



सत्यमेव जयते

MONTHLY MONITOR

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Special story on Industrial growth prospects in Page-2

WPI inflation within RBI target range

High money supply growth causing inflation

Cash Reserve Ratio hiked by 50 basis points

Lending rates expected to go upwards.

Broad money is growing at around 20%

The expected hike in interest rates might pull down the money supply growth.

April-November exports growth at 24.02%

Trade deficits widens to US\$ 36 billions.

Rupee/US dollar exchange rate appreciates

TOP STORIES

The WPI inflation rate continues to be a cause for concern. The rate is at 5.2% in December 2006 while the latest information on CPI inflation for October is at a high of 8.4%. This is despite reduction in the prices of fuel. The high growth in money supply could be driving the inflation upwards from the demand side. Due to same reasons, we expect the inflation to be above the RBI's targeted level of 5 to 5.5% by the end of March 2007.

Following inflationary pressure, the RBI has hiked the CRR by 50 basis points and also mopped up liquidity in the short-term money market. Following this, many of the large commercial banks have hiked their both lending and deposit rates. As the inflation is going to be above the targeted level and the growth of money supply is well above 20%, we expect further hike in the interest rates in the next review of the Credit policy.

The growth rate of money supply in December is at 20.2%. This is backed by increase in net foreign exchange assets of banks and also due to high credit demand from both government and the commercial sector. The recent hike in CRR might curtail the credit demand to some extent in the coming months. But this would largely depend on the stance of monetary policy in the forthcoming review.

The buoyancy in the trade sector continues. The exports growth in the month of November 2006 stood at above 33% and for April-November 2006 it is at 24%. On the other hand, imports are also growing at a high rate. In November the import growth is at 42.9%. This is despite the decline in the World oil prices. This trend has resulted in the widening of trade deficit to nearly US\$ 36 billions. The future performance in trade largely depends on the movement of World economic growth, which is expected to slowdown in 2007.

The Rupee/US dollar has appreciated to 44.2 in December 2006. This is backed by the accumulation of foreign exchange reserves, which has reached to US\$ 175.5 billions. Widening

Expected to depreciate marginally

Forex reserves rises to US \$175.5 billion

of trade deficit might lead to Rupee depreciation. But the expected hike in the interest rates and the inflow of FDI and FII funds might contain the Rupee from sharp appreciation. On balance, we expect the Rupee to depreciate marginally in the coming months.

Slow Industrial growth in October 2006 a blip?¹

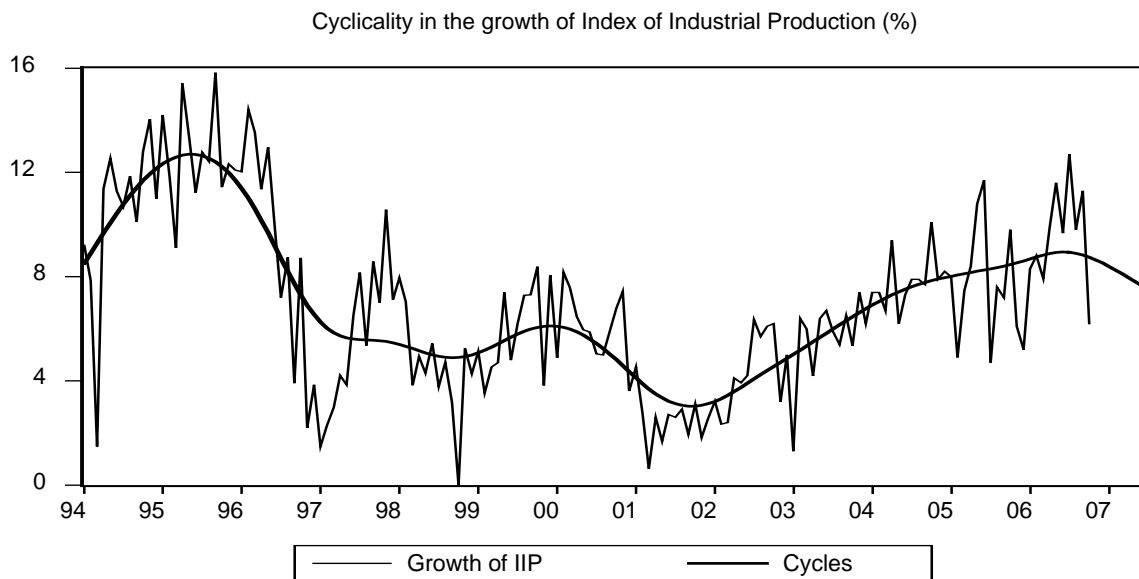
The growth of index of industrial production has showed a fall from 11.3 percent in September 2006 to 6.2 percent in October 2006 and from 9.8 percent in same month a year ago. This is despite three big festivals that we had in the month of October. The question that struck on all the economic analyst's mind is whether this fall just a blip or a sign of downward movement in the industrial cycle, which is moving upwards for almost four years. And this is the longest cycle that we are experiencing in the reform period. Given the current strong positive sentiments on the Indian economy, it would be easy and wise to say that this fall is just a blip and the industrial performance would be back to its high growth path. But to say that the industrial growth has reached its peak in the current cycle and only way is to move downward following the cycle, one has to be a skeptic and is also more challenging. Although we don't wish to be a doomsayer, there are some valid reasons that are leading us towards that direction. In Monthly Monitor, we have been saying for some time that there could be slowdown in industrial growth any time. One stylized fact before we present the skeptical thoughts is that the current industrial growth cycle is yet to reach to its peak that we experienced in 1995-96. Hence, there is a reason for further upward move in the industrial growth path.

It may be noted from the below graph, where we have presented monthly IIP growth (from 1994 to October 2006) and a thick line that explains the broad cyclical movement in the IIP growth (based on actual IIP growth data and the forecasts upto middle of 2007), that our econometric model shows that there could be turning point downwards in the IIP growth cycle in the near future, if not from next month. Hence, one reason for the expected slowdown could be due to business cycles. In the recent period, Indian economy has been increasingly integrating with the global economy in terms of both financial and goods market. Hence, the presence of strong business cycles, following the World growth (which is expected to move downwards according to World Bank's estimates), may not be surprising.

The other domestic factor that could cripple the industrial growth is the tightening of credit (through rising risk) to housing sector. To understand the spin-off effect of this, it is necessary to understand the recent trends in USA housing sector and its linkages to other sectors in the economy. It is simple to understand that the 'core group' of the industrial sector depends on the housing sector and the linkage between core and non-core groups of industrial sector is strong. Hence, any adverse impact on core group would lead to overall industrial slowdown. Now in India, following international interest rate cycles, the

¹ Slightly revised version has appeared in Business Standard, 16th December 2006, with different title.

RBI has adopted the tight monetary policy. With this other commercial banks have hiked (and continue to hike) their interest rates on retail loans and also their deposit rates. Past studies on India concluded that the interest rate channel of monetary transmission mechanism is weak, and credit channel is stronger than the interest rate channel. This conclusion, in our view, might not hold good now as the determinants of interest rates have changed in the recent times and also seen structural breaks in most of the financial variables in 2002-03. As in any emerging economies, in India also the real economic response to interest rate changes should have become more significant in the recent period. Hence, the hike in interest rate structure may lead to slowdown in the industrial output in the coming months.



Now a look at the non-food credit to commercial sector provides that there is a decline in its growth in the current year compared to previous year. Even the total credit (both to commercial and government sector) has also declined marginally in the current financial year. Another striking issue is that the credit to government, which was negative for quite some time, is growing at little above 4 percent. At this juncture one needs to make a well-informed judgment whether the credit to government would have crowding out or crowding-in effect on private investments, depending on the expenditure pattern of the government. As per the information available from media, until now there are no significant investments on the productive sectors. Rather the expenditure seems to have increased on populist schemes and on activities that strengthen human development, which increases productivity with a significant lag. Hence, the rise in credit to government mostly should have crowd-out effect on private investments.

There is a demand side story also. From the recent performance of exports, it is quite obvious that this year's industrial growth has been substantially contributed by the external demand. Now that World economic growth is expected to slowdown, sustaining of current external demand into 2007 is in question. The domestic demand is also expected to slowdown given the hike in domestic interest rates (on deposits) and also due to rise in inflation. Insignificance of festival demand on output in October means that there seems to be shift or slowdown in the spending pattern among the great Indian middle class. Overall, the demand side story is also not supporting the future high industrial growth.

Now the issue of 'overheating' that means that rising inflation rate on the back of high output growth, which we are experiencing right now. As it appears, the inflation for the current fiscal year could settle in the RBI's predicted range of 5-5.5 percent, which is high. (The inflation rate based on CPI (IW) is more than 7 percent!) The only way to 'cool' is to follow tight monetary policy, which the RBI did it by hiking the CRR. Further, it has been mopping the liquidity from the short-term money market for quite some time. As we have predicted way back in middle of 2005 (presented in Monthly Monitor) that the current interest rate cycle would peak by the end of 2006, it is turning to be true. In our view, the RBI might further fine-tune the policy by hiking the interest rates in such a way that it can contain the inflation rate by forgoing a marginal growth in output. As predicted earlier, we reiterate that with this hike (although this should have happened in the last round of monetary policy review) the interest rate cycle would peak.

All these forces us to accept, although hesitatingly, that the current upward industrial growth cycle is here to see the turning point. But the question remains when it would turn. In November and December 2006, the IIP growth, as expected by many analysts, could come back to the high growth path. But that would be due to low base in these two months. One needs to wait and watch from January 2007 data onwards.

IEG-DPC Forecast

<u>Variables</u>	<u>Latest Information available</u>	<u>Forecast for next Three months</u>
Inflation rate (WPI)	5.2 % on December 9, 2006.	Expected to be above 5.5%.
Inflation rate (CPI)	8.4 % for October 2006	Expected to decline marginally.
Growth rate of IIP	6.2 % in October 2006	8.5 % (average)
Growth rate of M3	20.2 % on December 8, 2006.	Expected to be around 20%
Prime lending rate	11 – 11.50 % in December 2006.	Lending rates to rise marginally
Re/\$ exchange rate	44.3 on December 28, 2006.	Depreciate to 44.9
Forex reserves	US \$175.5 billions on December 15, 2006.	To reach US\$ 182 billions by March 2007.
FII inflows	US \$ 1228 million in September 2006	Positive inflows
Growth rate of exports	33.6 % in November 2006	26.6 % (average)
Growth rate of imports	42.85 % in November 2006	29.6 % (average)

WPI Inflation rate is at 5.2%

Demand side factors causing inflationary pressure

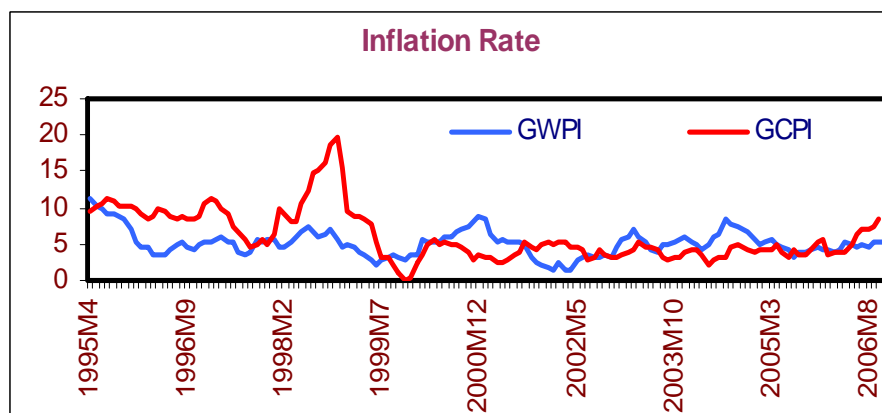
Inflationary expectations still persist in the medium term.

IIP growth plummets in October 2006

Inflation

The inflation rate based on WPI has declined marginally from 5.45% to 5.2% in the beginning of December 2006. This decline could be due to reduction in prices of petroleum and diesel, which has reflected in the fuel group prices (3.8%). But the prices of primary articles, edible oil and cement continue to grow at a higher rate of 7.7%, 10.1% and 20.7% respectively. On the other hand the prices of fruits and vegetables, sugar group and iron & steel have experienced almost no change. Contrastingly, the inflation rate based on CPI is growing at 8.4% in October 2006 reflecting the continuing divergence in the coverage and estimation of wholesale and retail market prices in India

Despite the stable world oil prices the inflationary expectations still persist in the economy due to demand side factors that are backed by high growth in money supply. Future inflation rate depends on two factors: the future monetary policy stance of RBI and on the performance of kharif. As it appears the kharif output is expected to be normal this year. The interest rate structure seems to be moving upward after the hike in CRR. Despite these trends, the year-end (March 2007) inflation rate is expected to be little above the RBI's targeted level of 5 to 5.5%



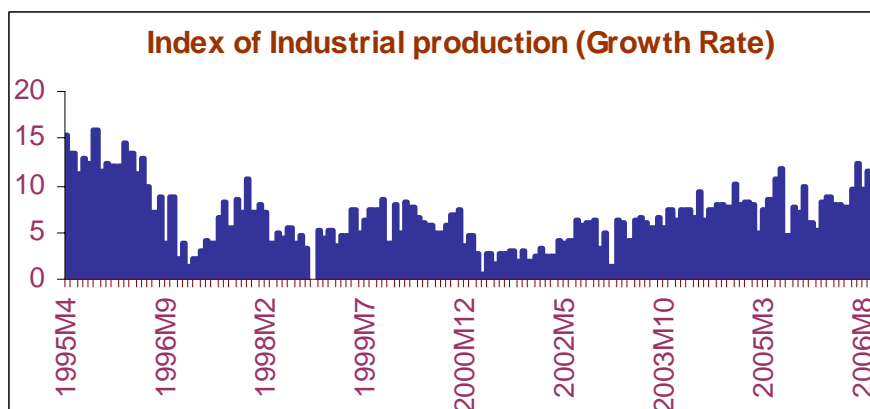
Forecast:

The WPI inflation forecast for the next three months to be 5.32, 5.46 and 5.7% and the CPI inflation rate to hover around 8%.

Industrial Production

The Index of Industrial production, which has experienced double digit growth in the first half of 2006-07, has declined to 14 month low of 6.2% in October 2006. In September the IIP registered a growth of 11.3%. This decline is largely backed by fall in manufacturing output (6%) while the output from mining and electricity has registered a growth of 4% and 9% respectively.

Both capital and consumer goods output growth decline sharply



From the Use based classification, the sharp fall in the capital goods output from 24.3% in 2005-06 to 8.2% in current year may be a matter of concern. Further the consumer goods sector has also seen a sharp fall to 0.5% from 14.6% last year. This fall is despite being the festival month wherein the past trends show a rise in consumer goods production. The discussion on future growth prospects is presented in page 2.

Forecast:

Based on the available information we forecast the IIP growth rate for the next three months to be 9.4, 8.3 and 8 percent respectively

Money and Credit

The broad money supply (M3) continues to grow at higher rates. As on 8th December 2006, the money supply growth is at whopping level of 20.2%. This high growth is contributed by rise in credit to government and commercial sectors and also due to rise in net foreign exchange assets of banks. The recent hike in CRR and in the lending rates of some of the major commercial banks will have adverse affect on credit off-take. On the other hand the expected rise in foreign exchange reserves may fuel further growth in money supply. On balance we expect the money supply growth to be at its current high level for some more time. But this will also largely depends on the monetary policy stance in the forthcoming review of monetary and credit policy of RBI

Forecast:

We forecast the growth rate of money supply (M3) to hover around 20.6% in the next three months.

Money supply growth is at 20.2%

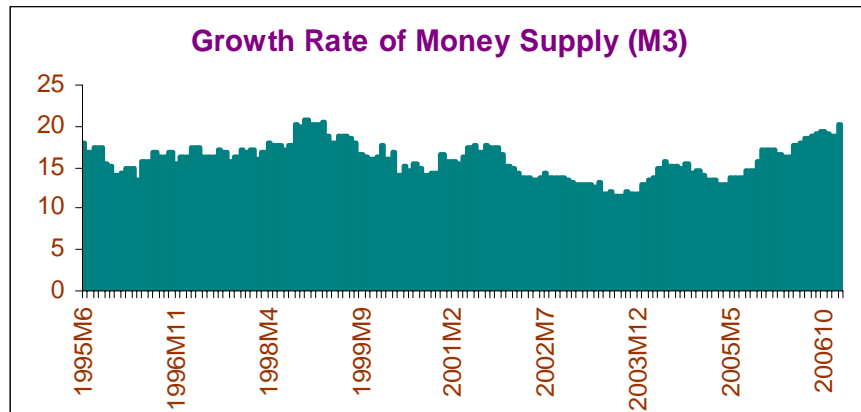
CRR hike might pull down the money growth

Lending rates are expected to follow the CRR hike

Domestic interest rate cycle to peak

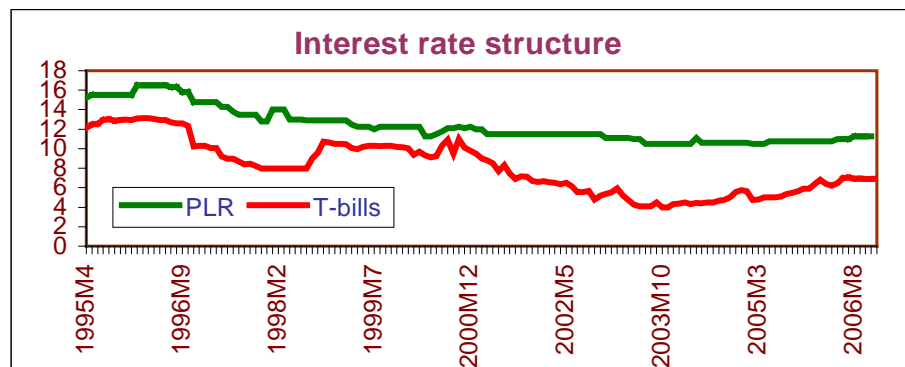
Exchange rate appreciates

Widening of trade deficit could lead to depreciation



Interest rates

Based on inflationary pressures, the Reserve Bank of India has hiked the CRR by 50 basis points from the existing level of 5%. This is against the long-term objective of bringing down CRR to 3%. Following this the major public sector banks such as SBI and PNB have hiked their deposit and lending rates. This has also reflected on the return on government securities. Although the international interest rate cycle seems to have peaked, in India, in our opinion, the rates are yet to peak. As the inflationary pressure still persists in the economy and money supply is growing above the target level, there could be a hike in the policy rates. With this we expect the current interest rate cycle to peak.



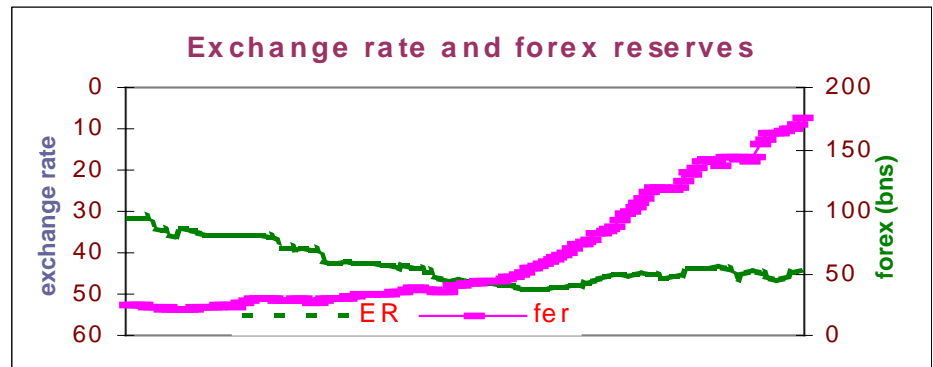
Forecast:

Based on the data up to December 2006, we forecast a further rise in prime-lending rate and also in the short-term rates.

Exchange rate

The Rupee/US dollar exchange rate continued to appreciate. By the end of December 2006, the exchange rate is at 44.26. This could be due to rise in domestic interest rates and also due to inflow of foreign exchange reserves. Our model predicts a marginal depreciation of Rupee/US dollar exchange rate due to two reasons. First the widening of trade deficit which has reached to more than US \$ 36 billion in April-November and secondly due to better than expected performance in US economy. As we

to better than expected performance in US economy. As we expect a policy interest rate hike in the coming months, it would help the Rupee from sharp depreciation. On balance we expect the rupee to depreciate marginally in the coming months.



Forecast:

The Rupee/US Dollar exchange rate is expected to depreciate to 44.9 by the end-March 2007.

Forex reserves continue to rise

Expected rise in interest rates might hamper the forex accumulation

Foreign Exchange Reserves

Foreign exchange reserves continue to rise. By the middle of December 2006 it stood at US \$175.5 billion. With this, in the current financial year the foreign exchange reserves have gone by a whopping US \$ 24 billion. Increase in foreign capital inflows in terms of both short and long term investment and hike in rating of domestic currency by most of the Credit Rating agencies must have led to this rise in foreign exchange reserves. The widening trade deficit and rise in domestic interest rate might to some extent slowdown the forex accumulation. But the expected increase in foreign investment might dampen down this adverse impact. Overall we predict a rise in forex reserves.

Forecast:

Forex reserves to reach US\$ 182 billions by the end of March 2007.

FII's are net buyers in the market

In September, FII investment is US\$ 1228 million

FII's to be net buyers in the coming months

Foreign Institutional Investment

The strong positive sentiments in Indian economy and bull run in domestic stock market resulted in positive inflow of FII for quite sometime in the current financial year. The FIIs have invested to the tune of US \$1228 million in September 2006. This could also be due to increase in the return to investment in the financial markets and also due to widening of interest rate differentials. As the Indian economy is expected to continue its robust growth, the FIIs would continue to be net buyers in coming months. It has also been perceived by international financial institutions that emerging markets in Asia could be safe investment destinations. This could result in diversion of some of the international capital to Indian markets.

Buoyancy in trade sector growth continues

Sustaining this trend in trade might be difficult

Trade deficit widens to US\$ 36 billion

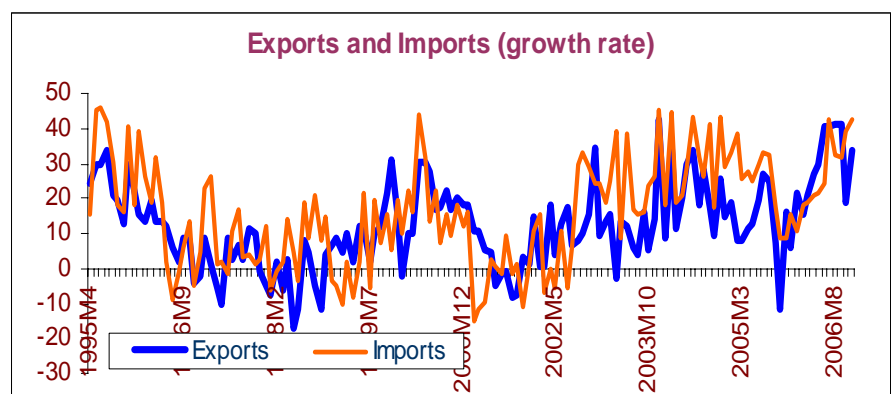


Forecast:

Based on the data upto September 2006, we predict a positive inflow of FII investments in the next three months.

Exports and Imports

The robust growth in trade sector continues. In the month of November 2006, exports have registered a strong growth of 33.6%. For the cumulative period of April-November it has grown by 24%. Although we expect the high growth in exports to continue in current financial year, there are some risks as it depends largely on World economic demand. The recent World Bank predictions of a slowdown in World growth in year 2007 are a cause of concern. On the other hand imports have registered an impressive growth of 42.9% in November 2006 and growth of 36.5% for cumulative period of April-November 2006. This high growth in imports is despite decline in World oil prices. As we have said in our early issue of Monthly Monitor the growth in imports could be due to rise in demand for exports.



Forecast:

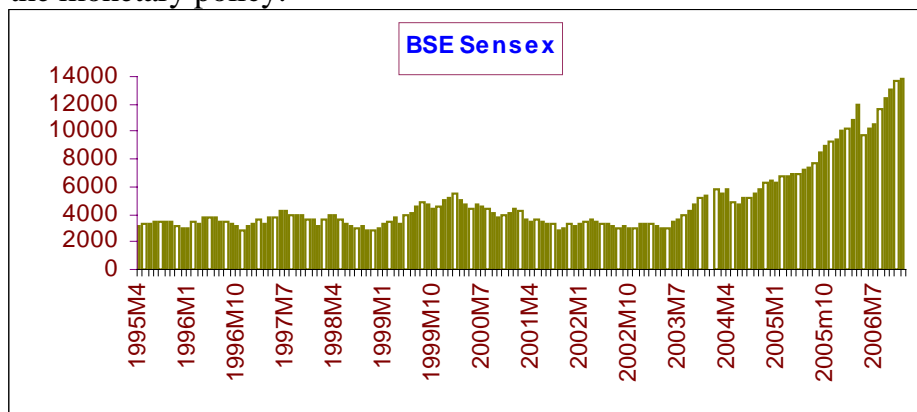
Based on the data up to November 2006, we forecast the average export growth to be 26.63% and the average import growth to be 29.61% for the next three month.

Sensex hovering around 13800 mark

Bull run backed by strong positive sentiments and FII inflow

BSE Sensex

The bull run continues in the Indian stock market, albeit with a few gyrations. The BSE Sensex has been hovering around 13800 in December 2006. This is backed by some strong macroeconomic fundamentals with high growth in the industrial sector output and also followed by huge inflow of FII funds. The future behavior of stock market depends on the industrial growth prospects and also on the monetary policy.



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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