MONTHLY MONITOR

सत्यमेव परमो धर्मः

Prepared by
N R Bhanumurthy

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Industrial growth declines sharply

In April-June 2008 IIP growth is at 5.2% compared to 10.3% in same period last year

Decline in both domestic and external demand led to this fall in IIP growth

This downward movement in IIP cycle is not surprise and is not expected to be short lived

On industrial slowdown….

The industrial sector data for the month of June 2008 has shown that for the first quarter of the current fiscal year, the IIP growth is at 5.2%, which is half of the growth of 10.3% that was registered in the same period last year. This raises the doubts on the industrial performance in the coming period. In other words, one may be interested to know the length and breadth of the current slow growth phase of the sector. Although the growth slowdown is very much predicted by us and many other analysts, it is necessary to understand the underlying causes for this slow growth before concluding about whether it has bottomed out or not. (In our previous issue, we did say that the industrial slowdown is here to stay for some time, although many opposed to this view at that time.)

One of the main reasons for this slowdown is the decline in the demand, both external and domestic. Slowdown in the global economy, US economy in particular that is staring at the economic recession, and the rise in the general price level across the globe has resulted in not so robust growth in exports even after providing fiscal incentives to this sector since last year. Similarly, the domestic demand has also declined due to rise in both inflation (to its near historic highs) and interest rates. In addition to this, we have been saying that there could be some growth cycles. It is well known that the high industrial growth cycle that started since 2003-04 has been the longest in the recent times and, hence, any downward movement of the cycle should not be a surprise and is not expected to be short lived. On the inputs side, although we don't see high interest rates as the reason for the slowing down in investments in the industrial sector, the rise in the fuel prices to its historical level could also be a factor for the declining industrial sector, through increase in the cost of production.

Now to the issue of length and breadth of the present slow growth phase, in our view the industrial growth is yet to be bottomed out. The reasons for this position are as follows. As said earlier, the cyclical component will ensure that the

Development Planning Centre, Institute of Economic Growth, Delhi University Enclave, Delhi-110007, India. Phone: (00)-91-11-27667365, Fax: (00)-91-11-27667410
E-mail: bhanu@iegindia.org URL: www.iegindia.org

downward movement is not short lived. Second, we expect the present double-digit inflation rate and its associated high interest rates to continue atleast until end of this year. This would dampen down the investments. Third, we don't expect the revival in the external demand soon, rather we expect sluggishness given the gloomy global economic outlook.

Capital goods growth declines sharply to 5.6% from 23.1%

Until recently, based on the robust growth in the non-oil imports (assumed to be largely intermediate goods used for production of final products domestically), some have argued that the rise in inflation and interest rates has not affected the domestic demand and, hence, industry is not expected to enter the recessionary phase. But the data for non-oil imports in June 2008 shows a decline to 13.8% compared to nearly 25% growth in April-May 2008. On the other hand, the imports of oil is growing at more than 50%, which is leading to depreciation and making non-oil imports costlier. Hence, in our view, the slow growth in industrial sector is in the beginning phase and is expected to last atleast the large part of the current fiscal year. The decline in the capital goods output growth from 23.1% to a meager 5.6% in the recent period could also corroborate this view.

Restrictions on ECBs would lead to fall in investments

Two other important factors to be analyzed in order to ascertain future industrial growth prospects are investments and the Sixth Pay Commission award. On the investments side, there are some indications that in the recent period some restrictions have been put on ECBs, a big source for cheap capital for the domestic producers, and it seems to have resulted in a significant fall in the actual borrowings. This is expected to result in holding the capacity expansion plans of many of the industries and also the new projects.

6th Pay commission award not to have the same impact as it had during 5th Pay Commission.

The impact of Sixth Pay Commission on the industrial performance is expected to be minimal. One may remember that unlike the Fifth Pay Commission, which has more than doubled the wages and had impact led to upward movement in the industrial growth for two years in the late 1990s, the Sixth Pay Commission award is much less. All these factors lead to a conclusion that the industrial growth is not bottomed out and is expected to prolong.

On GDP growth…..

The GDP growth in first quarter of 2008-09 fall sharply to 7.9%

In our previous issue of 'Monthly Monitor', we have predicted the GDP growth for the year 2008-09 will not be more than 7.5%. Now the dip in first quarter growth from 9.2% to 7.9%

	and other macroeconomic indicators only strengthen our forecast of 7.5%.
We did predict GDP growth of 7.5% for 2008-09	Main reasons for this outlook are the sharp decline in the demand (both external and domestic) following rise in the domestic inflation, decline in the global economic outlook and other external factors. These factors have resulted in fall in investments and are expected to have adverse impact on both industrial and service sector growth. Our own analysis shows, and we have said it elsewhere also, that the recent decline in the industrial growth is just a beginning of the downward phase of the cycle and is expected to continue atleast in the medium term.
Fall in industrial growth to have adverse impact on services output growth	It is also important to note that unlike in the recent past where service sector was the engine of growth, this time around, it is the commodity sector growth (besides global slowdown) that is going to provide impetus to services output and, hence, the overall economic growth. Therefore, if the present downward movement in industrial growth prolongs, this would result in low GDP growth in both 2008-09 & 2009-10.
Expected Kharif output to revive domestic demand	Declining food and fuel prices in the international market gives some respite and is expected to stabilize in the medium term, but at a much higher level than it was historically. Hence, the domestic prices (inflation) are expected to stabilize in the next fiscal year. This means that the demand constraint to extend to whole of this year atleast and would pull down the GDP growth to 7.5%. Only hope for any revival in demand is the expectations on the Kharif crop, which is supposed to respond to higher food prices. The floods, delay in monsoon in many parts of the country and ban on both exports and trading in commodity exchanges that resulted in slow crop sowing in the kharif would dampen down this optimism. The Sixth Pay Commission award, which is much less than previous pay hike, is also not expected to have significant impact on demand. In conclusion, all trends suggest that this year the growth would not be more than 7.5%.
Fall in the world commodity prices to soften the domestic inflation.	Other stories…. The inflation rate continues to be high and is a cause for concern. Growth in the prices of iron & steel and the primary articles are pushing overall inflation rates. Due to fall in the World oil prices and also due to the domestic monetary measures, we expect some moderation in the inflation rates in the coming months. But, wit the low base, this moderation would be significantly high only from the beginning 2009.

Both PLR and deposit rates increased. **Expect no further tightening as interest rate cycle peaked**	Following the recent monetary tightening measures, the overall interest rate structure (including PLR and deposit rates) have gone up. Going forward, we don't expect any further tightening as interest rate cycle has already peaked. Any further tightening would only hamper the growth instead of mitigating inflation rate.
Money supply growth continue to be higher	Despite the monetary measures, the money supply growth has not declined and is still above 20%. This could be largely due to raise in the net foreign exchange assets with the banking sector. But as we expect these assets to decline due to widening trade deficit, money supply growth is also expected to be moderated.
Robust growth in trade sector performance **Trade deficit widens to historical high**	Against our prediction, the exports growth continues to be robust. On the other hand, the imports growth has also increased sharply, largely due to huge oil import bill. We expect some slowdown in exports following decline in the external demand and also due to high domestic prices. But exchange rate depreciation might restrain from huge fall in exports. On the other hand, the fall in the global oil prices, would moderate imports growth also to some extent in the coming months.
Forex reserves falls to US$ 297 billions **FII outflow continues for fifth consecutive months**	Foreign exchange reserves declines to US$ 297 billions. This is largely due to huge trade deficit, which was above US$ 10 billions per month for the second consecutive month, and also due to strengthening of US dollar in the international markets. In addition to this, the continuous outflow of FII funds must have also led to this decline. Due to same factors, we don't expect any further accumulation of reserves atleast in the short term.
Exchange rate depreciates sharply **We expect exchange rate to be around 44 in the medium term.**	Exchange rate depreciated sharply to 44.3. Strengthening of US dollar and widening trade deficit has put buying pressure on the dollar counters. The expected decline in the dollar demand from the oil companies is expected to restrain the Rupee from further weakening. But the strengthening of US dollar in the international market would lead to depreciation to some extent. On balance, we expect the exchange rate to be little above 44 in the medium term.

IEG forecasts

Variables	Latest Information available	Forecast for next Three months
Inflation rate (WPI)	12.4 % as on 16th August, 2008	Around 11-12 %
Inflation rate (CPI)	7.69 % in June 2008	Expected to increase to 8%.
Growth rate of IIP	5.4 % in June 2008	To be around 5-6%
Growth rate of M3	20.6 % as on 15th August, 2008.	Expected to decline to 19.5%
Prime lending rate	13.25-14 % as on 15th August 2008.	To stabilize at this level
Re/$ exchange rate	44.07 as on 1st September, 2008	Expected to be around 44
Forex reserves	US $297.286 billions as on 22nd August 2008.	Expected to decline to US$ 295 billions.
FII inflows	US$ -3.011 billions in June 2008	Negative inflows
Growth rate of exports	31.2 % in July 2008	Around 17-20%
Growth rate of imports	48.1% in July 2008	Around 25-30%

Inflation

Inflation rate continues to be above 12%

The WPI Inflation continues to be at higher levels. In the month of August 2008, the inflation rate touched to a high of 12.6%. This high inflation has been primarily contributed by primary articles, fuel group, edible oils and iron & steel, whose prices are growing at 11.8%, 18%, 14.9% and 35.3% respectively. This rise in the inflation rate is largely due to international factors, which is at the moment showing some decline. But there are domestic factors also such as high money supply growth that are fueling inflation. It also due to high input costs such as high iron ore prices, which increased by around 50% since January, have also led to this high inflation. As we said in our earlier issue, there is also the base effect that is pushing the inflation upwards.

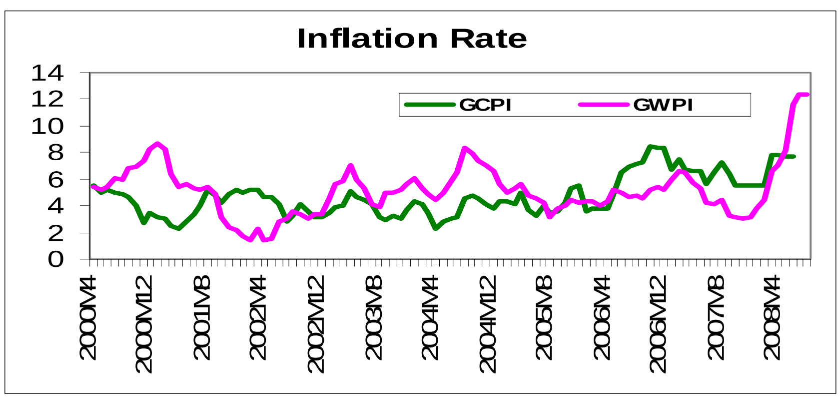
Expected to decline marginally

Fall in World commodity prices to dampen inflation

We expect the rise in inflation to subdue due to fall in the World oil and commodity prices in the recent month and also due to expected fall in the money supply growth. (World oil prices have dropped to US$109 per barrel). We also expect that by the year end, the inflation rate to come off the highs and prevail at single-digit.

Forecast:

The WPI inflation forecast for the next three months to be around 11-12%.



Industrial Production

Industrial slowdown continues

Capital goods growth drops sharply

The industrial sector growth continued to decline. For the month of June 2008, IIP growth is at 5.4% with a cumulative growth of 5.2% for April-June 2008. This is much lower compared to 10.3% in the first quarter of last year. This decline is largely contributed by fall in the growth of manufacturing sector growth. In the Use-based classification, the capital goods growth has fallen sharply 23.1% to 5.6%. Only positive sign is in the growth of consumer goods (both

Consumer goods growth increase

durable and non-durables) that increased from 3.6% to 10% in this month. Consumer durables growth, which was negative at -3.6% last year, has registered a positive growth of 3.5%.

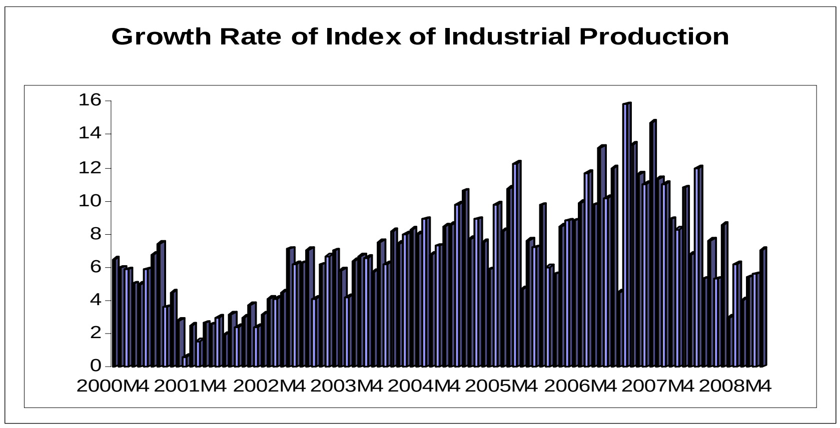
Slowdown industrial growth expected to continue in the medium term

Going forward, we expect the current slow growth phase to continue due to rise in the cost of production and also due to slackening of demand. In addition to this, there could also be some cyclical factor that is pulling the growth. But demand from the festival season and the Sixth Pay Commission award might to some extent restrain the industrial growth from sharp fall.

No major impact of 6th Pay and also festival demand

Forecast:

Based on the available information we forecast the IIP growth rate for the next three months to be 5.8, 6.1, and 5.6.



Money and Credit

Monetary tightening measures did not show much impact on money supply growth

Monetary tightening measures that RBI has taken up recently seem to have not shown any impact on the money supply growth. The broad money supply growth (M3) continues to grow at 20.6% by the middle of August 2008. This is largely due to rise in the growth of both net foreign exchange reserves with the banking sector and bank credit to commercial sector, which are growing at 36.5% and 24.2% respectively.

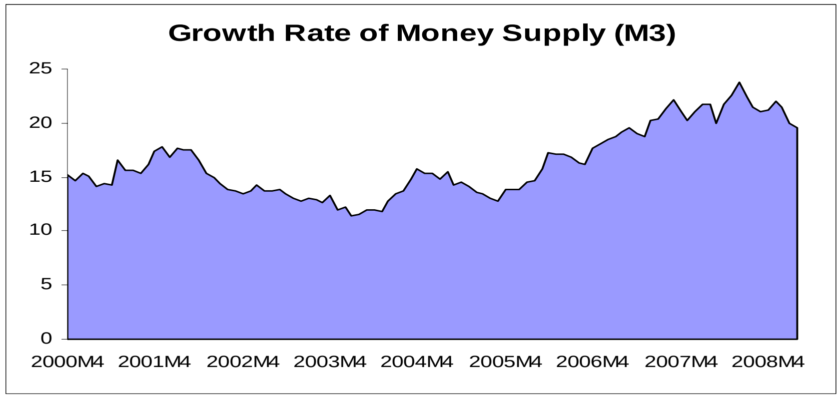
Foreign exchange assets continue to increase

Money supply growth expected to decline

We do expect that the monetary tightening measures result in slow money supply growth in the medium term. This is because the decline in the overall demand in the economy is expected to lead to slow credit off-take. Further, outflow of FII investments and sharp widening of trade deficit would result in decline in the net foreign exchange assets with the banking sector.

Forecast:

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



Interest rates

Following monetary measures, PLR and deposit rates increase

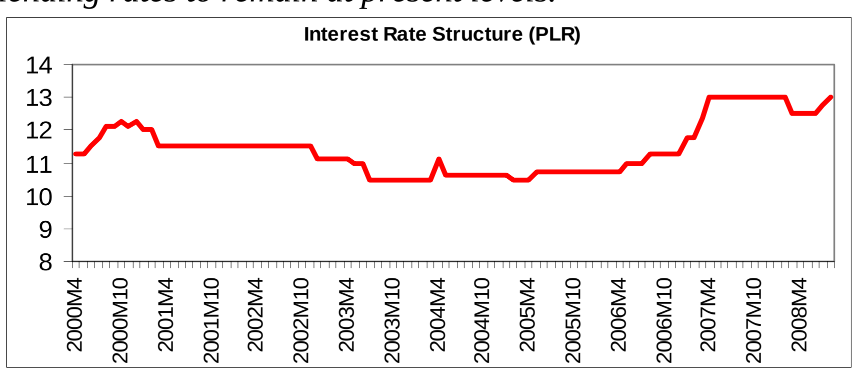
Interest rate cycle has already peaked

Expect no further tightening

The recent tightening of monetary policy has resulted in rise in the prime lending rates of most of the commercial banks. Right now the top five banks have hiked their PLR to 13.25-14% range. Following this, the deposit rates also have gone up for different maturities. Now the issue is whether this interest rate cycle is peaked? Based on our analysis, we feel that the interest rate cycle has peaked and we don't expect there is any need for further tightening of monetary policy. This is because of declining inflationary expectations following declining in the world commodity prices. The recent measures are expected to mitigate the inflation problem in the medium term and any further tightening would only prolong the downward movement in the industrial growth cycle.

Forecast:

Based on the data up to June 2008, we forecast that prime lending rates to remain at present levels.



Exchange rate depreciates sharply

Trade deficit and FII outflows lead to this depreciation

Slowdown in world oil prices might mitigate further fall in Rupee

Exchange rate

The Rupee/US dollar exchange rate has depreciated sharply to 44.3 by the first week of September 2008. Although we did predict that exchange rate to depreciate, this sharp depreciation was unexpected. One of the major reasons for this depreciation is the sharp widening of trade deficit, which for second consecutive months have crossed a record level of US$ 10 billions. In addition to this, the outflow of FIIs and strengthening of US dollar in the international markets have led to this depreciation. Going forward, we expect the exchange rate to remain at this level for some time as the demand for US dollars expected to increase in the medium term. But the slowdown in the world oil prices might restrain the Rupee from further sharp depreciation. It would also depend on the Central Bank's intervention in the market.

Forecast:

The Rupee/US Dollar exchange rate is expected to be around 44 in the medium run and than it is expected to appreciate.

Forex reserves fall on huge trade deficit and revaluation

Restrictions on ECBs to hamper foreign capital inflow

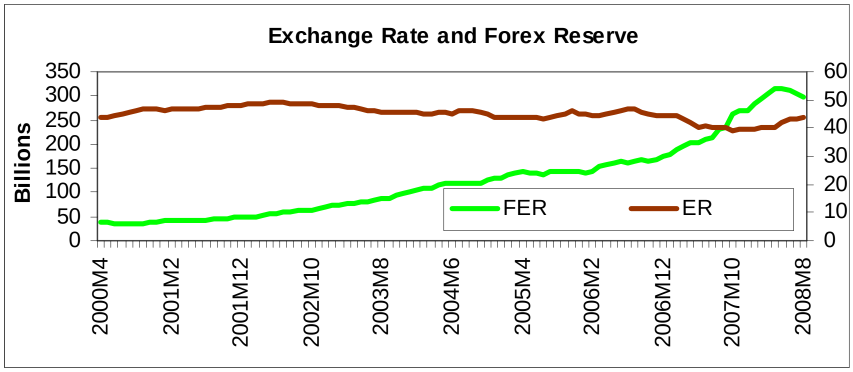
Foreign Exchange Reserves

The foreign exchange reserves continue to fall and right now at US$297.3 billions. This fall in reserves were attributed to large trade deficit and also due to outflow of FIIs from the equity markets. This could also be due to revaluation of other foreign currencies in the reserves basket, which has come down vis-à-vis US dollar due to strengthening of US dollar in the international market.

Based on our prediction, we expect the trade deficit to widen further and reduce the foreign exchange reserves further. In addition to this, the restrictions on the ECBs, which were one of the major sources for cheap funds for domestic producers, might also lead to fall in reserves. The decline in the World commodity prices seems to be the only respite that can restrain sharp fall in the reserves.

Forecast:

Forex reserves expected to fall and reach at US$ 295 billions



FIIs net sellers for fifth consecutive months

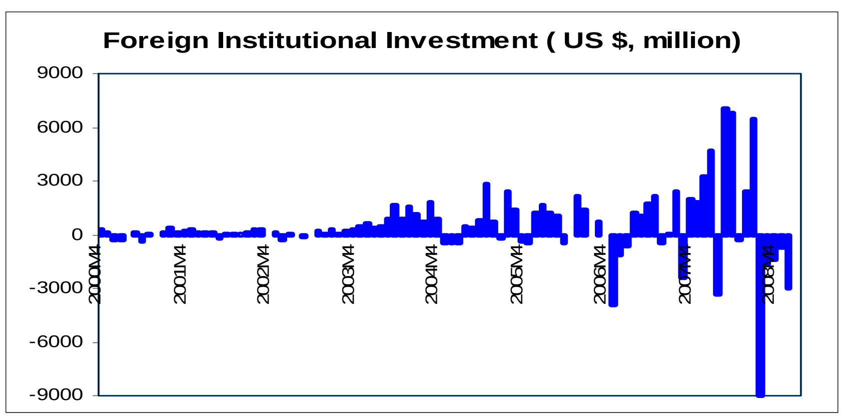
Fall in returns and decline in industrial growth could lead to more outflows

Foreign Institutional Investment

For the fifth consecutive month, the foreign institutional investors are net sellers. Based on the latest information, in the month of June 2008, FIIs withdrawn a large sum of US$ 3 billions from the equity markets. Although this could be largely due to international factors, there are domestic factors as well. They are the decline in the actual and expected returns in the equity markets and widening fiscal deficit that has potential to lead to downgrading of Indian economy by the rating agencies. These factors seem to have led to profit booking by the FIIs that resulted in outflows. As these risk factors remain, going forward, we expect the FIIs outflow to continue for the next couple of months.

Forecast:

Based on the data up to June 2008, we expect the FII to be net sellers in the next three months8.



Trade data shows robust growth

Exports grew at

Exports and Imports

Against our prediction, the exports registered a robust growth. In the month of July 2008, exports registered a growth of 31.2% and for the period April-July period a growth of 24.6%. This is despite the appreciation of Rupee and also after

31.2% while imports growth at 48.1%

Trade deficit widens sharply

banning of exports of many products. On the other hand, imports continue to grow at a high rate. In the month of June the imports grew at whopping 48.1%. This is largely due to sharp rise in the growth of oil imports which has increased by 69.3%. These trends in exports and imports have resulted in sharp rise in the trade deficit. For the second consecutive month, the trade deficit has widened to more than US$ 10 billions.

Exports growth to see mild slowdown

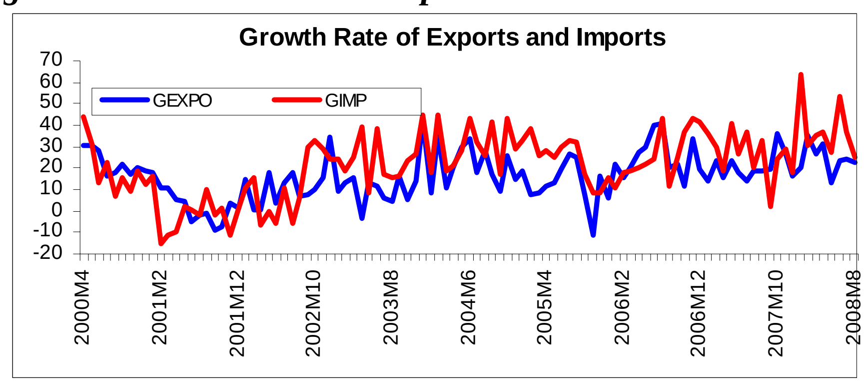
Oil imports bill to fall

Non-oil imports to moderate

Going forward, we expect that the high exports growth may not be sustainable due to expected slowdown in the global demand following high inflation rates and also due to ban on exports of many commodities. But the sharp depreciation of exchange rate might restrain in sharp fall in the exports growth. On imports, we do expect that following fall in the world oil prices, the imports bill to reduce and hence the growth. We also expect the non-oil imports to moderate due to fall in the domestic demand and production.

Forecast:

Based on the data up to July 2008, we expect the exports to grow at around 20% while imports at 32% in the next three

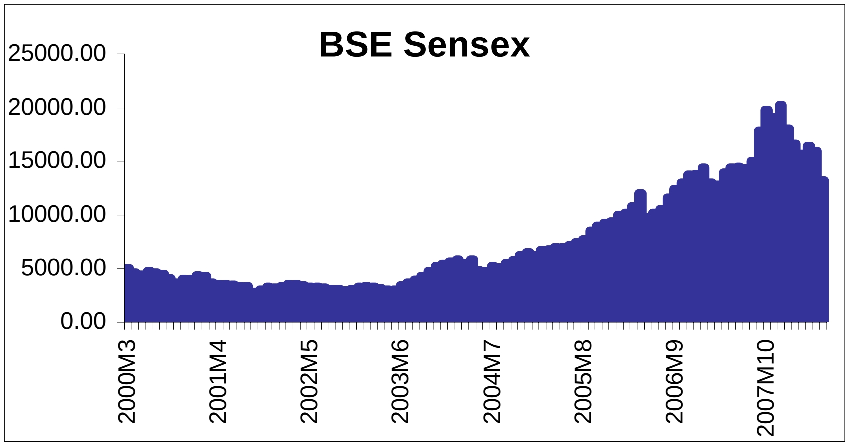


BSE Sensex

BSE sensex highly volatile

Fall in oil prices to be bullish

The volatility in the BSE sensex continues. In the beginning September 2008, the BSE sensex rebounded to a little above 15000 mark after touching its near term low in August. With high inflationary situation coupled with slowdown in the industrial growth, seems to have led to negative sentiments in the market. In addition to this, withdrawal of FII funds from the domestic market must have resulted in this bearish sentiment. In addition to this, no so impressive first quarter results and the expectations of same to continue in the second quarter as well, has also led to this bearish sentiments. But the fall in the world oil and commodity prices is expected to bring back some optimism in the financial markets.



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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