Dun & Bradstreet

ECONOMY OBSERVER

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Decide with Confidence

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View from the top

With inflation surging to a 13 year high of 11.89% for the week ended 28-Jun-08 and industrial production growth for May plunging to a six year low of 3.8%, concerns over slowdown in economic growth have intensified.

Driven by continuous surge in prices of industrial fuels (which are not subsidised) and increase in the prices of petrol, diesel and LPG, the inflation rate for the month of June averaged at 11.50% – denoting 3 percentage points increase over the inflation rate in May-08. International crude oil prices rose further to cross US$ 145 per barrel during the first week of Jul-08. This unabated rise in oil prices, coupled with depreciation in the rupee could exert further pressure on prices of industrial fuels like naphtha and bitumen oil. However, with inflation at double digit level, socio-economic-political conditions make it unlikely for the Government to increase fuel prices, atleast in the near future, despite the unprecedented rise in global oil prices putting further pressure on the oil companies and Central Government finances.

In order to contain inflationary pressures, RBI increased the repo rate by 75 basis points and CRR by 50 basis points (effective in two stages) during the month of June. Given the increased cost of borrowing, few banks have already initiated a rise in lending rates. Such increase in lending rates, could lead to moderation in demand in interest sensitive sectors, particularly, real estate, auto and other consumer durables. Expansion plans of the corporate sector are also likely to be adversely impacted owing to the firming interest rates and bearish sentiments in the equity market. Although coporates can take recourse to alternative sources of raising funds such as ECBs, ADRs, GDRs etc, the extent of funds raised overseas would depend on the risk appetite of international investors.

The impact of high interest rate and firming input costs is evident from the steep fall in the growth of industrial production. Growth in capital goods sector slowed down during the first five months of 2008 and averaged at around 7.6% vis-à-vis 17.6% during the same period last year. 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 on economic growth.

Dun & Bradstreet's Macro Economic Forecasts

		ACTUALS	
	FORECAST	Latest Period	Previous Month
Inflation (W.P.I)	12.2%-12.4%(Jul-08)	11.50%(Jun-08)	8.27%(May-08)
IIP Growth	5.0%-6.0%(Jun-08)	3.8%(May-08)	6.2%(Apr-08)
15-91-day T-Bills	8.8%-9.0%(Jul-08)	7.46%(Jun-08)	6.84%(May-08)
INR/US$	43.10-43.30(Jul-08)	42.82(Jun-08)	42.13(May-08)

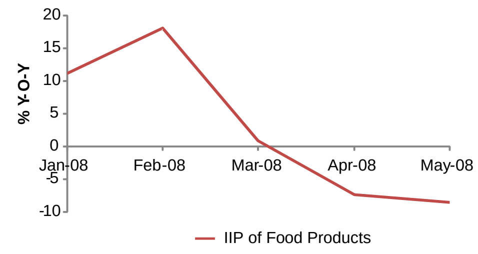
All figures are monthly averages

Real Economy

Food products pull down IIP growth by 63.7%

High interest rates, which led to a slowdown in demand, coupled with high input costs, have weighed down industrial production as is manifested in the IIP growth of 3.8% (a six year low) during May-08. Growth in IIP almost halved to average at 5% during Apr-May 08 as against an average of 10.96% in Apr-May 07. Given the subdued demand conditions, manufacturers are unable to pass on the entire increase in input costs to end-users. This has adversely impacted growth in the manufacturing sector. Production of food products and rubber, plastic, petroleum & coal products and metal products registered a negative growth rate, pulling down the growth in manufacturing sector substantially to 3.9% during May-08. The decline in production of food products pulled down IIP by as much as 63.7%.

Growth in IIP of Food Products



Source: CSO

As per the use based classification, production in capital goods sector grew by mere 2.5% during May-08. Although the sharp decline in growth of capital goods sector is primarily attributed to the high base effect (capital goods sector grew by 22.4% during May-07), deceleration in investment demand amidst high interest rate regime has also played a role in moderating growth in capital goods sector. Further, a moderation in growth of consumer durables segment (despite the low base of the previous year) is indicative of a slowdown in consumer demand in the face of high interest rates.

Given the surging global oil prices, high domestic inflation and money supply growth still beyond RBI's target, it is expected that the RBI would continue with its monetary tightening measures in order to curb demand side pressures. This is likely to affect demand in interest sensitive sectors such as auto, consumer goods, construction, etc, which in turn would lead to moderation in IIP growth. We expect IIP to grow within the 5.0-6.0% range during Jun-08.

Price Scenario

Fuel Group Inflation spurred to 16.28% during Jun 08

Inflation, as measured by WPI, surged to a 13 year high of 11.89% for the week ended 28-Jun-08 taking the average inflation for the month of Jun-08 to 11.50% – an increase of as much as 3 percentage points over May-08. With global oil prices hovering around US$ 145 per barrel, industrial fuel prices (which are not subsidised) witnessed a substantial increase, particularly of aviation turbine fuel (86.8%), Naphtha (58.74%), Bitumen (50.30%) and Furnace oil (67.89%). Further, reflecting the direct impact of the hike in administered fuel prices, inflation in LPG and petrol stood at 20.34% and 16.24% respectively during Jun-08. As a result, fuel group inflation spurred to 16.28% during Jun-08 as compared to 7.62% during May-08. In fact, when we exclude the fuel group category from the WPI basket, inflation during Jun-08 falls from 11.50% to 10.18%.

Contribution to WPI Inflation (%)

Items	Apr-08	May-08	Jun-08
Primary articles	24.64	24.21	21.54
Food Articles	10.39	10.13	9.06
Non-food Articles	9.19	10.06	9.14
Minerals	2.91	2.33	1.93
Fuel Group	13.10	13.28	21.01
Manufacturing products	62.26	62.51	57.45
Food Products	14.41	15.95	13.87
Edible oils	5.53	3.98	4.13
Oil cakes	6.01	7.47	6.69
Basic metal alloys and Metal products	23.23	20.37	16.25
Chemicals & chemical products	8.18	7.77	8.44

Source: CSO

In addition, supply side constraints in the domestic as well as international markets continued to exert upward pressure on the prices of food articles, non-food articles as well as minerals. As a result, the WPI for primary articles shot up to double digit level of 10.78% during Jun-08 as compared to 8.9% during May-08. Amongst the manufactured products prices of Basic Metal Alloy and Metal products group continued to move upwards backed by increase in prices of minerals like iron ore. The prices of edible oil and oil cakes remained elevated, contributing as much as 80% to inflation in food products. Consequently, the food product inflation increased to 13% during Jun-08 as compared to 11% during May-08.

While various measures taken by the Government and the RBI will help in containing inflation expectations, its direct impact on curbing inflation is likely to be limited as the second round impact of fuel price increase by way of rising input costs have begun to unfold. Given the continuous increase in global crude oil prices and existing supply constraints, we expect WPI to average between 12.2-12.4% during Jul-08.

Money & Finance

Call rates surge amidst tight liquidity conditions

Monetary Indicators				
	FY07	FY08	May-08	Jun-08
M3*	21.3	20.7	22.54#	20.81^
Bank Credit*	28	21.6$	25.52#	26.26^
Non food Credit*	28.4	22.3$	25.63#	26.55^
Prime lending rate (%) (Min-Max.)	10.25-12.5	12.25-12.75	12.25-12.75	12.50-12.75
Inflation (%)	5.4	4.51	8.15	11.5

Figures are percentage Y-O-Y growth
$ As on 28-Mar-08; # As on 23-May-08; ^ As on 20-Jun-08
Source: RBI

With inflation surging far above the RBI's target level, RBI announced a hike in repo rate and CRR by 50 basis points each for second time during the month (on 24-Jun-08). The hike in CRR in two tranches is expected to absorb approximately Rs 190 bn from the banking system. Given these monetary tightening measures, few banks have already announced hike in their lending rates, leading the PLR to rise by about 50 basis points to 13% as on 11-Jul-08. Despite high interest rates, credit offtake from banks displayed an increase of 26.26% as on 20-Jun-08 as compared with 25.52% during the previous month. This could be partially because of increase in borrowing by oil companies to meet oil import payments. Money Supply (M3) growth - though witnessing a marginal slowdown to 20.7% (as on 20-Jun-08) as compared with 22.5% during May-08 - is still above the RBI target rate of 16.5-17%.

High domestic inflation and the consequent monetary tightening measures taken by RBI affected the market sentiment as well. Call rates surged past 9% during Jul-08 while yield on ten-year benchmark gilt surged to 9.43% as on 10-Jul-08. Given the inflationary pressures in the economy, expectations about further hikes in the policy rates by the RBI are exerting upward pressures on bond yields. 15-91 days Treasury bill yields were in the range of 6.25-8.8% during the week ended 27-Jun-08. In the stock market, the BSE Sensex declined below 14,000 mark; registering a substantial decline of 18% during the month of Jun-08.

With inflation touching a 13-year high of 11.5% during Jun-08, price control will continue to be the over-ridding concern for the RBI. In view of unabated surge in global oil prices and money supply continuing to grow above the RBI's target level, we expect further hike in the policy rates by RBI in the forthcoming monetary policy review. With the further monetary tightening, short-term interest rates are expected to remain high. We therefore expect 15-91 days Treasury bill yields to remain in the 8.8-9.0% range during Jul-08.

External Sector

Trade deficit widens to US $ 10.77 bn

Current Account Balance (US$ bn)				
	Q1	Q2	Q3	Q4
FY07	-4.07	-6.28	-3.68	4.25
FY08	-6.30	-4.94	-5.12	-1.04

Source: RBI

In line with the continued surge in global crude oil prices, India's oil import bill rose by almost 50.8% to US$ 8.46 bn during May-08, taking the growth in total imports to 27.1%. On the other hand, exports (in dollar terms) grew by just 12.9% during May-08 as compared to 31.5% during Apr-08. The significant slowdown in exports growth could probably be attributed to the anti-inflationary measures such as export ban on certain commodities like non basmati rice, pulses etc. In rupee term, however, exports grew by 16.6% during May-08, reflecting the positive impact of rupee depreciation vis-à-vis US Dollar. Given the sharp rise in imports and moderation in exports growth, the trade deficit widened to US$ 10.77 bn during May-08.

CAD in Q4FY08 was lower at US$ 1.04 bn as compared to the earlier three quarters of FY08, owing to high net invisibles emanating from high NRI remittances and software export revenues. Nonetheless, it needs to be noted that Q4FY07 had posted a current account surplus of US$ 4.25 bn due to lower level of merchandise trade deficit. The current account deficit for FY08 increased by 78% to US$ 17.4 bn, which was 1.5% of GDP as against 1.07% of GDP in FY07. Net capital inflows, arising primarily from portfolio investment and banking capital excluding NRI deposits more than doubled to US$ 108.03 bn during FY08.

In the forex market, increase in oil importer-led dollar demand amidst surging global oil prices resulted in a fall in the value of the rupee to 43.29/US$ on 7-Jul-08. Given the global liquidity crunch and rising risk averseness of international investors, FIIs turned net sellers in equities to the tune of US$ 2.5 bn during Jun-08. FIIs outflow from the domestic equity market also weighed down the value of the rupee. Given the surging energy prices and slowdown in foreign fund inflows, we expect the rupee to be in range of 43.10-43.30 during Jul-08.

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