Dun & Bradstreet
# ECONOMY OBSERVER
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Decide with Confidence

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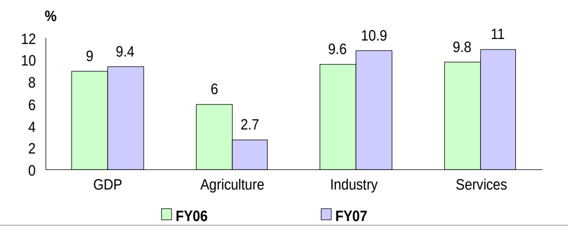
# View from the top

The Indian economy has registered an impressive growth rate of 9.4% for FY07. The per capita income in the economy has also grown at an encouraging 8.4%. Given the fact that it is largely investment led, the current GDP growth seems to be sustainable over the medium term at least.

There are also a few downside risks. Fourth quarter GDP growth numbers suggest a slight slowing down in the growth momentum compared to the previous year. In the event of low agricultural growth, prices of primary products could rise, which along with resurgence in international oil prices could lead to inflationary pressures again.

**GDP Growth**




*Source: CSO, D&B Research*

Though industrial production has continued to grow at a robust double-digit rate, sectors such as automobiles and consumer durables are already showing signs of slow-down, following the interest rate hikes. The infrastructure index growth has also slowed down in the first month of the current fiscal.

A significant development in the financial markets over the past month was the decline of the call rate to near zero level, the lowest ever. Major redemption of government bonds along with slower credit off take has led to surplus liquidity in the financial markets. After several weeks of refraining from absorbing the excess supply of foreign exchange, the RBI has reversed its position and tried to resist the appreciation of the domestic currency. However, it is sustained capital inflows that has been the main factor behind enhanced liquidity levels and the recent rupee appreciation.

The rising rupee will affect exports, especially given the composition of Indian exports which are price-sensitive and predominantly invoiced in US dollar.

**Key Economic Indicators**

| | Forecast | Latest Period | Previous Month |
|---|---|---|---|
| WPI | 4.8-5% (Jun 07) | 5.15% (May07) | 5.94% (Apr-07) |
| IIP Growth | 12% ( May 07) | 13.6% (Apr07) | 12.9% (Mar-07) |
| 91 day-T-Bills | 7.8-8% (Jun 07) | 7.6% (May07)* | 7.35% (Apr-07)* |
| INR/US$ | 40.20-40.50 (Jun 07) | 40.78 (May07) | 42.15 (Apr-07) |

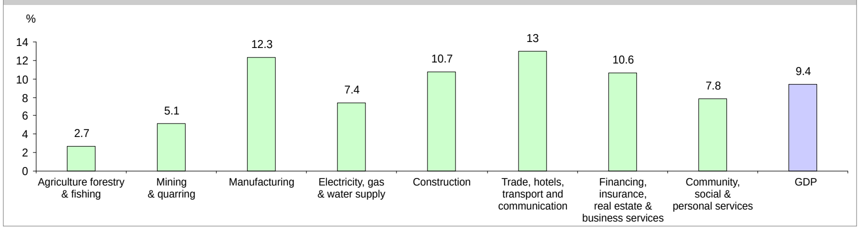
*all figures are monthly average, (y-o-y)*
** end of the month*

# Real Economy

## Economy on a strong growth path

India's annual GDP has grown by an impressive 9.4% in FY07, on top of 9% growth in FY06. Industry gave a stellar performance with a growth of 10.9%, fuelled by the manufacturing sector which clocked a 12.3% growth in FY07. Services sector too continued at high growth pace with a rise of 11% in FY07. Of the services sector, 'Trade, hotels transport and communications' registered the highest growth rate of 13% as against 10.4% in the previous fiscal. The strong GDP numbers have also translated into an 8.4% rise in per capita income (at constant prices) to Rs 22,483 in FY07 as against Rs 20,734 in FY06.

**Drivers of GDP growth in FY07**




*Source: CSO, D&B Research*

Growth in the agricultural sector however lagged behind at 2.7% for the fiscal. The fourth-quarter GDP growth at 9.1% was also slower than 10% in the year-ago period, primarily on account of slower growth in agriculture, construction and financial sectors.

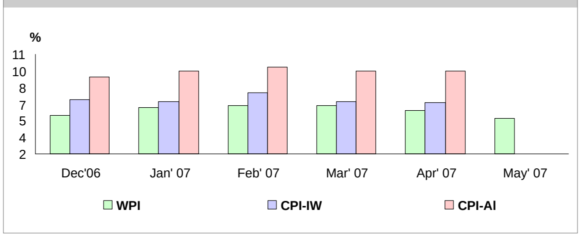
The details of the expenditure component of GDP reveal that the share of Private Final Consumption Expenditure in GDP has declined to 57% in FY07. The Gross Fixed Capital Formation as percentage of GDP at current market prices stood at 30% in FY07, reflecting fresh investments for creating additional capacity through fixed capital formation. This is also supported by stronger-than-expected 13.6% Y-o-Y growth in the Index of Industrial Production (IIP) for Apr 07. However, with higher interest rates already impacting demand in certain key sectors, we expect a slight moderation in IIP growth to around 12% in May 07.

# Price Scenario

## Inflation falls to below 5% levels

Domestic inflation, as measured by the Wholesale Price Index (WPI) has dipped below 5% levels for two consecutive weeks after eight months. WPI inflation for the week ended 02-Jun-07, stands at 4.80%, driven by a decline in the prices of food articles as well as a fall in the prices of some manufactured products. The high base effect of the previous year has also played a role in moderating inflation.

**CPI growth faster than WPI growth**




*Source: RBI, D&B Research*

As indicated in the exhibit, although inflation as measured by the Consumer Price Index continues to remain high, there has been some moderation as compared with previous months. The CPI inflation rate for industrial workers (CPI-IW) stands at 6.67%, (6.72% in Apr 07) the CPI inflation rate for Agricultural Labourers (CPI-AL) stands at 9.4% (9.5% in the previous month) in May 07.

Following RBI's efforts to tighten money supply in the economy, M3 growth rate has registered a decline to 19.6% after several weeks. Rising interest rates have also hit demand in certain sectors and demand side pressures on inflation have been contained. The impact of the appreciation of the rupee vis-à-vis the US Dollar, by way of cheaper imports, may have also had a dampening impact on the level of inflation.

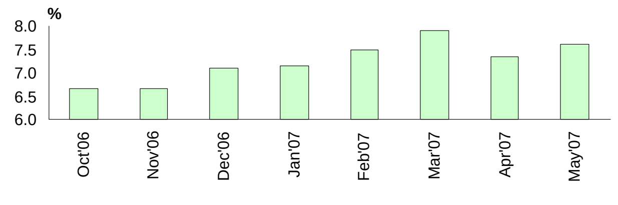
Given the RBI's continued commitment towards containing inflation and the strong base effect, inflation is expected to continue to hover around current levels in the short run. Further, given expectations of favourable monsoons and expected healthy growth in agricultural production, inflationary pressures should be further eased. Rising international crude oil prices, however, remain a downside risk. We expect the WPI inflation rate to average at around 4.8-5% in Jun 07.

# Money & Finance

## Call rates touch near zero level

Following the RBI's efforts to curb money supply in the economy, the M3 growth rate has fallen to 19.6% after several weeks, though still much higher than the targeted level to control inflation. Rising interest rates have started impacting credit off-take in the economy. Overall loans disbursed by Scheduled Commercial Banks have witnessed a slower growth; growth in credit lending declined by Rs 366.7 bn since Mar 07. Although loan growth has slowed down to about 26% (y-o-y as on 26-May-07), it is still higher than the targeted rate of 24-25%.

**15-91 Day Treasury Bill Yields**




*Source: RBI*

Despite the measures taken by the RBI, continued strong capital inflows into the economy have increased liquidity levels in the system to some extent. Further, in order to prevent the rupee from further strengthening, the RBI has resorted to intervention through dollar purchases, thereby increasing the supply of rupees in the system. The overnight call rates declined to near zero levels during the month. Redemption of Government securities, the slowdown in credit offtake and the capping of the amount that can be absorbed under the reverse repo auction are factors that have led to the surfeit of liquidity in the market.

15-91 day Treasury bill yields have been hovering around the 7.4-7.6% range during the month of May. In view of tightening of money supply conditions, we expect short-term interest rates to average at around 7.8-8% in June 07.

# External Sector

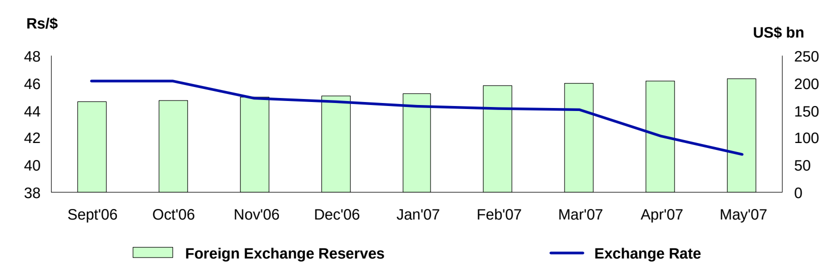
## RBI resumes intervention in the Forex market

Not withstanding the sharp appreciation of the rupee, India's exports grew by an impressive 23% to US$ 10.57 bn in Apr 07. Though export products with low value addition (those with less import contents) such as leather, textiles etc have been hit by the rupee appreciation, those with high import intensity have been able to neutralize the impact with lower import costs.

Strong growth momentum and rising domestic investments have driven the imports growth rate to 40.7% in Apr 07, backed by a 54.3% growth in non oil imports. The trade deficit for Apr 07 widened to US$ 7.1 bn, which is higher than the deficit of US$ 3.9 bn for the same period last year.

However, the global capital inflows into the economy have been continually increasing leading to a sharp rise in foreign exchange reserves. Foreign exchange reserves, aggregated US$ 208.4 bn as on 01-Jun-07, as compared to US$ 204 bn in the previous month.

**Forex reserves and INR/USD**




*Source: RBI, D&B Research*

The sustained strong inflow of foreign funds pushed the rupee to an all time nine-year high of 40.28 in May. After several weeks of refraining to intervene in the forex market, the RBI has reversed its position to prevent further appreciation of the rupee. Though it is too early to determine if the Central Bank is going to continue intervening, its possibility cannot be ruled out, now that the inflationary pressures seem to have been controlled. Given the current bullishness on the India stock market and no signs of a slowdown in capital inflows, we expect the average value of the rupee to be in the range of 40.20-40.50 to a dollar for Jun 07.

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