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Economic Weekly

Policy & Research Unit

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Economic Weekly

Indian Economy

Rate Hike On Cards: Persisting high inflation and Reserve Bank of India's increased commitment to contain inflation, despite slowing growth, makes us believe the central bank will go ahead with a 25-basis-point rate hike at its monetary policy meet on October 25. Governor D. Subbarao's recent remarks made it clear RBI will continue with rate hikes until inflation eases. This puts more risk to growth as industrial growth in August slowed to 4.1% from a year ago despite a favourable low base. It's quite probable that now Jul-Sep gross domestic product growth would be even lower from Apr-Jun growth of 7.7% on a year-on-year basis.

***IIP Growth Slows In August**: Industrial growth in August slowed to 4.1% on a year-on-year basis despite a favourable low base. Lower IIP growth was due to slower expansion of manufacturing at 4.5% and 3.4% fall in output in mining sector.

***WPI Inflation at 9.72% In September**: WPI inflation in September remained largely unchanged at 9.72% on an annualised basis from 9.78% a month ago. WPI index in September grew 1.3% from August.

***Exports Slow in September**: Exports growth slowed to 37% on a year on year basis from 44% a month ago. Trade deficit $9.8 billion from $14 billion in August.

***Forex Reserves Rise $0.7 billion:** Forex reserves in the week ended October 08, grew $0.7 billion to $312.2 billion largely due to rise in foreign currency assets.

*** Working Papers by RBI:** RBI recently published working papers titled, ' Empirical Analysis of Monetary and Fiscal Policy Interaction in India' and another on 'Recent Global Crisis and Demand of Gold By Central Banks'

Global Economy

*** G-20 Urges EU to Fix Crisis In A Week:** G-20 nations urged EU to plan a strategy in a week to fix debt crisis, which endangers the world. G-20 nation concluded a meeting in Paris last weekend. The meeting highlighted the need for a plan to avoid a Greek default. The meeting has set a October 23 deadline for EU nations to work out a plan before the next G-20 meeting in Brussels.

Table of Contents

Economic Weekly

Another Rate Hike Seems To Be On The Cards

Persisting high inflation and RBI's increased commitment to contain inflation despite slowing growth make us believe that a rate hike of at least 25 basis points is due at the central bank's monetary policy meeting on October 25. Governor D. Subbarao's recent statements have made it clear the Reserve Bank of India will continue with rate hikes until inflationary expectations are anchored and inflation subsides. What provides justification to RBI's continuing monetary tightening is the fact that headline inflation (measured by Wholesale Price Index) for September stood largely unchanged at 9.72% from a year ago compared with 9.78% in the previous month. With inflation staying above 8% for about 20 months now, inflationary expectations have got firmly entrenched, especially among households. These expectations are resulting in upward pressure on wages, which further fuel inflationary impulses. This makes the case of monetary tightening even more justified. On the other hand, continuous rate hikes put economic growth at a greater risk as industry expansion in August (measured through Index for Industrial Production) eased to 4.1% from a year ago despite a favourable low base. It is possible July-September GDP growth will be lower from 7.7% year-on-year growth recorded in April-June.

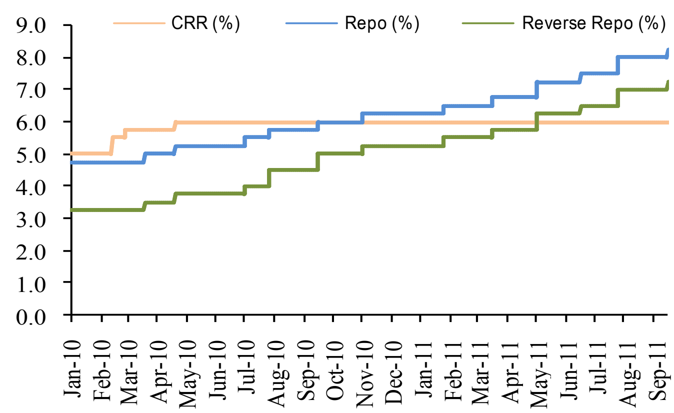
- **Monetary Tightening To Continue:** RBI governor said on Thursday: "We have had to raise rates to combat inflation." He said "when inflation runs as high as 9.8%, it is difficult to bring it down without compromising on growth. So we are trying to trade-off at this time on bringing down inflation even if it means bringing down growth." Similar views were echoed by Deputy Governor Subir Gokarn, who said RBI would pause rate hikes if inflation eases. A recent International Monetary Fund publication has justified RBI's monetary tightening, saying generalised inflationary pressures require an anti-inflationary stance.

- **No Let-up In Inflation:** WPI inflation in September stood at 9.72% on a year-on-year basis compared with 9.78% in August. There are no clear signs of inflation easing, and it has remained above 9% in past 12 months. Inflation averaged 9.6% in 2010-11 (April-March) and so far this financial year. Persistent levels of inflation indicate demand-side pressures exist. Food inflation eased a tad to 9.2% in September from 9.8% in August, although it remains high despite good monsoon. Last month, core inflation — a metric tracked closely by RBI — was 7.6% on a year-on-year basis, marginally lower from 7.8% in August.

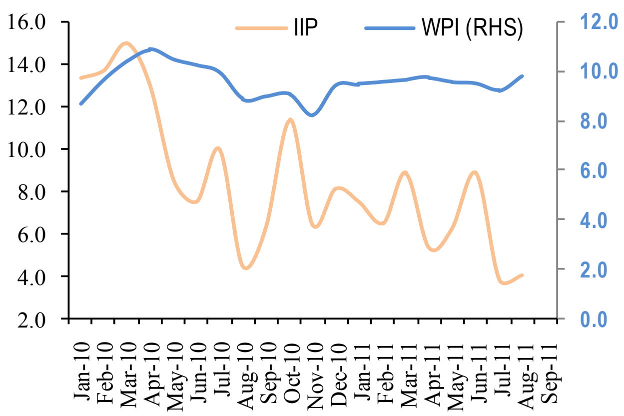
- **Rupee Depreciation:** Rupee's weakness has also dented any chances of a moderation in inflation**.** The Indian currency has depreciated around 10%, which has resulted in costlier imports. Thus, benefit of lower global crude oil and commodity prices hasn't accrued. India being a net importer of goods, rupee depreciation poses a significant risk. Imports account for 21% of GDP; thus impact of currency depreciation on inflation is significant. Costlier imports will directly impact manufactured goods inflation. Such an unfavorable environment complicates policy-making as external events are beyond the central bank's control.

- **Slower growth:** Industrial output growth in August slowed to 4.1% on a year-on-year basis despite a low base. Growth was lower than expected as manufacturing output grew only 4.5% from a year ago. Index of Industrial Production growth so far this financial year (April-September) has been sharply lower at 5.6% compared with 8.7% in the same period a year ago. Slower industrial growth this year is a clear indication of slowing economic activity. RBI has hiked interest rates 350 bps in past 20 months and its impact is showing. Monetary tightening and weaker investment climate put significant risk to growth prospects, and there is the likelihood of GDP growth slipping below 7.5% in the current policy environment.

RBI's Policy Rate Movement



IIP And WPI Inflation, % YoY



IIP Growth at 4.1% YoY in August

Fear of slowdown in industry came alive with lower IIP growth in August. Index of Industrial Production growth in August slowed to 4.1% on a year-on-year basis from 4.5% in the previous year despite a favourable low base. Lower IIP growth was due to slow expansion of manufacturing at 4.5% and negative growth of 3.4% in mining sector. Lower IIP growth in first two months of the second quarter of FY12 points to slowing gross domestic product growth. Industrial output growth so far in the current financial year has been a modest 5.6% on a year-on-year basis compared with 8.8% in the same period last year.

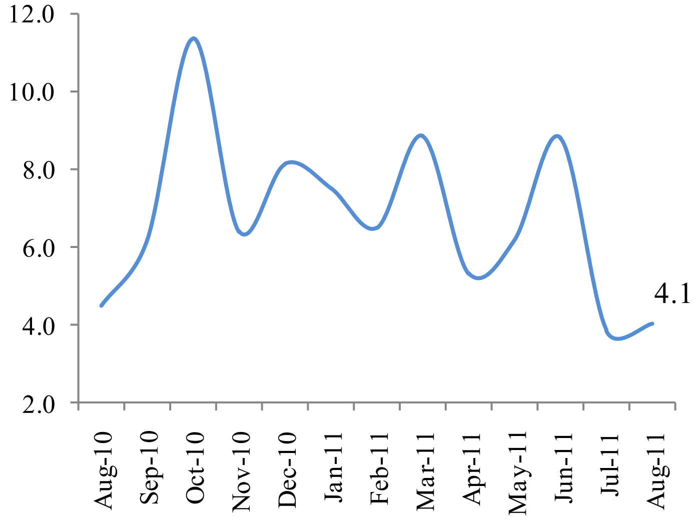
- **Sector-wise Performance:** Expansion has slowed across the board in all constituents of the IIP. In August, basic goods' growth slowed to 5.4% on a year-on-year basis from 9.5% in July. Intermediate goods' grew at low single digits of 1.3% against a 0.5% fall in the previous month. Only capital good growth recovered in August with 3.9% expansion against 13.8% fall in the previous month, which points to volatility in its index. Consumer durable goods' growth eased to 4.6% from 9% and consumer non-durable goods' growth slowed to 2.8% from 6.6% in July, pointing to easing consumer demand.

- **Industrial Groups:** Manufacturing sector grew marginally by 4.5% from 3.1% a month ago despite a favourable low base. Mining output fell 3.4% on a year-on-year basis against 1.5% growth in the previous month. Electricity sector posted growth of 9.5% during August, but lower from 13.1% in the previous month.

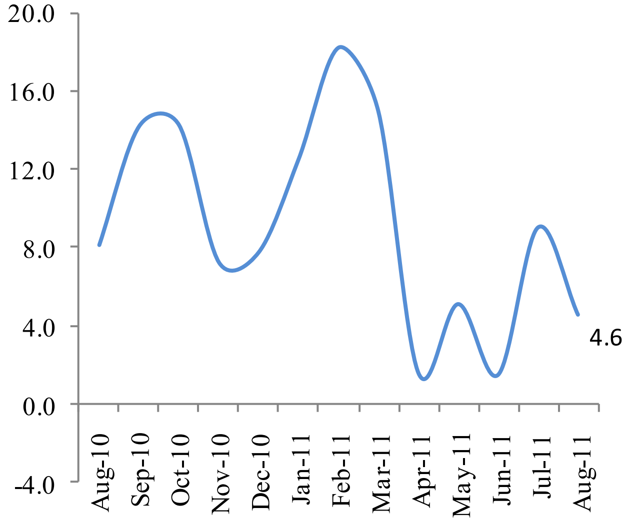
- **Volatility In Capital Goods Growth Continues:** Volatility in capital goods series continues. In August, capital goods growth stood at 3.1% after contracting 13.1% in July. Volatility in capital goods leaves much to be interpreted and thus renders it useless.

- **Poor Economic Climate:** Lower IIP growth points to slowing industrial activity. Unfavourable economic climate due to global uncertainty and high interest rates within the country are bound to impact economic growth. Like we have said before, industrial growth rate will turn lower except for seasonal deviations, such as festivals that lead to high production and re-stocking. Industry growth will slow further going ahead due to higher interest rates and relentless inflation. Slowing consumer goods' demand indicates that aggregate demand is also getting impacted. Slower industrial expansion will result in lower GDP growth in second quarter of 2011-12 (April-March). The impact of monetary tightening is beginning to show with slower industry growth. As indicated by RBI's officials, going ahead there could be more rates hikes that could further impact growth.

IIP, % YOY (New Series)



Consumer Durables, % YoY

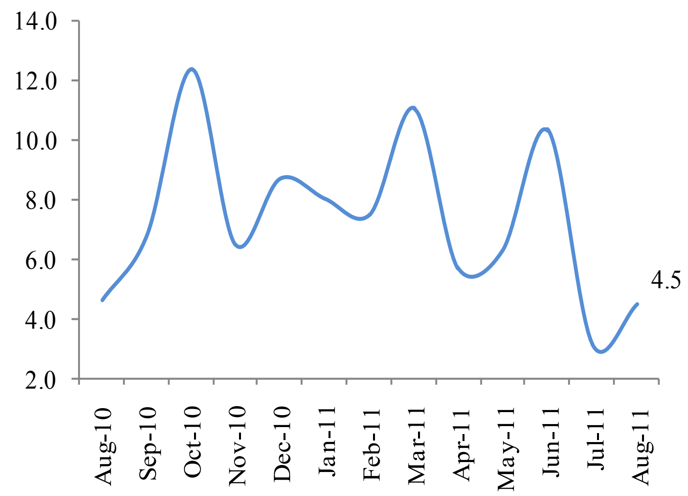


More Details:

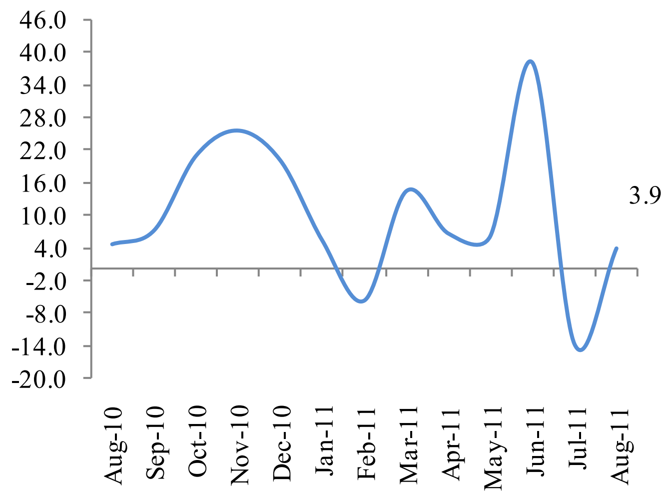
As per industry groups classification, 11 of 22 groups showed positive growth in August compared with 15 industries in the previous month.

% YoY	Weight %	Aug-10	Jun-11	Jul-11	Aug-11
IIP	**100**	**4.5**	**8.8**	**3.8**	**4.0**
Mining & Quarrying	**14.2**	5.9	-1.1	1.5	**-3.4**
Manufacturing	**75.5**	4.6	10.3	3.1	**4.5**
Electricity	**10.3**	1.0	7.9	13.1	**9.5**
Basic goods	**45.7**	3.8	7.5	9.5	**5.4**
Capital goods	**8.8**	4.7	38.2	-13.8	**3.9**
Intermediate goods	**15.7**	5.9	0.6	-0.6	**1.3**
Consumer goods	**29.8**	4.6	2.3	7.7	**3.7**
Consumer Durables	**8.5**	8.1	1.5	9.0	**4.6**
Consumer Non Durables	**21.3**	1.8	3.0	6.6	**2.8**

Manufacturing, % YoY



Capital Goods, % YoY



WPI Inflation Prints At 9.72% in September

The Wholesale Price Index inflation in September remained largely unchanged at 9.72% on a year-on-year basis compared with 9.78% in the previous month. WPI index in September grew 1.3% from August. Manufactured products' inflation also stood almost unchanged in September at 7.1% compared with a year ago.

- **Inflation Constituents' Trends:** Primary articles' inflation in September stood at 11.8% on an annualised basis compared with 12.6% in the previous month, largely due to high base effect last year. The index was up 1.3% from July. Food inflation eased to 9.2% on a year-on-year basis from 9.6% in the previous month. Non-food inflation decelerated to 14.8% from 17.8% in July due to base effect. Fuel inflation was up at 14.12% from 12.8% in the previous month. Manufactured products' inflation stood largely unchanged at 7.1% from 7.2% in previous month.

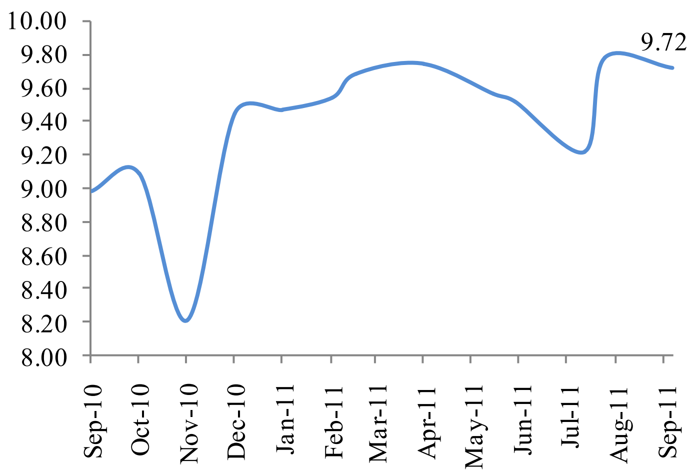
- **Revisions:** WPI inflation for July was revised upwards to 9.36% from the provisional rate of 9.22% . The extent of revisions has declined during the past two months, which is a positive trend.

- **Core Inflation:** Core inflation in September eased to 7.6% from 7.8% a month ago. Core inflation has stabilised in the 7.5% range, which is a good sign for containing inflation. Lower demand could be one reason that has restricted the pass-through of higher costs to consumers. It is essential that core inflation gets stabilised before easing.

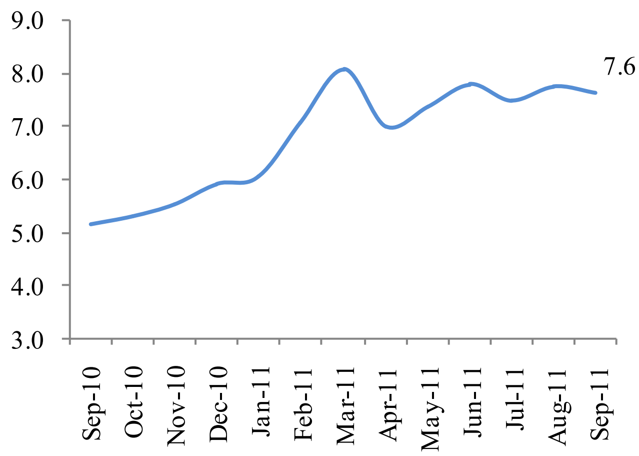
- **Primary Articles Inflation:** Pressure from primary articles and fuels is holding inflation at higher levels. In September, primary articles index jumped 1.3% from the previous month while fuel index grew 0.8%. Manufactured products index grew only 0.2% on a month-on-month basis. In the past months too, rise in prices of manufactured products has been far lower compared with the other two groups. Therefore, containing primary articles and fuel inflation is key to reining in overall inflation. Since fuel inflation is an external factor, only primary articles inflation can be addressed by the government. Any spike in food and non-food articles prices can spark overall inflation.

- **April– September Inflation:** Inflation in April–September stood at 9.6% on an annualised basis compared with 9.9% in the same period a year ago. Inflation has stayed over 9% in the past 12 months. Inflation averaged 9.6 % in FY11. This year policy-makers are expecting inflation to slow towards the end of the financial year.

WPI Inflation % YoY



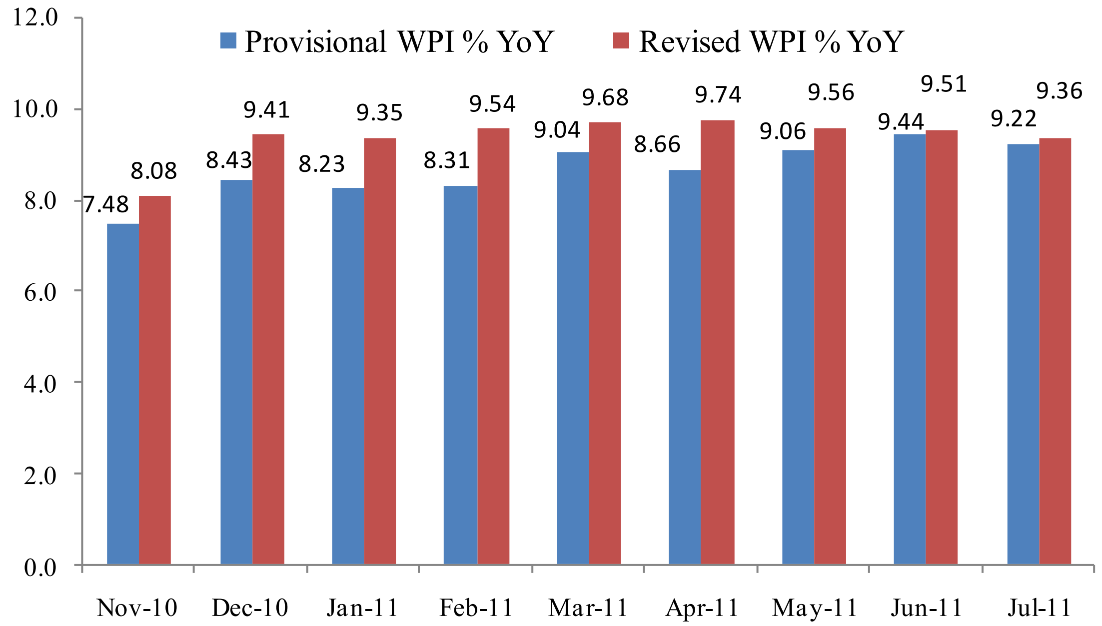
Core Inflation, % YOY



More Details:

	Index Sep-11	% YoY Jun-11	% YoY Jul-11	% YoY Aug-11	% YoY Sep-11
WPI	**155.8**	9.5	9.36	9.78	**9.72**
Primary articles	**202.2**	11.3	11.47	12.58	**11.84**
Food Articles	**196.5**	7.6	8.19	9.62	**9.23**
Non Food Articles	**184.4**	18.4	15.77	17.75	**14.82**
Fuel	**168.4**	12.9	12.04	12.84	**14.09**
Manufactured products	**138.6**	7.9	7.73	7.79	**7.69**

Trends in Revisions of WPI Inflation:



Export Growth Slows in September

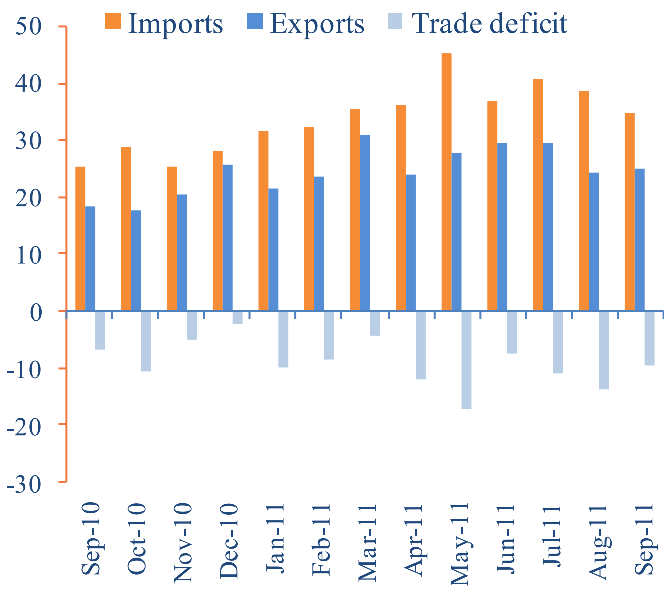
Exports growth slowed in September to 37% on a year-on-year basis from 44% and 88% growth witnessed in August and July, respectively. In April–September, exports grew 52% from a year ago. In dollar terms, exports stood $24.6 billion in September, almost unchanged from the previous month. Imports fell to $34.6 billion from $38.4 billion in August. Fall in imports in September narrowed the trade deficit to $9.8 billion from $14 billion in the previous month. Trade figures for September have not been released officially but have been quoted from Commerce Secretary Rahul Khullar's interactions with media.

- **April-September Trends:** India's exports grew 52% on a year-on-year basis in April-September to $160 billion. Imports stood at $235.5 billion and registered a growth of 32.4%. Trade deficit stood at $73.5 billion during the six-month period.

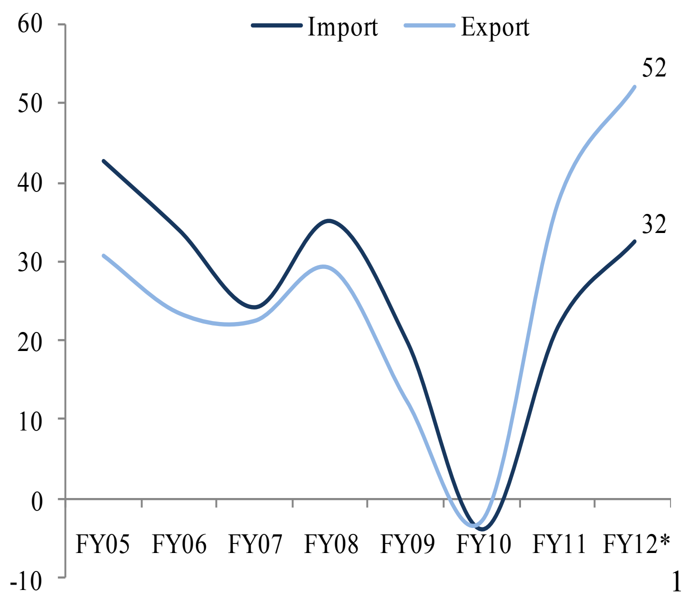
- **Industry-wise Export Trends:** In April-September, the following sectors witnessed high growth: engineering ($46.4 billion), grew 103% from a year ago; petroleum and oil products ($27 billion) 53% ; gems and jewellery ($18.5 billion) registered a growth of 23%; drugs and pharmaceuticals ($6.5 billion) 33%; leather ($2.25 billion) grew 26%; cotton yarn and fabric made-up ($3.4 billion) grew 22.5%; electronics ($5.7 billion) 67%; readymade garments ($6.8 billion) registered 32% growth.

- **Industry-wise Import Trends:** Imports trends during April-September are as followed: Petroleum, oil and lubricants' imports ($ 70.4 billion), up 42%; gold and silver ($31.1 billion), up 80%; machinery ($17.4 billion) rose 34%; electronics ($16.9 billion), up 33%; organic and inorganic chemicals ($9.3 billion) rose 26% and coal ($8.4 billion), up 43%.

Foreign Trade, $ billion



Growth, % YoY



Forex Reserves Rise By $0.7 Billion

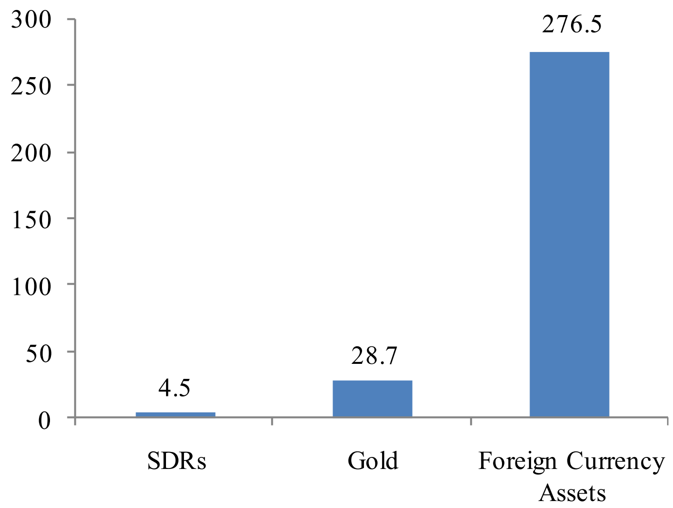
Foreign exchange reserves in the week ended October 8 grew $0.7 billion to $312.2 billion largely due to a rise in foreign currency assets.

Total forex reserves comprise foreign currency assets, special drawing rights and central bank's position in gold, all of which are measured in US dollars.

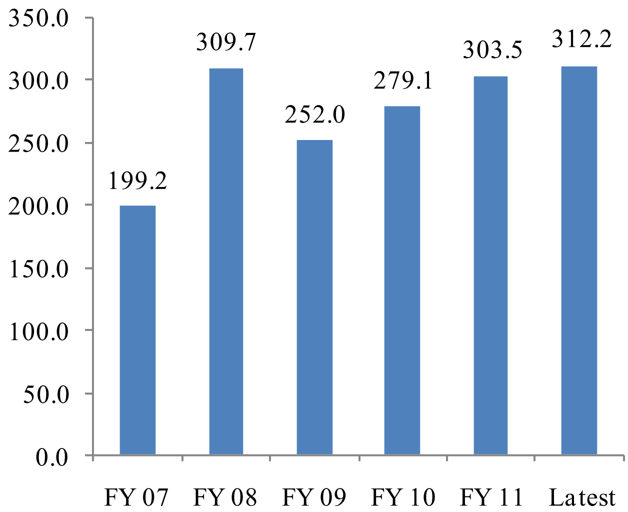
- In the week ended October 8, foreign currency assets increased by $0.7 billion to $276.5 billion due to revaluation changes, which led to rise in overall position in forex reserves.
- Position in gold increased , reserve position with International Monetary Fund and SDRs remained unchanged during the week.

US$ bn	Forex reserves	SDRs	Reserve Position in IMF	Gold	Foreign currency assets
17-Sep-11	316.8	4.5	3.0	28.3	280.9
24-Sep-11	312.7	4.5	3.0	28.3	276.9
01-Oct-11	311.5	4.5	2.6	28.7	275.7
08-Oct-11	312.2	4.5	2.6	28.7	276.5

Forex Reserves Components (in $ billion)



Forex Reserves Annual Trends (in $ billion)



Working Papers By RBI

- ‘**Empirical analysis of monetary and fiscal policy interaction in India’** is a working paper authored by Janak Raj, J.K. Khundrakpam and Dipika Das who are researchers at RBI.

Conclusion of the paper: “The major finding of the paper is that even after the elimination of automatic monetisation of fiscal deficit in 1997 and restraints on RBI from buying government securities in the primary market under the FRBM Act from April 2006, fiscal policy continues to substantially influence the conduct of monetary policy. Specifically, the reaction of the two policies to shocks in inflation and output is mostly in the opposite direction. While monetary policy reacts in a counter-cyclical manner, fiscal policy reaction is primarily pro-cyclical in nature. The positive impact of expansionary fiscal policy on output is highly short-lived, but there is a significant negative impact in the medium to long- term”.

Link to the paper: **http://www.rbi.org.in/scripts/PublicationsView.aspx?id=13841**

- **‘Recent global crisis and demand of gold by central banks’** is a working paper authored by A.K. Karungaran examining whether RBI’s purchase of gold was a reserves management strategy and whether such purchases affected the gold price trend.

Conclusion of the paper: “The findings of the Study show that central banks in most of the EMEs and advanced economies had either bought fresh stock of gold or stopped selling their existing stock of gold in the wake of the recent global crisis. Further, the paper has stated that India’s purchase of gold apparently did not have any impact on the gold price trend and hence the stock of gold is in line with the global accumulation trend. The paper states that it is difficult to address the ‘optimum level of gold’ for India, though there is a strong economic rationale to hold sufficient quantity of gold as part of official reserves, especially during the uncertain periods like global financial crisis”.

Link to the paper: **http://www.rbi.org.in/scripts/PublicationsView.aspx?id=13843**

G-20 urges EU to Fix Crisis In a Week

Group of 20 nations urged European Union to plan a strategy in a week to fix the debt crisis that endangers the global financial system. The G-20 ministers recently concluded a meeting in Paris last weekend. The meeting highlighted the need for a plan to avoid a Greek default. The meeting has set a October 23 deadline for EU nations to work out a plan before the next G-20 meeting in Brussels.

- **Discord for Greece Bailout:** There has been resistance among European Union nations for Greece debt restructuring. Also, Greece parliament needs to approve further fiscal measures that will make it eligible for further foreign assistance.

- **Europe's Plan:** The plan for restructuring debt which has not been made public yet is said to includes write-down of Greek debt. The plan also aims at raising the European Financial Stability Fund assets from 440 billion euros currently. Timothy Geiithner, US treasury secretary, said the plan has the right elements and they have to work more on strategy and details during the meeting in Brussels.

- **Risk to Global Growth:** If Greece bailout and debt restructuring fails, the world would be at a risk of contagion. There are risk to the unity of European Union and euro, which was constituted in 1999.