MONTHLY MONITOR

Prepared by N. R. Bhanumurthy **August 2005**

TOP STORIES

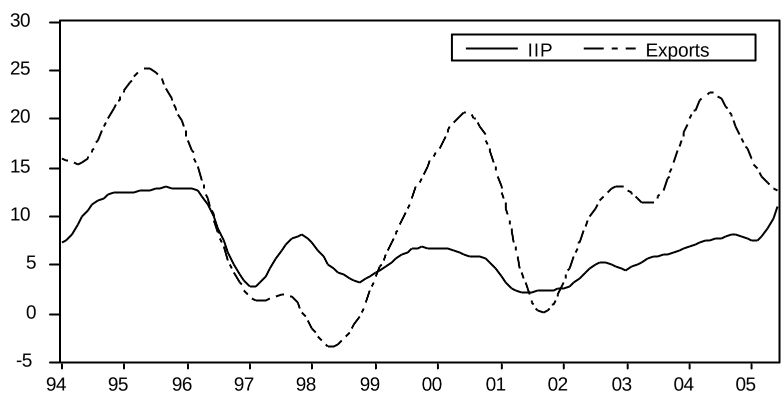
Buoyancy in industrial sector growth continues.

The index of industrial production registered double-digit growth for the second consecutive month. In June 2005, the growth rate of IIP was at 11.7%, which is the highest since mid-1996. The current high growth in IIP could be mainly due to growing external demand. Although high World oil prices and expectation of hike in domestic interest rates are great concern, the sustenance of this strong growth in IIP would depend heavily on the future external demand. This may be noted in the below graph that the cyclical movements in both export growth and the IIP growth are largely identical, although the export growth cycles are more sharper than IIP growth cycles.

This year's first quarter IIP growth is at 10.3% compared to 7.7% in 2004-05.

Sustenance of this high growth largely depends on external demand.

Cycles in growth rates of IIP and Exports



WPI inflation dropped to its 3 years low at 3.13%. But the inflationary pressure still persists.

Inflation rate based on WPI has dropped to 3.13% in the second week of August 2005, which is the lowest since October 2002. This is despite the inflationary expectations existing in the economy due to growing World oil prices. As rightly pointed out by the RBI, the current rise in world oil prices have large permanent component, which should eventually be reflected on the domestic fuel prices, if not immediately.

Money supply growth rises due to growing credit demand.

Money supply growth started rising. Currently M3 is growing at 14.7%, although at a slower pace compared to last year's growth of 15.5%. Growing credit demand backed by rise in business confidence and increase in the foreign exchange reserves must have led to this upward movement in the money supply growth. As we expect no further rise in the forex reserves, money supply

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growth is expected to stabilize at the RBI's target level of 14.5% in the coming months.

Forex reserves to fall marginally.

Exchange rate may depreciate further.

Forex kitty continues to bulge, but at a slower pace compared to last year. It has reached to US$143.2 billions by August 19th, 2005. On the other hand Rupee/US dollar has started depreciating. By the end of August 2005, it has depreciated to 44. Narrowing interest rate differentials and expected increase in the Dollar demand due to widening trade deficit must have led to this depreciation. Due to same reasons, we expect a further depreciation of exchange rate in the coming months.

Strong growth in trade sector continues

Backed by the recovery in the World Economy, India's exports continue to register the double-digit growth for the fourth consecutive month. In July 2005, it has achieved a growth of 26.8%. It also indicates growing competitiveness of India's exports in the international market. Imports also showed a strong growth of 33.2% in July 2005. Within imports it is the non-oil imports that are growing faster thereby reflecting the current boom in the industrial sector. As the World economic recovery and the expansion in the domestic industry is expected to continue, India's trade sector also expected to grow at double-digit. But the overall performance in the current fiscal year could be less than that of last year's growth.

IEG-DPC Forecast

Variables	**Latest Information available**	**Forecast for next Three months**
Inflation rate (WPI)	3.13% in August 2005.	Expected to be between 3.2-3.9%
Inflation rate (CPI)	3.3% in June 2005	3.4 to 3.6%
Growth rate of IIP	11.7% in June 2005	9.2% (average)
Growth rate of M3	14.7%in August 2005.	14.5% (average)
Prime lending rate	10.25 – 10.75 % in August 2005.	Lending rates might start rising
Re/$ exchange rate	43.98 in August 2005.	Exchange rate to depreciate.
Forex reserves	US $ 143.21 billions in August 2005.	Expected to decline marginally
FII inflows	Outflow of US$437 millions in June 2005.	Positive inflows
Growth rate of exports	26.8% in July, 2005	17.5% (average)
Growth rate of imports	33.21% in July, 2005	31% (average)

The WPI inflation declines.

Primary articles price drops.

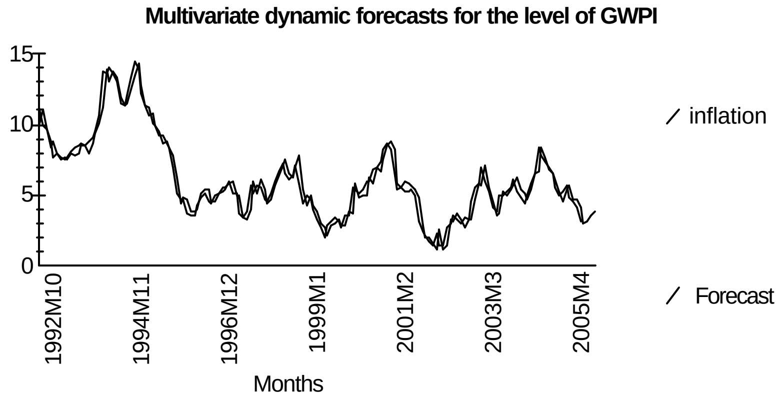
CPI inflation Rate fell to 3.3% in June 2005.

Inflation is expected to rise marginally in the coming months.

Manufacturing output grows at 12.5%

Inflation

The inflation rate based on WPI continues to decline. The inflation rate, which was around 5 percent in end March 2005, has declined to 3.13 percent by the second week of August 2005. This is despite the rise in fuel prices by 9 percent compared to last year. Although primary articles prices have indeed declined by 0.1 percent, fruits and vegetables prices have gone up by 6 percent. Edible oil prices fallen sharply by 6 percent while the prices of sugar group, cement, and iron & steel have gone up by 13.8, 7.4 and 5 percent respectively. The decline in the general inflation rate might be due to various monetary measures adopted by the Central Bank and also due to some supply side factors. But the inflationary pressures in the economy still persist, as the galloping World oil prices have not yet absorbed fully by the domestic prices. The impact of high and rising World oil prices would have to be certainly reflected in the domestic price level, either through direct hike in domestic fuel prices or indirectly through fiscal support. Postponing of this would only perturb the macroeconomic management.



Forecast:

Based on the available information we forecast the WPI inflation for the next three months to be 3.1%, 3.3%, and 3.9% and the CPI inflation rate to hover around 3.42%.

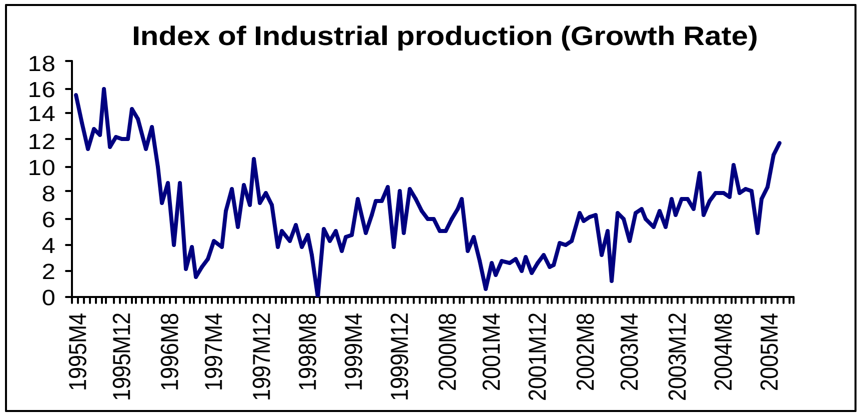
Industrial Production

Industrial sector registered a double-digit growth for the second consecutive month. For the month of June 2005, it has registered a growth of 11.7 percent compared to 7.3 percent in the same period last year. For the first quarter of current fiscal year, IIP growth stood at 10.3 percent. Manufacturing sector, which has registered a growth of 12.5 percent, majorly backs this growth. Among the Use-based classification, it is the Capital goods and the consumer goods (particularly the consumer non-durables), which showed strong growth. Existing positive sentiments in the economy and growing external demand as reflected in the high export growth have contributed to this high growth in the industrial sector. The sustenance of this high industrial growth would depend heavily on external demand besides other domestic factors.

Recovery in the industrial sector to continue.

Forecast:

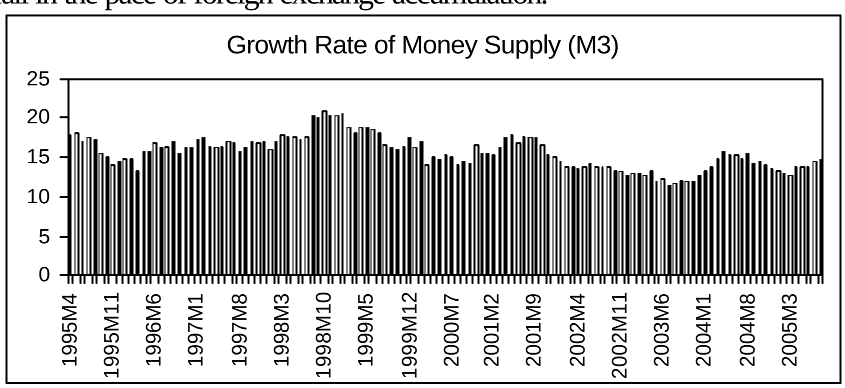
Based on the available information we forecast the IIP growth rate for the next three months to be 9.8, 9 and 8.6 percent respectively.



Money and Credit

Money supply growth to decline marginally even after high credit off-take

Money supply growth started increasing. In the beginning of August 2005 it registered a growth of 14.7 percent. Increasing bank credit to commercial sector (by 27.8 percent compared to 18.8 percent in the same period last year) must have led to this rise in the money supply growth. (Non-food credit by the commercial banks is growing at 34 percent on year-on-year basis, which is the highest in the reform era.) But the growth of net foreign exchange assets with the banking sector has dropped from 36 percent to 11.7 percent. We expect the money supply growth to fall marginally due to expected fall in the pace of foreign exchange accumulation.



Forecast:

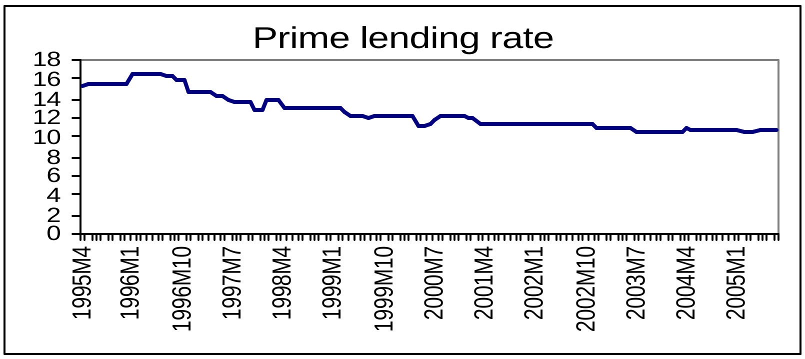
Based on the data up to August 2005, we forecast the growth rate of money supply (M3) for the next three months to be around 14.5 percent.

International interest rate cycle moving upwards.

Domestic interest rates expected to rise.

Interest rates

Prime lending rates continue to be stable. But the call money rates and the yield on Government securities have gone up marginally. Contrary to industry's expectations of hike in the Bank Rate, RBI has not increased the rate in its first quarter review of Monetary and Credit policy. This might be due to subdued inflation rate and presence of large surplus funds in the system. Further, as the industrial sector is in expansionary phase, monetary authorities must have postponed the rate hike with the assumption that it would adversely affect the investment decisions. But given the rise in expected inflation rate following growing world oil prices and upward movement of international interest rate cycle, the monetary authorities might not hold the current interest structure for long. We expect a rise in the interest rates in the coming months.



Forecast:

Based on the data up to August 2005, we forecast a marginal rise in prime-lending rate from its existing rate of 10.5 per cent in the next three months

Rupee/US dollar exchange rate would see marginal depreciation.

Exchange rate

The Rupee/US dollar exchange rate has started depreciating and reached to 44 by the end of August 2005. Growing trade gap and World oil prices must have increased the dollar demand. Further, narrowing interest rate differentials (US has hiked the interest rates nine times), which is expected to restrain further inflow of foreign exchange reserves, has also put pressure on the Rupee to weaken. For the same reasons, we expect further depreciation of Rupee in the coming months.

Forecast:

Based on the data up to August 2005, we forecast the Rupee/US Dollar exchange rate to depreciate marginally in the next three months.

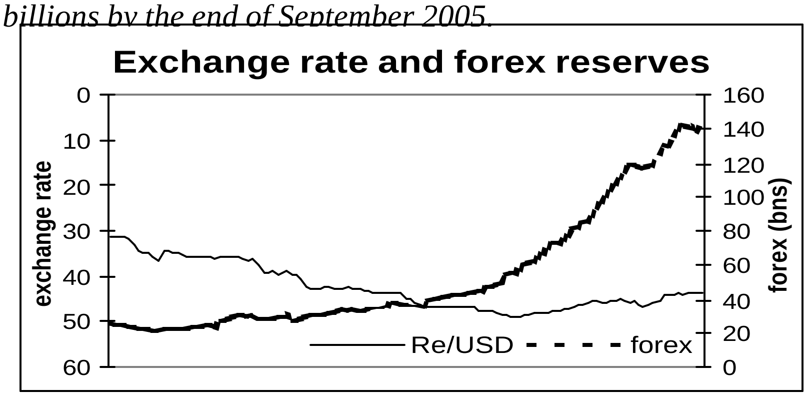
Foreign Exchange Reserves

We expect a slowdown in the pace of accumulation of forex reserves.

The foreign exchange reserves have reached to buoyant US$143.2 billions by August 19th, 2005. In the current calendar year itself (i.e., since January 2005), the economy has accumulated the reserves to the tune of US$12 billions, which is mostly due to short-term credit, growing export incomes and the growing external commercial borrowing. But the pace of accumulation in the current financial year is very much less than that of last year. For the next three months we see a marginal fall in the reserves due to narrowing of interest rate differentials, widening trade deficit and growing world oil prices.

Forecast:

Forex reserves are expected to decline marginally to US$ 142 billions by the end of September 2005.



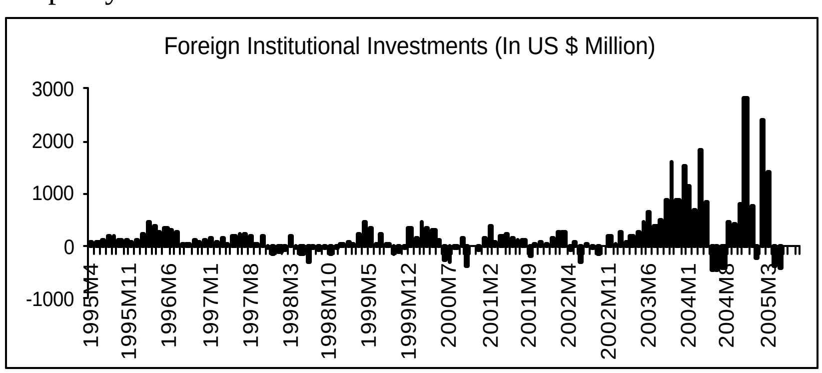
Foreign Institutional Investment

FIIs are net sellers in June 2005

In the month of June 2005, the FII investments have seen a net outflow to the tune of US$ 231 millions. Strengthening of US dollar in the international market and hardening of US interest rates, the flow of foreign funds in the economy has slowed down.

Future behaviour depends on domestic interest rate policy

Despite strong positive sentiments in the economy, impressive results of corporate sector and boom in the domestic stock market, the FIIs have turned net sellers in the domestic capital market. Future behaviour of FIIs depends heavily on the US dollar strength in the international market and domestic interest rate policy.



Double-digit growth in both exports and imports continue.

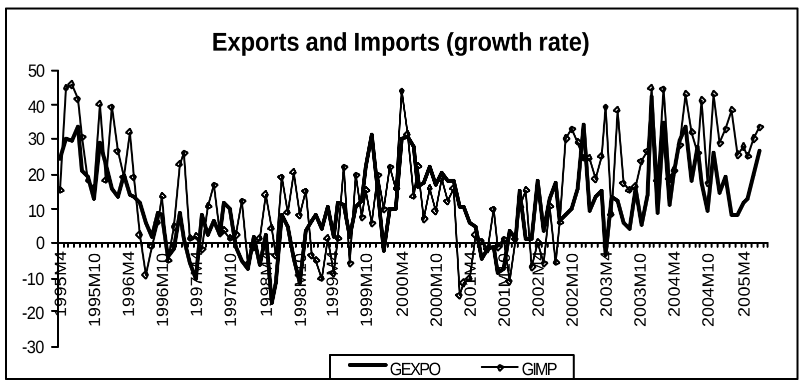
Trade performance in current year to be less than last year's.

Exports and Imports

Strong growth in trade sector continues. In July 2005 exports have registered a growth of 26.8 percent (for April-July 2005 it is 21.3 percent). This high growth in exports could be due to recovery in the World economy and it also indicates growing competitiveness of India's exports in the international market. On the other hand, imports also grew at a high rate of 33.1 percent in July 2005. Within imports, it is the non-oil imports that are growing faster thereby reflecting the current boom in the industrial sector. As the World economic recovery and the expansion in the domestic industry is expected to continue, India's trade sector also expected to grow at double-digit. But the overall performance in the current fiscal year could be less than that of last year's growth.

Forecast:

Based on the data up to July 2005, we forecast the average export growth to be 17.5 percent and the average import growth to be 31 percent for the next three months.



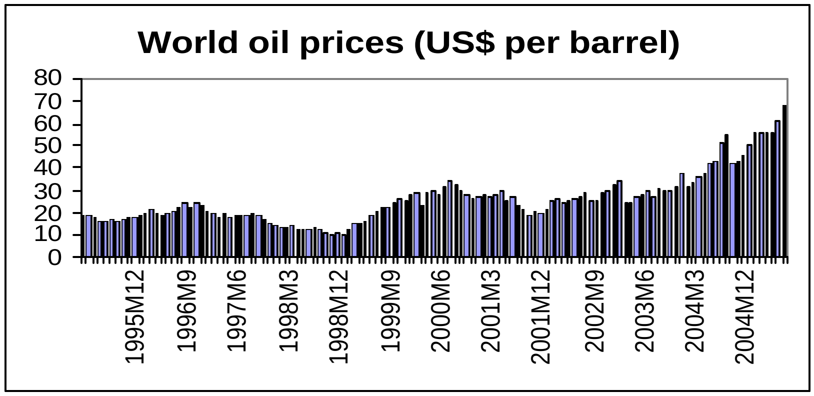
Hurricane Katrina –by rising oil prices - affects many countries, not just US.

World oil prices touch record level of US$ 70 per barrel.

Oil Price

This time it is the Hurricane Katrina and the death of Saudi Arabia King that pushed the World oil prices to the record level of US$ 70 per barrel and this has potential to create international energy crisis. At the moment it appears that the world oil prices would remain at higher levels for some more time, as the current high price is not due to supply side factors. The expected rise in the demand for oil from two big emerging economies like China and India, which are expected to grow at faster rate, will ensure the crude oil prices to remain high.

Following the increase in World oil prices, it was expected that the domestic fuel prices also would be hiked. But the Government is yet to revise the domestic fuel prices. This would only distort the market forces. Also, as RBI has rightly pointed out that the substantial part of recent spurt in the world oil prices has a permanent character, passing on to the consumers makes good economics.



BSE Sensex

Strong positive sentiments pushes up the stock prices to record levels.

Backed by the feel-good factor and good corporate results, the stock prices have zoomed to their new heights. The BSE sensex has crossed a historic level of 7800 mark in August 2005. Huge surplus liquidity in the system, low interest rate structure and the robust growth in the industrial sector must have led to unprecedented rise in the investments into stock market. For once, the movements in stock market prices seem to reflect the real economic performance.