June 13, 2011

Economic Weekly

Policy & Research Unit

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Economic Weekly

Indian Economy

* **IIP growth moderates**: The Index for Industrial Production (IIP, a measure of industrial performance) moderated in April 2011, both according to the new and the old series. IIP growth stood 4.4% YoY vs 7.8% YoY in March 2011, according to the old series, while the new series posted a 6.3% YoY growth compared with 8.8% YoY a month ago.

* **WPI primary articles inflation rises**: WPI Primary articles inflation rate rose to 11.52 %YoY for the week ending May 28, 2011, compared with 10.87% a week ago. Primary articles inflation increased due to increase in both food and non-food articles prices over the week. We expect a 25 bps hike in the coming monetary policy meet on June 16, 2011.

* **Forex reserves increased to $312.9 billion:** Forex reserves rose to $312.9 billion in the week ending June 3, 2011, due to an increase in foreign currency assets and valuation of gold in dollars.

* **Yield Curve turns flattish:** Yield curve in India for Government securities from 3 months to 11 years is trading in a range of less than 20 basis points with the 10-year benchmark being out of line with the curve by virtue of trading at a lower yield.

Table of Contents	

Economic Weekly

IIP Growth Moderates In April

IIP growth moderated in April 2011, both according to the new and the old series. IIP growth stood at 4.3% YoY vs 7.8% YoY in March 2011 according to the old series while the new series posted a 6.3% YoY growth compared with 8.8% YoY a month ago. IIP growth moderated in April 2011 due to broad-based moderation, except in basic good industries.

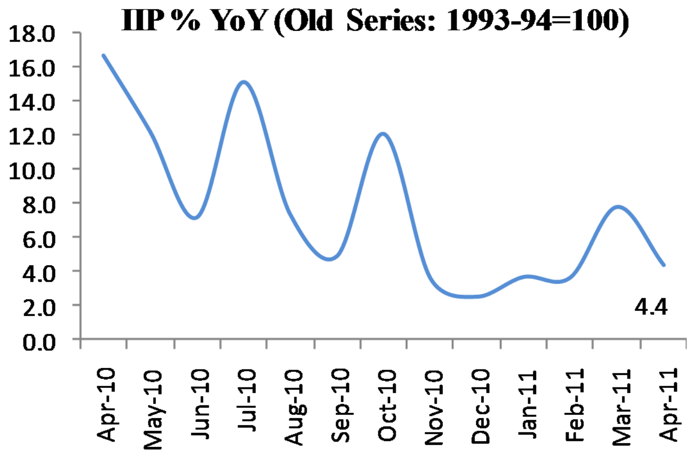
- **New IIP series launched: The** Committee of Secretaries (COS) approved the release of the new series of Index of Industrial Production (IIP) with 2004-05 as base. Estimates of industrial production during April 2011 under the new series were released on June 10, 2011, along with the old series for comparison and analysis purposes. The old series will be discontinued from September 2011. The salient features of new series are:
    - The new series has a representative basket of 682 items which is expected to better represent the structure and composition of industry.
    - Realignment of weights have been done and now manufacturing sector comprises of 75.5% of weight compared with 79.35% earlier while the weight of mining sector has gone up to 14.15% from 10.47% before.

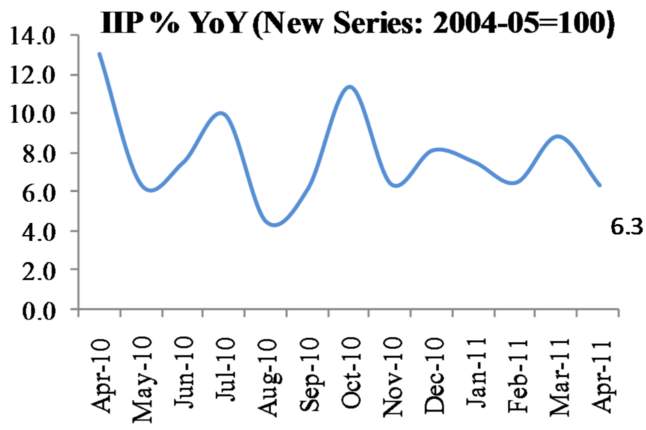
		1993-94	2004-05	1993-94	2004-05	1993-94	2004-05
	Sector	Items	Items	Items	Items		
1	Mining	64	61	1	1	10.473	14.157
2	Manufacturing	473	620	281	397	79.358	75.527
3	Electricity	1	1	1	1	10.169	10.316
4	Total	538	682	283	399	100.000	100.000

- **On use-based basis:** According to the old series, there is across-the-board decline in growth in April 2011 compared with last month. Barring basic goods growth, which improved to 5.6% YoY from 4.3% YoY a month ago, all other constituents registered a decline. Capital goods growth stood lower at 2.5% YoY compared with 13.5% YoY last month. Intermediate goods growth displayed sharp decline in growth to 2.3% YoY vs 6.14% YoY in March. Consumer durables growth was down to 9.19% YoY from 12.74% YoY due to high base and rising interest rates. Consumer non durables growth also moderated to 4.47% YoY from 6.67% YoY.

- **On a sectoral basis:** As per the old series, electricity growth stood at 6.3% YoY down from 7.2% YoY in March. While manufacturing growth stood at 4.4% YoY, while mining growth improved to 2.07% YoY.

- **Capital goods growth:** Capital goods growth remained volatile, according to the old series, while under the new series it maintained past month's growth trend. This suggests that the new series has been somewhat able to iron out frequent spikes and troughs of the old series.





- **Manufacturing lost momentum in April:** Manufacturing showed slower momentum in April 2011 as growth slowed to 4.4% YoY compared with 8.4% YoY growth in March according to the old series as intermediate, capital, and consumer goods registered a significant decline during the month.

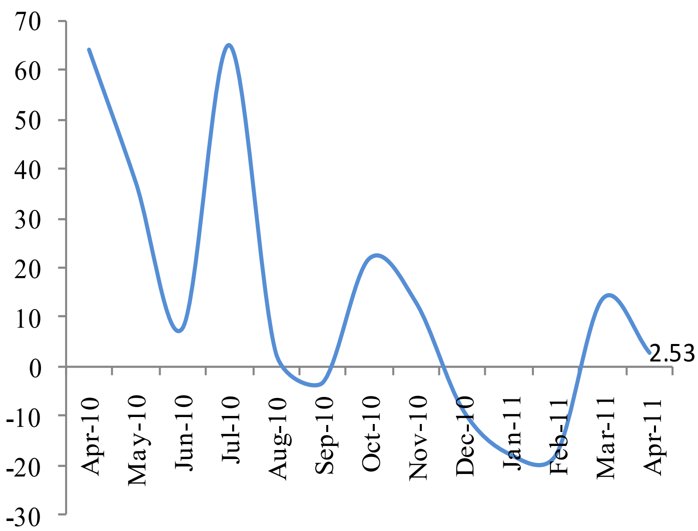
Trends in the old series

% YoY (1993-94)	Weight %	Apr-10	Jan-11	Feb-11	Mar-11	Apr-11
Industrial Production	100	16.64	4.0	3.7	7.8	4.4
Sector-based						
Mining	10.5	11.98	1.8	1.0	0.4	2.1
Manufacturing	79.4	18.0	3.7	3.6	8.4	4.4
Electricity	10.2	6.87	10.5	6.8	7.2	6.4
Use Based Classification						
Basic goods	35.6	9.12	7.6	6.0	4.4	5.6
Capital goods	26.5	64.1	-18.1	-18.2	13.6	2.5
Intermediate	9.3	10.82	7.8	8.6	6.1	2.4
Consumer goods	28.7	11.88	12.2	11.0	8.2	5.9
Durables	5.4	32.12	23.9	23.5	12.7	9.2
Non-durables	23.3	4.83	7.9	6.0	6.2	4.5

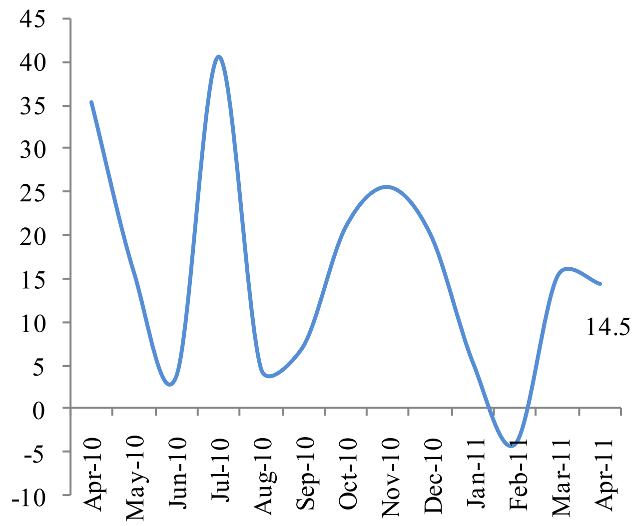
New IIP series

- **New series a better representative:** The new series has evened out sharp spikes from overall IIP. It is expected that the new series will be a suitable lead indicator for estimating economic growth and will help in correctly pointing the overall direction of growth on a monthly basis. Capital goods growth, which had so far contributed to frequent distortion in industrial performance, shows some leveling out as per the new series. However, more clarity of the performance of the new series will be seen in coming months.

Capital goods growth, Old Series



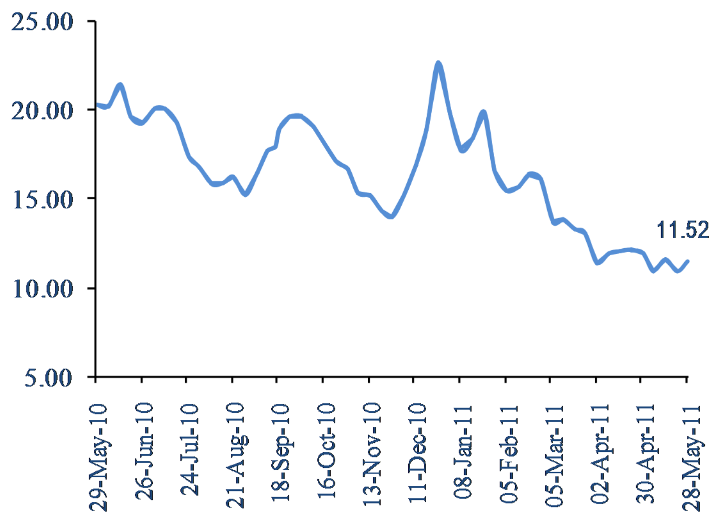
Capital goods growth, New Series



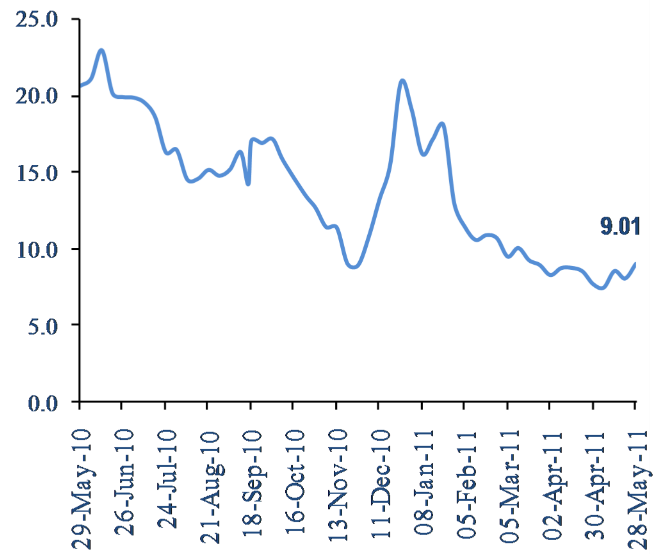
WPI Primary Articles Inflation Rose to 11.52% YoY

WPI Primary articles inflation rate rose to 11.52 % YoY for the week ending May 28, 2011, compared with 10.87% a week ago. Primary articles inflation rose due to increase in both food and non-food articles prices over the week.

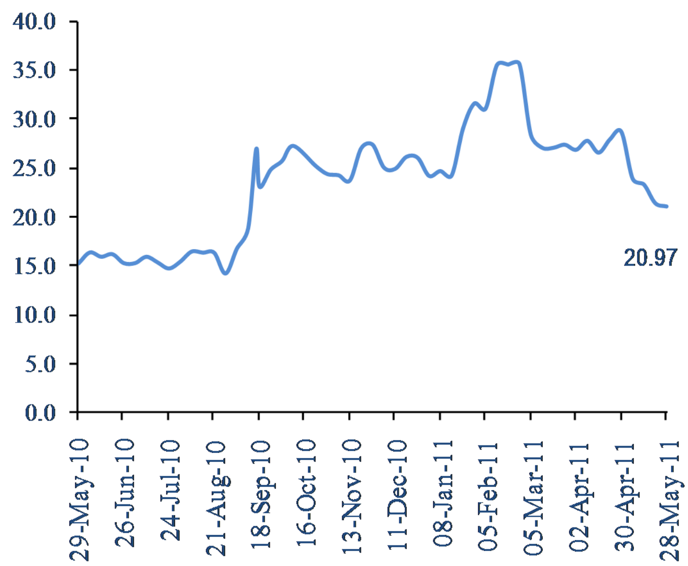
Primary Articles Inflation, % YoY



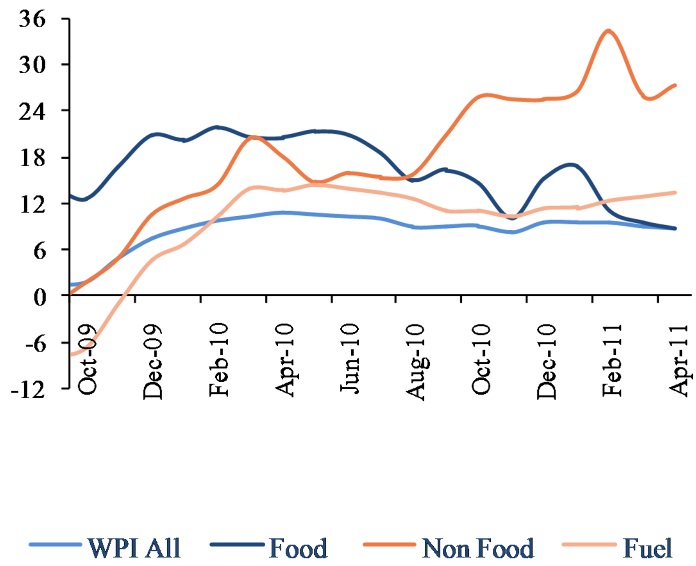
Food Inflation, % YoY



Non Food Inflation, % YoY



Monthly Trends ,% YoY



Trends in Primary Articles Constituents

- Food inflation rose to 9.01% YoY compared with 8.06% YoY a week ago due to increase in the index by 0.64% over the week. The sharp jump in food prices comes after easing of food prices last week. Food index rose due to rise in prices of tea (19%), pork and maize (4%), jowar (3%), milk, chicken and pulses over the week

- Non-food articles inflation eased to 20.97% YoY compared with 21.31% YoY a week ago due to a high base, despite jump in the index by 0.4% WoW .

- Minerals Index remained unchanged from last week.

WPI Sub groups	Index	% YoY	% YoY	% WoW	% WoW
	28-May-11	28-May-11	21-May-11	28-May-11	21-May-11
Primary articles	192.7	**11.52**	10.87	0.52	-0.36
Food Articles	187.5	**9.01**	8.06	0.64	-0.21
Non Food Articles	184.0	**20.97**	21.31	0.38	-1.03
Minerals	266.6	**12.11**	11.78	0.00	0.00
Fuel	160.7	**12.46**	12.54	0.00	0.37

Fuel inflation stood at 12.46% YoY as the index remained unchanged from last week. The index stood unchanged at 160.7 over the week.

Rate hike expected: We expect a 25 bps rate hike in the coming RBI policy meet on June 16 , 2011, despite a slower industrial growth as inflation continues to remain high. Primary articles has remained high and fuel inflation continues to rise which will put further pressure on manufactured items. We, therefore, expect RBI to hike interest rates to signal its monetary policy stand of giving priority to inflation combat over growth promotion.

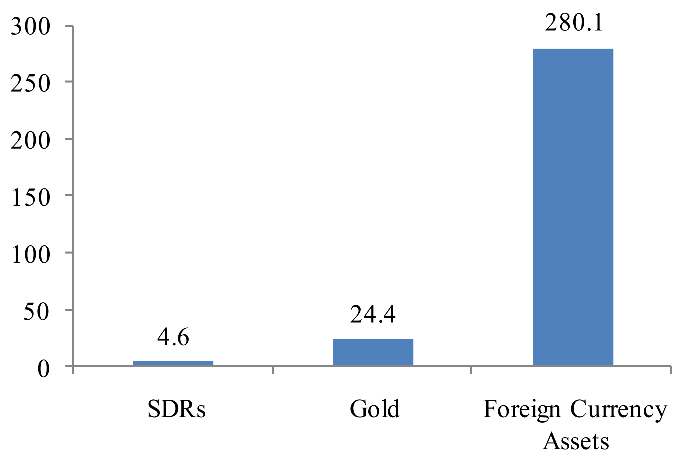
Forex Reserves Increased to $312.9 billion

Forex reserves rose to $312.9 billion in the week ending June 4, 2011, due to increase in foreign currency assets and valuation of gold in dollars. Forex reserves in India are valued in US dollars.

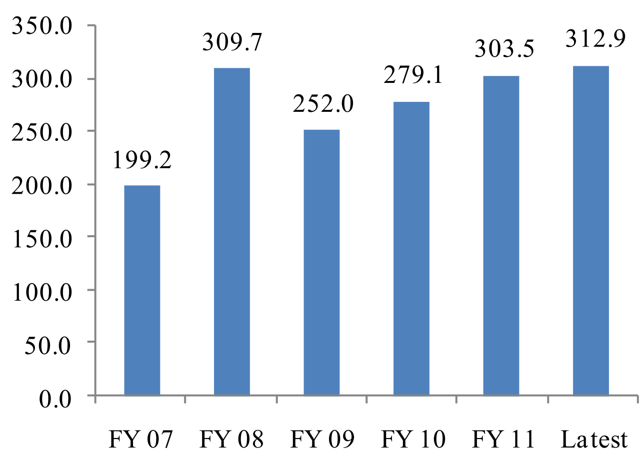
- Total forex reserves comprises foreign currency assets, SDRs and the central bank's position in gold, all of which are measured in US dollars.
- During the week ending June 4, 2011, foreign currency assets increased by $1.2 billion to $280.1 billion due to revaluation changes which led to an increase in the overall position in forex reserves.
- Positions in gold increased by $0.6 billion while that of SDRs remained unchanged over the week.

US$ bn	Forex reserves	SDRs	Gold	Foreign currency assets
14-May-11	307.5	4.6	23.8	276.1
21-May-11	308.5	4.6	23.8	277.2
28-May-11	310.2	4.6	23.8	278.9
04-Jun-11	312.9	4.6	24.4	280.1

Forex Reserves Components (in $ billion)



Forex Reserves Annual Trends (in $ billion)

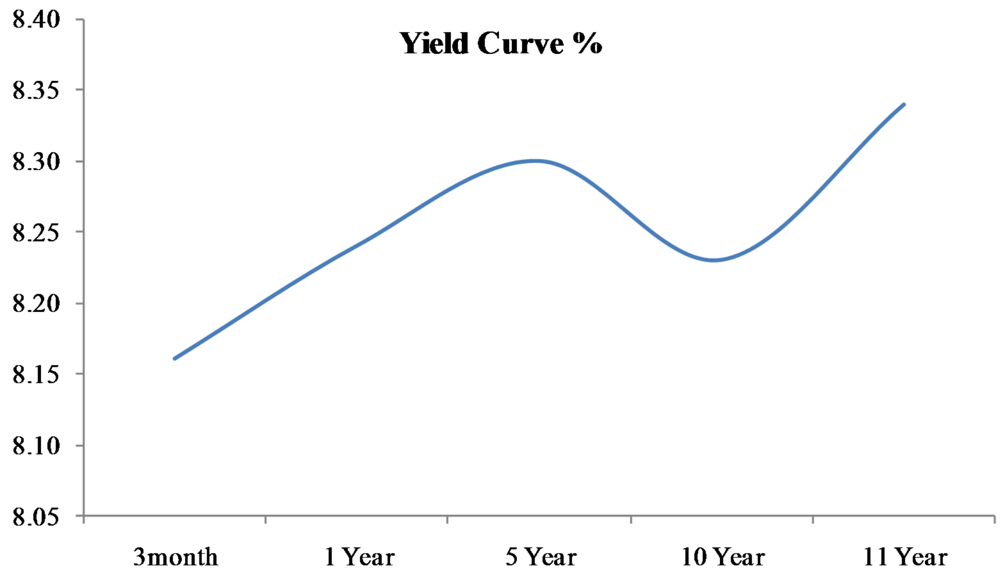


Yield Curve

The Indian government security market has been displaying a fairly flat yield curve for some time with there being some kinks in the curve. The 3-month T-bill on Friday was around 8.16%, the 1-year T-bill at 8.24%, the 5-year G-Sec (7.59% 2016) closed at around 8.3%, the 10-year benchmark (7.80% 2021) at 8.23% while the 11-year papers (8.08% 2022 and 8.13% 2022) closed in the vicinity of 8.34%.

Thus, we see an entire curve from 3 months to 11 years trading in a range of less than 20 basis points with the 10-year benchmark being out of line with the curve by virtue of trading at a lower yield. This is easily explained by the fact that the 10-year benchmark is supposed to be highly liquid and most traded. Since supply in this paper is still being built up, there is considerable demand for the same resulting in a lower yield.

On the other hand, Indian overnight indexed swap (OIS) curve inverted on Friday with the short-end of the curve rising sharply on expectations of high inflation in the short term and more tightness in cash conditions by mid-June when companies make advance tax payments. The spread between the five-year and one-year OIS turned negative for the first time since October 10, 2008, according to Thomson Reuters Data.



The OIS rates at close of trading on Friday were -- 1-Year OIS rate at 7.88%, the 2-year at 7.69% and the 5-year at 7.68%. The early morning action on Monday (today) has led to an increase in the inversion with 1-year at 7.85% and 5-years at 7.62%.

So what does this imply – worry about liquidity, worry about short-term interest rates and inflation expectations, or, should one worry about looming recession? It is believed that an inversion of interest rates is a signal of an impending recession. The argument goes that as interest rates in the near term keep rising, there is lower demand (both consumption and investment), and since people expect inflation to be lower in the future, they defer both these demands rather than meet them at higher interest rates. Is this necessarily what is playing out right now?

We believe that the current scenario has more to do with immediate inflation concerns, expectations of further rate hikes by RBI and the tight liquidity conditions expected.

RBI has ensured that liquidity in the system has been averaging a negative of about ₹75,000 crore, or roughly 1.5% of Net Demand and Time Liabilities. This situation has also been helped by the temporary cash flow mismatches of the government (higher tax refunds) which has led to the government borrowing through a new borrowing instrument called Cash Management Bills, which are bills of less than 90 days duration. Advance tax outflow is expected to suck out another ₹40-50,000 crore by June 15, leading to further tightness.

However, as long as the government spends what it borrows, the liquidity comes back into the system. Also some ₹40,000 crore of government securities maturing in the first half of July will bring some liquidity back into the system.

At the same time, the persistently high inflation has led to expectations of further rate hikes by the RBI. The market is factoring all of these and hence the short term rates are high. Overnight rates are also unlikely to exceed 8.25% where RBI is willing to lend an additional ₹50,000 crore under the Market Stabilisation Facility (MSF).

The markets also expect that in the medium term inflation will decline due to favourable monsoons and reduction in oil subsidies if the government raises prices of oil products.

Taking all these factors into account, it would be premature to conclude that we are heading for a recession. A recession is defined as two successive quarters of negative growth. What we may end up seeing is a slowdown in growth due to the rate hikes by RBI, a moderation in inflation due to better monsoons and lowering of food prices, a pause or halt in rate hikes by RBI once inflationary expectations have moderated, and, thereafter a flatter yield curve that will move towards a normal sloping yield curve as capacity is built up on the supply side.

The joker in the pack as always will be commodity prices. We should be worried about large spikes in oil prices more than steady oil prices albeit at a higher level.

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