MONTHLY MONITOR

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Global financial crisis leads to downward revision of GDP growth to 7% in 2008/09

Recession looms at some developed economies

Both industry and service growth to slowdown

Crisis led to moderation in inflationary expectations

Global financial disturbance and the Indian Economy

The sub-prime crisis that started in 2007 and limited to the US economy has created systemic problem through out the global financial system following collapse of a big investment bank. The stock market indices and business confidence have plunged to their medium term lows that stopped the existing projects and hampered new investments. It has also created short term liquidity constraints and has led to run on the banks. The real economic impact of this financial turmoil is expected to be very large. It has been officially stated that developed economies such as US and EU are entering a recessionary phase. Even the World economic growth has been predicted to decline.

The impact of this financial crisis on India is also going to be significant, as India is not decoupled with the global macroeconomic behavior. In the short term, it did create the liquidity problems as there was a flight of short term foreign capital from the domestic financial market and brought down the BSE Sensex to around 10000. In the medium term, this is expected to pull down industrial output growth, which is already in a slowdown phase. The service sector, of which two sectors namely 'trade, hotels, group' and the 'financing, insurance, group', growth is strongly linked with the global economy. Hence, any decline in the global economic activity is expected to have adverse impact on the domestic services growth. Overall, based on DSE-IEG macro model, this year the GDP growth is expected to slowdown to 7% compared to 9% growth last year. This adverse impact is also expected to spillover to the next fiscal year, where we predict a growth of 7.7%. This expected slow growth would derail the 11th Plan growth target of 9%.

On inflation front, this crisis indeed brought down the inflationary expectations as it led to decline in the world oil prices to around US$70 per barrel after reaching a peak of US$ 142 in July. This would have positive impact on the domestic economy through reduction in overall interest rate structure, which could stimulate domestic demand.

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Rupee/US dollar exchange rate to depreciate in the short-term

Financial sector reforms to be delayed

On the external sector front, we might see a fall in the foreign exchange reserves due to outflow of short term capital in the short term. Together with this, predicted fall in exports would result in weak Rupee. But given the strong domestic fundamentals, we do expect that this adverse impact is limited only to the short term and there would be resilience in the economy in the medium term once the demand and investments pick-up. On the reforms side, the significant adverse impact would be the possible shelving of much-awaited financial sector reforms that is expected to enhance financial inclusion.

IIP growth dips to 1.3% in August 2008

August IIP growth at 1.3%

The declining phase in industrial output continues. But the sharp fall in growth to 1.3% in the month of August 2008 was unexpected. For the first five months of the current fiscal year, the IIP growth stood at 4.9% compared to 10% in the same period last year. This sharp fall in growth has been contributed by the fall in growth of manufacturing output to 1.1% compared to 10.7% last year.

Rise in cost and decline in demand lead to slowdown

We have been saying since the beginning of this fiscal year that industrial sector would enter the slowdown phase. The reasons for such expectation were the expected decline in the demand (both domestic and external) following rise in cost of production that resulted in high prices and also due to some cyclical slowdown. The recent IIP trends vindicate our position.

Slowdown phase to continue until the end of current fiscal year

The recent events in the global financial markets and the consequent reactions in both monetary and fiscal policies across the World and in India, is expected to bring down the cost of production. But, the length of the current industrial slowdown could be much longer than initially anticipated as there are recessionary fears in most of the trading countries such as US and EU. There is a need for more counter-cyclical measures to incite the demand. But, given that India already has huge off-budget expenditures and with the expectation that the fiscal deficit this year could be higher than the targeted, it appears there is less room left for counter-cyclical measures. Overall, we expect the industrial growth continue to be in slowdown phase in the rest of the year.

GDP growth forecast revised downwards to 7%

Following domestic and external factors, GDP growth revised downwards to 7%

Recent developments in the macroeconomic situation have led to revision of our GDP growth forecasts downwards to 7% for the year 2008-09 (this is based on DSE-IEG Macroeconometric model). This downward revision is due to expected slowdown

Decline in food & fuel prices internationally would restrain industry from sharp slowdown	in the services sector output growth, in which some of the sub-sectors are largely dependent on global economy (US in particular) that is facing a recessionary threat. The sharp decline in the IIP growth in April-August 2008 together with decline in the second quarter corporate results only indicates that this year the overall industrial growth would be much smaller than last year's growth of 9%. Rise in inflation and interest rates and decline in investments in the current year seems to have had adverse impact on demand. Together with this, the global financial crisis, which has potential to drag some of the developed economies into recession and created short term liquidity concerns, appears to have led to slowdown in the credit to production sectors. But the decline in the food and fuel prices in the international markets would have some favorable impact on prices and, hence, interest rates in India. This would restrain the overall economic activity (industrial performance in particular) from sharp fall.
	Other stories….
Inflation rates continue to moderate **Inflationary expectations moderated** **Single digit inflation by January 2009**	As predicted in our earlier issue, the moderation in inflation rate has begun. The WPI inflation for the week-ending 3rd October has declined to 11.44%. This decline has been contributed by decline in both fuel group and manufacturing inflation. But the primary articles inflation has gone up marginally. But the overall inflation rate is still much higher and continues to be a cause for concern. Following decline in the food and fuel prices internationally, the inflationary expectations in India have indeed declined. Together with this the monetary policy tightening measures that were adopted in the first half of 2008 is expected to bring down the inflation rates further. Our forecasts show that the inflation rates would come down to single digit from January 2009 onwards.
RBI cuts both CRR and Repo rate **Further cut is necessary to stimulate the economy**	The RBI, for the first time after almost five years, has reduced the CRR by 250 basis points and the repo rate by 100 basis points. Following this, we do expect that the deposit rates also to decline. Although the cut in CRR is to ease the liquidity constraints in the short term money market, the cut in repo rate should be seen as a medium term policy to stabilize growth. This is in consistence with what we have been saying that there is a need to reduce the overall interest rate structure as it would hamper growth more than it offset inflation in the medium term. But this reduction is insufficient to prop-up economic activity and need further cut in repo rate.

Money supply growth declines to 19%

This decline could be temporary

The money supply growth has declined to 19% in the beginning of October. This seems to be largely due to sharp rise in the non-monetary liabilities of the banking sector. On the components side, it is the fall in deposits (both time and demand) that has contributed to decline in the overall money supply growth. The outflow of foreign exchange reserves to the tune of nearly US$ 20 billions does not reflect in the money supply (in both M3 and reserve money). In the medium term, we expect that due to the widening of trade deficit and outflow of foreign capital, the growth in the net foreign exchange assets with banking sector to decline. But the recent cut in CRR and repo rate might enhance the credit to commercial sector. On balance, the overall money supply growth is projected to be at around 19% in the medium term.

Export growth continue to be robust

Imports growth at 51.2% in August

Trade deficit widens sharply

Despite the slowdown in external demand and export ban on various commodities, the overall export growth continues to be robust. In the month of August the growth is at 26.9% while for whole of April-August, it is at 35.1%. On the other hand, the imports growth has also increased sharply (by 51.2% in August), largely due to huge oil import bill. The recessionary fear in the developed economies and rise in the domestic cost of production is expected to pull down the export growth. But the sharp depreciation of exchange rate would hold the exports from huge fall. The fall in food and fuel prices in the international markets would moderate the imports growth also to some extent in the coming months.

Forex reserves decline to US$274 billion

The foreign exchange reserves declines sharply to US$274 billions by the first week of October, 2008. This could be due to outflow of short term foreign capital from the domestic capital markets and also due to widening of trade deficit (US$13.9 billion in August alone). We expect no further accumulation of reserves in the next three months given, the short term uncertainty in the global financial markets.

Rupee/dollar exchange rate depreciates to 48.99

Exchange rate expected to appreciate

The depreciation in exchange rate continues. At present the Rupee/US dollar is at 48.99 as on 20th October 2008. This sharp deprecation is attributed to two factors. They are widening of trade deficit and outflow of short term foreign capital that resulted in the decline of foreign exchange reserves. As the US dollar in the international market is expected to be weaken and the trade deficit to slightly moderate, we don't see further depreciation of the exchange rate in the coming months.

IEG forecasts

Variables	Latest Information available	Forecast for next Three months
Inflation rate (WPI)	11.44 % as on 4th October, 2008	Between 10-11 %
Inflation rate (CPI)	9.02 % in August 2008	Expected to be around 9%.
Growth rate of IIP	1.3 % in August 2008	To be around 4-5%
Growth rate of M3	19 % as on 26th September, 2008.	To stabilize between 18.5-19%
Prime lending rate	13.75-14 % as on 3rd October 2008.	Expected to decline
Re/$ exchange rate	48.99 as on 20th October, 2008	No further depreciation expected
Forex reserves	US $274 billions as on 10th October 2008.	Reserves to decline marginally
FII inflows	US$593 millions in August 2008	Negative inflows
Growth rate of exports	26.9 % in August 2008	Around 21%
Growth rate of imports	51.2% in August 2008	Around 32%

Inflation

Moderation in inflation rate started

As predicted in our earlier issue, moderation in WPI Inflation has started, although it is still at a higher level. For the week-ending 4th October, inflation rate stood at 11.44%. This fall in inflation has been contributed by the decline in the inflation rates in fuel group and also in the manufacturing group. The prices of manufacturing and food products continue to increase at above 10%. Within the manufacturing, prices of iron & steel and edible oils are growing at 30.7% and 11.2% respectively. Fruits & vegetables prices, on month-on-month basis, have increased by 4.7%. As we have said earlier also, this high inflation is largely due to international factor such as high crude oil and food prices and is not specific to India alone.

But the rise in food inflation is a cause for concern

Iron & steel prices increase by 30.7%

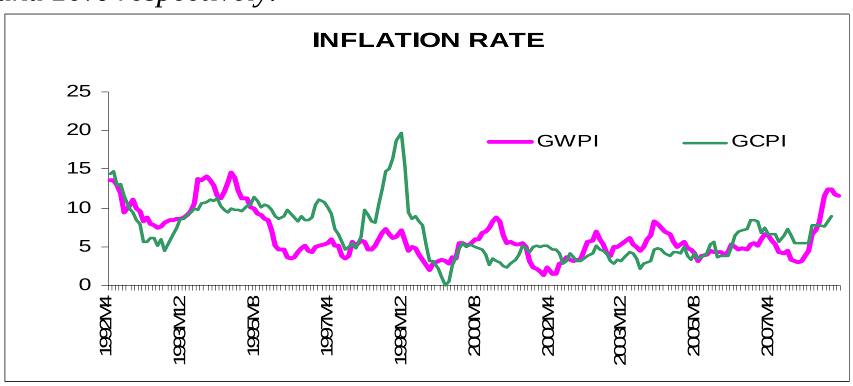
Decline in world food & fuel prices brings down inflationary expectations

The recent monetary and fiscal measures that were taken in the early 2008-09 seem to have started showing impact on the inflation rates. Together with this, the decline in the food & fuel prices in the international markets has also brought down the inflationary expectations. We do expect that these factors would result in reduction of the production costs and cool the inflationary situation in the coming months. In addition to these structural factors, there is also a base effect, which is low at present. Overall we expect that by the year end, the inflation rate to prevail at single-digit.

Year-end inflation to be at single-digit

Forecast:

The WPI inflation forecast for the next three months to be 10.8, 10.5 and 10% respectively.



Industrial Production

IIP growth in August declines sharply to 1.3%

The industrial sector growth continued to decline. But the drop in August 2008 to 1.3% (compared to 10.9% in same period last year) is very sharp and larger than our expectations. This fall in IIP growth has been contributed by decline in all the sub-sectors. Mining, manufacturing and electricity sectors have declined to 4%, 1.1% and 0.8% respectively. Only positive factor is the growth in consumer goods segment, which is growing at 5.1% compared to almost zero percent in the last year. Within the consumer goods, it

Capital goods growth declines to 2.3% compared to 30.8% last year

is the consumer durables growth that is growing at 5.1% compared to -6.2% in August 2007. The growth of capital goods has fallen sharply to 2.3% from 30.8% in August 2007.

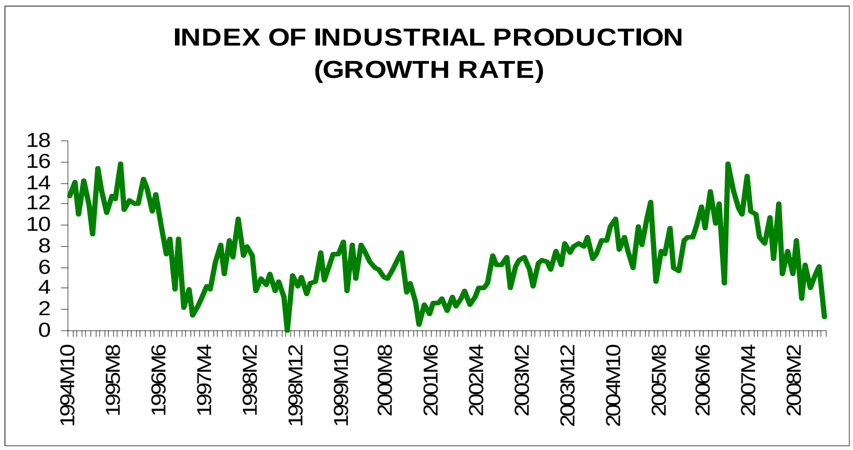
Festival demand and 6th Pay to stimulate demand

Interest rate cut to encourage investments

Although the festival demand and the Sixth Pay Commission proceeds might restrain the sharp fall in IIP growth, going forward we do expect the current slowdown to continue atleast until the end of 2008-09. This is largely due to rise in cost of production and also due to slackening of demand (both domestic and external). Recent cut in repo rate, if it lead to reduction in PLR, is expected to encourage investments and, hence, industrial output to increase.

Forecast:

Based on the available information we forecast the IIP growth rate for the next three months to be 4.0, 5.1 and 4.4%.



Money and Credit

Money supply growth declines to 19%

But both credit and foreign exchange assets growth increase

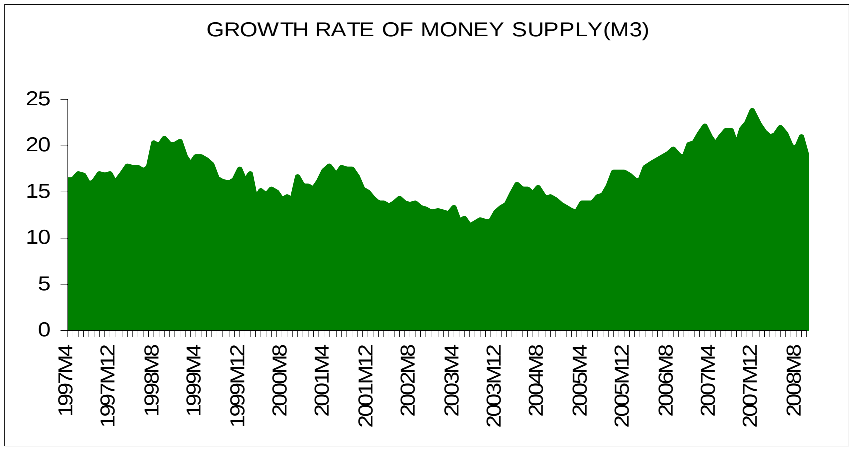
Any further decline depends on credit off-take and FIIs

The money supply growth (M3) has declined to 19%. But both banking credit to commercial sector and the net foreign exchange assets with the banking sector continue to increase and is currently growing at 23.2% and 35.4% compared to 21.2% and 26% respectively. It appears that the decline in money supply growth is contributed mostly by the net non-monetary liabilities of the banking sector. Recent decline in the foreign exchange reserves seems to have not reflected in the money supply as even the reserve money growth has increased to 28.7% compared to 26.6% last year.

The monetary tightening measures that were taken in the early 2008-09 seem to have not shown much impact on the money supply growth. But the cut in CRR and repo rate could lead to further rise in money supply growth, but this would largely depend on the credit off-take and FII behavior.

Forecast:

We forecast the growth rate of money supply (M3) to be around 19% in the next three months



Interest rates

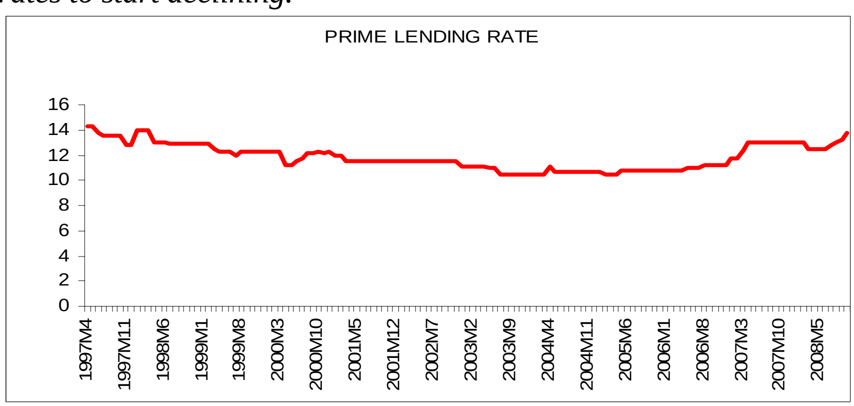
RBI cuts both CRR and Repo rate

Real impact of this cut depends on its impact on lending rates

The recent cut in CRR and the repo rate, by 250 and 100 basis points respectively, is expected to bring down the overall interest rate structure in the economy in the coming months. It may be noted that we have been saying that there is a need to bring down the interest rates to propel the growth as high interest rates were hampering growth more than it is offsetting the inflationary pressure. We have also said that the interest rates have already peaked and only way is the downward movement. This is based on the assumption that the decline in the food & fuel prices in the international markets has already brought down the inflationary expectations. Impact of the recent cut on economic activity depends on the extent of reduction in lending rates by the banks. At the moment it appears that this cut in repo rate may not be sufficient for the banks to pass benefit to the consumers.

Forecast:

Based on the data up to June 2008, we forecast that prime lending rates to start declining.



Exchange rate

The Rupee/US dollar exchange rate continue to depreciate. By the middle of October, it has depreciated to 48.9. In our previous issue we did predict that the exchange rate would not depreciate

Exchange rate depreciates sharply

FII outflow and decline in reserves seems to have led to this depreciation

Relaxation in ECB norms might restrain the Rupee from further weakening

further and that was based on the assumption that US dollar is expected to weaken in the international market. Against our prediction, it appears that the outflow of short term foreign capital and the demand for Dollar to cover the import bills seems to have had larger impact on the Rupee/US dollar exchange rate. Interest rate differentials, which is an important factor that helps in taking arbitrage advantage and is right now very high, also seems to have not led to inflow. Decline in the foreign exchange reserves following widening of trade deficit and FII outflows, must have also led to this deprecation. Recent decision to relax the ECB norms might help in forex accumulation. In addition to this, the decline in the world oil prices is expected to result in appreciation of Rupee to some extent.

Forecast:

The Rupee/US Dollar exchange rate is expected to be around 47 in the next three months and then expected to appreciate.

Foreign Exchange Reserves

Forex reserves dips to US$274 billions

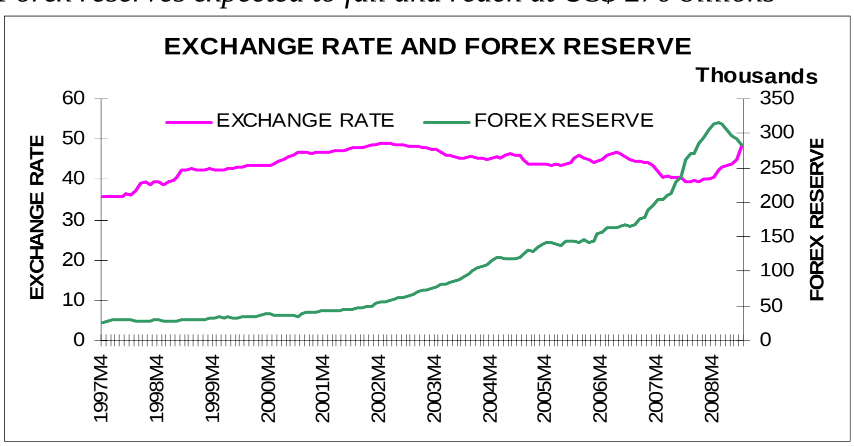
Foreign exchange reserves continue to fall and right now at US$274 billions. This fall in reserves were attributed to large trade deficit and also due to outflow of FIIs from the equity markets. Based on newspaper reports, it appears that the RBI has intervened in the market to protect Rupee from weakening by selling Dollars in the spot market. 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.

This fall could be due to widening trade deficit and RBI selling in spot market

Based on our prediction, we expect that foreign exchange reserves to deplete marginally in the coming months. But the relaxation of ECB norms and decline in the world commodity prices might restrain the fall in reserves to some extent.

Forecast:

Forex reserves expected to fall and reach at US$ 270 billions



After five consecutive months, FIIs turned out to be net buyers

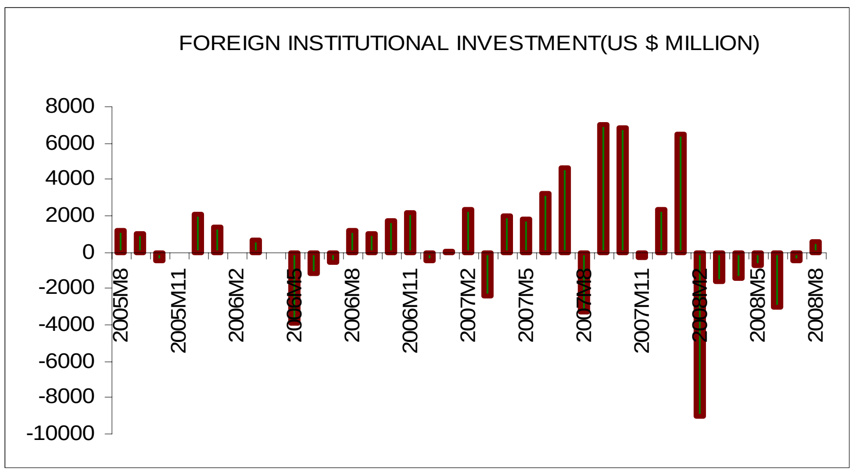
But expected to be net sellers due to high volatility in the international market

Foreign Institutional Investment

Latest information on FII investments shows that in the month of August, FIIs are net buyers in the market with US$593 millions. But volatility in the global financial markets that led to sharp decline in stock indices across the globe to their medium term lows is expected to have adverse impact on the FII inflows in coming months. (The BSE Sensex has fallen to around 10000 after touching an all time high of 21000). In addition, decline in the industrial sector output growth and fall in corporate earnings in the second quarter would also expect to discourage FII investments. Future behavior of FIIs would also depend on the stability of the global financial markets.

Forecast:

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



Robust growth in exports continue

Oil import growth at record 76.7%

Trade deficit widens to US$13.9 billion in August alone

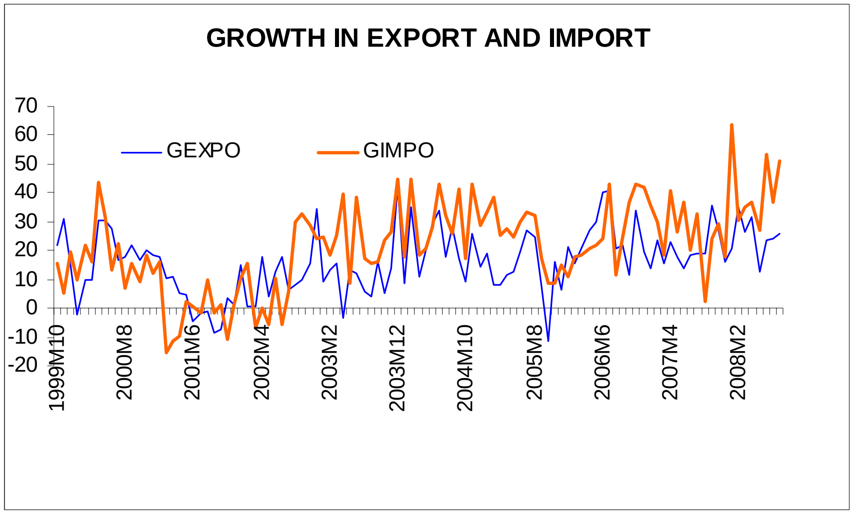
Exports and Imports

Exports growth continues to be robust. In August 2008, exports registered a growth of 26.9% and the cumulative growth of 35.1% during April-August period. This high growth in exports is despite the high cost of production, which is an important variable for competitiveness, and ban on exports of some of the agricultural commodities. On the other hand, imports also increased by 51.2% during August 2008. Within imports, it is oil imports that have increased by whopping 76.7% largely due to high world oil prices.

Going forward, we do expect that there could be some deceleration in the growth of exports due to expected decline in the external demand and slowdown in the overall economic activity. On the imports front, our model predicts an average growth of 32% in the next quarter. This is despite decline in the world oil prices, which has been offset by sharp exchange rate depreciation. We also expect non-oil imports to moderate due to fall in the domestic demand and production.

Forecast:

Based on the data up to August 2008, we expect the exports to grow at around 21% while imports at 32% in the next three



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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