September 19, 2011

Economic Weekly

Policy & Research Unit

DhanlaxmiBank
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Economic Weekly

Indian Economy

***Rupee's Depreciation To Add To Inflation**: Sharp depreciation of INR against dollar in the last month has raised concerns on inflation management. Even as RBI hiked interest rates by 25bps last Friday (September 16) to contain inflationary expectations, the unfortunate recent slide in rupee will raise prices as imports become costlier. Crude oil imports have risen in value terms and this has led oil companies to raise petrol costs as petrol is currently deregulated. Rupee depreciated by 4.91% in last month, 3.38% in the last fortnight and 1.02% last week against the dollar.

***WPI Inflation in August Rises to 9.78% YoY**: WPI inflation in August 2011 rose to 9.78% YoY compared with 9.22% YoY a month ago. Recent petrol price hike of RS 3.14/ litre is going to add 7 bps di--rectly to inflation while the indirect impact will be come with a lag.

*** Trade Deficit Rises to $14 billion:** Trade deficit widened to $14.1 billion in August as exports growth in August came down to 44% YoY compared with 88% YoY a month ago. Exports stood lower at $24.1 billion compared with $29.3 billion a month ago. The commerce secretary has stressed that high exports growth might not continue going ahead. The Reserve Bank, in its recent mid-quarter monetary policy meeting, has expressed concerns that the global slowdown might impact exports.

*** Forex Reserves Decline by $4.3 billion:** Forex reserves saw one of the sharpest decline in recent months. Forex reserves came down to $ 316.5 billion, largely due to changes in RBI's foreign currency basket.

Global Economy

*** Uncertainty on Greece Prevails:** European Union and IMF are going to decide this week whether Greece is eligible for next round of payments to avoid default. The next payment is due in coming month for the loan package approved by EU & IMF in July 2011. IMF officials earlier this month observed 'lapses' in the Greece budget which led it to suspend its review.

Rupee's Depreciation To Add To Inflation

Sharp depreciation of INR against dollar in the last one month has raised concerns on inflation management. Even as RBI hiked interest rates by 25bps last Friday, primarily to contain inflationary expectations, the unfortunate recent slide in the rupee value is also going to have an inflationary impact since imports become costlier. Crude oil imports have become costlier and this led oil companies to raise petrol costs by Rs 3.14/litre as petrol is deregulated. Rupee depreciated by 4.91% in last one month, 3.38% in the last fortnight and 1.02% last week, against the dollar.

- **Euro Concerns Led To Dollar Rise**: The dollar has appreciated against major currencies as investor concerns regarding the Euro's stability multiplied during the past one month. What has not helped matters is the visible divide among Euro nations on a bailout policy, as well as the exit of a senior ECB member in protest against the central bank's plans to buy sovereign paper to bail out some debt-stressed sovereigns. The Euro weakened against the US dollar by 3.68% last month. This led to dollar gaining across major currencies in the world including pound sterling and yen. The INR's recent depreciation against the dollar is also due to the value realignment between the Euro and US dollar.

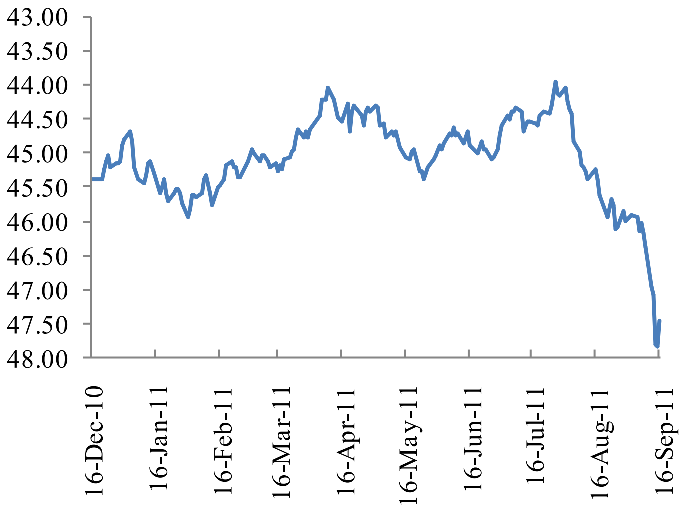
- **Rupee's Slide:** Global environment impacted rupee and it depreciated by 4.91% in the last one month, 3.38% in the last fortnight and 1.02% in the last week against the dollar. As RBI has indicated that they would intervene only in cases of extreme volatility in the foreign currency markets, the Rupee depreciated against US dollar.

- **Rupee Recovered From Intraday Low of Rs 48.02/USD**: INR/$ levels recovered after touching intraday low of ₹48.02 witnessed in September 2009 as Euro gained against US dollar. Since then INR has recovered to current levels of ₹47.45/$ levels. Euro, though weaker by 3.68% against the dollar, has regained 0.76% of its losses.

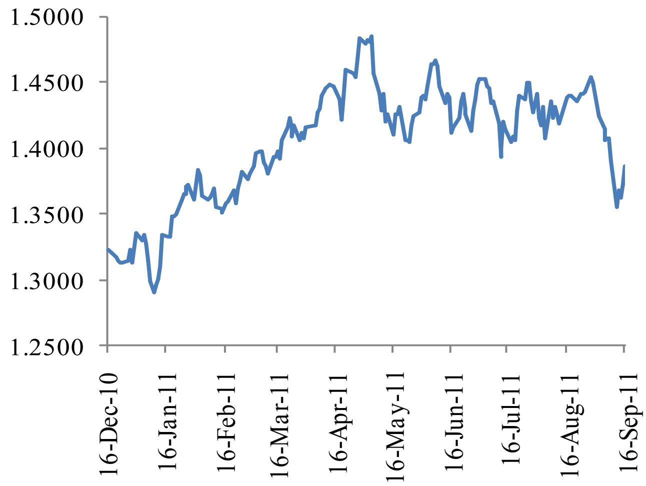
- **Imports To Become Costlier:** Imports are expected to get costlier if rupee remains weaker against the dollar. The recent rise in petrol prices by Rs 3.14/ litre is an evidence of the rising imports costs. India is a trade deficit nation with imports accounting for ~21% of GDP. A weaker Rupee will definitely impact the economy with higher imports prices.

- **Policy Making:** RBI raised interest rates by 25 bps in the monetary policy meet on September 16, 2011, to contain inflationary expectations. RBI has hiked interest rates by 350 bps in the past 20 months. However, certain events — such as, depreciation in currency or grant of additional dearness allowance to government employees — makes policy making difficult as costlier imports or escalating demand adds to price rise across the economy. 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.

USD/INR



EUR/USD



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WPI Inflation in August Rises to 9.78% YoY:

WPI inflation in August 2011 rose to 9.78% YoY compared with 9.22% YoY a month ago. WPI index in August rose due to an across-the-board rise in prices. WPI index grew by 0.58% over the last month. The recent petrol price hike of Rs 3.14/ litre is going to add 7 bps directly to inflation while the indirect impact will be come with a lag.

- **Across-the-board Rise In Prices:** Primary articles inflation grew to 12.6% YoY after subsiding over the past two months. Manufactured products inflation rose to 7.2% YoY compared with 7% YoY in last month. Fuel inflation rose to 12.8% YoY compared with 12% YoY a month ago.

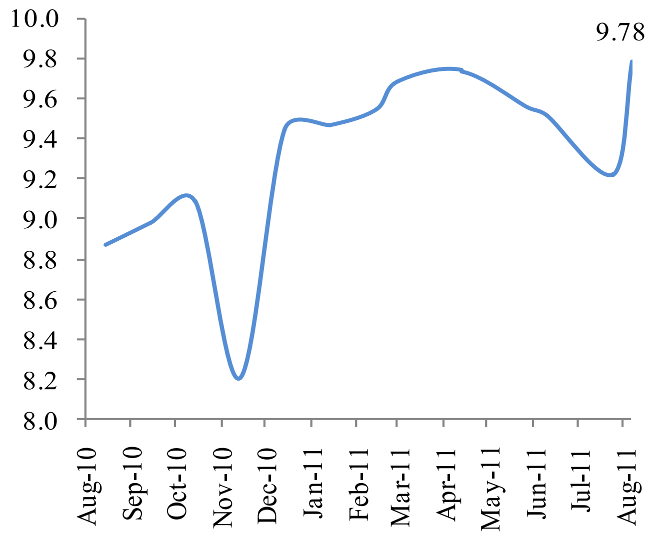
- **Pressure Remains From Primary Articles:** Primary articles inflation continues to put pressure on inflation as both food and non-food inflation continues to rise. Food inflation rose to 9.6% YoY compared with 8.2% YoY a month ago. Non-food inflation rose to 17.8% YoY compared with 15.5% YoY a month ago. Surprisingly, even a good monsoon has not been able to arrest the rise in food prices.

- **Revisions:** Upwards revisions of previously released WPI inflation figures continues. However, the extent of revisions to inflation has come down as inflation for June 2011 was revised upwards by 7 bps only to 9.51% YoY from 9.44% YoY before. Previously, revisions to final figures were in the range of 50-123 bps.

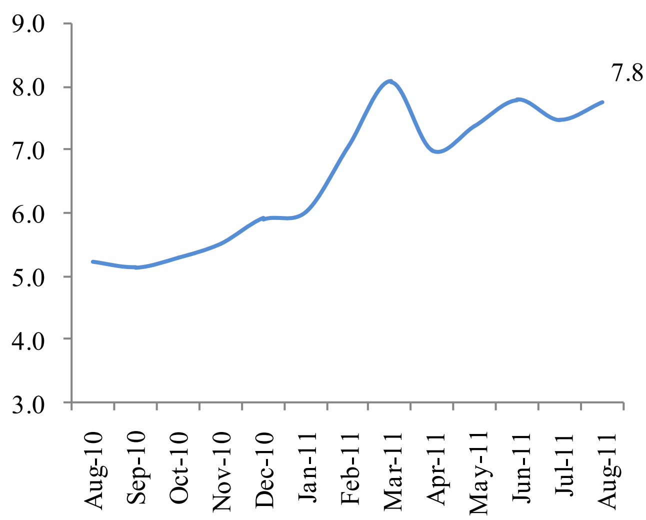
- **Core Inflation:** Core inflation rose to 7.8% YoY from 7.5% YoY before. Rise in core inflation shows that inflationary pressures continues to rise. Another interpretation is that demand pressures remain strong which is why producers are able to pass on the higher costs.

- **Monetary Stance**: Higher and sticky inflation has led RBI to hike interest rates by 350bps in the last 20 months. RBI continues to be concerned with higher inflation, which is close to double digits. Thus, further hikes cannot be ruled out even as some central banks across the globe have resorted to rate cuts — such as Brazil— due to deteriorating global environment. According to RBI's policy guideline, any change in its current monetary policy stance can emanate only from either the global environment or a moderation in inflation. If he global environment deteriorates considerably, RBI might put an end to monetary tightening.

WPI Inflation, % YoY

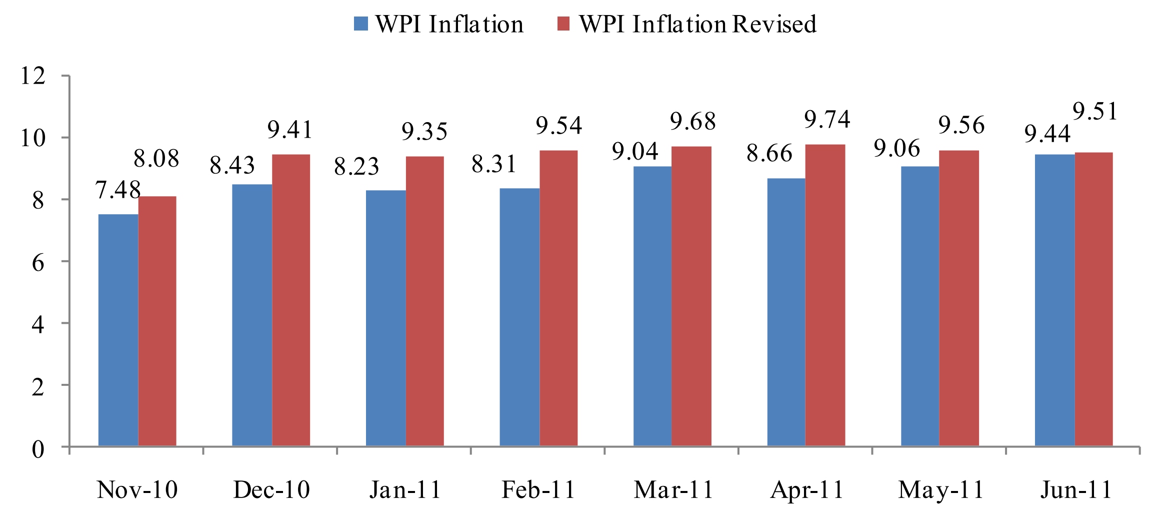


Core Inflation, % YoY



More Details:

Revisions to WPI Inflation:



Trends In WPI Inflation Constituents:

% YoY	Weight	Index August	Mar-11	Apr-11	May-11	Jun-11	Jul-11	Aug-11
WPI	100	154.9	9.7	9.7	9.6	9.5	9.2	**9.8**
Primary	20.1	199.6	13.4	15.1	12.9	11.3	11.3	**12.6**
Food	14.3	193.7	9.4	10.7	8.3	7.6	8.2	**9.6**
Non Food	4.3	181.1	27.4	26.9	21.4	18.4	15.5	**17.8**
Minerals	1.5	306.6	15.2	23.6	29.6	23.4	25.0	**23.4**
Fuel & Power	14.9	167.0	12.5	13.0	12.3	12.9	12.0	**12.8**
Manufactured	65.0	138.3	7.5	6.8	7.4	7.9	7.5	**7.8**

Trade Deficit Expands to $14.1 billion

Trade deficit widened to $14.1 billion in August as exports growth came down to 44% YoY compared with 88% YoY a month ago, despite lower imports growth. Exports stood at $24.1 billion compared with $29.3 billion a month ago. Commerce secretary has stressed that high exports growth might not continue going ahead. RBI in its recent monetary policy meet expressed concerns that the on-going global slowdown might impact overall exports.

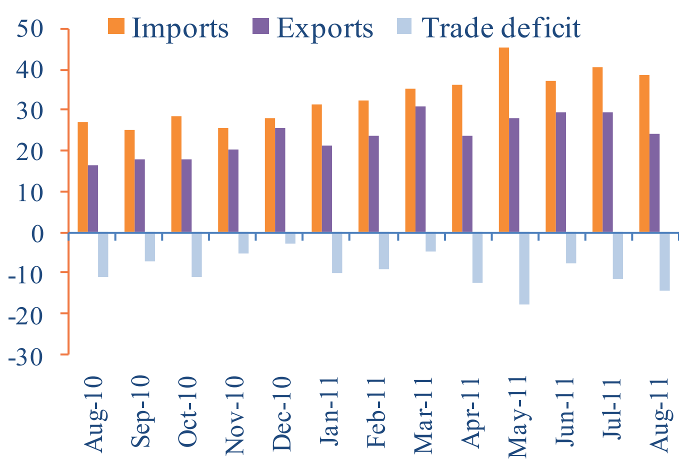
- **Trade Deficit Widens:** The trade deficit widened to $14.1 billion in August as exports growth came down despite lower imports growth in August. Trade deficit stood $11.1 billion in July. Trade deficit in the April–August 2011 period stood at $62.4 billion. Trade deficit last year stood at $100 billion.

- **Exports** in August 2011 stood at $24.3 billion compared with $29.4 billion a month ago. Exports growth stood at 44% compared with 82% in July. April-August 2011 exports stood at $135 billion, which represents 55% growth over last year. Exports growth though lower in August is still higher compared to last year.

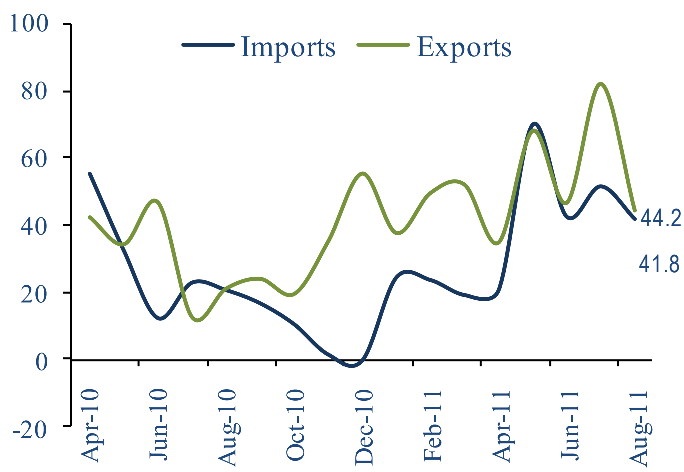
- **Imports** in August stood at $38.4 billion compared with $40.4 billion a month ago. Imports growth in August stood at 42% YoY in August compared with 51.5% YoY in July. April-August 2011 imports stood at $197 billion which is a 45% YoY growth over same period last year.

- **Exports Growth May Come Down:** Officials in the commerce ministry have pointed out that high exports growth may not continue in the future due to deteriorating global economic environment. Like we have earlier mentioned that higher exports growth could have been due to two reasons — namely diversification of markets by Indian exporters and, secondly, frontloading of exports in anticipation of the imminent expiry of DEPB (Duty Entitlement Passbook) Scheme, which expires on September 30, 2011. These two factors, especially the latter, might have led to frontloading of exports and thus high exports growth has been registered so far. As exporters pushed for exports to gain incentives given by the DPEB scheme before it expires. Even RBI in its latest mid quarter monetary policy meet has hinted that the global slowdown might impact exports growth. It could impact the current account balance and could raise a concern if not matched by capital flows.

Trade Balance, $ bn

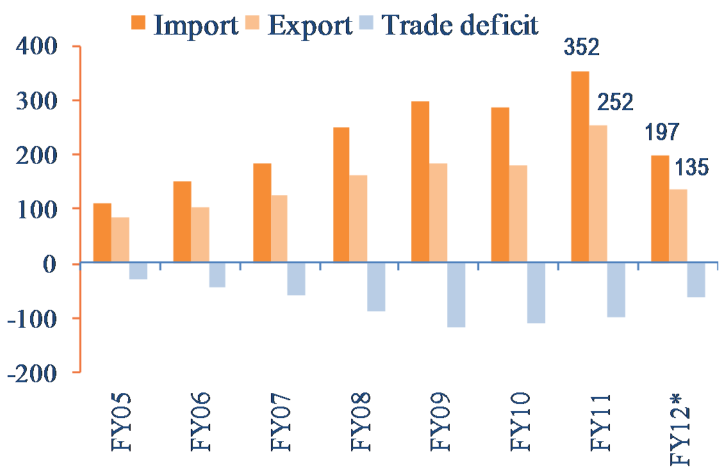


Exports & Imports growth, % YoY

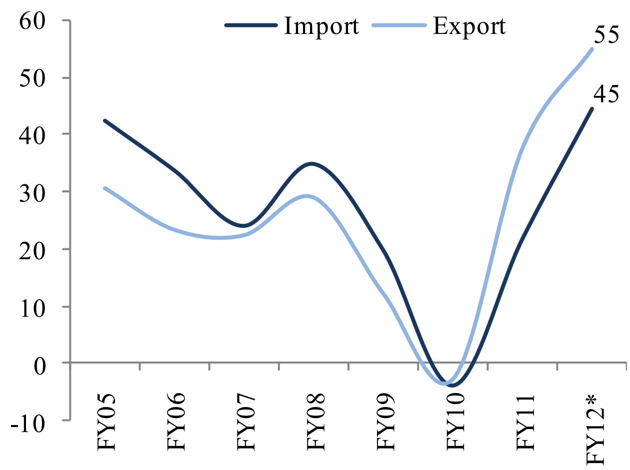


More Details:

Annual Trends, $ Billion



Annual Growth, % YoY



**April-August 2011*

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Trade Deficit has widened in recent years

$ Billion	Import	Export	Trade deficit
FY05	111	84	-28
FY06	149	103	-46
FY07	185	126	-59
FY08	250	163	-87
FY09	299	183	-116
FY10	288	178	-109
FY11	352	252	-100
FY12*	**197**	**135**	**-62**

**April-August 2011*

Forex Reserves Decline by $4.3 billion

Forex reserves during the week ending September 10, 2011, saw one of the sharpest decline in recent months. Forex reserves came down to $316.5 billion largely due to a decline in foreign currency assets. Foreign currency assets during the week declined by $4.2 billion.

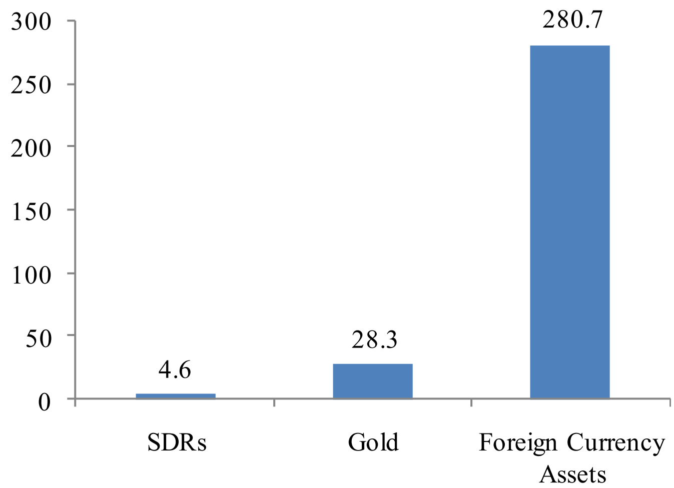
Total forex reserves comprise foreign currency assets, SDRs and the central bank's position in gold, all of which are measured in US dollars.

- During the week ending September 10, 2011, foreign currency assets fell by $4.2 billion to $280.7 billion due to revaluation changes and possible RBI intervention in the foreign exchange markets which led to a fall in the overall position in forex reserves. RBI intervenes through nationalised banks to check volatility of the rupee. Other factors, such as a sell-off in domestic equities markets, could also be a reason which leads to demand for dollars.

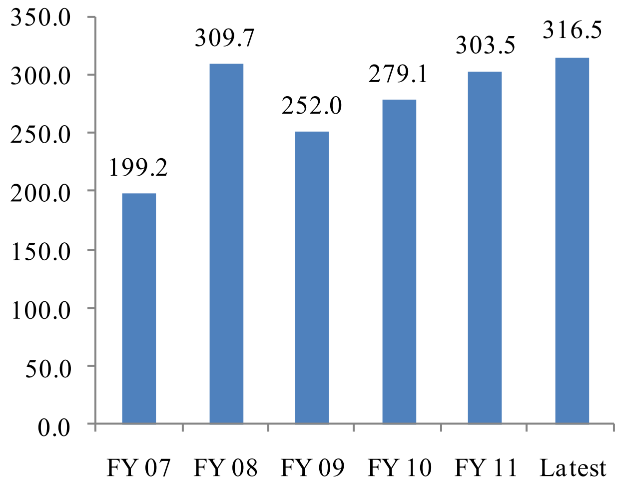
- Position in Gold, reserve position with IMF and SDRs remained largely unchanged during the week.

US$ bn	Forex reserves	SDRs	Reserve Position in IMF	Gold	Foreign currency assets
20-Aug-11	318.2	4.6	3.0	25.3	285.3
27-Aug-11	319.2	4.6	3.0	25.3	286.2
03-Sep-11	320.8	4.6	3.0	28.3	284.9
10-Sep-11	316.5	4.6	3.0	28.3	280.7

Forex Reserves Components (in $ billion)



Forex Reserves Annual Trends (in $ billion)



Uncertainty About Greece Continues To Dog Markets:

European Union and IMF are going to decide this week whether Greece is eligible for the next round of payments to avoid default. The next payment is due in October for the loan package approved by EU & IMF in July 2011. A few of EU members had raised a concern that Greece has not done enough to meet budget targets.

- **Bailout Suspended:** IMF and EU inspectors had suspended their review earlier this month after discovering lapses in the Greece budget.

- Greece is expected to meet EU officials for the release of the sixth tranche of the loan on October 03, 2011. The loan is essential for Greece to meet its obligations.

- Sweden's Finance minister Andes Borg after a EU meeting in Poland remarked that Greece has not done enough to meet its target. Sweden currently is not a member of EU. It recently cut interest rates to avoid appreciation of its currency, as investors sold the Euro and made a beeline for stronger currencies. Interestingly, the Swiss central bank came in for some flak after it decided to install an artificial — and administered — ceiling for the Swiss Franc, to avoid sharp appreciation eroding the competitiveness of its exports.

- Greece is expected to lower budget deficits, create a reserve surplus and pursue structural reforms according to the terms of agreement reached on the bailout.

- Thus higher taxes and lower wages seems tough in the difficult environment it is in currently. EU & IMF support is the only key that can prevent Greece from default. Greece bailout terms are difficult to achieve in this state of environment.

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