MONTHLY MONITOR

Prepared by N. R. Bhanumurthy February-March 2006

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TOP STORIES

GDP growth for 2005-06 is estimated at 8.1%.

The advance estimates for 2005-06 shows that Indian economy to grow strongly at 8.1 percent, higher than compared to 7.5 percent growth in 2004-05 (quick estimates). At sectoral level, agriculture, industry and services are estimated to grow at 2.3, 9 and 9.8 percent respectively. Although estimated agriculture output growth might be possible, the estimated industrial output growth, in our view, seem to be at a little higher side. Based on our forecasts, the industrial output growth may not exceed 8 percent and, hence, the overall GDP growth would be little above 7.5 percent.

RBI hikes the short-term policy rates.

Many commercial banks hike both deposit and lending rates.

As predicted in our earlier issues, the RBI did hike the short-term interest rates in its recent Credit policy. The presence of liquidity constraints in the market, narrowed interest rate differentials, and inflationary expectations must have led to this hike in the domestic rates. Due to same reasons, we expect a further upward movement in the interest rates in the coming months. Following this hike in policy rates, most of the commercial banks have hiked their interest rates (both deposit and lending). Money supply growth continues to be well above the targeted growth largely due to robust growth in credit off-take.

IIP grows at 8.3%

Future movement depends on external demand and credit availability

After two months of low growth, the industrial sector registered a high growth of 8.3 percent in January 2006. (For the period April-January it is 8 percent). This is majorly contributed by high growth in capital goods output. As majority of studies have shown that the interest rate – output nexus is weak in India, recent hike in interest rates might not have any adverse impact on the industrial output. Rather, future movement of industry depends largely on the external demand and credit availability.

Subdued inflation continues.

But inflationary expectations still persist

Inflation continued to be subdued largely due to fall in prices of edible oil and iron & steel. But the inflationary expectations still persist, as the full pass-through of high world oil prices is yet to happen. Added to this, high growth in money supply, which is expected to have a lagged impact, has also led to rise in inflationary expectations.

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Despite IMD redemption, forex reserves saw only mild decline.

Despite the redemption of IMD funds to the tune of US$ 7 billions, the foreign exchange reserves saw only a mild decline. Currently the reserves are at 143 billions. The hike in domestic interest rates might help forex kitty to bulge. But the widening trade gap (currently US$ 33 billions) would deplete the reserves to some extent. The FII investment, which was negative in last part of 2005, is expected to be positive in the coming months.

Trade deficit widens. By now it reached to US$ 33 billions.

On the trade front, the exports growth gone up to 21.46 percent in January 2006 compared to single digit growth of 6.2 percent in the previous month. With this the growth for April-January is around 18.9 percent, which is less than last year's growth of above 25 percent. For the month of January the import growth is at 10.7 percent and for April-January it is 26.7 percent. Overall, our model shows that the growth in both exports and imports for the whole of 2005-06 would be much less than the last year's growth.

IEG-DPC Forecast

Variables	Latest Information available	Forecast for next Three months
Inflation rate (WPI)	4.29% in February 2006.	Expected to decline marginally.
Inflation rate (CPI)	4.37% in January 2006	Expected to decline marginally.
Growth rate of IIP	8.3% in January 2006	6% (average)
Growth rate of M3	16.3% in February 2006.	Expected to decline to 16% (average)
Prime lending rate	10.25 – 10.75 % in February 2006.	Lending rates to rise
Re/$ exchange rate	44.5 in March 2006.	Depreciate to 44.9
Forex reserves	US $ 143.1 billions in February 2006.	US $ 142 billions by the end of May 2006.
FII inflows	Outflow of US$ 17 millions in November 2005.	Positive inflows
Growth rate of exports	21.46% in January, 2006	11% (average)
Growth rate of imports	10.7% in January, 2006	16% (average)

Union Budget 2006-07: A Comment

The Budget 2006-07 was presented on the back of high expectations from industry. But the first reaction to the Budget can be that it is just a continuation or an 'annexe' of the Budget 2005-06. Only significant outcome that is part of the document is from the fiscal numbers. It is heartening to see that the fiscal deficit for 2005-06 would be less than the budgeted figure and for the year 2006-07 it is estimated at 3.8 percent of GDP. In addition to this, all other fiscal indicators are showing very healthy trends. This might be well received by the private sector and also the international rating agencies.

A caution regarding the fiscal numbers is that one needs to keep in mind that these figures for 2005-06 are based on the robust growth that India had achieved in the first three quarters. It would not be wise to think that this trend to continue in the last part of 2005-06 and also in the fiscal year 2006-07 as well particularly when there is some uncertainty regarding the sustainability of current industrial performance (in November and December 2005 the IIP growth was 6.1 and 5.6 percent respectively against the Finance Minister's expectation of above 9 percent overall industrial growth for the whole year). Further, while at the time of preparation of Budget 2005-06, the implicit assumption regarding the GDP growth was around 7 percent. Hence, as the economy is certainly going to grow more than this assumption, all the fiscal figures turned out (or can turn out) to be much better than the Budgeted figures. Contrary to this, in the present Budget, it appears that the implicit assumption regarding GDP growth seems to be nearly 8 percent. As the recent Economic Survey rightly pointed out that there are certain risks in the economy, particularly the inflation and interest rate risks, this assumption regarding the GDP growth seems to be a bold and risky one.

As the economy is passing on a very positive sentiments, it was felt that the time is ripe for some bold reforms that are impeding the economy for a long. But, unfortunately, the Government seems to be no mood to take such measures. It appears that only crisis will lead to bold reforms but not the strong economy. On top of it, the Government seems to have shelved the disinvestments program that was necessary to raise productivity in the industrial sector. Contrary to the Economic Survey, the Budget completely sidelined the issue of reforms in power sector, oil pricing policy, and subsidies.

On the positive side, the Budget has by and large tries to address the needs of the common man – *aam admi*. Major focus on the agriculture and rural development, particularly under the Bharat Nirman Yojana, is very welcoming, as it will have both forward and backward linkages. The reduction in the customs rates on many commodities is expected to lead to reduction in the production cost. Together with this the reduction in excise duties is expected to reduce the output price and the inflationary pressures.

Overall it appears that the Government is trying to achieve what is known as sustainable and pro-poor (or inclusive) growth rather than the high growth with widening inequalities. The reaction from the stock market (a widely accepted media indicator for rating the Budgets), on the Budget day, in our view only indicates that it is 'business as usual' for the industry and market. In other words, the Budget definitely did not impress the markets and the industry that was dreaming big.

Inflation

WPI inflation remains subdued.

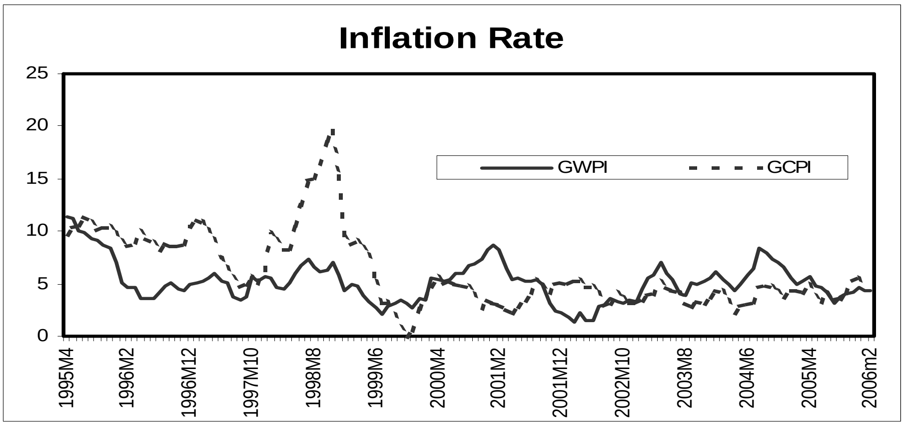
The inflation rate based on WPI has declined to 4.29 percent by the end of February 2006. This decline is mainly due to fall in the prices of edible oils and iron & steel. But the prices of sugar group, cement and fuel group have gone up by 9.1, 8.8 and 7.7 percent respectively. Due to rise in the duty on edible oils in the recent Budget, their prices might go up further in the coming months. As the high world oil prices are yet to be passed on completely to the domestic consumers, the inflationary pressures still persist in the economy. Added to that the high money supply growth (above 15 percent since September 2005), which is expected to be inflationary with a lag, also to some extent sustain this inflationary pressure. Overall, the inflation rate in the year 2005-06 would end at less than RBI's forecast of 5 percent, but the inflationary pressures still exist and expected to be seen in the next fiscal year. Following fall in WPI inflation, the CPI inflation also declining and is expected to decline further.

Inflation in 2005-06 will end at below RBI expectations

Inflationary expectations still persist for the medium term.

Forecast:

The WPI inflation forecast for the next three months to be 4.1%, 4.3%, and 4.5% and the CPI inflation rate to hover around 4.3%.



Industrial Production

Capital goods output leads the revival in IIP growth

After a slow growth for two consecutive months, the industrial output rebounded in January 2006. The IIP growth for this month is 8.3 percent compared to 7.5 percent in the same period last year. (For the period April-January the growth is at 8 percent, which is less than last year's growth of 8.4 percent.) This growth is backed by 9.2 percent growth in the manufacturing sector. From the Use-based classification, capital goods output has registered a robust growth rate of 26.3 percent while there is a decline in the growth of consumer goods to 7.2 percent compared to 15.2 percent in the same period last year.

We have been saying that the current industrial growth is majorly backed by the external demand besides other domestic factors. The

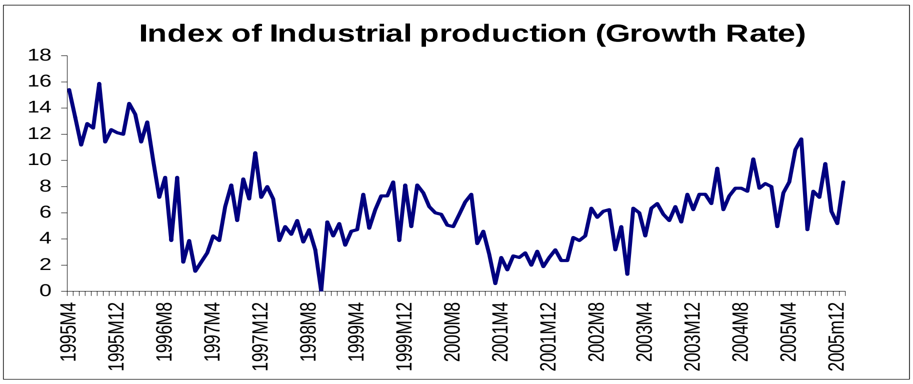
CSO's advance estimates for industry is at higher side.

For whole of 2005-06 industry to grow below 8%

volatile growth in the exports is expected to have adverse impact on the domestic industry. Since exports growth for the next two months are expected to be less than its average growth (around 12 percent), this high growth in industrial output may not be sustainable in the next two months. Added to this external factor, raising domestic interest rates particularly to the real estate and slow growth in the core sector output might adversely affect the industry from demand side. Overall, the growth of IIP for 2005-06 would be expected to be below 8 percent. The CSO's advance estimates for industrial sector shows that overall industry to grow at 9 percent, which, in our view, seems to be at a higher side.

Forecast:

Based on the available information we forecast the IIP growth rate for the next three months to be 5.3, 6.2 and 6.7 percent respectively.

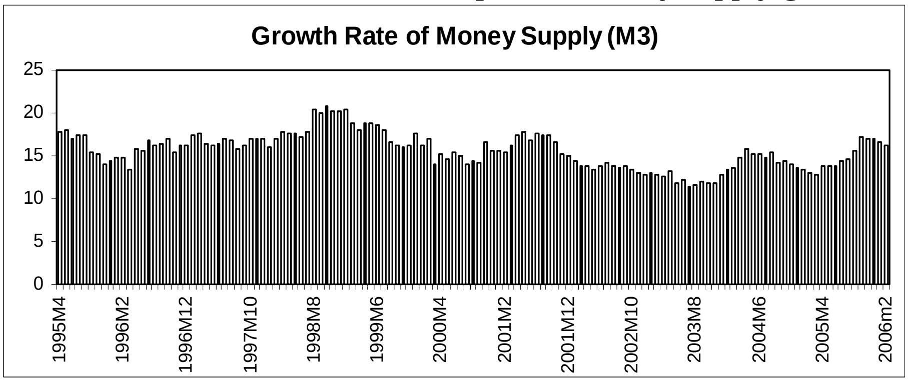


Money and Credit

Broad money continues to grow above targeted level

Credit demand is growing at 28.5%

Money supply growth, although declined marginally compared to last two months, continues to remain at high level. In February 2006, the growth rate of M3 was at 16.3 percent. This raise is mainly due to growing credit disbursements to commercial sector by whooping 28.5 percent. The decline in the foreign exchange reserves has led to fall in the growth of net foreign exchange assets with the banking sector from 15.8 percent a year ago to 7.4 percent. Recent hike in the domestic interest rates might put downward pressure on the demand for liquidity thereby reducing the money supply growth. Added to this, the expected fall in the pace of forex accumulation would also lead to drop in the money supply growth.



Forecast:

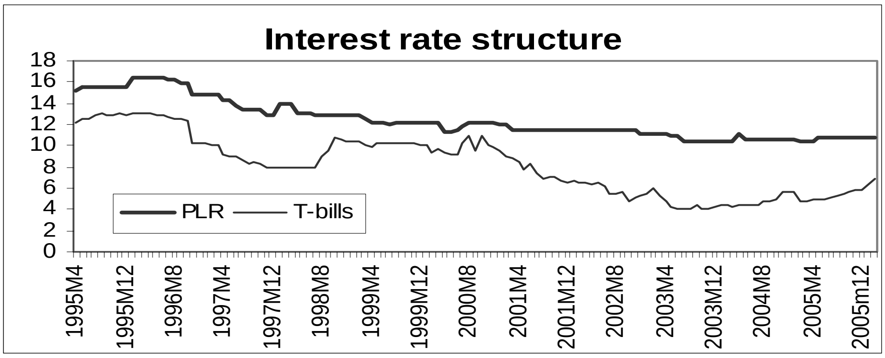
We forecast the growth rate of money supply (M3) for the next three months to be around 16 percent.

Interest rates

RBI hikes the policy rates

As we expected, the RBI, in its recent Credit policy, has hiked the short-term interest rates. (The regular readers of Monthly Monitor might note that for the past few months we have been saying this imminent raise in domestic interest rates). Followed by this, many banks have already started hiking both deposit and lending rates. Short-term interest rates such as call money rate and T-bill rates on short-term maturity have already gone up. Besides, open economy factors, the pressure on liquidity due to both demand (from industrial sector) and supply factors (redemption of IMD funds, and fall in the pace of forex accumulation) has led to this raise in interest rates. At the moment it appears that the current interest rate cycle would move further upwards given the presence of inflationary expectations.

Commercial banks follow the hike.



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

Exchange rate appreciates

Widening trade gap might weaken the Rupee

Against our prediction of depreciation, the Rupee/US dollar exchange rate has actually appreciated from above 45 in December 2005 to 44.5 in February 2006. The redemption of IMD funds seems to have had no impact on the exchange rate. The hike in interest rates seems to have led to this appreciation of Rupee. But the exchange rate is expected to depreciate in the coming months due to widening trade gap. Further, the fall in the foreign exchange inflow could also lead to depreciation.

Forecast:

The Rupee/US Dollar exchange rate is expected to depreciate to 44.9 in the coming months.

Despite IMD redemptions, forex reserves declined only marginally.

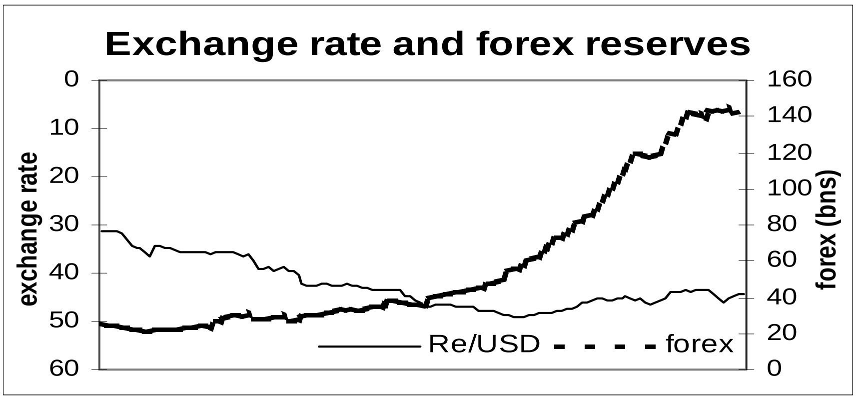
Foreign Exchange Reserves

Despite the redemption of IMD funds to tune of US$ 7 billions, the foreign exchange reserves have only declined marginally to US$143.1 billions by middle of February 2006 compared to above 144 billions in December, 2005. Although the recent hike in domestic interest rates might lead to forex accumulation, widening trade gap (which is already over US$ 33 billions) would have adverse impact on the reserve accumulation. On balance, we see a marginal fall in the reserves in the coming months.

Expected to fall further.

Forecast:

Forex reserves are expected to decline to US$ 142 billions.

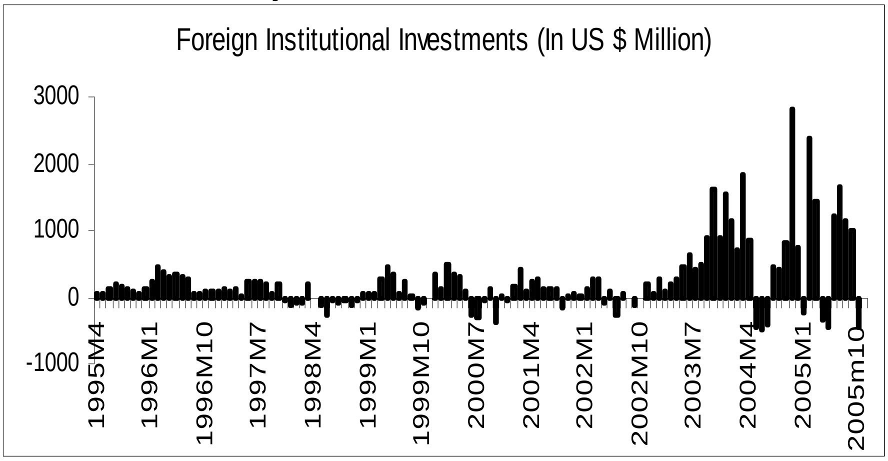


FIIs are net buyers in the last part of 2005.

Foreign Institutional Investment

After a huge inflow of more than one billion per month for fourth consecutive month, the FIIs turned out to be net sellers. The latest information available for November 2005 shows that for the second consecutive month FII was negative. This could be due to profit booking by the foreign investors and also due to hike in the US Federal interest rates that led to the outflow. The recent hike in domestic interest rates and the continuing bull run in the stock market might lead to more FII inflows in the coming months. But this would also depend on the future movements in the US interest rate cycle.

Expected a positive FII inflow in the coming months



Exports growth rebounded.

Imports growth decelerates

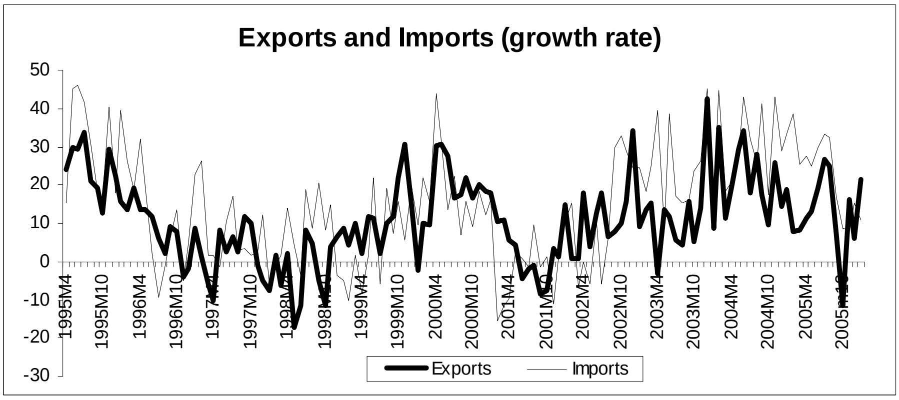
Trade deficit at US$ 33 billions

Exports and Imports

The export growth for the month of January 2006 has gone up to 21.46 percent compared to single digit growth 6.2 percent in the previous month. With this the growth for April-January is around 18.9 percent, which is less than last year's growth of above 25 percent. Growing trade relationships (agreements) with many countries in Asia and other regions helping our export growth. Although imports are growing at double digit, the magnitude of growth has declined. For the month of January the import growth is at 10.7 percent and for April-January it is 26.7 percent. As there is a raise in import penetration in domestic industry, any fall in imports (particularly the non-oil) would have adverse impact on the domestic industry. Overall, growth in both exports and imports for the whole of 2005-06 would be much less than the last year's growth.

Forecast:

Based on the data up to January 2006, we forecast the average export growth to be 11 percent and the average import growth to be 16 percent for the next three months.



Positive sentiments in the economy lead the bull run.

Sensex touches an all time high.

BSE Sensex

The bull run continues in the domestic stock markets. The BSE sensex has reached to the all time high of 10800 points in the first week of March 2006. This is despite rise in the domestic interest rate structure and fall in the FII investments. The strong positive sentiments in the economy backed by the robust output growth particularly in the industrial sector, which led to rise in the stock returns, and growing disposable incomes must have contributed to this bull run. As we expect FII to be net buyers in the coming months, this could extend the bull run further.