MONTHLY MONITOR

June 2009

Industrial sector shows some recovery signs **Strong recovery depends on response monetary policy response**	**Highlights** Industrial sector shows some recovery signs. For May 2009, IIP growth stood at 2.7%. This is contributed by sharp rise in the growth of consumer durables goods and the intermediate goods output. Previous fiscal stimulus packages seem to start showing up on the industrial demand. But the sustenance of this would also depend on the response from monetary policy.
Inflation rate continues to be negative **Inflationary expectations building up following monsoon vagaries and fiscal deficit**	Inflation rate continues to be negative. At the commodity group level, the prices of fuel group, iron & steel and edible oils have sharp fall. But the prices of sugar group and primary articles continue to increase (inflation in sugar group is at whooping 33.3%). Recent hike in fuel prices, monsoon vagaries and the expansionary fiscal policy has already led to rise in inflationary expectations. In addition to this, further rise in the world oil prices might also see pushing prices in the coming months.
Money supply growth continues to be above 20% **Credit to government grows by 48.6%** **Net forex assets with banks see negative growth** **Upward pressure on interest rates seen**	Money supply continues to grow above 20%. Sharp rise in the growth of bank credit to government sector has contributed to this high growth. But the growth in credit to commercial sector and net foreign exchange assets, which were drivers of money supply growth for quite some time, have dropped to 15.1% and -1.9% respectively. Following Budget, we donđt expect fall in the money supply growth in the coming months. On the interest rates, as fiscal deficit is expected to go up further in the current fiscal year, actually there could be an upward pressure on the rates in the medium term.
Both exports and imports decline sharply **Trade deficit narrows**	Deceleration in trade sector continues. Both exports and imports growth decelerated to -29.2% and -39.2% in May 2009. As there is no much change in the global economic outlook we expect negative growth in exports to continue for some more months. In terms of imports, oil imports might rise following increase in the world prices. But the demand for intermediate imports largely depends on the stimulus packages.
Forex reserves increase to US$ 264.6 billions **Positive FII flows in April**	Foreign exchange reserves continue to rise. Currently it is at US$ 264.6 billions. Increase in foreign investments, NRI funds and reduction in trade deficit seems to help forex accumulation. FIIs

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Exchange rate appreciates marginally	also turning out to be net buyers. Latest data show that in April 2009, FIIs invested nearlyUS$2.2 billions. But this trends in forex reserves has not shown much impact on exchange rate, which has appreciated marginally to 48.7. The future movement of exchange rate would depend on the behaviour of foreign investors and the world oil prices.

IEG forecasts

Variables	Latest Information available	Forecast for next Three months
Inflation rate (WPI)	-1.55 % as on 27th June, 2009	-0.65%, -0.05% and 0.49%
Inflation rate (CPI)	8.7 % in April 2009	8.15%, 7.62% and 7.12%
Growth rate of IIP	2.7 % in May 2009	1%, 1.45% and 1.64%
Growth rate of M3	20.2 % as on 19th June 2009.	Expected to remain at this level
Prime lending rate	11-12.25% as on 19th June 2009.	Expected to decline further
Re/$ exchange rate	48.71 on 9th July 2009	Depreciate to 49.38 by September 2009
Forex reserves	US $264.58 billions as on 26th June 2009.	Expected to be at US$ 265 billions by September 2009
FII inflows (Net)	US$ 2245 millions in April 2009	FIIs to be Positive
Growth rate of exports	-29.2 % in May 2009	-21.5%, -22.6% and -10.9%
Growth rate of imports	-39.2% in May 2009	-26.2%,-21.8%, and -11.9%

Inflation still shows downward trend

The metal prices and prices of primary article declined further

Inflation

As predicted, the WPI inflation started showing negative numbers. For the week-ending13th June 2009, the inflation rate stood at-1.1%. Fuel group prices show a fall of 12.6% while in the manufacturing group the prices of both edible oil and iron& steel experiencing negative growth of -9.7% and -19.9% respectively. But the prices of primary articles (particularly the fruits and vegetables) and sugar group prices are showing a sharp rise. (Sugar group inflation is at whooping 33.3%). Although, large base effect could be one reason for this negative inflation, the slowdown in the domestic demand and fall in the international prices also must have contributed to this low inflation.

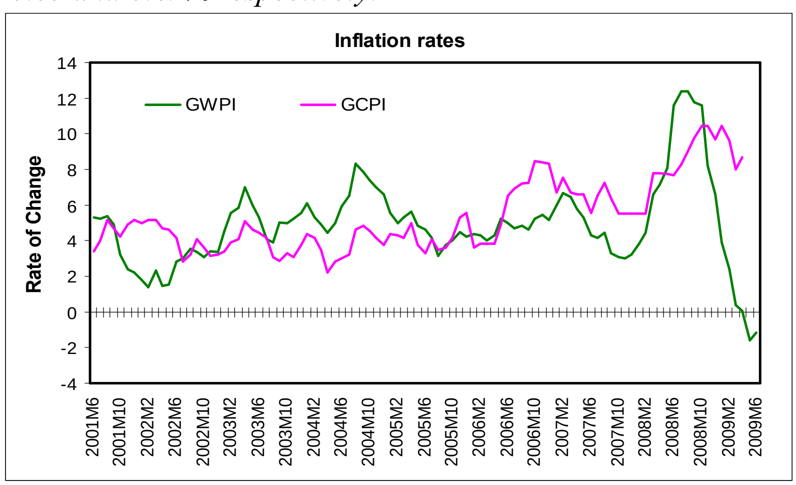
Rise in fuel prices are likely to add to inflation in coming months

Going forward, we expect the inflation to continue to be negative for some more weeks. But there are positive inflationary expectations building up in the economy largely due to recent hike in the fuel prices and below normal rainfall, which might push the food prices further. In addition to these, the expansionary fiscal policy, which is expected to enhance demand, could also raise the inflationary expectations further.

Fiscal expansion most likely to increase the demand reversing the deflationary trend

Forecast:

The WPI inflation forecast for the next three months to be -0.65, -0.05 and 0.49% respectively.



IIP shows some recovery, reversing the declining trend witnessed in early 2009

Industrial Production

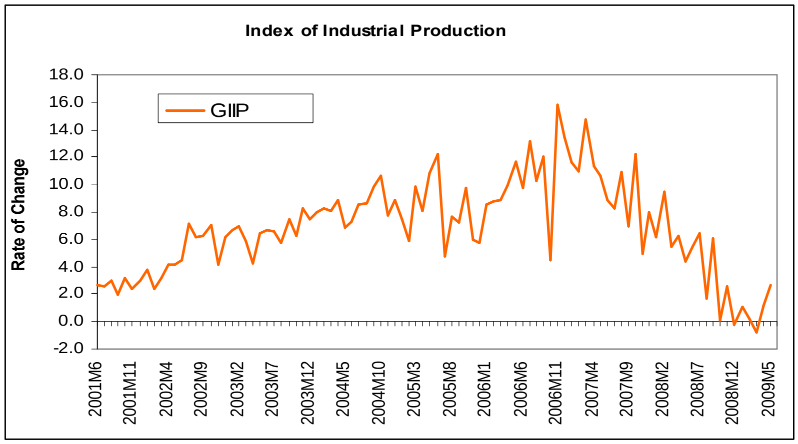
The Industrial slowdown showing some recovery signs. For the second consecutive month, the IIP growth turned out to be positive. In the month of May 2009, IIP growth stood at 2.7%. This positive growth has been contributed largely by the consumer durable goods and the intermediate goods. But both capital goods and consumer non-durables growth turned out to be negative, indicating that it is still early to infer that industrial sector is showing some strong recovery.

Electricity, Manufacturing and Mining sectors continued to be leaders though as compared to last year changes have been very low except for electricity

Recent stimulus packages and the Budget proposals are expected to further enhance domestic demand. This would have some positive impact on the industrial sector in the short term. But the full recovery would largely depend on the response from the monetary policy. In the current situation, it appears that the interest rates might start moving upwards following expected increase in government borrowing, which might have adverse impact on the private investments and, hence, the industrial productions.

Forecast:

Based on the available information we forecast the IIP growth rate for the next three months to be 1.0%, 1.45% and1.72%.



Money and Credit

There has been sharp increase in bank credit to government sector

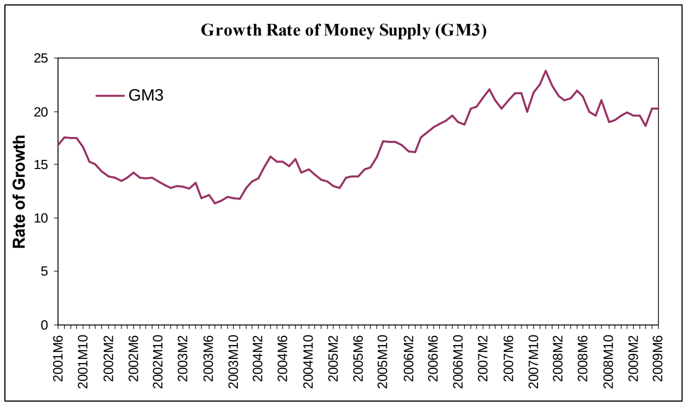
Money supply growth started increasing. Currently it is at 20.2%. This sharp rise in money supply growth, which was around 18% in April 2009, is contributed by the government borrowing program. The net bank credit to government sector has zoomed to 48.6% compared to meager 9.4% in the same period last year. On the other hand the net bank credit to commercial sector has declined to 15.5% from 24.5% last year. This reflects a sharp shift in the credit from private sector to government. Unusually, the net foreign exchange assets with the banking sector have also showed a negative growth of -1.9% against 52.1% last year.

Further fiscal deficit planned for this budget are likely to add to growth in money supply

As the government borrowing is expected to increase further in the coming months due fiscal expansionary proposals in the recent budget, we expect the current high growth in money supply to continue. Following reduction in policy interest rates, if the commercial bank does not reduce the lending rates then the growth in credit to commercial sector could decline further.

Forecast:

We forecast the growth rate of money supply (M3) to remain at the current level of 20.2% in the next three months



Interest rates

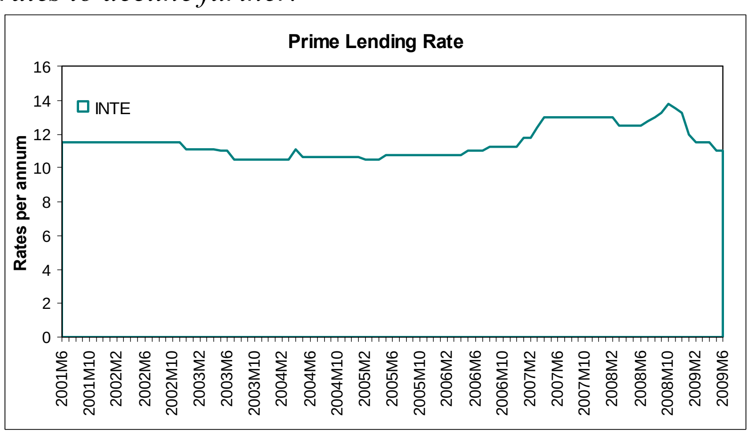
There has been less pressure on prime lending interest rates to increase

The decline in the policy inflation rates and deflationary expectations has put downward pressure on the lending rates for quite some time. But as the transmission of reduction in the policy interest rates on prime lending rates appears to be very weak, rates have not seen changes as much as it was expected. Currently the prime lending rates of five major banks is in the range of 11 to 12.25%. With negative inflation rates, there are pressures on the central bank to further cut the policy rates. But, in our view, there is not much scope for further reduction in rates for two reasons. First, negative inflationary situation is expected to be short-lived and inflationary expectation is already building-up. Secondly, in addition to foreign exchange outflow, the sharp rise in fiscal deficit could lead to higher demand for money and could create liquidity constraints.

Forecast:

Based on the data up to June 2009, we forecast that prime lending rates to decline further.

The policy rates as well as deflationary situation have reduced the pressure on interest rates to rise



Exchange rate

International conditions appear create volatility in the foreign exchange market. Currently the Rupee/US dollar exchange rate has appreciated and is at 48.7. This appreciation could be due to

Exchange rates have been volatile

International as well as domestic factors have contributed to volatility

decline in the trade deficit and positive inflow of foreign capital (both FII and FDI). In addition to this, the short term increase in the NRI funds must have also helped this appreciation. Going forward, the movement exchange rate could largely depend on the behaviour of foreign investors and the world oil prices. As it appears, the high world oil prices might result in depreciation of exchange rate to some extent in the coming months.

Forecast:

The Rupee/US Dollar exchange rate is expected to depreciate to 49.38 by September.

The foreign exchange reserves increased for the month of June

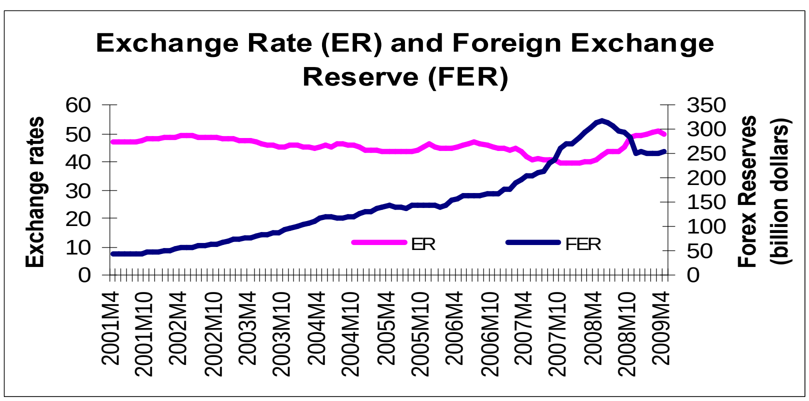
Reversing of foreign institutional investment outflows have been major contributor to this

Foreign Exchange Reserves

The accumulation in foreign exchange reserves continues. By the end of 26th June 2009 the reserves stood at US$ 264.6 billions. This rise in reserves has been due to inflow of foreign investments and the NRI funds. In addition to this, high interest rate differentials and narrowing trade deficit must have also helped this accretion. Due to same reasons we expect further accretion of reserves. But the sharp rise in government deficit and the re-look at the recent changes in FDI norms could hamper inflow of foreign funds. In addition to this, expected rise in the oil import bill might also restrain the high accumulation of reserves. In addition to this, continued bearishness in the world markets could also act as a dampener.

Forecast:

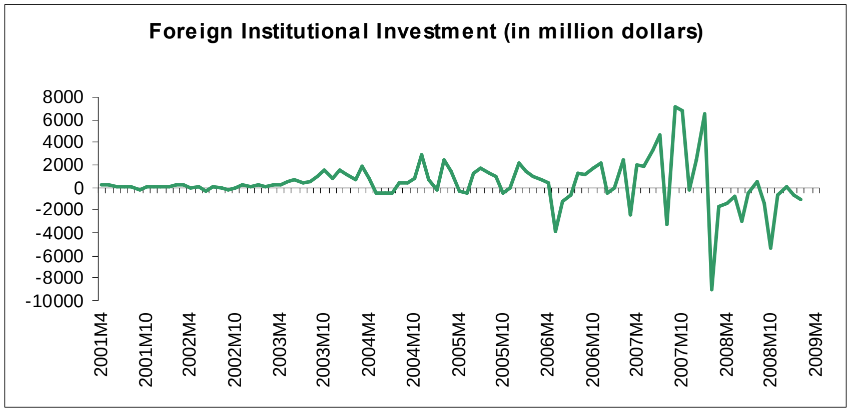
Forex reserves expected to reach at US$ 265 billions by the end of September 2009



FIIs seen investing in stock market

Foreign Institutional Investment

Negative trend in FII inflows end. The FIIs in the month of April 2009 invested US$ 2.254 billions, which indicate that the global perception on the Indian economy seems to have turned positive. But the continuation of this trend largely depends on the domestic economic policies. Rising fiscal deficits, with which Indiaðs investment position could be downgrades, might have adverse on the FII flows. But if this policy results in strong macroeconomic recovery, which is too early to judge, then we might see strong inflows. As the fall in stock indices after the Budget is any indication, we might not see high inflows, as was seen in April 2009, in the short term.



Forecast:

Based on the data up to April 2009, we expect the FII to be net buyers in the next three months.

Exports and Imports

Exports remained negative for this months that reflects the weak external demand

For the eighth consecutive month, the export growth turned out to be negative. In the month of May 2009, the exports registered a growth of -29.2%. For the April-May period, the growth stood at -31.2%. The continuing sluggishness in the in the external demand following recessionary trends in industrialized nations and large base effect must have resulted in this sustained negative growth in exports. As there is not much change in the global economic outlook for the immediate future, we expect exports continue to decline in the next three months. Although there are some policy measures in the recent Budget for the exporters, in our view, it may not have much impact on the exports.

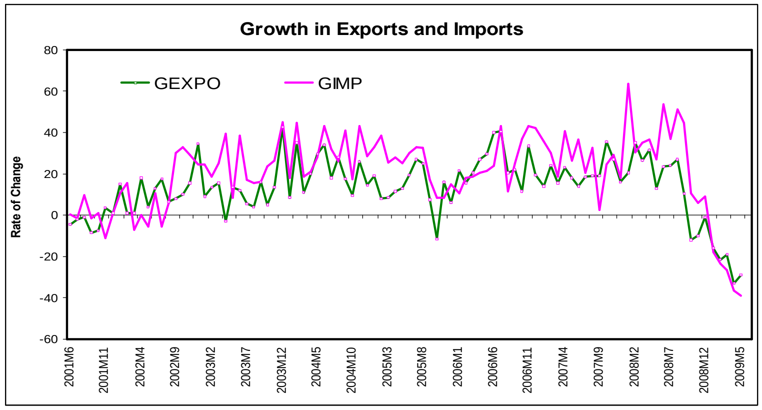
Imports declined by 38%

Trade deficit narrows

Imports also continue to decelerate for the fifth consecutive months. In May 2009, imports growth fell sharply to -38%. Within imports, it is the oil imports that have seen a big fall of -60.6% while the non-oil imports fell by -25.4%. Decline in the demand for intermediate goods imports, sharp fall in the oil import bill and huge base effect appears to have resulted in this negative imports. As the world oil prices have again gone up above US$60, we might see the oil import bill rising. But the non-oil imports largely depend on the stimulus packages. This negative trend in both exports and imports has resulted in narrowing of trade deficit to -US$5.2 billions and is expected to decline further.

Forecast:

Based on the data up to February 2009, we expect both exports and imports growth to be negative at around -18% and -20% respectively in the next three months (average).



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 ñA Short-term Time Series Forecasting Model for Indian Economyò available on our institute website at **http://www.iegindia.org/dis_bhanu_72.pdf**

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