MONTHLY MONITOR

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May-June 2008

Inflation increases above 11% for fourth consecutive week

Prices of iron & steel, edible oil, Cotton and other food prices has seen sharp rise

Rise in world food and fuel prices continues

The double-digit inflation is here to stay until December 2008

Monetary & fiscal measures to moderate inflation marginally

Slowdown in economic growth does not warrant any further rate hike

Controlling money supply growth needs to be a priority

Strong Rupee policy might be more appropriate to moderate inflation expectations

On Inflation and Economic Growth…..

The WPI inflation continues to increase above 11%. For the weekending 28th June 2008, the inflation rate stood at 11.89% as compared to 11.63% in the previous week and 4.42% a year ago. This sharp rise in inflation is due to hike in the fuel prices and also due to double-digit rise in the prices of Iron & Steel, edible oils and food items other than fruits & vegetables. Galloping world fuel & food prices has resulted in this high inflation not only in India but also in most of the economies in the region. (We have said last year that any delay in passing the rise in world fuel prices would only postpone the high inflation situation.)

Going forward, our forecasts show that the double-digit inflation to stay atleast until the end of December 2008. This is due to low base (inflation was less than 4% until December 2007) and also due to lagged response to both monetary and fiscal measures taken recently to moderate inflation rate. But expected good Rabi season output might moderate the inflation rate to some extent from August onwards.

On the face of high and increasing inflation rates, the RBI has further tightened the monetary policy. This is based on the assumption that there could be second round effects of higher fuel prices on the overall price index and also to cool the demand side factors, if any. Given that the inflation rate has further moved upwards, some analysts have called for more tightening of monetary policy. In our view, any further tightening might result in the economy to harsh landing, since beginning 2008 it's already showing a downward movement. Instead, it would be appropriate for the RBI to intervene in the forex market to strengthen the Rupee. This could result in lower import cost and also

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reduces money supply growth, which, in turn, could moderate inflation both in the supply and demand side.

GDP growth to be around 7.5%

Raising production cost and decline in the demand to soften growth

Agricultural growth to be robust

On the growth front, our forecast show the GDP for the year 2008-09 to decline to around 7.5% against 9% in 2007-08. This is largely due to high inflation and interest rates, which has already resulted in slowdown in the growth of industrial output growth. In addition to this, the expected decline in the demand (both external and domestic) and also due to expected slowdown in the global economy (on which our service sector largely depends) would also pull down the GDP growth. Only agricultural output is expected to sustain its last year's high growth due to good monsoons.

On Current Account Deficit….

Raising current account deficit a cause for concern

World oil prices and slowdown in exports lead to widening CAD

Galloping world oil prices have brought in the fears of leading to an unsustainable current account deficit (CAD). The recent data on CAD shows that for the year 2007-08 it has increased to 1.5% of GDP from 1.1% in the previous year (nearly US$17.4 billions from US$9.8 billlions in 2006-07). It is expected that the CAD for the current year could increase further given that oil prices are soaring to new highs almost everyday. This is no doubt a cause for concern, more so when this is due to high import bill and not due to increase in the investment activity. In other words, the increase in CAD due to rise in the oil import bill may not be solvent as this is more due to the external shocks than due to adjustment by the domestic consumption and investment agents. (The reconciliation between BOP and DGCI&S data on imports for 2007-08 is US$12.8 billions). Hence, the severity of the increasing CAD depends on the nature and not on the extent.

Invisibles and remittances to grow due to weak Rupee

We do expect that the CAD to cross 2% in the current fiscal year. But this could be due to both higher oil import bill and also due to expected widening of fiscal deficit with a moderating economic growth. This can affect the growth in the medium term and further worsen the CAD. Only factor that could mitigate this adverse impact is the expected robust growth in the invisibles collection due to weakening of Rupee in the recent months. This could also trigger software exports. Further, the rise in the interest rate differentials expected to attract large inflow of remittances and foreign capital.

Available foreign exchange reserves to cover CAD

Increasing foreign exchange reserves, despite sharp outflow of both portfolio investments and also the direct investments by the Indian companies abroad, could help financing the CAD. But this year we do expect that the reserves accumulation also to decline due to expected decline in the portfolio investments, ECBs, and FDI following dampening of economic activity.

Imports are more sensitive to exchange rate changes than exports

Interest rate channel to address CAD is weaker than exchange rate channel

Many studies have shown that compared to exports, imports are more sensitive to exchange rate changes. Hence, it would be appropriate if the RBI intervenes to protect the Rupee from further weakening. This would result in cheaper imports and narrow the trade deficit. (In any case there are lots of restrictions applied on exports to mitigate inflation). We cannot have asymmetric intervention by RBI, where it had bought dollars to control the rupee from strengthening two years back, while now when the Rupee is actually weakening (and hurting imports)the RBI is not intervening. In our opinion, interest rate channel to control CAD could be weaker compared to exchange rate channel.

To sum up, the treatment for the present level of CAD should not be similar to what was done when it widened sharply a couple of years ago. It needs to be restricted as the second order effects of this could push inflation to further upwards, hampering the investment climate and, hence, growth in the economy.

S & P's hint to downgrade India's rating is overstating the risk

The Standard & Poor's hints at downgrading India's investment rating. But we don't see any reason for this as the domestic fundamentals are still strong. If it is due to high inflation rates, one needs to keep in mind that despite the raising international fuel and food prices, India's inflation at the moment is one of the lowest in the region. Expected widening of CAD is largely a result of external shock and is not specific to Indian economy alone. Fiscal deficit could also widen a little, but it will not be as sharp to have an adverse impact on the other macroeconomic fundamentals.

Industrial output growth declines sharply ***Capital goods growth fell to 2.5% from 22.4%*** ***After a long time consumer durable goods growth positive***	**Other stories….** Industrial output growth in May 2008 has declined sharply to 3.8% from 10.6% in the same period last year. At the disaggregated level, the decline is witnessed across the board except in consumer durables growth, which has registered a positive growth after a long time. Capital goods growth in particular has seen a sharp decline from 22.4% to 2.5%. This decline in IIP growth can be attributed to the decline in both external and domestic demand and also due to rise in the cost of production. As predicted earlier, due to these factors and some cyclical behaviour, our model shows that the slow growth in IIP is here to stay for some time.
Domestic interest rate structure move upwards ***Money supply growth declines marginally***	Following hike in policy interest rates and the CRR, the overall domestic interest rate structure (both deposit and lending rates) have moved upwards. The money supply growth has also seen a slight decline, which is currently at 20.7%, although it is still above the RBI's targeted level. We expect the money supply growth to decline through fall in the demand for commercial credit and some outflow of foreign currency.
Exports growth moderates, while imports growth continues to be robust ***Trade deficit widens to US$20.6 billions in April-May 2008***	On the trade front, exports growth declined to 12.9% largely due to high domestic inflation, which might have made exports less competitive, and also due to overall decline in the external demand. But the imports grew at 27.1% in the month of May 2008. High oil prices and sustained rise in the non-oil imports have contributed to this growth. As a result, the trade deficit has widened sharply to US$20.6 billion in April-May 2008.
Exchange rate depreciates to 43.16 ***Expect further depreciation***	As predicted by us earlier, the exchange rate has indeed depreciated to 43.16 in the first week of July 2008. Widening trade deficit could be a major reason for this depreciation. Due to same reason, we expect the exchange rate to depreciate further. But the extent of depreciation depends on RBI intervention.

IEG forecasts

Variables	Latest Information available	Forecast for next Three months
Inflation rate (WPI)	11.89 % as on 28th June, 2008	Around 11-12 %
Inflation rate (CPI)	7.75 % in May 2008	Expected to decline marginally.
Growth rate of IIP	3.8 % in May 2008	To be around 4-6%
Growth rate of M3	20.7 % as on June 20th, 2008.	Expected to decline marginally to 20%
Prime lending rate	12.50-12.75 % as on 27th June 2008.	Upward movement expected
Re/$ exchange rate	43.16 as on July 12th , 2008	Expected to be around 43
Forex reserves	US $308.3.1 billions as on June 20th 2008.	Expected to increase.
FII inflows	US $ -1.4 billions in April 2008	Uncertain
Growth rate of exports	12.9 % in May 2008	Around 13-16%
Growth rate of imports	27.1% in May 2008	Around 25-30%

Inflation rate escalates to 11.89%

Iron & Steel and edible oil prices rise sharply

Double-digit inflation to stay until end of 2008

Good rabi crop to moderate food prices

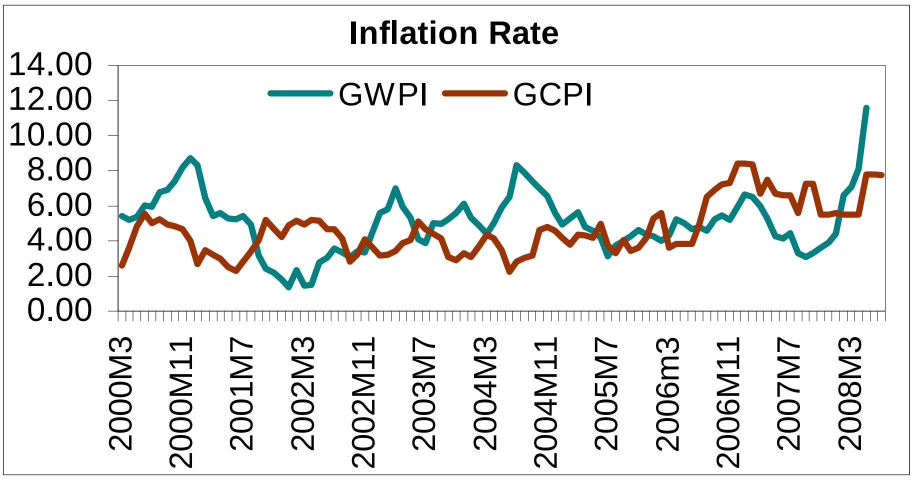
Inflation

The WPI Inflation continues to surge ahead at very high levels touching double-digit around 11.89% for the week ending June 28th. This spiraling inflation has been predominantly due to global supply side factors. Global food prices backed with high fuel prices has worsened inflationary situation worldwide. These global inflationary factors have also had a bearing towards domestic inflation given the increasing integration of markets. The two segments that have contributed to this high inflation are fuel group and iron & steel with growth seen at 16.2% and 35.3% respectively. High iron ore prices, which is the main input in steel production has seen an increase in prices of around 50% since January mainly due to global factors. Moderation in iron & steel prices alone can result in 1% decline in overall inflation. Apart from this primary articles and manufacturing segment have also been growing at 10.5 % and 10.3% respectively.

The inflationary situation is expected to continue until December 2008 largely due to low base. Recent monetary and fiscal measures coupled with expected good rabi season production would not further aggravate the inflation situation in coming months.

Forecast:

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



Industry growth plummets to 3.8 %

Industrial Production

As we had predicted earlier, the industrial sector entered into slow growth phase. This is due to both domestic and external

Manufacturing and electricity sector grew by 3.9% and 2% respectively.

factors. The index of industrial production plummeted to 3.8 % in the month of May 2008, which is lower than 7% growth in the previous month. All the major sectors registered a decline in growth. The manufacturing and electricity sector growth declined to 3.9% and 2% respectively, whereas the mining sector registered a growth rate of 5.2%.

Capital goods output growth declines sharply

After a long time, consumer durables growth positive

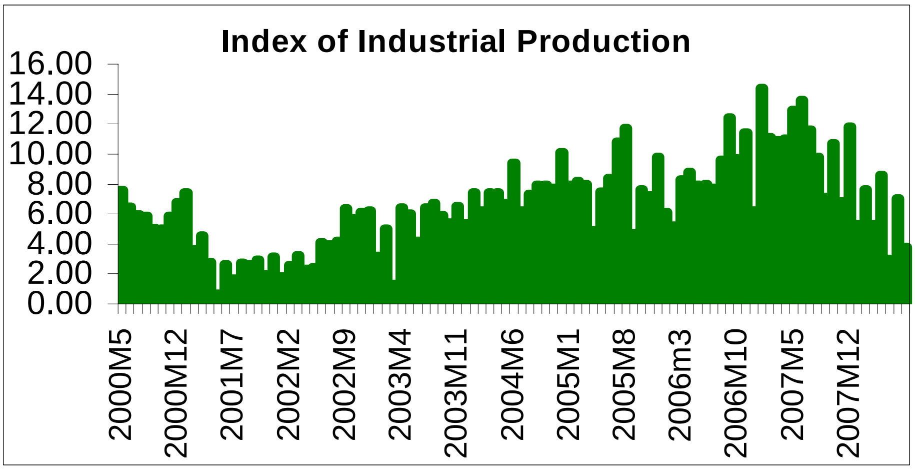
In the Use-based classification also all the three segments of basic, capital and intermediate goods registered low growth at low levels of around 3 %, 2.5 % & 1.2 % respectively, which is less than the previous year's growth. Under consumer goods segment, the durables goods growth, which was negative for quite some time, has registered positive growth of 4.4%.

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.

High input prices and decline in demand to moderate IIP growth

Forecast:

Based on the available information we forecast the IIP growth rate for the next three months to be 4.6, 4, and 4.4.



Money supply growth declines marginally to 20.7%

Money and Credit

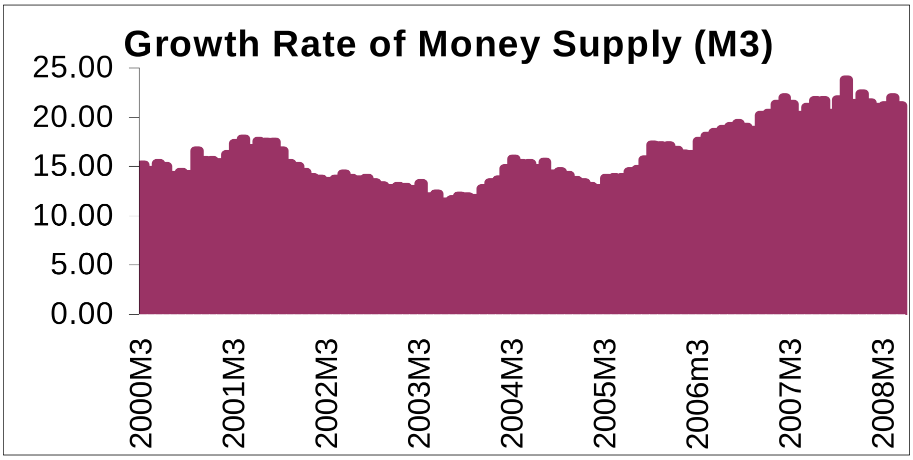
Broad money supply growth (M3), although declined marginally, continues to grow above the RBI's targeted level of 18.5%. For the week-ending 20th June, money supply grew at 20.7%. Sharp rise in the net foreign exchange assets at 56.3% and 24.4% growth in the credit off-take has resulted in this high money supply growth.

Net foreign exchange assets increase sharply

Recent hike in the interest rates and declining demand might pull down the credit demand. Together with this, the expected decline in the foreign exchange assets expected to bring down the money supply growth further.

Forecast:

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



Interest rates

CRR rate hiked to 8.75%

Repo rate hiked by 50 basis points

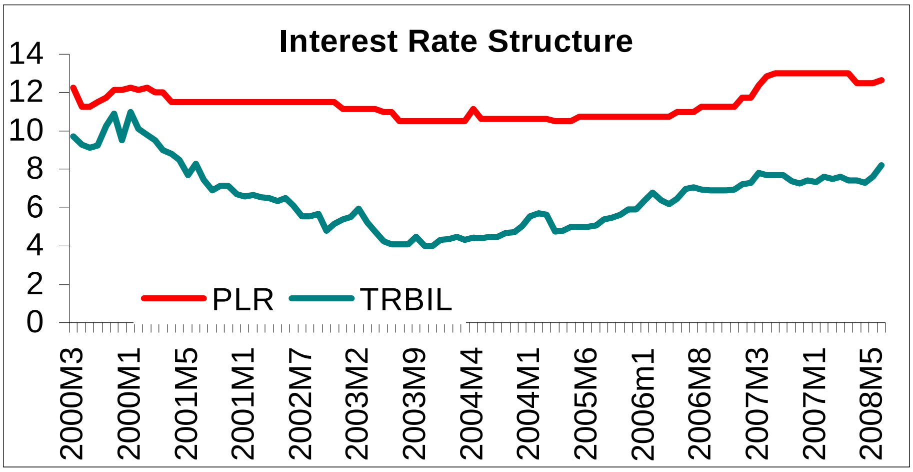
Both deposit and lending rates increased

With the Inflationary situation touching double digit figures, it was expected that the RBI would tighten the monetary policy. This was done with the recent hike in both CRR and Repo rate. The hike in the Repo rate from 8% to 8.5% would lead to hike in loan rates by the banks as they would like to pass the extra cost to the consumers. This would also result in hike in the deposit rates. This credit constraining steps would take some time to take effect. The Prime lending rates of the five major commercial banks have slightly moved upward around 12.50-12.75% as on week ending June 27th.

With inflationary situation still likely to prevail for some more months we could see more aggressive tightening, although not warranted, by the RBI to contain the credit demand.

Forecast:

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



The Rupee/US dollar exchange rate continues to depreciate

Exchange rate

As predicted by us, the Rupee/US Dollar exchange rate depreciated to above 43 level. As on 11th July, the exchange rate stood at 43.16. This depreciation has been mainly due to two factors. First and most prominently due to the high crude oil prices. Huge demand of dollars by the oil companies with oil hovering around record levels of around US$145 per barrel has been one of the reasons for weaker currency. Secondly and more recently there has been a trend of FII outflow from the equity markets. With this there has been a strong demand for dollar from foreign institutional investors and foreign banks In addition to this sudden demand, the sharp widening of trade deficit must have also contributed for this depreciation.

Widening trade deficit and heavy demand of dollar by oil companies leading to this depreciation.

In the short term, we expect the Rupee to be at its current position of around 42-43. But it would largely depend on the RBI intervention. As global oil prices seen to hover around these high levels, the demand for dollar would increase resulting in weak Rupee in the coming months.

Record oil prices would retain the exchange rate at it's at present level in the medium run.

Forecast:

The Rupee/US Dollar exchange rate is expected to be around 42-43 in the medium run and than it is expected to appreciate.

Foreign Exchange Reserves

Forex reserves declined marginally to US$ 308.3 billion.

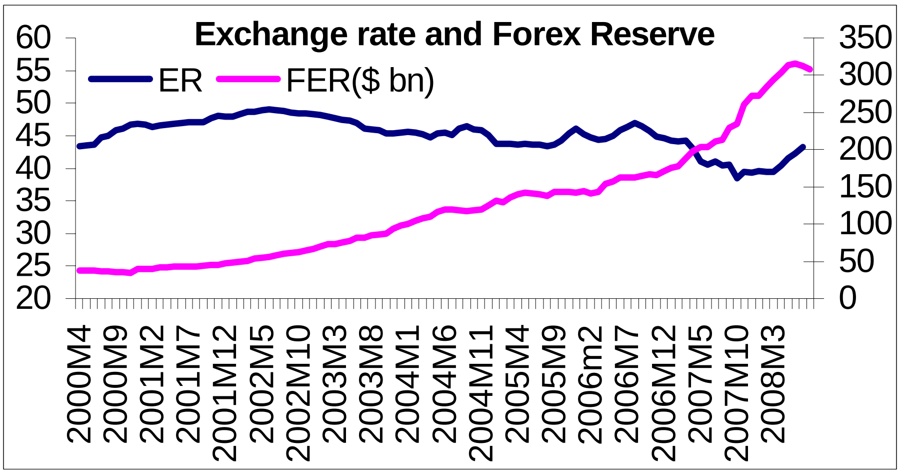
Foreign exchange reserves have seen a quite a fall to US$ 308.3 billion as on week ending July 4th 2008 as compared to US$316.1 billion seen last month. Sharp widening of trade deficit in April-May 2008 and the withdrawal of FIIs from the stock market must have resulted to this decline in the reserves. Also weakening of other foreign currency against the US dollar in the international market must have also led to fall in reserves in terms of US dollars.

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

As we expect the trade deficit to widen further, we don't see any further accumulation of reserves in the coming months. Further, the probability of oil prices to reduce seems to be quite less in the near future which entails that forex reserves may be utilized as a buffer by the RBI for holding Rupee from further appreciation.

Forecast:

Forex reserves expected to increase



Foreign Institutional Investment

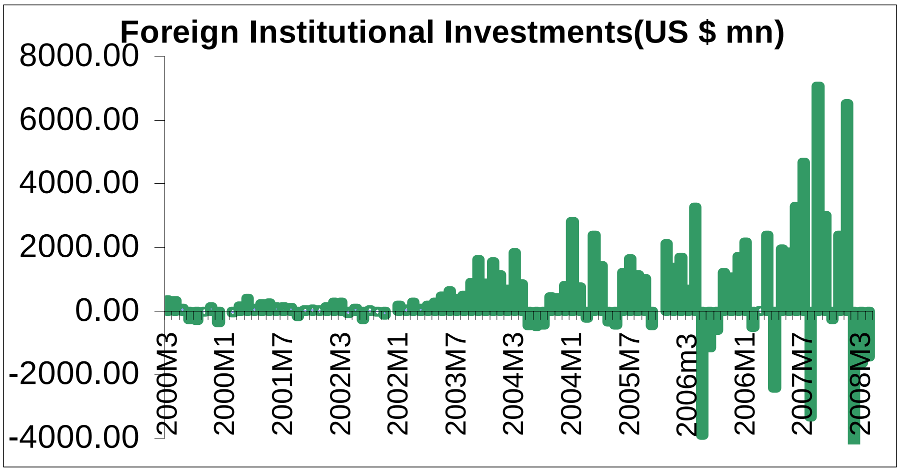
FIIs continue to be net sellers for the third consecutive month

In April, FII's were net sellers to the tune of US$ 1.4 billion

Foreign institutional investors continue to be net seller for the third consecutive month. For the month of April FII's were net sellers of the tune of around US$ -1432 million as compared to US$ -1643 million in the month of March 2008. This sort of selling has been due to chain of events. Firstly uncertainty cropped into the market due to the US financial meltdown. Then the inflationary contagion came that resulted in rise in input prices leading to slowdown in industrial growth. High oil prices led to depreciation due to heavy demand by oil companies. Now due to the depreciation FII seems to be into profit booking mode resulting in outflows. Going forward, we expect the FII outflow to continue for the next couple of months.

Forecast:

Based on the data up to April 200, we expect the FII to be net sellers in the next three months8.



Exports and Imports

Exports register sluggish growth

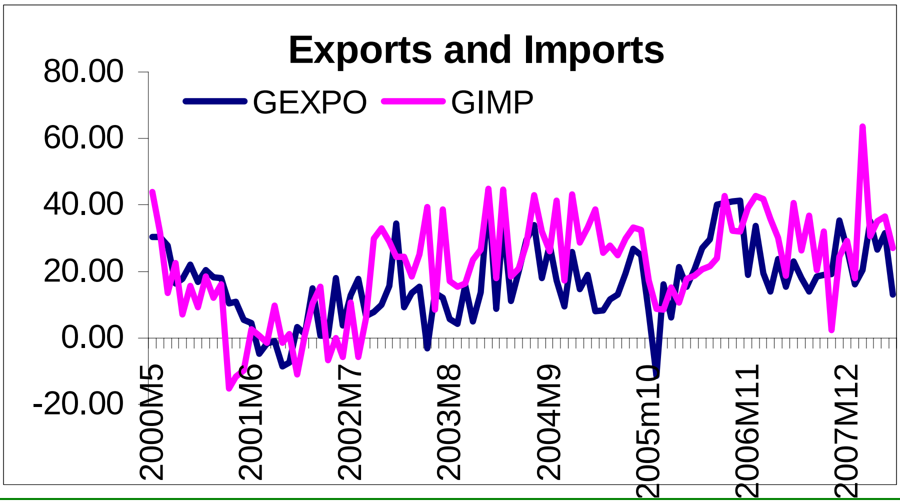
Exports and imports grew at 12.9% and 27.1% respectively

The uncertain and slowing world economy seems to have started to take a toll on the Indian exports. Despite the depreciating rupee, the exports registered a sluggish growth of around 12.9% in the month of May. The cumulative growth for the April-May period comes around 21.7%. . On the other hand, on the back of high oil prices, the imports registered a growth of 27.1% in the month of May. The cumulative growth that it registered for April-May was 31.7%. As a result of this trend, the trade deficit for the April- May period has widened sharply to US$20.6 billion as compared to US$ 13.9 billion in the same period last year.

Restrictions and decline in the external demand contributes to this slowdown

We expect the slowdown in exports growth to continue due to the restrictions put on various commodities and also due to decline in the external demand following rise in domestic prices. On the other hand, due to high oil import bill, the import growth to be at its current high level. But we also expect the non-oil imports to moderate in the coming months.

High world oil prices and cost of non-oil imports led to high imports growth

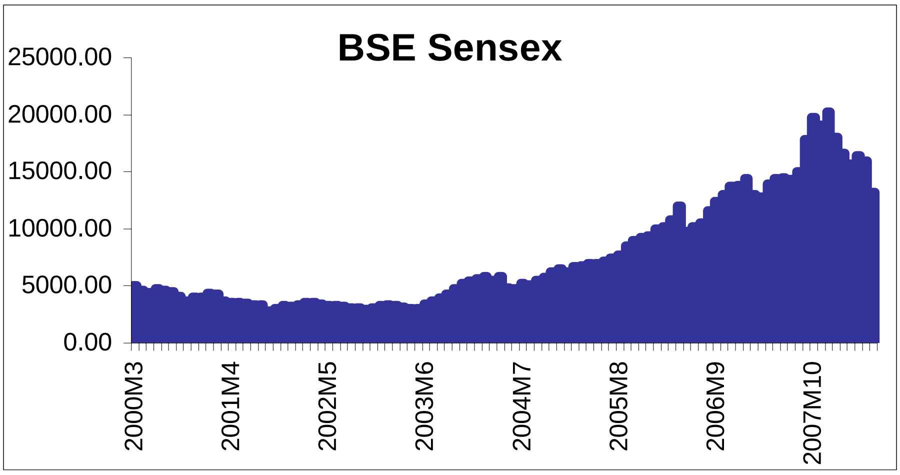


Decline in the BSE sensex continues

Sluggish first quarter corporate results to pull down sensex further

BSE Sensex

The sensex continues to remain volatile with huge falls seen in the market April 2008. Currently it is hovering around 13000 points. 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. As the first quarter corporate results are to be made public, which is expected to be sluggish, selling pressure might continue for some more time. Further, the rise in the yields in the capital market must have also given arbitrage advantage to shift the funds from stock to other 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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