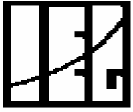


MONTHLY MONITOR

Prepared by
N R Bhanumurthy

February 2008

Top Stories

GDP growth for 2007-08 is estimated to be at 8.7%

Based on advanced estimates, the GDP growth for the year 2007-08 is estimated to be 8.7% as compared to 9.6% registered in 2006-07. Except two industry groups, namely electricity and trade group, all other industries are expected to decline. This low growth, compared to previous three years, is expected given the rise in the cost of capital and decline in the demand (both domestic and external demand).

IIP growth slips to 7.6% in December 2007 against 13.4% last year

Consumer durables goods continue to be slow

The industrial sector growth for the month of December 2007 is 7.6%. This decline could be due to large base of 13.4% in the same period a year ago. The growth of consumer durables goods, which was negative for most of the period in this year, has grown at 2.2%, although for the whole of April-December period it is still –1.3%. The reduction in the lending rates and recent Budget proposals might reverse the slowdown in the industrial sector.

Inflation rate crosses 5% mark

Inflationary expectations still persist

The inflation rate, which has become a global concern, has crossed the 5% mark in February 2008. Increasing commodity and oil prices (at US$ 106 per barrel) in the world markets is expected to sustain the inflationary pressure in the coming months.

Prime lending rates reduced

Policy rates unchanged

On the interest rate front, against our expectation, the RBI has not changed the interest rate structure expecting that it could fuel inflation. But the recent reductions in the prime lending rates of major banks would encourage the credit off-take. We feel that the current inflationary expectations are largely due to supply-side shocks and any stickiness in the policy interest rates, particularly when the interest rate differentials widened sharply, would only hamper the growth.

Exchange rate depreciates, mostly due to widening of trade deficit

As predicted in our previous issue, the Rupee/US dollar exchange rate has indeed depreciated to 40.30. The widening of trade deficit and the uncertainty in the global financial markets, which led to outflow of short-term capital, has led to this depreciation. Due to same reasons, we expect that the Rupee to be range bound in the medium term.

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

Union Budget: 2008-09 – A comment

On the back of robust GDP growth, inflationary expectations, and with large expectations of 'please-all' policies as this is the last full budget of the current UPA government, the Union Budget: 2008-09 was presented on 29th February 2008. Some significant points in this budget are as follows.

1. The Budget presents robust fiscal figures of 1.4% and 3.1% of revenue and fiscal deficits for the year 2007-08 respectively, which are less than the budget estimates.
2. The Budget proposes to hike the outlays for both education and health sectors under various schemes both in plan and non-plan. (Health expenditure increased by 15% compared to 2007-08)
3. Increases the coverage of NREGS to all the 596 rural districts of the country
4. To achieve 4% growth, it targets to increase the gross capital formation to 16% of GDP during the 11th Plan from the existing 12.5% in 2006-07.
5. It waives completely all the outstanding loans upto 31st March 2007 of marginal and small farmers with the scheduled commercial banks, regional rural banks and co-operative credit institutions, which are estimated at nearly Rs.60, 000 crores.
6. It takes measures to develop the corporate bond market and to launch exchange-traded currency and interest rate futures.
7. Customs duty has been reduced or removed completely on most of the items, while the excise duty (CENVAT) on all the goods reduced from 16% to 14%.
8. On the direct tax front, the budget hikes the threshold limit of exemption from personal income tax to Rs.1.5 lakh.
9. Similar to the Security Transaction Tax, it introduces Commodity Transaction Tax (CTT) on the options and futures market.
10. With all these proposals, the Budget estimates to achieve the Fiscal Deficit of 2.5% while the Revenue Deficit of 1%.

Some comments on this Budget from the macroeconomic issue are as follows.

1. To sustain the high growth, the Budget rightly identifies the need for enhancing domestic demand through loan waivers and hiking the tax exemption limits. This would certainly help the industrial sector through enhancing consumption demand. This would be near similar to what happened for industrial output growth in 1997-98 after the Fifth Pay Commission.
2. The reduction in the customs and excise duties, if it is passed on to the final consumers, would enhance the demand and also help in controlling inflationary situation.
3. The Budget deficit target of 2.5% of GDP seems to be unachievable as there are many off-budget items that need to be covered. Two main items are the Sixth Pay Commission award and the subsidy on the oil bonds. Further, it also postpones the achievement of FRBM's target of revenue neutral by one more year. Although, from the international experience this is not unusual, this might be looked at skeptically by the international and credit rating agencies.

4. The introduction of CTT on similar lines with STT could retard the exchanges particularly when they are in a nascent stage and the volumes are very much less than the securities market. In addition to this, it would also lead to rise, although marginally, in the commodity prices, which is already threatening the inflation management.
5. Although the 11th Plan targets an investment of US$ 500 billions for infrastructure under PPP, this Budget, which covers the second year of the 11th Plan, does not seem to provide substantial allocation to infrastructure, which is widely accepted as a hindrance to sustain the high growth path.
6. The sops given to the farmers and the various proposals for the agriculture would, without any doubt, help the whole rural activities. But to achieve 4% growth in this sector, it is necessary to address the demand side issues as well.

Overall, this Budget is expected to achieve the government's objective of 'inclusive growth' by focusing both on sustaining the high growth and also providing more allocation to agriculture and social sector.

IEG forecasts

Variables	Latest Information available	Forecast for next Three months
Inflation rate (WPI)	5.02 % as on 23rd February, 2008	Around 5%
Inflation rate (CPI)	5.5 % in January 2008	Expected to decline marginally.
Growth rate of IIP	7.6% in December 2007	6.1%, 7.5% and 7.1%
Growth rate of M3	21.5 % as on February 15th, 2008.	Expected to be above 21%
Prime lending rate	12.75-13.25 % in February 2008.	Lending rates to decline
Re/$ exchange rate	40.32 as on March 4th, 2008	Expected to be around 40.3
Forex reserves	US $301.2 billions as on February 29th 2008.	To reach US$305 billions by the end of May 2008.
FII inflows	US $ 2.39 billions in December 2007	Positive Inflows
Growth rate of exports	20.47 % in January 2008	Around 15%
Growth rate of imports	63.57 % in January 2008	Around 23%

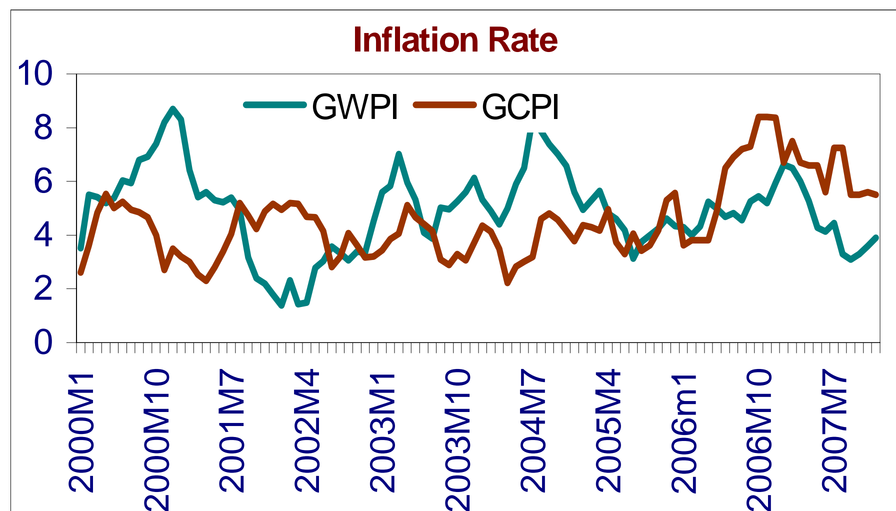
Inflation

Inflation rate crosses 5% level

The inflation rate, based on WPI, has touched to a high of 4.86 percent by the weekending 16th February 2008. This is despite the huge base of 6.73 percent in the same period last year. This rise in the WPI inflation is largely due to increase in the commodity and food articles prices, which has now become an international concern. But this inflation level is still below the RBI's targeted year-end rate of 5 percent. The tight monetary policy, hike in the domestic fuel prices, and the ban on exports of some commodities seem to have helped in controlling inflation. But the recent Budget proposal, which is expected to prompt large consumption, might increase inflation to some extent from the demand side. Further, sustained high growth in the money supply will also create inflationary pressures in the long term. Overall, although the inflation would still be contained at below 5 percent by the end of March 2008, in the early 2008-09 we might see the inflation rate little above 5 percent, largely due to rising commodity and world oil prices and also due to low base.

Double-digit growth in the prices of edible oils and cement

Rise in world oil & other commodity prices and money supply growth to be inflationary in the long-run



Forecast:

The WPI inflation forecast for the next three months to be 5%, 4.9% and 5.1 % *respectively.*

Industrial Production

Moderation in industrial growth continues

Index of industrial production (IIP) registered a growth of 7.6 percent in the month of December 2007. It was 13.4 percent in the same period a year ago. This sort of subdued growth was expected due to worrisome external factors (read US financial crisis) coupled with a high base effect. The major sectors of

For April-December, the consumer durable goods grows at -1.3%

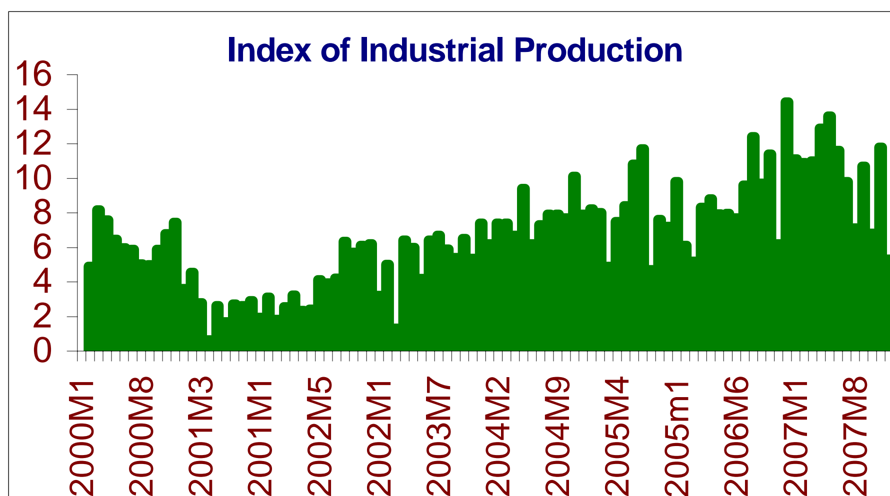
mining, manufacturing and electricity registered growth rates of 3%, 8.4% and 3.8% respectively on the back of high growth last year. In the Use-based classification, basic goods and intermediate goods have also been growing at lower levels around 3.1% & 7.2% respectively. In the consumer goods segment, durable and non-durable segments have been growing at 2.2% and 10.6 % respectively. The consumer durables growth for the whole of April-December 2007 is still negative at -1.3 percent. It is only the capital goods sector output at 16.6 percent that is pulling the overall IIP growth.

Capital goods output grew at 16.6%

Recessionary trends in the US economy and the rise in the cost of capital hampers industrial growth

Rise in the cost of capital, decline in both domestic and external demand and the large base seems to have led to this slowdown in the industrial output growth this year. The future growth also depends on the cost of capital and the demand. The recent reduction in the lending rates by most of the large banks and the budget proposals (including the Sixth Pay Commission award) is expected to reverse the domestic industry from slowdown. But this would also depend heavily on the extent of US economic recession, which appears to be large.

Budget proposals to increase the demand for industrial goods



Forecast:

Based on the available information we forecast the IIP growth rate for the next three months to hover between 6-7%

Money and Credit

Money supply continues to be above 21%

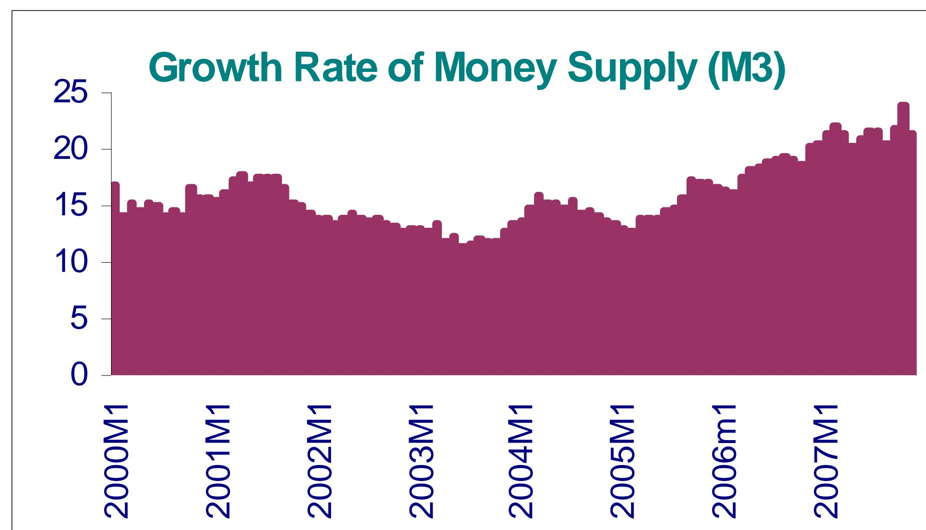
Broad money supply growth (M3) continues to remain at the higher side of above the 20% mark. For the week ending February 15th it registered a growth of around 21.5%. One of

the major reasons for the continuation of tight monetary policy, despite the slowdown signs in the real sector, is due to the sustained high money supply growth, which has potential to raise inflationary expectations. This high growth has been sustained due to consistent raise in the growth of time deposits with banks at 25% in the components side. On the sources side, it is the sustained accumulation of foreign exchange reserves. It is reflected in the net foreign exchange assets of banking sector, which is growing at 33%. On the other hand, the credit to commercial sector is also growing at 20.5 percent although this is less than the last year's growth of 27 percent. This is despite the prevailing high interest rate structure and also the recent hike in CRR.

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

Overall, the money supply growth is expected to continue its high growth path in the medium term, largely due to less control over the volatile foreign portfolio investments by the central bank.

Money supply expected to grow at the current rate following less control over foreign capital inflows.



Lending rates of major banks reduced

No change in the policy rates

Forecast:

We forecast the growth rate of money supply (M3) to hover above 21 percent for the next three months.

Interest rates

We have been saying that following the sharp reduction in the US interest rates, which led to widening of interest rate differentials, the domestic rates are also to be brought down. But the RBI continues with its tight monetary policy, with no change in the policy rates, largely due to prevailing inflationary expectations. But the recent reduction in the

Overall interest rate structure should decline

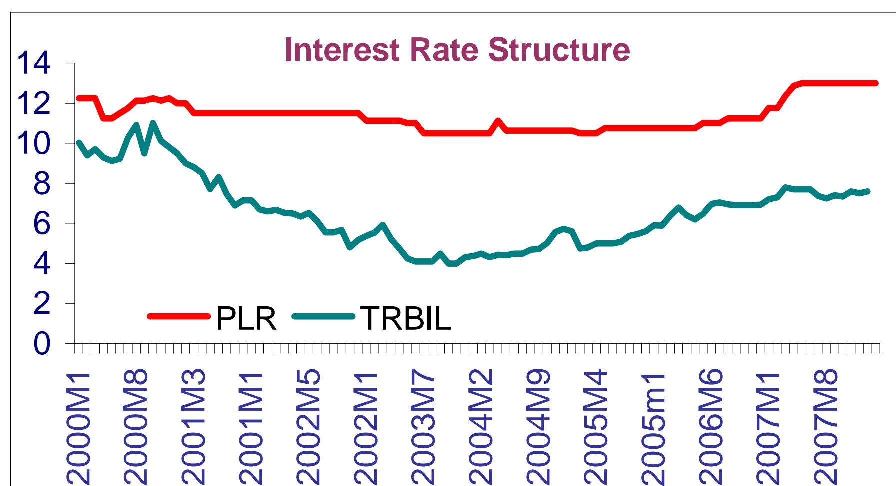
Rising inflation is not due to demand side reasons.

lending rates by most of the banks, particularly the large ones, shows that the interest rate structure is indeed declining. The suggested reduction in policy rates usually acts as a signaling factor. But the commercial banks' reduction in rates even without the RBI's signals might help the industrial sector, which seems to be moving towards low growth path. At present the prime-lending rates of the major commercial banks stood at around 12.75-13.25%. Overall, it is prudent to reduce the policy interest rates as the rising inflation, which has become a global phenomenon, is largely due to supply shocks in the international market rather than due to demand side reasons. Any stickiness in the interest rates, particularly when the rate differentials are widening, would only hamper growth and fuel inflation in the long run.

Any stickiness in the interest rates to hamper growth

Forecast:

Based on the data up to February 2008, we forecast that prime lending rates to decline.



Exchange rate

It may be noted that in our last issue of Monthly Monitor, we have predicted the depreciation of Rupee/US dollar exchange rate to around 40. The exchange rate has indeed depreciated to above 40. As on March 3rd 2008, Rupee/US dollar exchange rate stood at around 40.4. One of the reasons that we provided for this expected depreciation is the expected widening of trade deficit. It may be noted that just in the month of January 2008 the trade deficit has widened to whooping US$ 9.4 billions. In addition to this, the uncertainty in the global financial markets due to sub-prime crisis has also led to outflow of short-term foreign capital

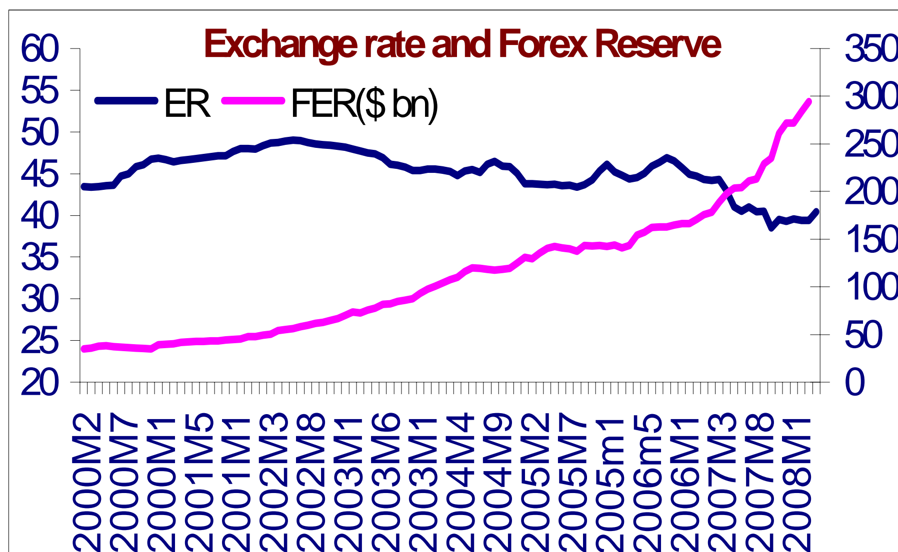
As rightly predicted by us, the exchange rate has depreciated

This is largely due to widening trade deficit

Outflow of foreign portfolio investments also contributed to this depreciation

from India, which in turn led to depreciation of Rupee. Due to same reasons, we don't expect any appreciation of Rupee in the coming months and it would be range-bound.

Exchange rate to be range-bound



Forecast:

The Rupee/US Dollar exchange rate is expected to be stable around 40.3 for some time.

Foreign Exchange Reserves

Forex reserves crosses US$300 billion

Foreign exchange reserves continue to bulge. As on February 29th 2008, the reserves stood at whooping US$301.2 billion. This is despite the widening of trade deficit and also outflow of short-term foreign investments following the turbulent global financial market situation. One reason for this rise could be due to revaluation of foreign currencies, other than US dollar, in the currency basket that have strengthened against the US dollar. The slowdown in the US economy and the reduction in the US interest rates are expected to lead to inflow of foreign currencies to safe havens and emerging markets such as India. But the expected widening of trade deficit might contain any sharp accumulation in the coming months. On balance, the forex accumulation would be not as large as we have seen in the calendar year 2007. This may also depend on the forthcoming Monetary and Credit Policy in April 2008.

This is largely due to revaluation of other currencies vis-à-vis weakening US dollar

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

Forecast:

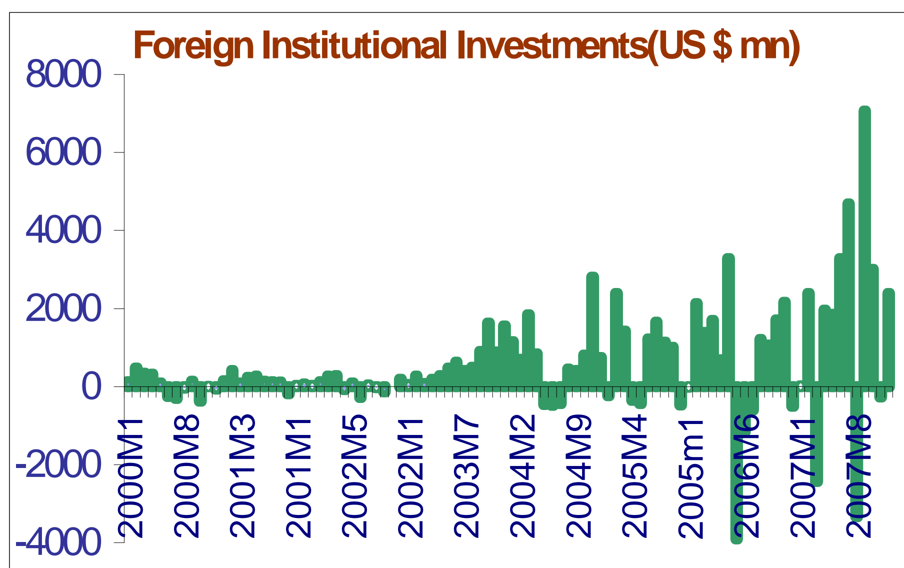
Forex reserves to reach US$ 305 billions by the end of May 2008.

FIIs are highly volatile

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

Foreign Institutional Investment

Uncertainty prevailing in the world economy can be best illustrated by looking at the volatile movement of foreign institutional investors. During the month of October 2007 FII were net buyers at about US$ 6833 million whereas in November FII turned out to be net sellers to the tune of US$ -265 million and in the very next month December (latest data available) they have turned out to be net buyers of US$ 2396 million. This volatility can be explained by the prevailing turbulence in the international markets following sub-prime crisis, which is threatening to lead to recession in the US economy and its transmission to emerging market economies such as India. Following the sharp reduction in the US interest rates, it is generally expected that there would be inflow of the FII investments. But this time around, the FIIs seems to be net sellers, which resulted in sharp fall in the stock prices.



Forecast:

Based on the data up to December 2007, we expect the positive inflow of FII investments.

Exports and Imports

Trade sector shows robust growth

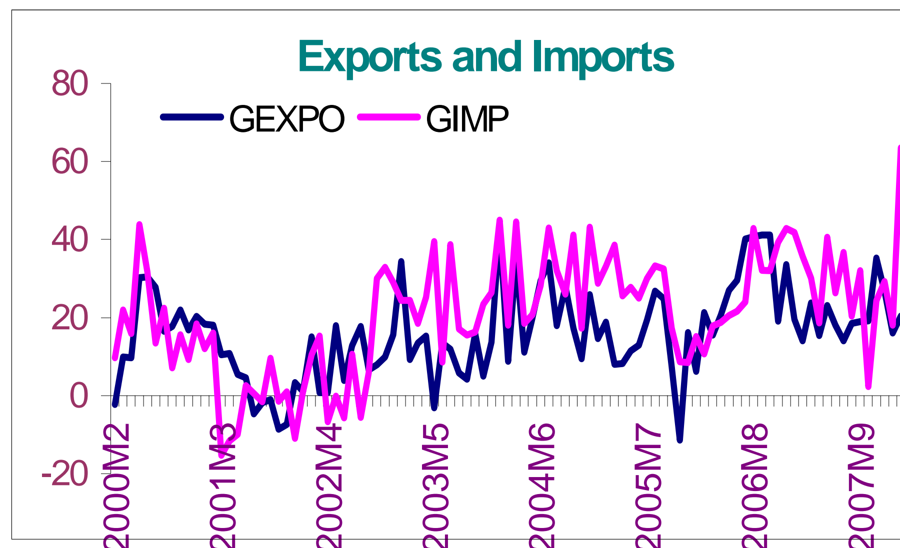
Despite the appreciation of rupee by 12% since June 2007, the exports registered a growth of 20.4% in the month of January 2008. During the cumulative April-January period it has registered a growth of around 21.6 %. On the other hand,

Exports and imports grew at 20.4% and63.5% respectively

imports grew at a whopping 63.5% in the month of January with cumulating growth during the April-January period being around 29.63%. This has resulted in sharp widening of trade deficit to US$ 67.4 billions in the period April- January.

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

Although, we expected a slowdown in the exports growth, it appears that the sops provided by the government to the exporters must have helped to sustain the high growth in the exports. Regarding the high growth in imports, it is found that



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

this growth was largely contributed by high growth in the non-oil imports. Rise in the cost of oil, which has crossed US$100 per barrel, must have also contributed to this rise in imports. This high growth could also be due to weakening of US dollar in the international markets.

Given the recessionary signals in the US and, hence, in the world economy, we still expect the export growth to moderate in the coming months. In terms of imports, although we expect moderation in the intermediate goods imports, rise in the cost of other imports, including oil, we expect imports to grow at above 20%.

BSE Sensex

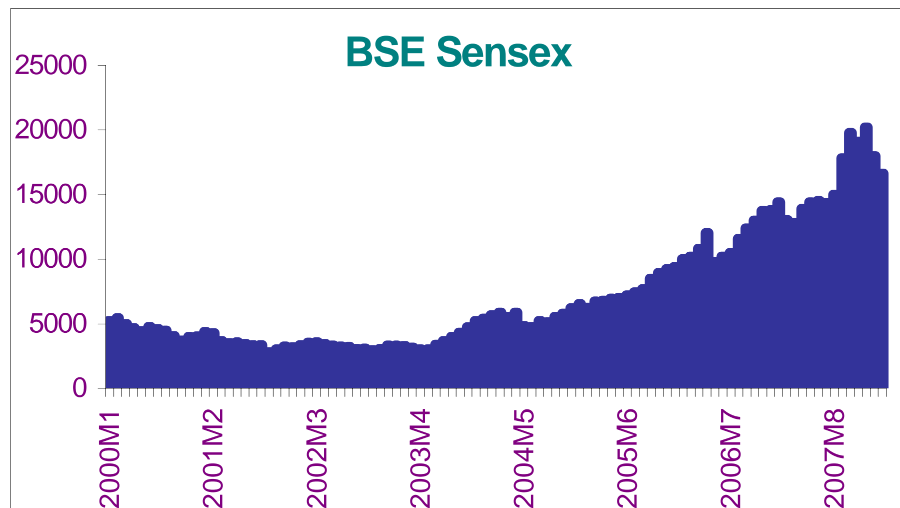
The stock market is highly volatile

Fell to less than 16000

The volatility in the stock market continues amid concerns of worsening economic signals emanating from the US economy. The extent of the volatility can be gauged by the single day falls that are happening with more than 5% fall seen quite frequently in the last few months. As on March 7th the BSE Sensex was hovering at less than 16000 points with high

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

volatility. With financial crisis spreading its tentacles to other parts of the world, this volatile behavior is expected in the coming weeks also.



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**

The views expressed in this document are author's alone and not to be attributed to the institute to which the author belongs.