MONTHLY MONITOR

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

Special column on interest rates in page-3

GDP growth in Q2: 2005-06 is 8%

Agriculture grows at 2% compared to no growth last year.

Negative growth in exports while imports grows at single-digit.

The IIP growth inOct,2005 is 8.5%.

Negative growth in mining output continues.

Inflation rate started rising.

Prices of fruits & vegetables grow at 20.4%.

Forex reserves might fall due to redemption of IMD funds.

TOP STORIES

The estimates for the second quarter of 2005-06 show a high GDP growth of 8% compared to 8.1% in the first quarter and 6.7% in the second quarter last year. This rise in growth is contributed by all the three sectors, though manufacturing has slightly declined from 9.6% last year to 9.2% in the current year. As we have said in the September issue, the overall GDP growth for the year 2005-06 would be at 7%.

For the first time, after thirty months, the exports growth has turned out to be negative. In the month of November 2005, exports registered a growth of –11.38%. Similarly, imports also come down to single digit growth of 8.68% after nearly three years. Although we expect the exports growth to be positive in the coming months, it would be only in single digit. The positive impact of SAFTA will start showing only in the medium to long run.

The industrial sector continues its high growth path. In October, it has registered a growth of 8.5%. As we have said in our earlier issue that the sustenance of high industrial growth would depend heavily on future external demand besides other domestic factors. As the exports have shown a negative growth in November, the current high growth in IIP might not recur. Following the closure of Kudremukh mines, the mining sector would continue its negative growth for some more months.

The inflation rate (WPI) has started rising. It has gone up to 4.62% in December 2006, compared to around 4% last month. This rise is mainly contributed by the high growth in the prices of fruits & vegetables (20.4%). Despite the fall in the world oil prices from its historic peak level, the inflationary pressure in the economy still persists due to domestic real factors and is expected to go up further in the coming months.

Foreign exchange reserves are expected to fall due to redemption of IMD funds to the tune of US$ 7 billions. But the extent of fall would depend largely on domestic banks' capacity to attract these funds. The reserves are also expected to fall due to other reasons such as narrowing interest rate differentials and widening trade deficit. Due to the same factors, the Rupee/US

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Exchange rate expected to depreciate.	widening trade deficit. Due to the same factors, the Rupee/US dollar exchange rate, which has depreciated marginally in December, is also expected to depreciate further.
High growth in money supply. ***Credit demand expands.***	The money supply growth (M3) continues to be at high level of 17.1% in December 2005, which is mostly due to rising credit off-take. We expect a fall in the money supply growth due to slowdown in the pace of forex accumulation and also expected drop in credit demand.

IEG-DPC Forecast

Variables	**Latest Information available**	**Forecast for next Three months**
Inflation rate (WPI)	4.62% in December 2005.	To 5% by the end of March 2005.
Inflation rate (CPI)	4.18% in October 2005	Decline marginally.
Growth rate of IIP	8.5% in October 2005	7% (average)
Growth rate of M3	17.1% in December 2005.	Expected to decline to 16.5% (average)
Prime lending rate	10.25 – 10.75 % in September 2005.	Lending rates to rise
Re/$ exchange rate	45.23 in December 2005.	Depreciate to 45.5
Forex reserves	US $ 144.05 billions in December 2005.	BIG fall expected due to IMD redemptions.
FII inflows	Inflow of US$1,008 millions in September 2005.	Positive inflows
Growth rate of exports	-11.38% in November, 2005	6.3% (average)
Growth rate of imports	8.68% in November, 2005	14.1% (average)

Are there interest rate cycles in India?

There is a great deal of discussion in India about the future movement in the domestic interest rate structure, particularly after the upward movement in the US interest rate cycle. Towards this issue, we conducted a study[*] that tries to examine the behaviour of various Indian interest rates such as call money rate, and yield on secondary market securities with maturity periods of 15 to 91 days, 1 year, 5 years and 10 years. It was found that although the interest rates depend on some domestic factors such as money surprise, yield spread and expected exchange rate, it is majorly affected by the movements of international interest rates, although with a significant lag. The policy variables such as domestic Bank rate and US Federal Funds rate did not show any significant impact on any of the market interest rates. We also found that since the late 1990s domestic interest rates show some cyclical movement. The forecasts of cyclical behaviour show that, except for call money rate, all yield rates are expected to move upwards following the upward movement of the international interest rate.

The interest rate downturn, as witnessed since the year 2000, seems to have ended in the middle of 2004. The upturn in the interest rates on Government securities started in the recent period is now likely to continue for at least about two years. However, as reflected from its observed movement, it may taper off at a peak much lower than recorded during the high interest rate regimes in mid-1990s'. Three reasons might have contributed to this. First, the real interest rate seems to have reached the floor during the industrial slow down of early 21st century. There was only one possible way to move from there on. Secondly, the industrial recovery from about 2003 onwards together with the rising international oil prices creating a rising inflationary expectation which have also contributed to this upturn in the interest rates. Finally, the persistence of high fiscal deficit and the limit to RBI sterilization policy option has led to an increase in supply of Government securities corresponding to the demand. To some extent the upturn is restrained by easy liquidity created by the influx of foreign capital, especially in the form of portfolio investments in Government securities and bonds. The cyclical movement in the interest rate during the market regime is not unexpected. It is also to be noted that the floor of the interest rate in a developing country like India is expected to be higher than that of the rich countries with a surplus capital.

There are three obvious policy implication: first, the soft interest rate regime witnessed during the late 1990s and the early 21st century is now over. The Government would have to, therefore, borrow at a comparatively higher cost. Secondly, the PLR on bank credit to the private sector is now unlikely to go down because of the hardening of the interest rates of Government securities. The banks may have to, therefore, improve the operational efficiency to restrict the rise in PLR. Finally, the integration of interest rates in India, especially of yields on both short and long term Government securities, with the global interest rates imply that the Indian financial system will now have a cyclical movement along with the global cycles. Hence, the Indian financial markets cannot remain immune to global financial system. The policy makers, therefore, have to take note of this in monetary and fiscal policy operations.

[*] "Modeling Indian Interest Rate Cycles", by B B Bhattacharya, N R Bhanumurthy and Hrushikesh Mallick; IEG Mimeo.

The WPI inflation started rising.

Prices of fruits & vegetables grow by 20.4%.

CPI inflation Rate also rises to 4.18% in October 2005.

Expected to rise further in the coming quarter.

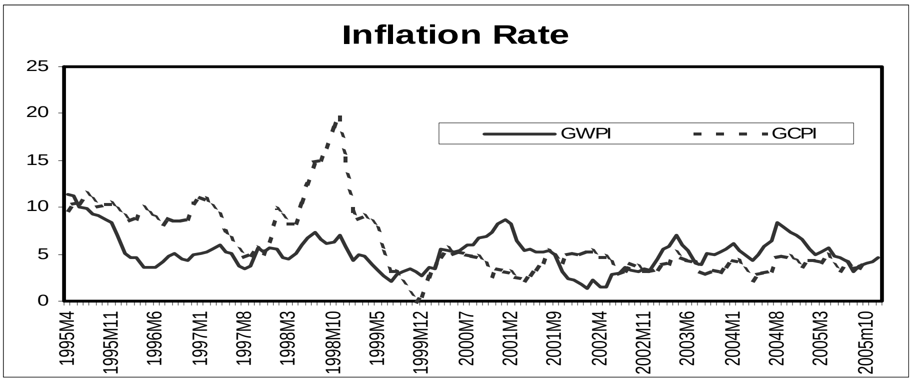
Mining to show negative growth due to closing of mines in Kudremukh.

Inflation

After showing a decline for some time, the WPI inflation started rising and reached to 4.62 percent by 17th December. Except the prices of edible oil, all other commodity prices are growing at more than 5 percent. The prices of fruits & vegetables have gone up by 20.4 percent, which may be due to supply-side reasons. The prices of cement, iron & steel and fuel group are growing at 10, 8.3 and 7.6 percent, respectively. This rise in general inflation rate might be due to both demand (from rising money supply) and supply (from primary articles, particularly fruits & vegetables) side. Despite fall in the world oil prices from its historic peak level, the inflationary pressure in the economy still persists due to domestic real factors and is expected to grow further in the coming months. The rate of inflation, based on the CPI (industrial workers) has increased from 3.63 percent in September 2005 to 4.18 percent in October 2005.

Forecast:

The WPI inflation forecast for the next three months to be 4.7%, 4.9%, and 5.1% and the CPI inflation rate to hover around 4%.



Industrial Production

The IIP growth for the month of October is 8.5 percent (against our forecast of 8.2 percent in October 2005 issue). Although this growth is higher than the previous month's figure, it is less than the growth of 10.6 percent registered in October 2004. For the period between April to October, the industry grew at 8.4 percent. At the disaggregated level, it is the manufacturing sector, which is contributing highly. It has grown at 9.6 percent. Mining continues to show negative growth since June. Among the Use-based classification, it is the Capital goods that showed a strong growth of 24.1 percent.

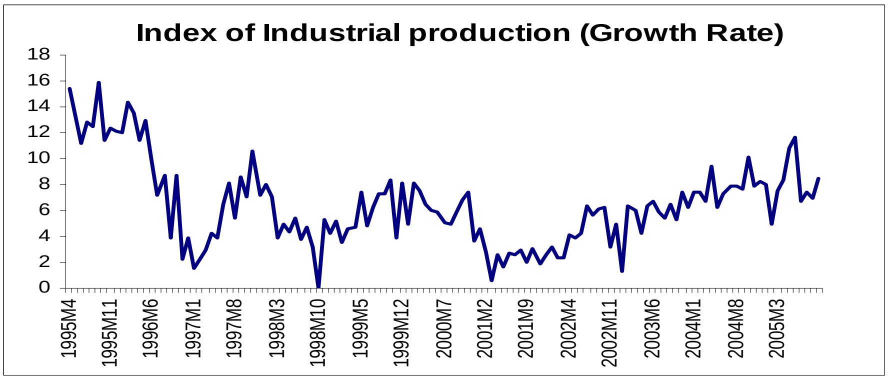
Existing positive outlook on the economy backed by expectations of strong external demand must have contributed to this growth in industry. We have said in our October issue that the sustenance of

Manufacturing outpu grows at 12.5%

high industrial growth would depend heavily on future external demand besides other domestic factors. As the exports have shown a negative growth in November, the IIP growth in the coming months might slowdown. Following the closure of Kudremukh mines, the mining sector would continue its negative growth for some more months. Core sector has declined to 3 percent for November 2005.

Forecast:

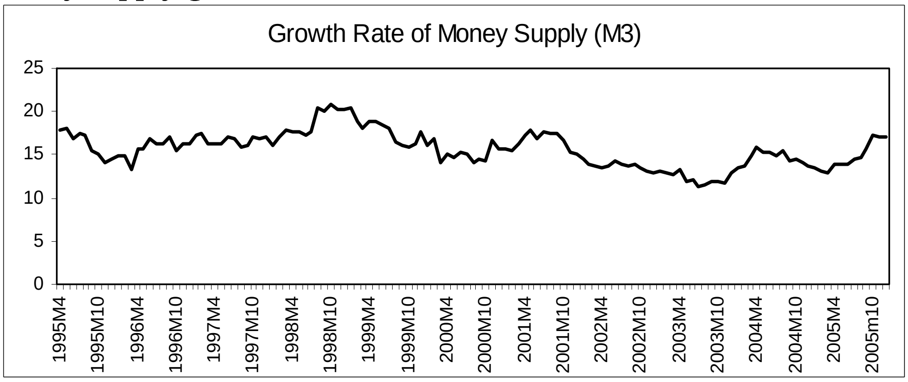
Based on the available information we forecast the IIP growth rate for the next three months to be 8, 7.2 and 6.3 percent respectively.



Money and Credit

Money supply growth continues to be at high level of above 17 percent. Currently it is growing at 17.1 percent compared to 13.9 percent in the same period a year ago. This high monetary expansion is due to the growing bank credit to commercial sector, which is at 26.5 percent. But the growth of net foreign exchange assets with the banking sector has dropped from 26.2 percent to 14.3 percent. The recent redemption of IMD funds and its impact on the change of money stock largely depends on the domestic banks capability to attract the redeemed IMD funds. Added to this, the fall in the pace of forex accumulation would also lead to drop in the money supply growth.

Money supply growth to decline despite high credit off-take



Forecast:

We forecast the growth rate of money supply (M3) for the next three months to be around 16.5 percent.

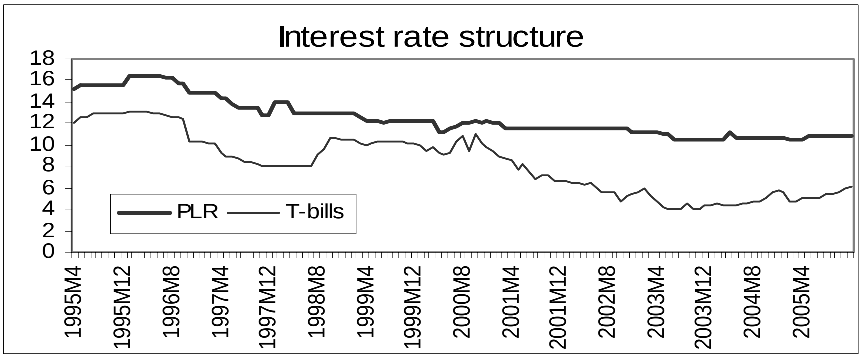
Yield on G-secs are rising.

Lending rates continue to be sticky.

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 and also volatile due to liquidity shortage in the money market and also due to hike in the policy rate. The redemption of IMD funds, might put additional pressure on the liquidity and, hence, the interest rates. As the international interest rates are moving upwards thereby widening interest rate differentials, it would be quite difficult to attract the redeemed IMD funds. This, together with slowly rising inflation rate, is expected to put pressure on the domestic liquidity and the interest rates. Hence, it would be difficult for the monetary authority to hold the interest rates further at their current levels. Sooner it may hike the rate. (see column on interest rates in page-3)



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.

Rupee/US dollar exchange rate would see marginal depreciation.

Exchange rate

The Rupee/US dollar exchange rate continues to depreciate and reached to 45.23 by the end of December 2005. The redemption of IMD funds to the tune of US$ 7 billions may not have much impact on the exchange rate in the short-run as it has been supplied from the RBI's reserves. But the exchange rate is expected to depreciate due to expected rise in the trade gap. Further, narrowing interest rate differentials, which is expected to restrain further inflow of foreign exchange reserves, would also put pressure on the Rupee to weaken in the coming months.

Forecast:

The Rupee/US Dollar exchange rate is expected to depreciate to 45.5 in the coming months.

IMD redemptions to have direct impact on forex reserves.

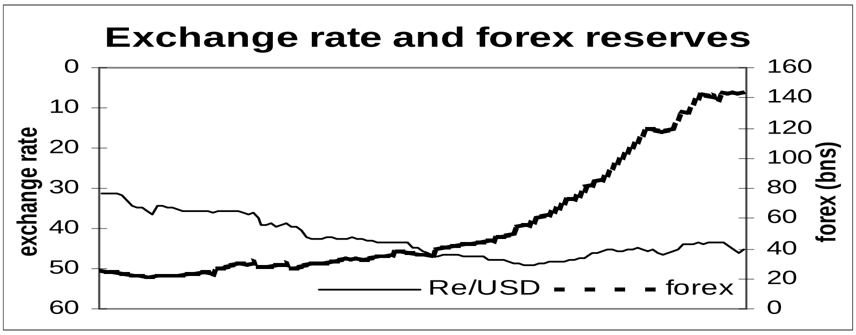
Foreign Exchange Reserves

The foreign exchange reserves have reached to buoyant US$144.05 billions by December 23rd, 2005. By the end of December the IMD funds to the tune of US$ 7 billions has been redeemed. As the interest rate differentials have widened, it may be difficult for the domestic banks to attract these funds. Together with this, expected rise in the trade deficit would result in a fall in the forex reserves in the coming months. Given huge reserves, and if there is no shortage in the liquidity, this may not affect the financial system. For the next three months we see a fall in the reserves due to narrowing of interest rate differentials and widening trade deficit.

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

Forecast:

Forex reserves are expected to decline to US$ 140 billions.

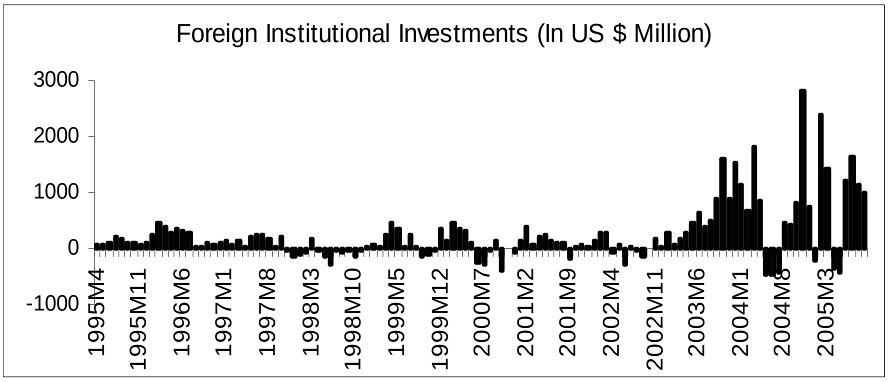


Foreign Institutional Investment

For the fourth consecutive month, the net FII inflow was above one billion. In the month of September, which is the latest information available, the FII investments were at 1008 millions. This large inflow in short-term foreign capital is mostly due to positive sentiments in the domestic financial markets reflected in the buoyant movement in the Sensex. As the US dollar is strengthening in the international markets and widening interest rate differentials, we may not see such a large inflows in the coming months.

Large inflow of FII seen since June 2005

Future behaviour depends on domestic interest rate policy



Exports and Imports

After almost thirty months, exports have shown a negative growth. In the month of November 2005, it has registered a

After nearly three years, exports register negative growth.

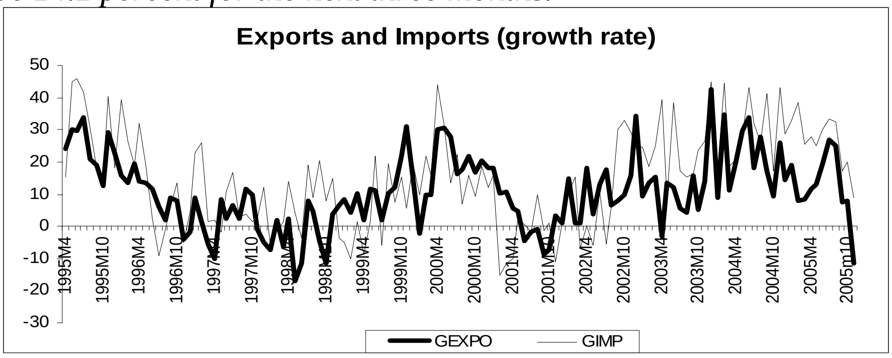
Single digit growth in imports.

Positive impact of SAFTA might be felt only in the medium to long run.

growth of –11.38 percent, which is said to be due to 'sectoral factors'. Despite this fall, the growth for April-November, 2005 is around 16 percent. Is this the beginning of downward movement in exports? As we have predicted in our October 2005 issue of Monthly Monitor, there are some economic cycles in the export growth that are following the output cycles of ASEAN and G7, which are expected to move downwards. Hence, it would be reasonable to say that the high exports growth period is over for the time being. Similar to exports, imports growth has also fallen to single-digit after nearly three years. In November 2005, it grew at 8.68 percent. The impact of SAFTA on trade will start showing only in the medium to long-term.

Forecast:

Based on the data up to November 2005, we forecast the average export growth to be 6.3 percent and the average import growth to be 14.1 percent for the next three months.



BSE Sensex

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

The positive sentiments in the economy continue to pull the stock market prices. On the first day of trading in the new year, 2006, the BSE Sensex registered a record high of 9400. Continuous inflow of FII investments to the money market and growing industrial sector must have led to this bull run in the stock prices. Although we expect the FII inflow to money market to be positive, the narrowing interest rate differentials might restrain the FII from huge investments. But, as the current rise in stock prices are backed mostly by the domestic factors, this may not adversely affect the stock prices significantly.