



Decide with Confidence

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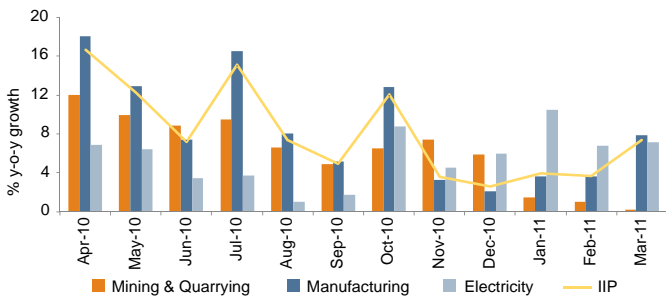
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Persistence of high inflation, at a time when India is on the verge of achieving the pre-crisis growth levels, continues to be the cause of concern for the common man and the government authorities alike. The fact that the sources of price pressures has shifted from food articles to primary non-food articles and then manufactured non-food products has further accentuated the pressure of managing inflation by the Government as well as the RBI. Sustained elevated level of global crude oil prices has been increasing the subsidy burden of the government. In order to adhere to the fiscal consolidation process the Government has raised the petrol prices while an increase in the LPG and diesel prices shortly is also being contemplated. These, along with other factors such as the incomplete pass-through of the non-administered fuel prices, uncertain outlook on the geopolitical tensions in the MENA region, possibility of global commodity prices especially food, minerals and metals staying firm has increased the upside risks to inflation in the near to medium term.

Clearly, a high growth level in an economy is not sustainable under a high inflationary situation. As pointed out by RBI "high and persistent inflation undermines growth by creating uncertainty for investors and driving up inflation expectations". The RBI in its annual monetary policy has responded to the current scenario by resorting to an aggressive policy rate hike at the cost of impacting growth. The question that arises here is - how far should the central bank go ahead before taking a pause with regard to tightening its policy rates? Given that the inflationary pressures in the economy would continue to persist for some more time, we expect the RBI to maintain its monetary policy tightening cycle. However, the magnitude of the increase would vary on how the inflation pans out in the near to medium term. If inflationary pressures continue to remain at the current levels with no major upticks from the international commodity prices we anticipate an increase of another 25-50 basis points in the policy rate. However, if the commodity prices trend upward from the current level it would put further pressure on the manufactured inflation and hence wage inflation which would then warrant further aggressive policy tightening. In case such a situation prevails we expect a hike in the repo rate by around 100 basis points. Going ahead, such high interest rates would not only help in tempering inflation expectations but would also curb the demand side pressures especially, investment demand. In such a scenario, the consequent moderation in the investment activity might restrain the GDP growth to around 8.0-8.2% during FY12.

IIP growth remains below its long term average growth level

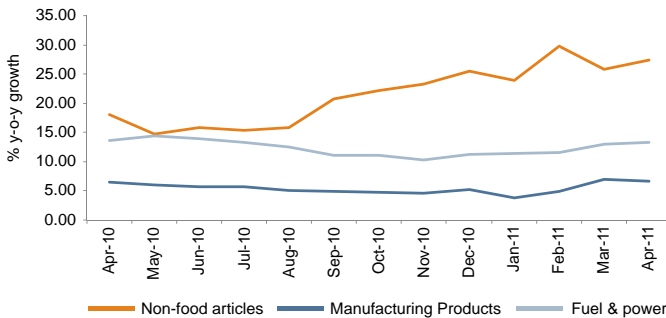


Source: CSO

Real Sector

- The IIP recorded a growth of 7.3% (y-o-y) during Mar-11 and 7.8% for FY11.
- The mining, manufacturing and electricity sectors grew by 5.9%, 8.1% and 5.6% respectively during FY11.
- While the capital goods grew by 12.9% during Mar-11, after posting a decline for three consecutive months, it recorded a growth of 9.3% during FY11. Capital goods had grown by 20.9% during FY10.
- Consumer goods grew by 7.5% during FY11 as compared to 6.2% during FY10.
- During FY11, six core infrastructure industries registered a growth of 5.9% as against 5.5% during FY10.

Non-food Inflation on the upward trend

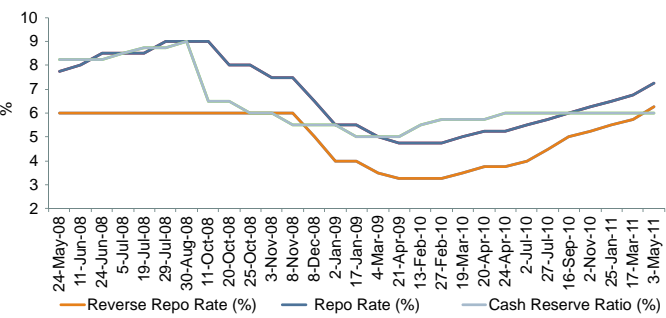


Source: Ministry of Commerce & Industry

Price Scenario

- WPI inflation moderates to 8.66% during Apr-11 from 9.43% during Mar-11 on the back of the downward trend in the inflation for primary articles.
- Primary articles inflation fell to 12.05% during Apr-11 as compared to 12.96% in Mar-11.
- The fall in primary articles is due to the moderation in the food articles which came down to 8.71% during Apr-11 as compared to 9.47% during Mar-11, while inflation in non-food articles remained elevated at 27.33%. Non-food articles inflation stood at 25.88% during Mar-11
- The inflation in the fuel and power group increased to 13.32% during Apr-11 as compared to 12.92% recorded during the previous month.
- Though the inflation in the manufactured products witnessed slight moderation to 6.18% during Apr-11 as compared to 6.50% during Mar-11, it still remains elevated, indicating demand pressures.

RBI resorts to further tightening in its policy rates

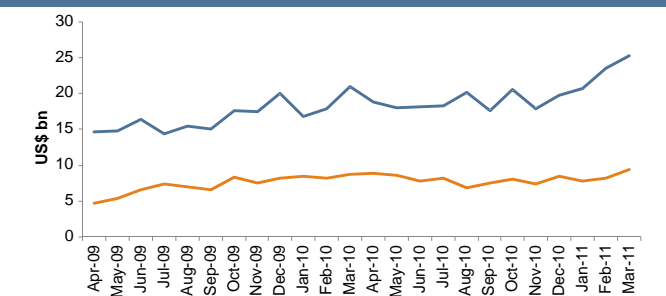


Source: RBI

Money & Finance

- The Repo rate under the Liquidity Adjustment Facility (LAF) increased by 50 basis points to 7.25% with immediate effect.
- The reverse repo rate under the LAF, determined with a 100 basis point spread below the repo rate, will stand adjusted at 6.25%.
- The Bank Rate and the Cash Reserve Ratio (CRR) of SCBs kept unchanged at 6.0%.
- The Marginal Standing Facility (MSF) rate, determined with a spread of 100 basis points above the repo rate, gets calibrated at 8.25%. This rate will come into effect on operationalisation of the MSF.
- Savings bank deposit interest rate increased to 4.0% with immediate effect.
- RBI projects money supply (M3) growth at 16% and Non-food credit growth at 19% for FY12.

Imports continue to march higher



Source: DGCI&S, CMIE

External Sector

- According to the provisional trade figures, exports for FY11 grew by 37.6% US\$ 245.9 bn, while imports grew by 21.6% to US\$ 350.7 bn leading to a lower trade deficit of US\$ 104.8 bn.
- Petroleum products export recorded a growth of 50.58% to US\$ 42.45 bn.
- Engineering goods registered a growth of 84.76% to cross US\$ 60 bn thereby, constituting the largest component of exports.
- The export for the Gems & Jewellery sector grew by 15.34% to US\$ 33.54 bn.
- The Drugs & pharmaceuticals sector witnessed a 15.08% growth to US\$10.32 bn.
- The exports of Iron Ore witnessed a decline of 25% to US\$ 4.5 bn.



Dun & Bradstreet's Macro Economic Forecasts

	Forecast	Latest Period	D&B's Comments
Inflation W.P.I	8.2%-8.4% May-11	8.66% Apr-11	As domestic fuel prices witnessed its steepest hike, risks to inflation remain clearly on the upside, reinforced by the persistence of demand-side pressures as reflected in non-food manufacturing inflation. However, the likely slide in global commodity prices along with monetary policy tightening by the RBI is expected to contain the WPI inflation from Q3 FY12.
Inflation C.P.I (I.W)	8.5%-8.7% Apr-11	8.82% Mar-11	
Exchange Rate INR v/s US\$	44.50-44.70 May-11	44.37 Apr-11	The rupee is expected to remain strong in the medium term, as foreign fund inflows owing to interest rate differentials will continue to provide support. Nonetheless, downside risks to the rupee may emanate in the event of recovery in global crude oil prices and major change in global macro-economic conditions. Given the volatility in the crude oil prices the rupee is expected to remain weak during May-11.
I.I.P Growth	5.0%-6.0% Apr-11	7.33% Mar-11	In the medium term, while higher exports may provide some impetus to manufacturing growth, elevated input prices particularly for coal, coupled with rising interest rates would debilitate overall industrial activity. Given the high base effect, with a 16.6% growth in April 10, IIP growth is expected to remain sluggish during Apr 11.
GDP Growth	8.1 Q4 FY11	8.2 Q3 FY11	
15-91 days T-Bills	6.9%-7.1% May-11	6.99% Apr-11	The lagged impact of policy rate hikes by the RBI and continued rise in inflationary pressures would keep bonds yields at elevated levels for most part of FY12. Rising cost of funds for banks', owing to a hike in policy rate, savings rate as well as higher provision requirement for bad and restructured loans, is expected to pose downside risk to credit growth going forward.
10 year G-Sec Yield	8.0%-8.2% May-11	8.20% Apr-11	
Bank Credit*	20.5%-20.7% May-11	21.2 % Apr-11	

All figures are monthly average

* Refers to End Period



SEZs: Losing their sheen?

Special Economic Zones (SEZs) have a great potential in attracting both foreign and domestic investment, enhancing a country's exports, improving infrastructure, generating employment, boosting manufacturing and allowing a particular country to compete with other countries. Asia's first export processing zone (EPZ) was established in Kandla (India) in 1965. From Nov 2000 to Feb 2006, SEZs in India functioned under the provisions of the Foreign Trade Policy. With the SEZ Act, 2005 coming into effect in February 2006, there was a rush to set up SEZs across the country. However, India's SEZ development story is plagued by bureaucracy and red tape, high cost of capital, lack of institutional support, infrastructural bottlenecks, among others. Despite the first EPZ being set up in India, the country lags behind other Asian countries such as China, Malaysia, Taiwan, etc. SEZs have not taken off in India as much as was expected. This is essentially because unlike India, the focus of these countries has been to provide generous incentives to attract foreign investment and technology, and thereby transform their industry structure from labour-intensive to technology-intensive industries.

Nevertheless, the contribution of SEZs in India's exports cannot be ignored. Exports from SEZs recorded a CAGR of 58.6% during FY04 to FY10, as compared to the CAGR of 19.3% registered by total exports from India. Reeling under the impact of the global slowdown, when overall exports from India posted near flat growth in FY10, exports from SEZs grew by a whopping 121.4%. Further, share of exports from SEZs in India's total exports has jumped from around 5% during FY04-FY07 to nearly 30% in FY11.

The rapid growth in SEZs has been accompanied by several controversies. One of the main controversies shrouding India's SEZs has been regarding the arbitrary manner in which land is acquired for these zones. The involvement of real estate firms and property developers in the SEZ space has also gathered significant criticism, as these firms perceive the SEZs as ideal opportunities for developing modern urban facilities by misusing the various incentives doled out by the central and state governments.

In the wake of the global economic slowdown and subdued export prospects, several SEZ developers had to put their plans on hold or seek exits. As a result, the pace of SEZ development in the country also slowed down. The financial viability of the SEZs has become a matter of concern. For several investors, SEZs have turned out to be financially challenging ventures, mainly on account of rising costs, rising interest rates and limited access to finance. Apart from the issue of financial viability, one of the most important reasons why SEZ development has not taken off in India to the desired extent is on account of the problems related to land acquisition. SEZ developers have

been unable to secure land. Local residents oppose to SEZ projects being set up in their region for fear of being physically or occupationally displaced. As a result, in several instances, the entire project has been brought to a standstill or scrapped.

This perhaps explains why over half the SEZs (formal approvals) belong to the IT/ITeS sector. Since the minimum land requirement for setting up IT/ITeS SEZ is only 10 hectares, it is easier to set up SEZs in this sector. However, over-dependence on sector-specific SEZs has hampered overall SEZ development in the country, as these types of SEZs are vulnerable to cyclical and other economic factors. For example, the IT/ITeS sector in India was severely hit on account of the global economic meltdown. Moreover, while exports from IT/ITeS SEZs contribute about 24% to total SEZ exports (FY10), multi-product SEZs contribute a lion's share of 66%. In such a scenario, it is apparent that multi-product SEZs would be a viable option for sustained and long-term development and growth of SEZs in India.

Large size of SEZs, stronger linkages with the local economy, robust infrastructure, strategic location, investor-friendly administration, decentralisation of decision-making authority, and flexible labour laws are the main reasons for success of SEZs in China. In China, SEZs were established mainly to attract FDI, expand exports and accelerate infusion of new and modern technology. Unlike India, SEZs in China are large, multi-sectoral and do not have formal boundaries separating them from surrounding communities. Further, unlike China where the government plays a more critical role, in India investments in SEZs have come mainly from the private sector. For India to emulate the Chinese success story with SEZs, the need of the hour is concerted efforts in developing world class infrastructure within the SEZs so as to attract more industries.

India enjoys several advantages mainly strong economic growth prospects, availability of large pool of skilled workforce, a strong manufacturing base, vast domestic market and strong potential in capturing increased pie in global trade. To exploit the full potential, instead of merely being an implementing agent/facilitator, the Government should play a more proactive role in promoting SEZs. It should do the balancing act; on the one hand, it should provide the necessary support for land acquisition, speedy administration and approvals, and on the other, ensure that interests of the locals are protected. These factors would go a long way in providing the much needed impetus for development of SEZs in India, achieving the core objectives of boosting India's exports and attracting FDI, at the same time ensuring inclusive growth.