MONTHLY MONITOR

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Highlights	## Top Stories
Inflation level reached to an uncomfortable level of 7.57% ***Non-core components pushing prices upwards*** ***Monetary policy to have less impact on inflation in the short-run*** ***Fiscal measures to dampen inflation***	The WPI inflation has reached to an all time high of 7.57% for the week ending April 19th. This rise in inflation has been largely contributed by the rise in the prices of primary articles, edible oil and iron & steel prices. Although the present inflation is much higher than the RBI's comfortable level, it appears that this is largely due to supply side reasons emanating from food and fuel prices, which are global phenomena. The impact of increasing food prices on the domestic economy is expected to be transitory as Rabi crop could mitigate the food prices, while the world fuel prices has large permanent component as it has hit an all time high of US$ 122 per barrel. The hike in the CRR would not bring down prices in the short run while fiscal policy measures is expected to moderate inflation in the short run. Overall, we expect inflationary pressure to cool down and would be below 7% in the coming months.
Industrial growth at 8.6% ***Consumer durables growth positive*** ***High interest rates and declining demand to dampen down the IIP growth in 2008-09***	The growth of IIP in the month of February 2008 has been estimated to be at 8.6%, which is higher compared to 5.6% growth in January 2008. The growth of consumer durables, which was negative for last few months, has turned out to be positive. We expect that the growth in the industrial sector to slow down in the coming months largely due to the rise in the cost of capital and decline in the demand (particularly the external demand). In addition to these factors, increase in the inflation rates is expected to dampen the industrial output and, hence, the overall economic growth in the current fiscal year by reducing the domestic demand.
Despite Rupee appreciation, exports growth robust	Despite the appreciation of Rupee and the falling external demand, the exports growth continues to surge. This could be due to fiscal incentives provided by the government. In the month of March 2008, it has registered a buoyant growth of 26.6%. With this the growth for the whole of 2007-08 is

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Raise in oil import bill leads to high import growth ***Trade deficit widens to US$ 80 billions***	estimated at a robust 23.02%. Similarly, imports also grew at 35.24% in March and at 27.01% for the whole of 2007-08. For the year 2008-09, the new Foreign Trade policy targets the exports of US$ 200 billions. In our view, given the global economic uncertainty and domestic inflationary situation, achieving this target could be challenging.
Money supply continue to grow at 21% ***It might reduce due to CRR hike and forex outflow***	On the monetary front, the money supply continues to grow much above the RBI's targeted growth. The recent hike in the CRR, open market operations and the widening of trade deficit is expected to reduce the money supply growth. On the other hand, the interest rates are stable, although there is some upward pressure due to rising inflation. In the medium term, we don't expect any rise in the interest rates.
Forex reserves at US$ 312 billions ***Exchange depreciates to 41.6***	The foreign exchange reserves, after accumulating a record level, have declined slightly and currently at US$ 312.9 billions. This could be due to widening of trade deficit. Due to same reason, the Rupee/US dollar exchange rate depreciated sharply to 41.6 as on 7th May. This is despite the weakening of US dollar in the international markets.

IEG forecasts

Variables	Latest Information available	Forecast for next Three months
Inflation rate (WPI)	7.57 % as on 19th April, 2008	Around 6.4 %
Inflation rate (CPI)	7.8 % in March 2008	Expected to rise.
Growth rate of IIP	8.6 % in February 2008	9%, 6.6 % and 8.9%
Growth rate of M3	21.2 % as on April 11th, 2008.	Expected to be around 20%
Prime lending rate	12.25-12.75 % in April 2008.	Lending rates to remain stable
Re/$ exchange rate	41.6 as on May 8th, 2008	Expected to be around 41.5
Forex reserves	US $312.8 billions as on April 25th 2008.	To reach US$315 billions by the end of June 2008.
FII inflows	US $ -8.9 billions in February 2008	Positive flows
Growth rate of exports	26.5 % in March 2008	Around 15%
Growth rate of imports	35.2 % in March 2008	Around 23%

Inflation

Inflation rate escalates to 7.57%

Iron &Steel prices growing at whopping 34.1%

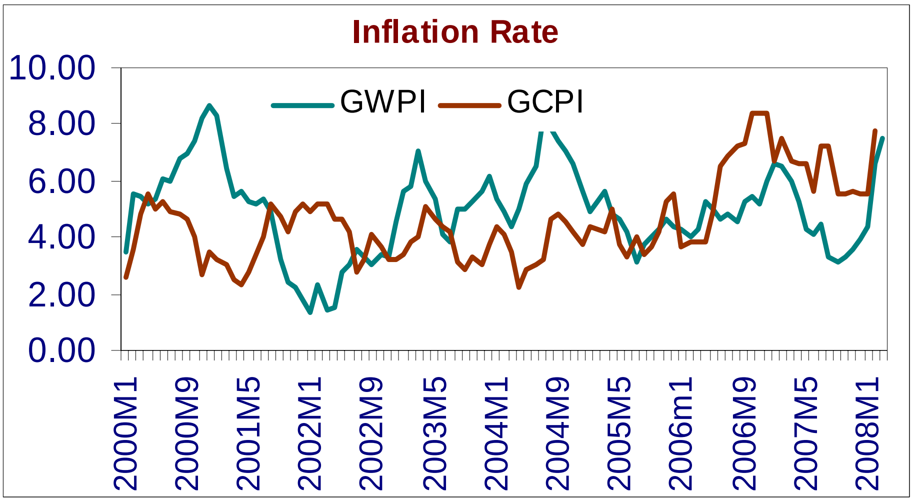
The sudden spurt that has been seen in the inflation rate in the recent times has been mainly due to supply side factors, which now has become a global phenomenon. The WPI inflation stood at 7.57% as on week ending 19th April 2008. The surge has been largely contributed by the rise in the prices of primary articles, edible oils and iron & steel, which have been growing at 8.2%, 14.7% and 34.1% respectively. This spurt in inflation is not only contributed by the global factors, but also due to domestic factors such as sustained high money supply growth (which has been above 21% for a long time) and the presence of steel cartels (which is holding prices despite many fiscal measures). On the other hand, the CPI inflation for the month of March stood at 7.8%, above the WPI inflation.

Supply side factors aggravating the inflationary situation

Rising world oil prices to have long term impact on prices

The inflationary situation is expected to cool to some extent in the coming months following many fiscal measures that are taken. The recent decision of the steel companies to reduce their price and the predicted good rabi crop is also expected to put downward pressure on the inflation rates. But the hike in the CRR would only anchor inflationary expectations in the long run. Overall, we expect the inflation to decline in the next quarter. But the decline may not be large given the sustained increase in the world oil prices, which is currently reached a record level of above US$122 per barrel.

Expected decline in money supply growth to anchor inflation expectations



Forecast:

The WPI inflation forecast for the next three months to be 7%, 6.6% and 6 % *respectively.*

Industry grows at robust rate of 8.6%

Consumer durable goods growth positive

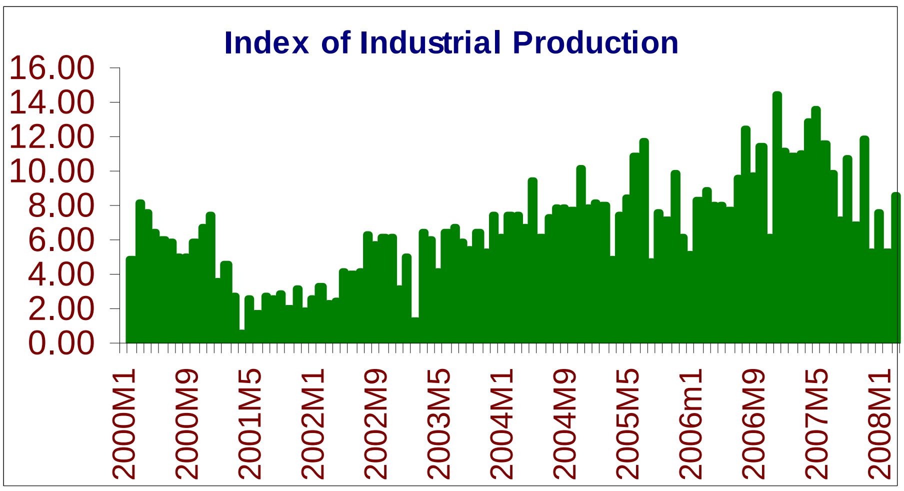
Textile output growth negative

High input prices and decline in demand to drag IIP growth

Industrial Production

The index of industrial production increased by 8.6% in the month of February 2008, which is higher than 5.8% growth in the previous month. This is despite the expectation that there could be slowdown in the industrial sector. But this is much less than the 11% growth in the same period last year. While manufacturing sector growth declined, the electricity sector registered a growth of 9.8% compared to 3.3% in the same period last year. At the two digit level, the growth in the textile products has become negative, which could be due to the appreciation of the Rupee that must have affected its exports. In the Use-based classification, basic goods, capital and intermediate goods are growing at around 7.3%, 10.4% & 8.2% respectively, which is less than the previous year's growth. In the consumer goods segment, the durables goods growth, which was negative for quite some time, has seen a positive growth of 3.3%. But for the whole of April-February the growth is still negative at -1%.

Rise in the cost of capital and decline in the demand (both domestic and external), we expect some moderation in the industrial output growth in the coming months. The decline in credit off-take and the inflationary situation would further dampen down the industrial growth. Overall, we expect the industrial sector to grow at around 8% in 2008-09 compared to nearly 9% growth in the 2007-08.



Forecast:

Based on the available information we forecast the IIP growth rate for the next three months to be 9%, 6.6% and 8.9% respectively.

Money supply growth continues to be above 21%

This is largely due to sharp rise in net foreign exchange assets.

Credit to government also rises sharply

Money supply growth to decline following RBI's measures

Prime lending rates stable

Recent RBI policy not to have any impact on rates

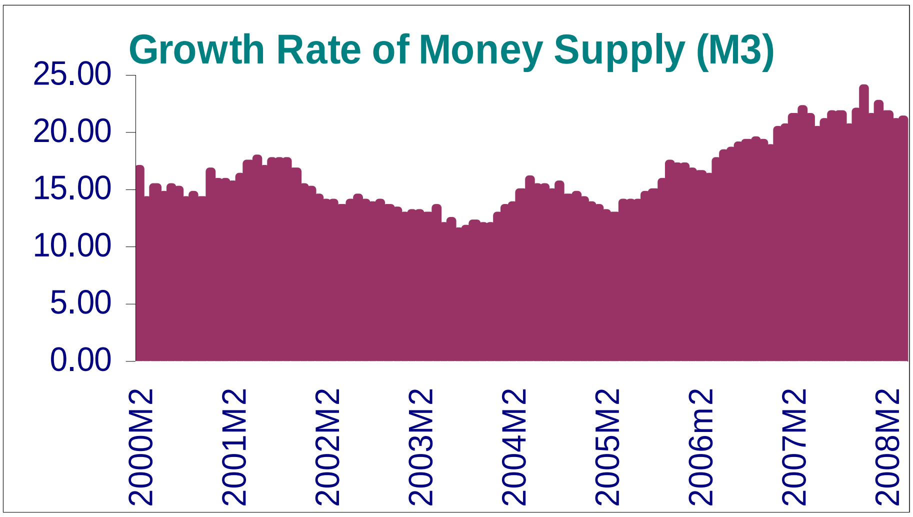
Money and Credit

Broad money supply growth (M3) continued to grow above the 20% mark with the growth for week ending April 11th at 21.2%. This is much higher than the RBI's targeted growth of 17.5 to 18%. The sustained high growth has been mainly contributed by the high growth of net foreign exchange assets of the banking sector, which is at 39.6% in the sources side. There is also a sharp rise in the growth of banks' credit to government, which is at 22.2% compared to 6.9% in the same period last year. On the other hand, the growth of credit to commercial sector has declined from 25.5% last year to 21.7%.

We expect the money supply growth to decline in the coming months due to recent hike in the CRR, open market operations, and decline in both foreign exchange reserves and the credit demand. It is only the expected widening of fiscal deficit, which seems to be financed by the banks, which would lead to expansion in the money supply growth.

Forecast:

We forecast the growth rate of money supply (M3) to decline to 20% in the next three months



Interest rates

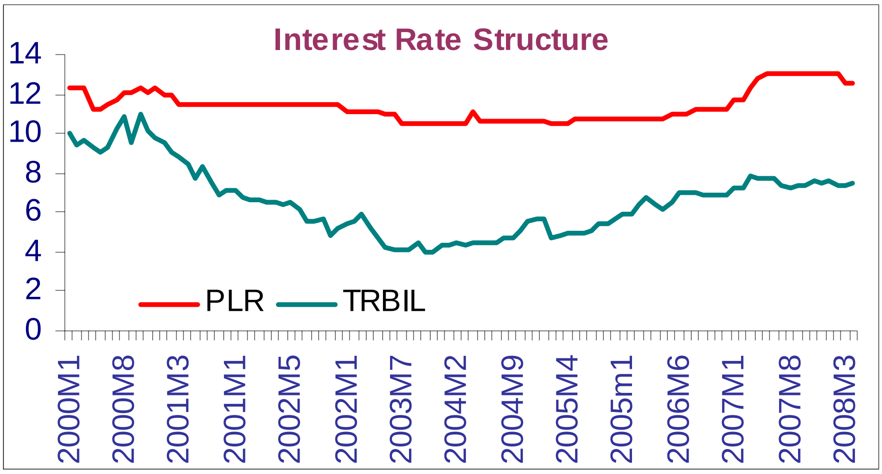
Against our expectation that interest rate structure would come down due to excess liquidity in the system and the widening interest rate differentials, the RBI, in its recent annual policy, has not tampered with the interest rates. This could be largely due to increasing inflation levels, which was well above the tolerable level. The hike in the CRR by 75 basis points may

Interest rates need not be linked with present inflation

not put upward pressure on the domestic interest rates. As the current inflation is not due to demand side reasons, we feel that interest rates should not be linked to inflation rates. Further, given that the high interest rates have started affecting the real economic activity, it would be suggested to reduce the interest rates. Otherwise, the fall in the output growth might add to and prolong the already inflationary situation.

Forecast:

Based on the data up to April 2008, we forecast that prime lending rates to remain stable



Exchange rate

The Rupee/US dollar exchange rate depreciates sharply to 41.6

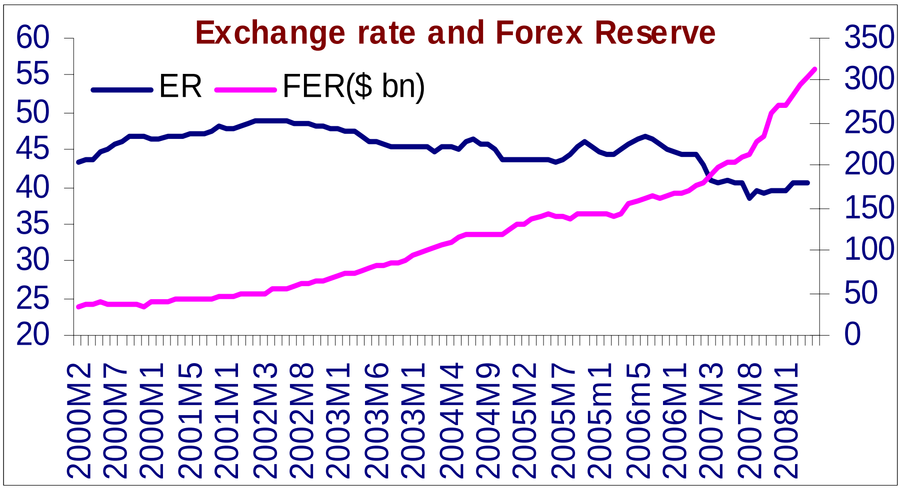
The Rupee/US Dollar exchange rate has seen sharp depreciation in the first week of May from 40.5 to 41.7. It appears that this is largely due to sharp rise in the demand for dollars from the oil companies in the wake of increase in the world oil prices. This is despite the weakening of US dollar in the international market. In addition to this sudden demand, the widening of trade deficit must have also contributed for this depreciation.

Rise in the demand for dollars from the oil companies led to depreciation

In the short term, we expect the Rupee to be at its current position of around 41.5, as the exchange rate is allowed to be market determined. But in the medium term, we expect some appreciation as the US dollar position in the international market would have major influence on the domestic currency. However, the overall outlook depends on the RBI's intervention in the forex market.

Forecast:

The Rupee/US Dollar exchange rate is expected to be around 41.5 in the short term and then appreciate marginally in the medium term.



Foreign Exchange Reserves

Forex reserves hovering around US$ 312 billion.

Foreign exchange reserves continue to grow at a robust rate with reserves touching US$312.8 billion in the week ending April 25th. But in this week it has also shown a decline of US$ 663 millions, indicating that the impact of large trade deficit would lead to further reduction in the reserves. As the India's economic fundamentals are still strong and sentiments are positive, we expect an increase in the foreign investments into emerging market economies such as India as the growth outlook in developed countries appears to be not so positive following the global market disturbances. With this we expect that India's forex reserves would increase further despite trade deficit and other issues.

Widening trade deficit and outflow of short term capital would restrain from further accumulation

Forecast:

Forex reserves to reach US$ 315 billions by the end of June 2008.

Foreign Institutional Investment

FIIs net sellers in the month of February 2008

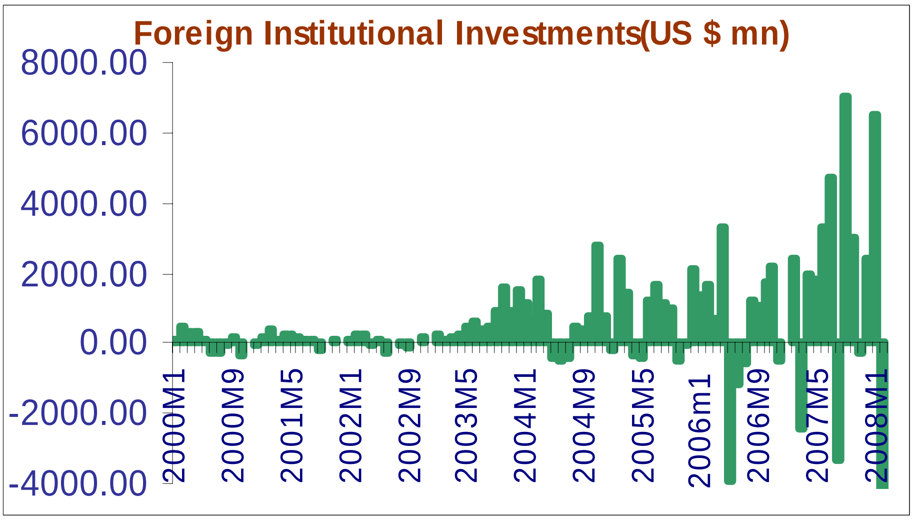
With uncertainties surrounding world economy heavy selling was seen at the tune of around US$ -8904 million in the month of February as compared to a positive flow of US$ 6739 million in January 2008. This sort of heavy selling was expected especially due to escalating financial situation in the US and expectation of some sort of a contagion effect percolating into the emerging markets. One of the major reasons for such gyration seen in FII flows is the uncertainty surrounding the state of financial markets and also the

The sub-prime crisis and the consequent reduction of US interest rates expected to lead to FII inflows

worsening situation in US. But given that the Indian economy may not be much affected due to the sub-prime crisis, we expect the FIIs would be net investors in the market.

Forecast:

Based on the data up to February 2008, we expect the positive inflow of FII investments.



Exports and Imports

Trade sector shows robust growth

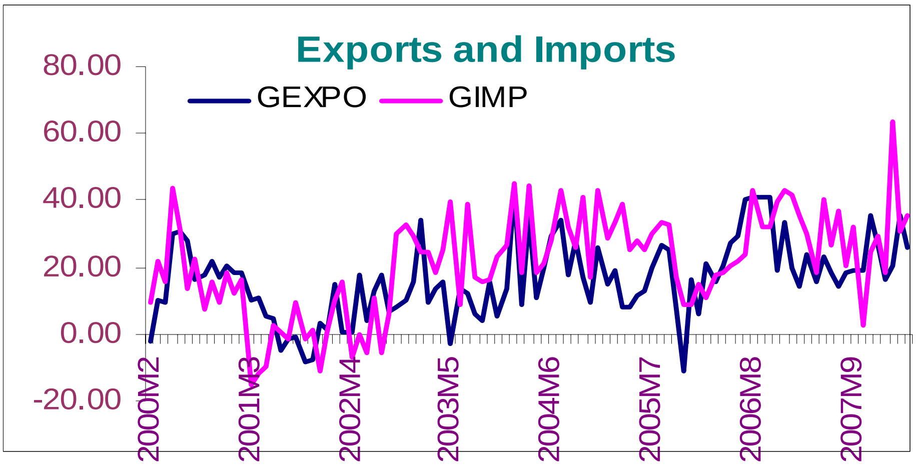
Exports and imports grew at 26.5% and 35.2% respectively

Despite the appreciation of rupee the exports registered a growth of 26.5% in the month of March 2008. During the cumulative April-March period it has registered a growth of around 23.02 %. On the other hand, imports grew at a high rate of 35.2% in the month of March with cumulating growth during the April-March period being around 27.01%. The trade deficit has widened to US$ 80.4 billions in the period April-March 2008.

Government's sops to exporters seems to have helped sustain high export growth

Rise in the world oil prices and cost of non-oil imports led to high imports growth

Although, we expected a slowdown in the exports growth, it appears that the fiscal sops provided by the government to the exporters must have helped to sustain the high growth in the exports. On the other hand, high growth in imports has been contributed by raising cost of oil in the international markets and due to strong Rupee in the month of March 2008. Now as the export incentives have been removed and instead caps on the export of some commodities, we expect that the exports growth to moderate. Regarding imports, the oil import bill is expected to be larger given the sharp rise in the world oil prices.

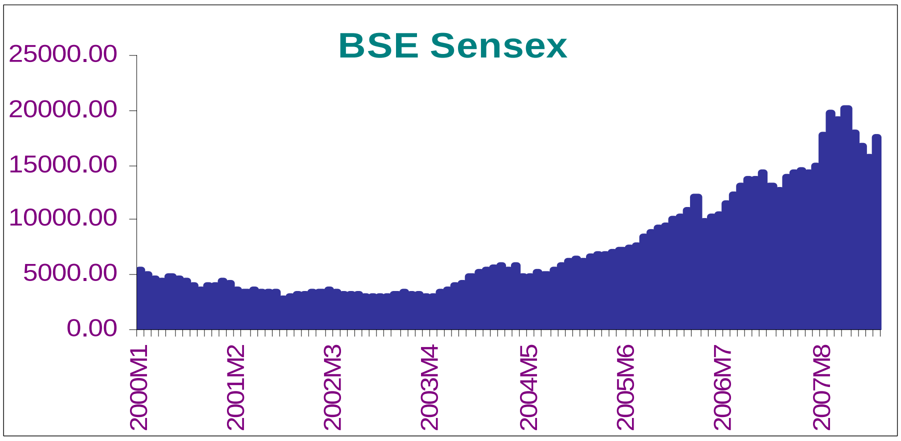


BSE Sensex

The volatility continues in BSE

The volatility in the stock market continues. This could largely due to the integration of domestic financial markets with the international markets, which continue to be volatile following the sub-prime crisis in the US economy. But the impact of this sub-prime crisis on India appears to be not so large as domestic fundamentals (except inflation) are still strong and the exposure of Indian banks in the debt market is not significant. In addition to this, fourth quarter results, which are above the expectations, also must have helped the Indian stocks.

Uncertainty in the global financial markets lead to more volatile domestic stock market



Note:

The forecasts that are presented in this document are based on the time series model namely Vector Autoregression model (VAR). Each variable has an independent model. This is based on monthly data from April 1993 onwards upto latest information available. The lag length for each VAR model is chosen with the help of Akaike Information Criterion (AIC). We estimate and forecast the VAR models by using Micro FIT software. More details is available at "A Short-term Time Series Forecasting Model for Indian Economy" available on our institute website at **http://www.iegindia.org/dis_bhanu_72.pdf**

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