

October 31, 2011

Economic Weekly



Indian Economy

***REER Declines, But Not A Big Worry:** Indian rupee's depreciation in the past two months against major global currencies has resulted in a 6.3% decline in the six-currency Real Effective Exchange Rate since August. REER, which measures a currency's competitiveness against other major currencies, is an indicator of its relative value versus foreign currencies. RBI's non-interventionist approach despite rupee's recent slide shows the central bank is comfortable with the weakness in the Indian unit that has been triggered by international events. Also, it raises hopes that rupee will recover once global currency volatility settles.

***WPI Primary Articles Inflation Rises:** WPI primary articles inflation for the week ended October 15 stood at 11.75% on an annual basis compared with 11.18% a week ago. Primary articles inflation increased because of rise in food articles prices during the week.

***Forex Reserves Rise \$0.9 billion:** Foreign exchange reserves in the week ended October 22 grew \$0.9 billion to \$318.4 billion largely due to a rise in foreign currency assets.

***Currency Trends:** Currency trends against greenbacks and expectations for the coming week.

***Articles by RBI Officials:** Deepak Mohanty, executive director at Reserve Bank of India, published an article "Inflation: Decoding the Dynamics". The article talks about the need to address structural constraints to managing inflation in the long run.

Global Economy

*** Euro Leaders Finalise Rescue plan:** On October 27, EU leaders concluded marathon talks in Brussels with an agreement on the plan to bail out Greece. In the crisis summit, 14th in 21 months, the leaders patched together a rescue plan, which included asking bondholders to take 50% losses on Greece debt and raising the capacity of European Financial Stability Fund to 1 trillion Euros (\$1.4 trillion).

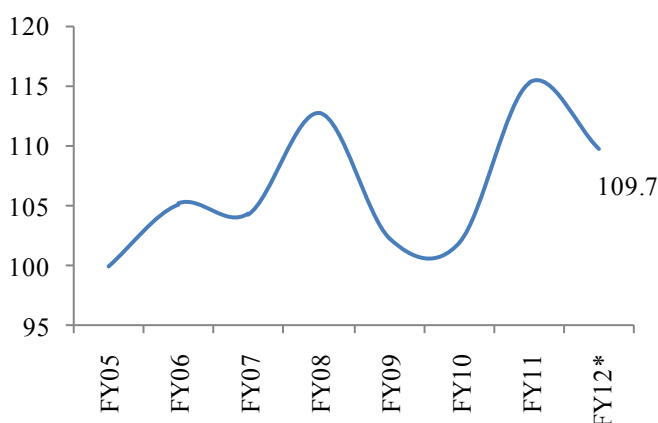
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REER Slides, But Not Worrisome

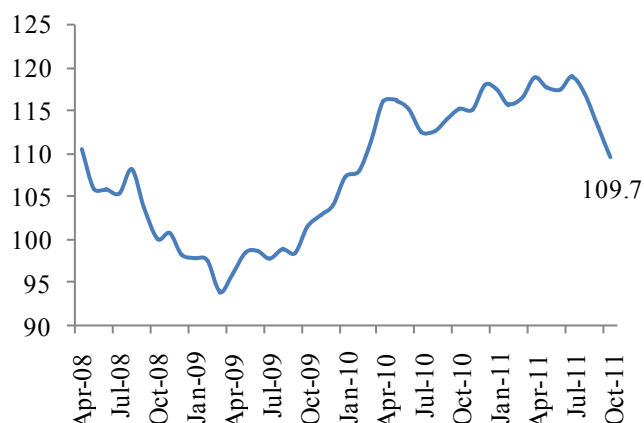
Rupee's depreciation in the past two months against major currencies has resulted in a 6.3% decline in Real Effective Exchange Rate (REER), 6-Currency (Base: 2004-05) index since August. REER measures a domestic currency's competitiveness against other major currencies and is an indicator of its relative value versus foreign currencies. The index weakened to 109.7 on October 17 from 117.1 as of August-end. REER above 100 indicates relative strength of the currency, and the latest level shows that despite the recent slide, mainly due to euro's weakness against the dollar, the Indian currency remains relatively strong. Reserve Bank of India's non-interventionist approach suggests the central bank is comfortable with volatility triggered by international events and sits well with the analytical construct of 'Impossible Trinity'. Also, it raises hopes rupee will recover once global currency volatility settles.

- ◆ **Rupee Not That Weak:** Although rupee has depreciated against major global currencies, it is still relatively strong in REER terms at 109.7. REER is defined as weighted average of nominal exchange rates adjusted for price differentials between domestic and foreign countries. REER relates to purchasing power parity hypothesis. REER levels of 109 implies that rupee is stronger compared with the base year of 2004-05. Being a net importer of goods, a stronger rupee might have worked well for India. This argument seems to have some resonance with RBI's total inaction in spot foreign exchange markets since November 2010, from when rupee has gained consistently. RBI's net dollar sales and purchase data show the central bank is comfortable with a stronger domestic currency versus global majors.
- ◆ **REER Trends:** The 6-currency REER index rose to 112.76 in the period leading up to the economic crisis in 2007-08. During the crisis, REER weakened as rupee depreciated due to fall in capital flows. In one of the sharpest fall during the period, it fell to 93 levels in March 2008. REER stood near 100 for almost two years in 2008 and 2009. As the economy gathered pace, REER started appreciating and scaled 116 by April 2010. From April 2010, REER has stayed around 115 for 17 months. REER's strength and weakness before and after the crisis have been due to demand and supply factors led by capital flows. However, recent slide in rupee has been triggered by euro-zone problems.
- ◆ **Rupee Movement :** The nominal value of the rupee weakened against dollar by around 13.5% since August and touched a low of 50.07 on October 21, in one of the sharpest drops since 2009. Rupee not only fell against the US currency, but also weakened against all other key currencies such as pound sterling, euro and yen. As on October 21, the rupee was down 9.5% against the sterling, 9.3% against euro and 14% against the yen from its August 31 levels. Last week, rupee was off its lows as euro gained against dollar.
- ◆ **PRU Analysis:** *Rupee's recent slide has been due to euro weakness against dollar and not due to domestic demand and supply gap. This gives us reason to believe rupee will recover as major currencies get realigned. Euro has recovered from its recent lows and that has already led to rupee strengthening against the dollar. On Friday, the Indian currency closed at 48.70 versus the dollar, up almost 2.8 % from lows of 50.07 recently. Balance of payment position so far has been favourable too and the non-interventionists approach of the RBI adds to our belief rupee will eventually recover.*

6-Currency REER, Annual



6-Currency REER, Monthly



More Details:

- ◆ The 6-currency REER index in India is calculated using the following currencies: Euro, Yen, Pound Sterling, dollar, Hong Kong dollar and renminbi.

$$REER = \prod_{i=1}^n [(e / e_i) (P / P_i)]^{w_i}$$

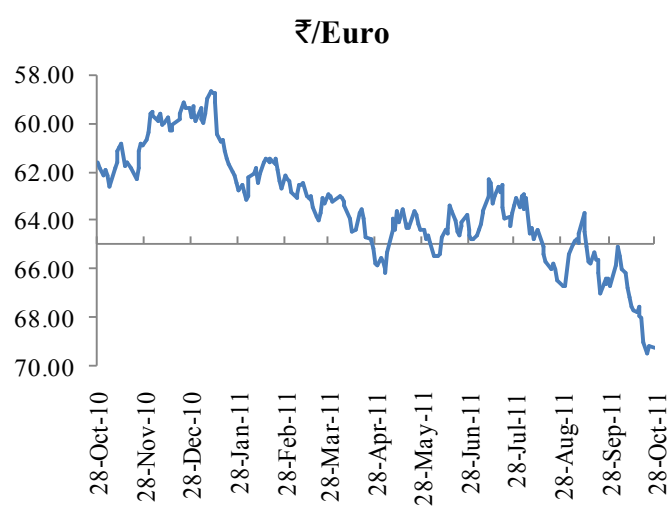
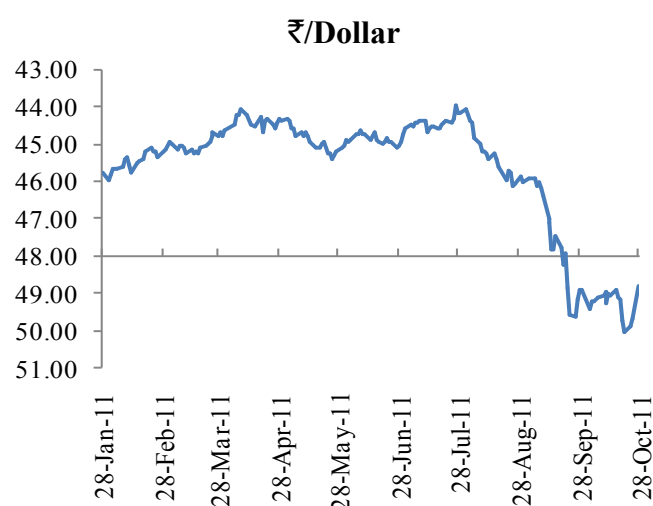
- ◆ REER uses the following formula: where e refers to SDR (Special drawing rights with IMF) per Indian Rupee, e_i refers to SDRs per foreign currency and w_i stands for weights obtained by using its share in bilateral trade. P stands for WPI and P_i stands for the respective CPI of the foreign country.

- ◆ The REER 6-currency index, with 2004-05 as the base, is a dynamic index which uses 3-year moving averages for calculation of weights.
- ◆ There is also a 36-currency REER index, which is also used to measure competitiveness of currency. However, this index is not used too frequently since CPI data for many nations comes with a 3-month lag.

Historic Trends of Weights in REER:

Year	Euro	Japan	UK	USA	Hong Kong	China
1993-94	42.06	14.01	12.04	26.33	4.55	1.01
1994-95	40.25	13.5	11.73	26.95	5.4	2.17
1995-96	39.22	13.44	11.33	26.95	6.07	2.98
1996-97	38.95	12.87	11.25	27.29	6.15	3.49
1997-98	39.28	11.76	11.55	27.46	6.03	4.2
1998-99	38.71	11.03	11.82	28.21	6.03	4.2
1999-00	37.79	10.64	11.86	28.59	6.68	4.44
2000-01	36.67	9.92	12.15	29.12	7.48	4.65
2001-02	35.88	9.3	12.06	29.08	8.02	5.67
2002-03	35.55	8.31	11.67	29.51	7.67	7.29
2003-04	35.52	7.85	10.84	28.9	7.55	9.34
2004-05	35.12	7.15	10.13	28.19	7.45	11.96

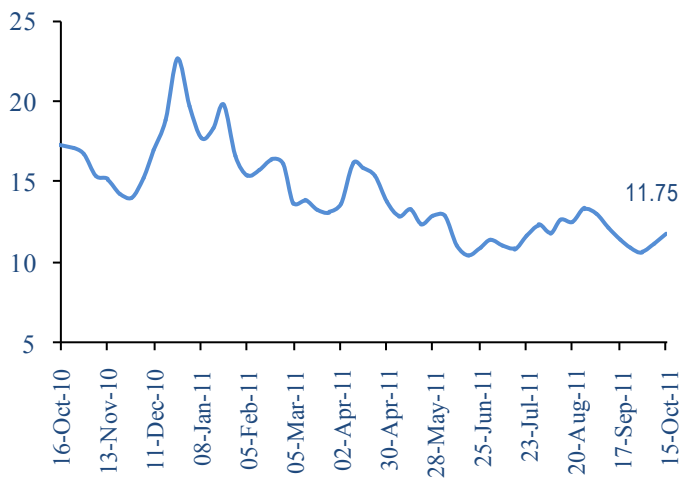
Note: Weights might have changed in recent years with Indian trade becoming far more diversified. However, the data elucidates respective importance of a currency with respect to Indian Rupee.



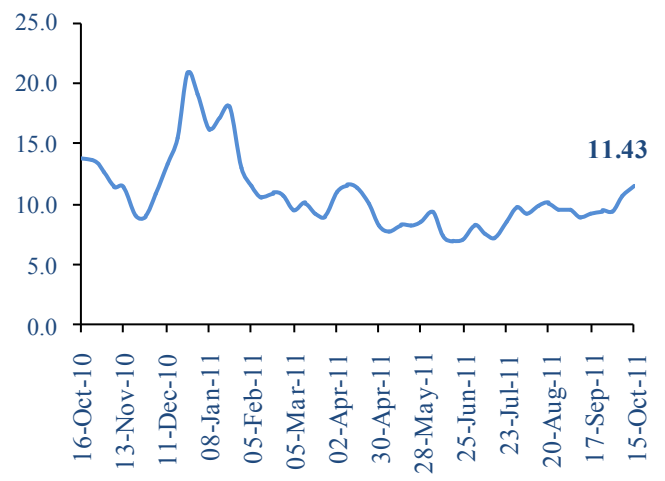
WPI Primary Articles Inflation

WPI primary articles inflation for the week ended October 15 stood at 11.75% on an annual basis compared with 11.18% a week ago. Primary articles inflation increased because of rise in prices of food articles during the week. Food inflation rose to 11.43% from a year ago, compared with 10.60% in the previous week.

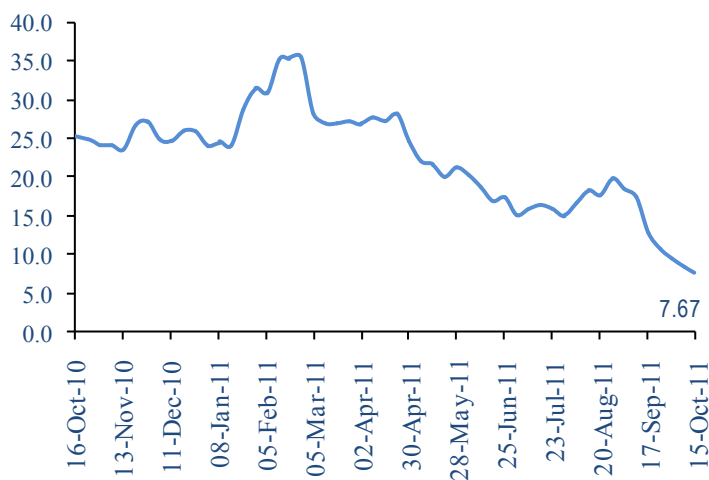
Primary Articles Inflation, % YoY



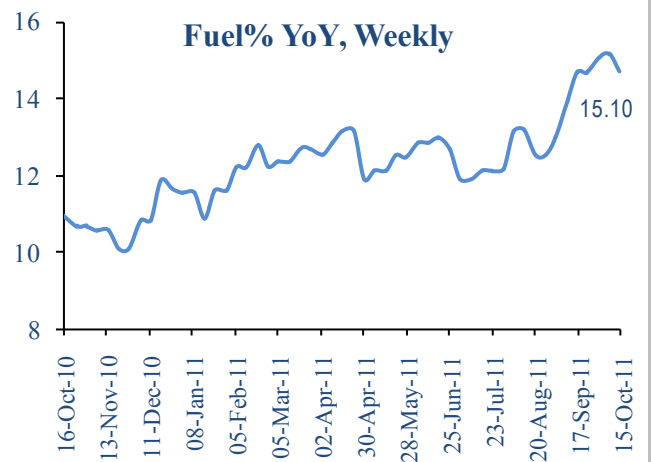
Food Inflation, % YoY



Non Food Inflation, % YoY



Fuel Inflation, % YoY



Trends In Primary Articles Inflation

- ◆ Annual food inflation in the week ended October 15 stood at 11.43% compared with 10.60% a week ago. Food inflation was up due to food prices rising 0.25% compared with the previous week. Food prices rose during the week due to higher prices of pulses, condiments and fruits and vegetables.
- ◆ Non-food articles inflation eased to 7.67% on an annual basis compared with 8.59% a week ago due to a high base in the previous year and decline in prices during the week. Non-food articles index fell 0.06% from the previous week due to a decline in prices of oilseeds, silk and cotton during the week.
- ◆ Minerals inflation increased to 21.59% from a year ago compared with 19.72% in the previous week due to rise in the index by 1.84% over the week.

WPI Sub groups	Index	% YoY	% YoY	% WoW	% WoW
	15-Oct-11	15-Oct-11	08-Oct-11	15-Oct-11	08-Oct-11
Primary articles	203.8	11.75	11.18	0.34	0.20
Food Articles	200.3	11.43	10.60	0.25	0.40
Non Food Articles	179.8	7.67	8.51	-0.06	-0.39
Minerals	303.6	21.59	19.72	1.84	0.00
Fuel	170.1	14.7	15.17	0.00	0.06

- ◆ Fuel inflation stood lower at 14.70% on an annual basis in the week ended October 15 from 15.10% in the previous week. Fuel inflation eased due to a high base as there was no change in the index during the week.

Forex Reserves Rise By \$0.9 Billion

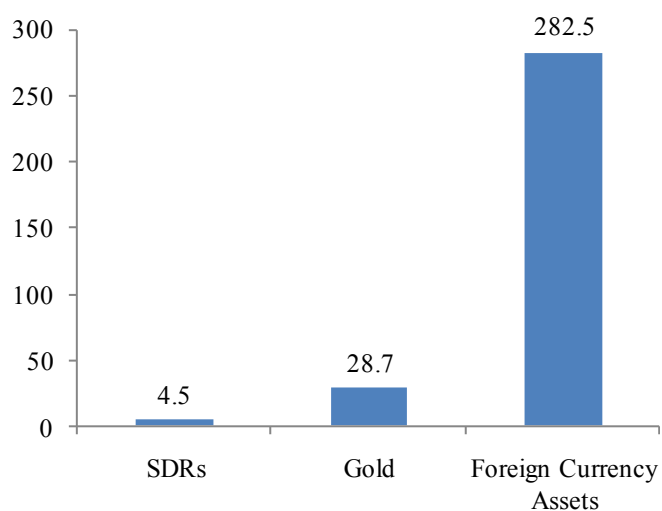
Foreign exchange reserves in the week ended October 22, 2011, rose \$0.9 billion to \$318.4 billion, largely due to a rise in foreign currency assets.

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.

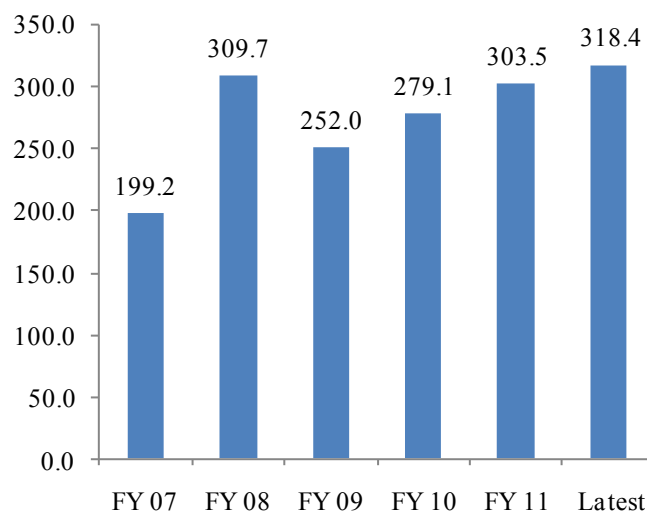
- ◆ In the week ended October 22, 2011, foreign currency assets increased by \$0.9 billion to \$282.5 billion. Revaluation changes could have led to increase in foreign currency assets during the week.
- ◆ Position in gold increased, reserve position with International Monetary Fund and SDRs remained unchanged during the week.

US\$ bn	Forex reserves	SDRs	Reserve Position in IMF	Gold	Foreign currency assets
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
15-Oct-11	317.5	4.5	2.6	28.7	281.7
22-Oct-11	318.4	4.5	2.6	28.7	282.5

Forex Reserves Components (in \$ billion)



Forex Reserves Annual Trends (in \$ billion)



Article by RBI Senior Officials

Inflation: Decoding The Dynamics: Deepak Mohanty, executive director at RBI, published an article in www.livemint.com titled 'Inflation: Decoding The Dynamics'. The article talks about need to address structural constraints to manage inflation in the long run.

Mohanty discusses three main issues —

- ◆ How did inflation dynamics change ?
- ◆ How will inflation evolve in future ?
- ◆ Why do we need to contain inflation ?
- ◆ The article stated: “While inflation is expected to moderate towards the later part of the year, reflecting monetary tightening and likely softening of global commodity prices, fiscal policy needs to be supportive in containing aggregate demand. In addition, there is an urgent need to address the issue of structural supply constraints, particularly in agriculture, so that these do not become binding constraints in the long run, hampering the task of inflation management.”

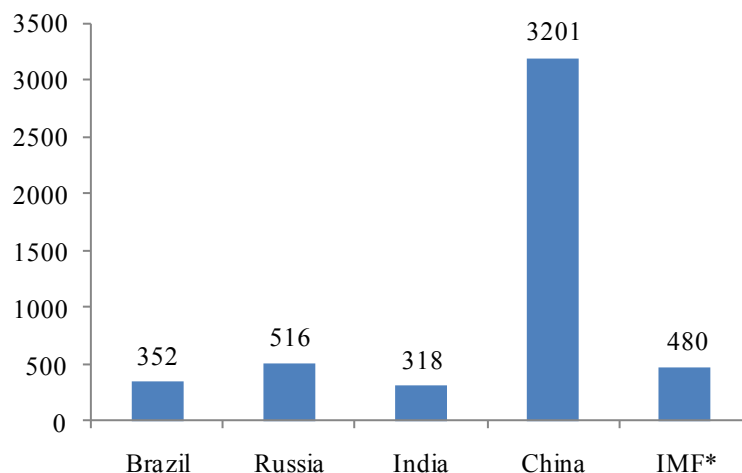
Link to the article: http://www.rbi.org.in/scripts/BS_SpeechesView.aspx?Id=610

Euro Leaders Finalise Greece Rescue Plan

On October 27, European Union leaders ended their marathon talks in Brussels after agreeing on a plan to bail out Greece. The Brussels meet, the 14th crisis summit in 21 months, agreed on the broad contours of the terms: to ask bondholders to take 50% losses on Greece debt, and to raise the capacity of European Financial Stability Fund to 1 trillion euros (\$1.4 trillion).

- ◆ **Greece Rescue Accord Reached:** Early October 27, Euro leaders finalised on a rescue plan to bail out Greece. The terms of the plan require banks to take 50% write-downs on Greece debt. Also, it was widely agreed to raise the capital of the rescue fund European Financial Stability Fund to \$1 trillion. French President Nicolas Sarkozy remarked “the accord will allow Greece to save itself”. German Chancellor Angela Merkel said the agreement is “a good joint package to take the next steps”. Euro leaders have termed the latest efforts as the final package.
- ◆ **Euro To Reach Beyond Borders:** European leaders tried to reach International Monetary Fund and BRICs nations (Brazil, Russia, India and China, which are all deemed to be at a similar stage of newly advanced economic development) to raise capital to expand the rescue fund size. French President Sarkozy spoke to Chinese officials to raise capital for the fund. Chinese Premier Wen Jiabao has shown willingness to aid euro plans to help contain the financial crisis. Stable and fund-rich BRIC nations are expected to help the eurozone by subscribing to its debt, which would provide them means to rescue embattled counties. Sarkozy came under criticism from opposition parties in France over the issue of taking Chinese help, since it is believed that Chinese help is likely to be forthcoming only at a significant cost.
- ◆ **Rise Of Chinese Power:** China has \$3.2 trillion of forex reserves. Its reserves is even bigger than that of the IMF, which has just around \$480 billion of capital. China can easily help the euro-zone avoid a debt default. Given its increasingly strong economic muscle, it is expected China will expect certain trade relaxation from the euro-zone states. China could ask for more access to Euro nations as the area accounts for 21% of its exports. A former IMF official remarked “there will be some quid pro quo’ if Chinese help is taken. China can also force the euro zone to stop raising the issue of Chinese yuan devaluation.
- ◆ **ECB Excluded On Purpose:** Germany prevailed over attempt to utilise European Central Bank funds for rescuing troubled euro nations. To ensure financial stability to other nations and to prevent euro nations from frequently looking for bailouts, Germany insisted that ECB be excluded from bailouts. ECB could have easily rescued debt-ridden nations by buying trillion dollar of bonds.
- ◆ **ECB Gets New Chief:** Mario Draghi succeeded Jean Claude Trichet to become president of the European Central Bank. Earlier, Draghi was governor of Bank of Italy and was member of ECB council prior to that. Draghi has become ECB head at a time when the central bank is in a severe crisis. He has also worked with World Bank and Goldman Sachs.

Forex Reserves by BRIC Nations & IMF, \$ billion



Currency Trends

	USD/INR	EUR/USD	GBP/USD	USD/JPY
Open:	49.85	1.3864	1.5945	75.67
High:	50.005	1.4247	1.6152	79.46
Low:	48.73	1.3796	1.589	75.55
Close:	48.75	1.4145	1.6126	79.16

USD/INR:

Last week, Indian rupee traded in range of 48.70-50.00. For this week, we expect rupee to trade in 48.25-49.50 range. Rupee's support and resistance for this week are as follows:

Resistance 1:	49.5933	Support 1:	48.3183
Resistance 2:	50.4367	Support 2:	47.8867

EUR/USD:

Euro/US dollar weekly support and resistance for this week are as follows:

Resistance 1:	1.4329	Supports 1:	1.3878
Resistance 2:	1.4514	Support 2:	1.3612

GBP/USD:

Pound sterling/US dollar weekly support and resistance for this week are as follows:

Resistance 1:	1.6222	Supports 1:	1.5960
Resistance 2:	1.6318	Support 2:	1.5794

USD/JPY:

US dollar/yen weekly support and resistance for this week are as follows:

Resistance 1:	80.5633	Supports 1:	76.6533
Resistance 2:	81.9667	Support 2:	74.1467



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