MONTHLY MONITOR

Prepared by N. R. Bhanumurthy April 2006

TOP STORIES

Policy interest rates unchanged

Risk weightage on commercial real estate loans and venture capital funds raised

Against our expectations, the recent Monetary and Credit policy has not changed the policy interest rates to support the current credit off-take and thereby the growth momentum. But it has raised the risk weightage on the commercial real estate loans. Following this, major commercial banks have hiked their interest rates on home loans. This is expected to have spin-off effect on the real economy as well. Given the persistence of inflationary expectations and sharp rise in the money supply growth (to 17.6% against RBI's target of 15%), in our view, RBI might not hold the policy rates for long.

IIP grows at 8.8%

Current upward movement in the industrial cycle may end at any time now

Robust growth in industrial sector continues. For the month of February 2006, IIP has grown at 8.8%, mostly backed by the good performance in manufacturing sector. The current upward movement in the industrial cycle, which is lasting for longer period than previous ones, is expected to end any time now. For this, the dip in core sector growth in 2005-06 could be an early indication.

Exports cross US$100 billion in 2005-06

Trade deficit widened to US$ 39.6 billion

Buoyancy in the trade sector continues. For the whole of 2005-06, exports have registered an impressive growth of 24.7%. While it is necessary, the sustenance of this high growth would be a challenging task. On the other hand, imports also grown at 31.5%. Trade deficit widened to whopping US$ 40 billions. Sustaining of this trend in exports and imports, which is necessary for the overall growth performance of the economy, in the year 2006-07 would be a challenging task.

But inflationary expectations still persist

The WPI inflation rate for the year ending 2005-06 was 3.5 percent, which is less than the RBI's projected level. But the inflationary expectations still persist in the economy following high world oil prices, which are not reflected in the domestic prices, and also due to sudden spurt in money supply growth, which is inflationary with a significant lag.

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.

Rupee/US dollar exchange rate depreciates	As predicted in our earlier issue, Rupee/US dollar exchange rate depreciated to 45. Although trade deficit was supposed to lead to this depreciation, it appears that strong intervention by RBI had bigger role in the exchange rate depreciation. This has also led to rise in the foreign exchange reserves by nearly US$ 6 billions since 31st March 2006. FIIs continue to be net buyers in the stock market.
Money supply increases by 17.6%	Money supply (M3) growth has shown sudden spurt in April 2006. It has increased by 17.6% on the back of strong credit off-take. Recent hike in the lending rates by major commercial banks might reduce the credit demand and thereby the money supply growth. Recent Credit policy projects the money supply growth at 15 percent for 2006-07 with a preference for 'maintaining a lower order'. This would be possible only if there is a fall in credit demand.

IEG-DPC Forecast

Variables	Latest Information available	Forecast for next Three months
Inflation rate (WPI)	3.55% in April 2006.	Expected to increase marginally.
Inflation rate (CPI)	4.9% for March 2006	Expected to decline marginally.
Growth rate of IIP	8.8% in February 2006	7.5% (average)
Growth rate of M3	17.6 in April 2006.	Current high growth is expected to continue.
Prime lending rate	10.25 – 10.75 % in April 2006.	Lending rates to rise
Re/$ exchange rate	45.01 in April 2006.	Depreciate to 45.6
Forex reserves	US $ 157.26 billions in April 2006.	Forex reserves expected to decline marginally.
FII inflows	Inflow of US$ 1386 millions in January 2006.	Positive inflows
Growth rate of exports	20.63% in March, 2006	12.2% (average)
Growth rate of imports	18.68% in March, 2006	20.9% (average)

Inflation

WPI inflation continues to be below 4%

On the contrary CPI saw a rise of 4.9%

The WPI inflation rate in the year 2005-06 ended at less than the RBI's projected rate. It was 3.5 percent. Despite sharp rise in the prices of both fuel group (by 8.3 percent) and cement (by 16.4 percent) this low level of inflation rate continues in April also. By the middle of April, it was 3.55 percent. This could be due to decline in the inflation rates of edible oils and iron & steel (by 2.6 and 11.6 percent respectively). Following fall in WPI inflation, one would expect that the CPI inflation also decline with a lag. Contrary to this, it has increased to 4.9 percent in March 2006.

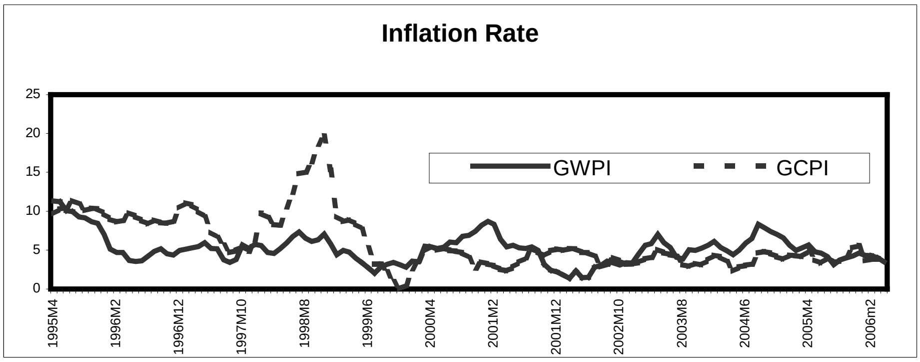
Inflationary expectations still persist due to rise in both oil prices and money supply growth

RBI projects 5-5.5% inflation for 2006-07

For the year 2006-07, the RBI has projected the inflation rate of 5 to 5.5 percent. This might turn out be true for two important reasons. The international oil prices continue to be above US$ 70 per barrel for quite some time and are yet to be reflected completely in the domestic prices. As it appears, the current high oil prices seem to have large permanent component, ultimately it needs to be absorbed by the domestic economy. The sudden spurt in the money supply (M3) growth (by 17.6 percent April 2006) might be inflationary with a lag from the demand side. The only respite would be the MET department's prediction of normal monsoons in this year.

Forecast:

The WPI inflation forecast for the next three months to be 3.69%, 3.8%, and 4% and the CPI inflation rate to hover around 4.5%



Industrial Production

Backed by strong manufacturing sector performance, robust growth in IIP continues

The industrial sector continues to show strong performance for the second consecutive month. In the month of February 2006, the IIP growth is at 8.8 percent compared to 5.9 percent growth in the same period last year. This growth is backed by 9.5 percent growth in the manufacturing sector. From the Use-based classification, capital goods output has registered a robust growth rate of 13.5 percent while consumer goods grow at 12.4 percent.

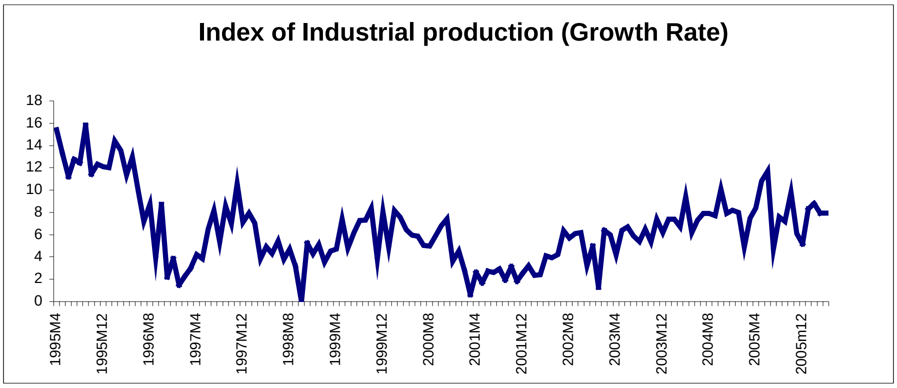
Upward movement in the industry cycle may end at any time

Core sector output dips in 2005-06

In our previous issue of Monthly Monitor, we have predicted a low growth of IIP for February 2006 and said that the current upward movement in the industrial cycle, which is lasting long compared to previous cycles, might end. Although we still predict the downward movement of the industrial cycle, the timing could be different from our previous prediction. The decline in the core sector growth from 5.8 percent in 2004-05 to 4.9 percent in 2005-06 can be an early indication of our predicted downward movement in the industrial cycle. The recent raise in the lending rates of commercial banks (particularly for the home loans) only strengthen our view.

Forecast:

Based on the available information we forecast the IIP growth rate for the next three months to be 7.6, 7.4 and 6.6 percent respectively.



Money and Credit

Sudden spurt seen in growth of broad money

Credit demand continues to grow above 28%

RBI projects 15% growth in 2006-07

Money supply (M3) growth has shown a sharp increase from around 16 percent March 2006 to 17.6 percent in middle of April 2006. This is majorly due to rising bank credit to commercial sector, which is currently growing at a robust level of 28.7 percent. Increasing foreign exchange reserves might have also contributed to this high growth to some extent. This recent hike in the lending rates (particularly for the home loans) by major commercial banks might to some extent reduce the credit demand and thereby the money supply growth. But the current pace of forex accumulation, if it continues, would keep the money supply growth at its current high level. Recent Credit policy projects the money supply growth at 15 percent for 2006-07 with a preference for 'maintaining a lower order'. This would be possible only if there is a fall in credit demand.

Forecast:

We forecast the growth rate of money supply (M3) for the next three months to be around 17.4 percent.

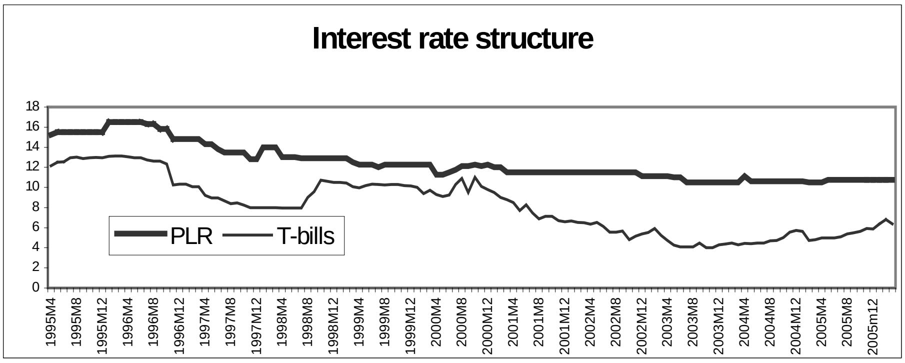
No change in policy rates

Commercial banks hike lending rate

RBI might not hold policy rates for long

Interest rates

Against the expectations, the RBI, in its recent Credit policy, has maintained the existing interest rate structure. But the policy has hiked the risk weight on loans to commercial real estates. This has led to hike in the home loan rates by major commercial banks. Given the persistence of inflationary expectations and raise in the international interest rates, in a capital scares country like ours one would expect that domestic interest rates also to go up. But the recent RBI's stance focuses on continuation of the current credit expansion thereby the growth momentum. Due to reasons specified above and the hike in interest rates (both deposit and lending) by major commercial banks, in our view, the RBI might not hold the policy rates for long.



Forecast:

Based on the data up to December 2005, we forecast a marginal rise in prime-lending rate and also in the short-term rates.

Exchange rate depreciates

Widening trade gap might lead to further depreciation

Exchange rate

As predicted in our earlier issue, the Rupee/US dollar exchange rate depreciated to 45. This could be due to intervention of RBI in the forex markets (the net forex assets of RBI has gone up by nearly Rs 38,000 crores between 31st March to 21st April 2006) thereby releasing funds to ease the liquidity constraints. Together with the RBI intervention, widening trade gap and strengthening of US dollar in the international markets must have led to the depreciation of the exchange rate. If this trend continues, we expect further depreciation in the coming months.

Forecast:

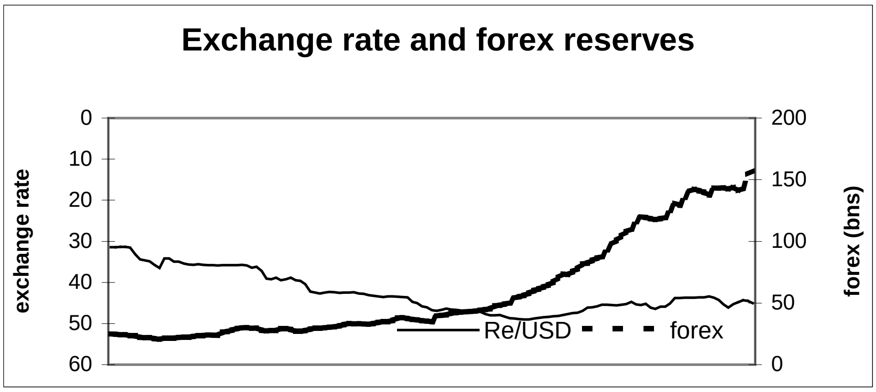
The Rupee/US Dollar exchange rate is expected to depreciate to 45.2 in the coming months.

Despite huge trade deficit, forex reserves bulge

Expected to decline marginally

Foreign Exchange Reserves

In the recent period, the foreign exchange reserves have increased sharply from US$143.1 billions in February 2006 to 157.3 billions by the middle of April 2006. This is despite the huge trade deficit (US$ 39.6 billions) occurred in 2005-06. Although FII are net buyers in the recent period, this huge forex accumulation could not be possible without the RBI's intervention. Further, with high oil prices and with narrowing interest rate differentials, we only expect a marginal fall in the reserves in the coming months. But this would largely depend on the RBI's behaviour.



Forecast:

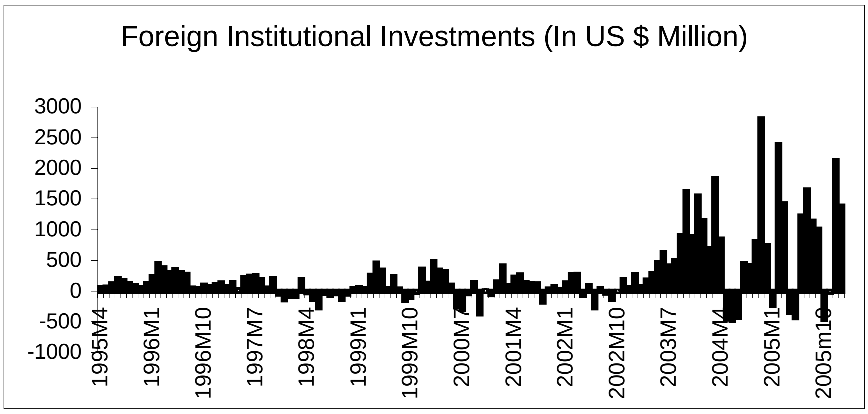
Forex reserves are expected to decline marginally.

FIIs continue to be net buyers in January.

Expected a positive FII inflow in the coming months

Foreign Institutional Investment

Recent data on FII inflow shows that FIIs are net buyers to the tune of US$ 1.4 billions in January 2006. Given the strong positive sentiments on the Indian economy, which is sustaining the bull run in the stock market for quite sometime, this FII behaviour is expected. Narrowing interest rate differentials might restrain the future FII flows to some extent. But the robust outlook for Indian economy would see the FII inflows in the coming months. But this would also depend on the future movements in both Indian and the US interest rate cycle.



Forecast:
FII inflows would be positive for the coming months

Exports and Imports

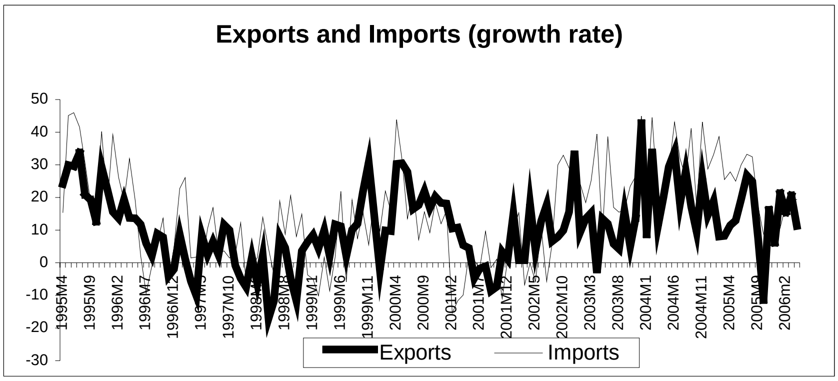
Export growth for 2005-06 has turned out to be whopping 24.71%

Trade sector performance continues to be buoyant. The export growth for the month of March 2006 has gone up to 20.63 percent. With this the export growth for the whole of 2005-06 is turned out to be whopping 24.71 percent. In this year the exports have also crossed US$ 100 billions.

Import growth for 2005-06 is 31.52%

On the other hand, the imports have also grown at 18.68 percent in March 2006 and at 31.52 percent for the whole of 2005-06. While the oil imports have become costlier, the raise in the imports of intermediate goods have led to this high growth in imports. This trend in exports and imports led to huge trade deficit to the tune of nearly US$ 39.6 billion. Sustaining of this trend in trade, which is necessary for the overall growth of the economy, in the year 2006-07 would be a challenging task. Our forecasts show that while imports may grow at current levels, exports growth would fall in the coming months.

Trade deficit at US$ 39.6 billion



Forecast:
Based on the data up to March 2006, we forecast the average export growth to be 12 percent and the average import growth to be 21 percent for the next three months

BSE Sensex

Sensex touches another peak in April

The BSE sensex reached another peak in April 2006. It has crossed 12000 points and the bull run continues further. Good corporate results backed by the FII investments, have boosted the share prices to the record levels. Given the low returns on the savings deposits and other financial instruments, stock market is turning out to be a good investment destination (as reflected in increase in demat accounts) for the small investors. In that sense, Indian stock market seems to have come a long way.

Good corporate results backed by FII inflows help continue the bull run