestic currency to nine-year high against the dollar has started weighing in on India's exports. Exports growth rate slowed down to 18.07% in May 07, significantly lower than 23.06% growth in April 07. Imports growth rate stood at 26.36%, leaving a trade deficit of US\$ 6.21 bn. Though oil imports growth slowed down to 2.99% to US\$ 4.74 bn, non-oil imports have grown by a robust 41.58% to US\$ 13.34 bn fuelled by rapid economic growth.

The government has announced a Rs 14-bn-a-year relief package to exporters hit by sharp appreciation of the rupee, including interest rate relief, adjustment of duty drawback rates and reimbursement of export claims. The sectors worst hit by appreciation in the value of the domestic currency are IT and IT-enabled services, textiles, leather, sugar and pharmaceuticals.

Continued inflow of foreign capital, both short term and long term, and the arbitrage advantage in rupee investments following widening interest rate differentials, have led to INR appreciating against all major international currencies. Bullish market sentiments backed by equities market rising to new levels and soft USD overseas have also provided support to the rupee. The INR/USD exchange rate touched 40.48 in the first week of July 07 in spite of steady intervention by the RBI in the foreign exchange market.



Source: RBI

With moderating industrial production and decline in credit off take, exports growth might witness a further slowdown. However the consequent widening of trade deficit might restrain the rupee from sharp appreciation. RBI is also likely to maintain steady presence in the market to check any sharp rise in the domestic currency.

We expect the average value of the rupee to be in the range of 40.70-40.90 to a dollar for July 07.

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

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