MONTHLY MONITOR

Prepared by **N. R. Bhanumurthy** **July 2006**

TOP STORIES

RBI hikes the short-term interest rates.

Domestic interest rates are yet to peak

More hikes are expected

As per our predictions, the RBI in its recent Monetary and Credit policy had hiked the short-term rates by 25 basis points while retaining the Bank rate and CRR at its existing levels. The RBI had retained the growth projections at 7.5 to 8% while indicating the need for strong policy measures to control the inflation rate at 5 to 5.5%. This only indicates that there is a strong inflationary pressure in the economy, which could result in higher rate than as targeted by the RBI. On the interest rate front, we might see further hike in the coming months as the current upward movement in the interest rate cycle is yet to peak.

Industrial sector growth buoyant

The growth in industry to be less than last year

Industrial sector continues to be robust. For the month of May 2006, it has registered a double-digit growth of 10%, although this is less than the last year's growth of 10.8%, which is mostly due to decline in the growth of mining and electricity sectors. Although the recent hike in the domestic interest rates might not have large adverse effect, the increase in the oil prices is expected to have spin-off effect on the industrial output through raise in input prices. Further, due to some cyclical (both domestic and international) factors, we expect the industrial sector to register low growth compared to last year.

WPI inflation rises

Money supply growth and oil prices to push year end inflation above 5.5%

The WPI inflation rate is currently at 4.68%, which is mostly due to hike in the domestic oil prices and increase in the prices of primary articles. We expect the inflation rate to increase further due to incomplete pass-through of world oil prices and due to some seasonal factors. Huge money supply growth, which is at 18.8%, and uncertainty in the world oil markets could push the inflation rate to above 5.5% by the end of 2006-07.

Robust growth in exports

Trade deficit widens to US$12 billion

Stalling of trade negotiations to affect trade

Buoyancy in the trade sector continues. The exports growth for the month of June 2006 is at 40% while the imports are growing at 23%. This trend in exports and imports has resulted in widening trade deficit. For the first three months of current financial year the deficit stood at over US$ 12 billions. With the presence of strong positive sentiments in the economy, the high growth in both exports and imports might be sustained for some more time. But the collapse of the recent round of WTO negotiations and suspension of India-ASEAN FTA talks might marginally drag the current pace of export growth.

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Exchange rate continue to depreciate

Hike in interest rate to restrain Rupee from further fall

As we have predicted, the Rupee/US dollar exchange rate continue to depreciate. By the end of July 2006, it has touched 47. Widening trade deficit following a rising world oil prices and narrowing of interest rate differentials must have led to this depreciation. The recent hike in the domestic interest rates and some slowdown signals from the US economy might restrain the Rupee from further fall. On the other hand, there is a slowdown in the pace of forex accumulation, which is now at nearly US$163 billions. FII inflows continue to be positive.

Money supply growth at 18.8%

Bank credit to commercial sector declines

In the month of July 2006, money supply (M3) increased at the rate of 18.8%, which is very much above the RBI's target rate of 15%. This sharp rise in the money supply is despite decline in the growth of bank credit to commercial sector, which is 27.6% compared to 28.4% in the same period last year. Bank credit to government, which was negative for long, has become positive and increased by around 4%. Recent hike in the lending rates by major commercial banks might reduce the credit demand and thereby the money supply growth.

IEG-DPC Forecast

Variables	Latest Information available	Forecast for next Three months
Inflation rate (WPI)	4.68% in July 8, 2006.	Expected to be above 5%.
Inflation rate (CPI)	4.9% for May 2006	Expected to decline marginally.
Growth rate of IIP	10% in May 2006	8.4% (average)
Growth rate of M3	18.8% in July 2006.	Current high growth is expected to continue.
Prime lending rate	10.75 – 11.25 % in July 2006.	Lending rates to rise marginally
Re/$ exchange rate	46.9 in July 2006.	Expected to appreciate
Forex reserves	US $ 162.66 billions on July 14, 2006.	To cross US$ 170 billions by October 2006.
FII inflows	US $ 3,276 million as on April 2006	Positive inflows
Growth rate of exports	40.17% in June 2006	25% (average)
Growth rate of imports	23.98% in June 2006	20% (average)

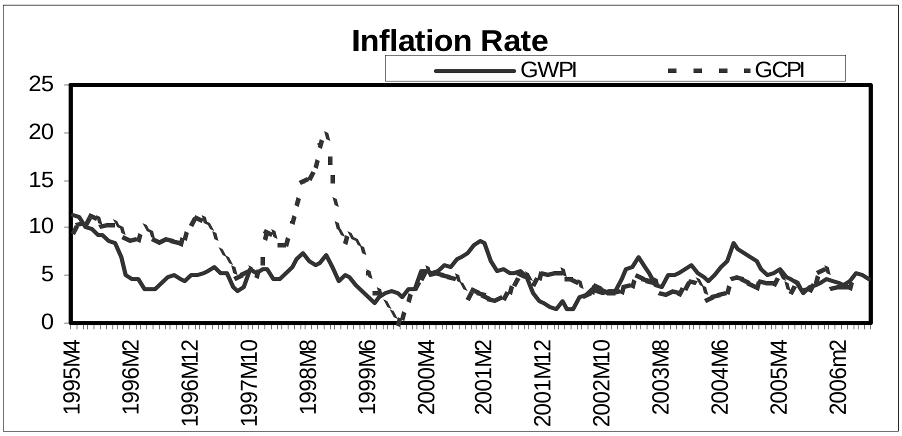
WPI inflation increases

Cement prices increases by 19.8%

Inflationary expectations still persist for the medium term.

Inflation

The inflation rate based on WPI rises. As on July 8th the inflation rate is at 4.68 percent. This rise could be attributed to hike in the domestic fuel group prices, which have gone up by 7.3 percent and also due to the prices of primary articles, which has gone up by 7.4 percent. Added to this, the prices of cement, which has increased by 19.8 percent, has also led to the high overall inflation rate in the economy. On the demand side, the high money supply growth (of 18.8 percent) must have also put upward pressure on the domestic prices.



Given that there is an incomplete pass-through of world oil prices in the domestic economy and due to demand side factors, the inflationary expectations still persist in the economy. Hence, we expect the inflation rates to increase further in the coming months. The extent of increase would largely depend on the future movement of world oil prices and the performance of monsoon. But the sustained strong growth momentum that is witnessed in industry might moderate inflation to some extent. Overall, we expect the inflation rates to be above 5 percent in the coming months.

Forecast:

The WPI inflation forecast for the next three months to be 5%, 5.2%, and 5.4% and the CPI inflation rate to hover around 4.8%.

IIP registers double-digit growth

Industrial Production

Robust growth in industrial sector continues. In the month of May 2006, it registered a double-digit growth of 10 percent backed by a buoyant growth in the manufacturing sector (of 11.3 percent). But this is slightly less than the growth witnessed in the same period last year mostly due to decline in the growth of both mining and electricity output. From the Use based classification, capital goods

Robust growth in capital goods continues

electricity output. From the Use-based classification, capital goods output has registered a robust growth rate of 20.5. The growth in consumer goods output has declined to 9.1 percent compared to 18.4 percent in the same period last year.

Core sector growth declines

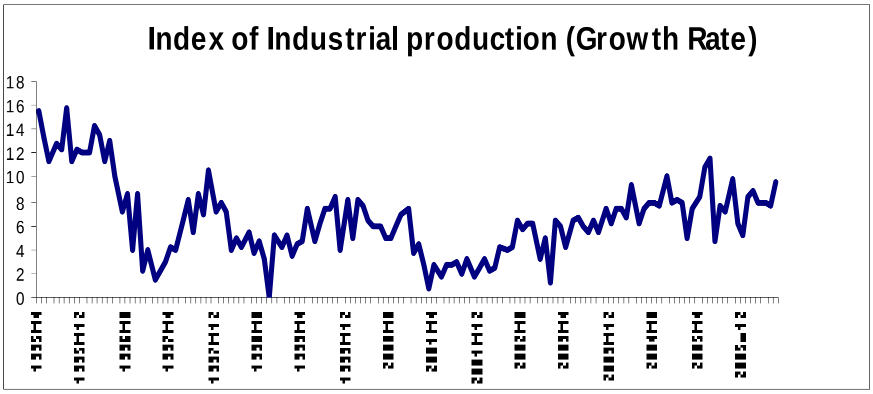
Fuel prices to have spin-off effect on industry

The growth momentum in the industrial sector is expected to slowdown to some extent in the coming months due to cyclical factors. Although the recent hike in the policy interest rates might not have large negative impact on the industrial output, the hike in domestic fuel prices might have spin-off effect on the output through rise in the input prices. The decline in the core sector growth from 8.1 percent in May 2005 to 5.1 percent in May 2006 can be an early indication of our expected downward movement in the industrial cycle.

Industrial growth in 2006-07 to be less than last year growth

Forecast:

Based on the available information we forecast the IIP growth rate for the next three months to be 8.7, 8.7 and 8.2 percent respectively.

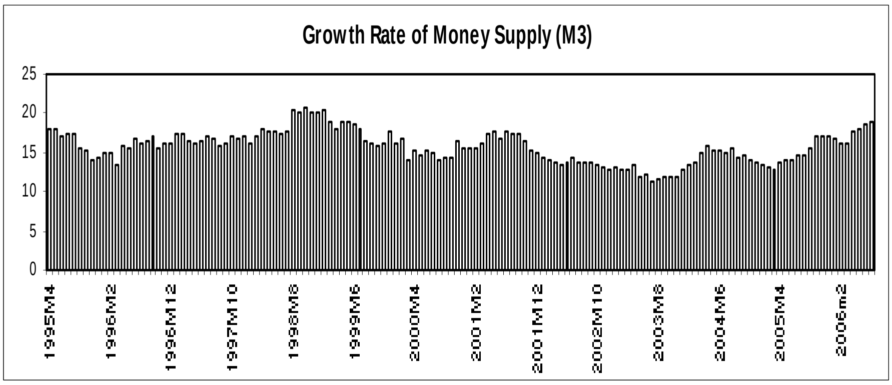


Broad money continues to grow above targeted level

Bank credit to commercial sector declines

Money and Credit

High growth in money supply continues. In the month of July 2006, money supply increased by 18.8 percent compared to 14 percent in the same period last year. This sharp rise is majorly contributed by rise in the bank credit to the government, which was negative till recently, and also due to high growth in the net foreign exchange assets of the banking sector. On the contrary the growth bank credit to commercial sector has declined marginally to 27.6 percent compared to 28.4 percent last year. The expected increase in the forex reserves and buoyancy in the overall economic activity would lead to further rise in the money supply growth in the coming months. But the current upward movement in the interest rate cycle might restrain any further rise in the money supply growth.



RBI hikes the short-term rate

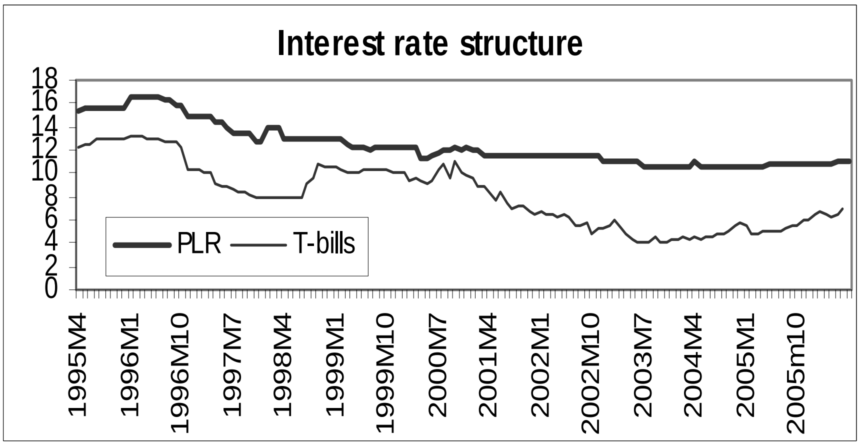
Present interest rate cycle is yet to peak

Forecast:

We forecast the growth rate of money supply (M3) to decline marginally in the next three months.

Interest rates

As predicted by us, the RBI, in its recent first quarter review of Monetary and Credit policy, has hiked the short-term interest rates by 25 basis points, while retaining the existing Bank rate and CRR at 6 and 5 percent respectively. (The regular readers may note that we have predicted this current upward movement in the interest rates way back in September 2005 itself. As per our forecasts, we expect the current upward movement in the interest rate cycle to peak in the third quarter of financial year 2006-07.) With this hike both short term and medium term rates have aligned making the yield curve flat. Given the persistence of inflationary expectations due to rise in world oil prices and other supply-side factors, we expect further hike in the domestic interest rates in the coming months.



Forecast:

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

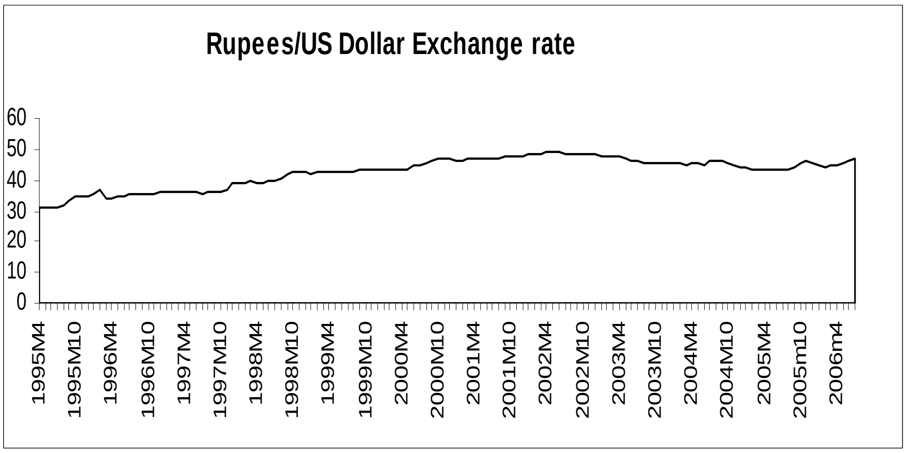
Exchange rate continue to depreciate

Interest rate hike to restrain further depreciation

Exchange rate

As predicted in our earlier issues, the Rupee/US dollar exchange rate continued to depreciate and reached to a three year low of 46.9 in July 2006. Narrowing interest rate differentials followed by continuous hike in the US interest rates and widening of trade deficit, which is currently at more than US$ 12 billions, and strengthening of US dollar in the international market must have led to this sharp depreciation in the exchange rate. Recent hike in the policy interest rates is expected to restrain the Rupee from further weakening.

Forecast:
The Rupee/US Dollar exchange rate is expected to start appreciating in the coming months.



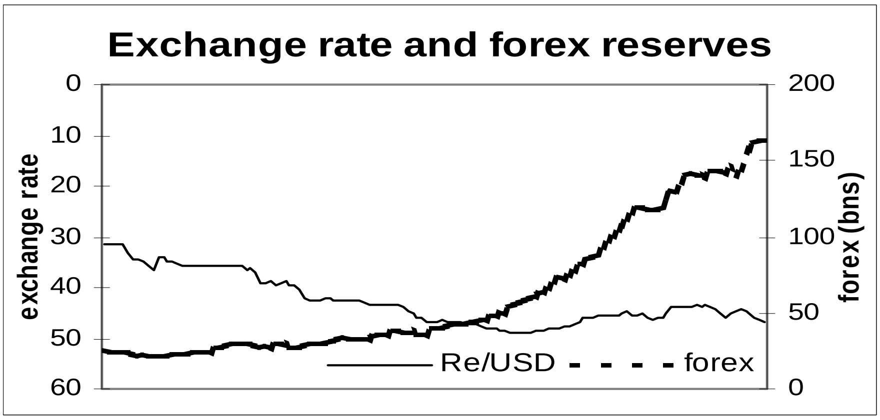
Pace of Forex accumulation slowed down

Expected to touch US$ 170 billion by October 2006

Foreign Exchange Reserves

India's forex kitty continues to bulge. Currently it is at US$ 162.6 billions. This is despite the huge trade deficit incurred in the first quarter of 2006-07 and also due to high volatility in the international financial markets that kept short-term foreign investors away from the domestic market. Although the narrowing interest rate differentials and high world oil prices have resulted in a marginal outflow of forex assets in June, the recent hike in the policy interest rates by RBI might lead to further accumulation of forex reserves in the coming months.

Forecast:
Forex reserves to cross US$ 170 billions by the end of October 2006.

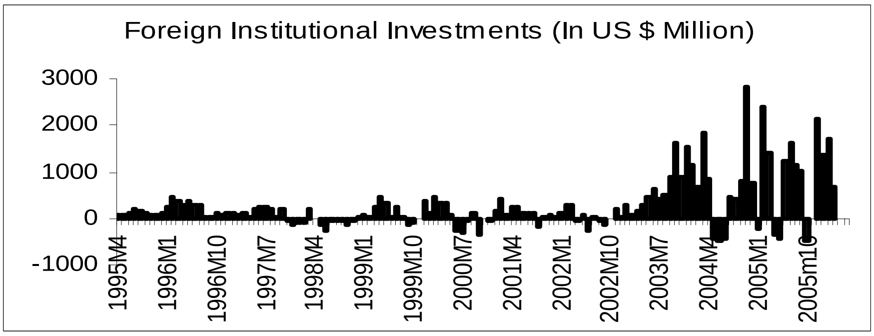


Foreign Institutional Investment

FIIs invested US$ 3.2 billions in April 2006

FII continue to be net buyers in the market. In April 2006, FII invested to the tune of US$ 3,276 millions. Given the strong performance of the industrial sector, which is well above the market expectations, this FII behaviour is natural and it is expected to continue in the coming months. Added to this, the recent hike in the interest rates might also see that FIIs are net buyers in the market. But this would also depend on the future movements in both Indian and the US interest rate cycle.

Expected a positive FII inflow in the coming months



Exports and Imports

Exports growth continue to be strong

Trade deficit at US$ 12 billions in first quarter of 2006-07

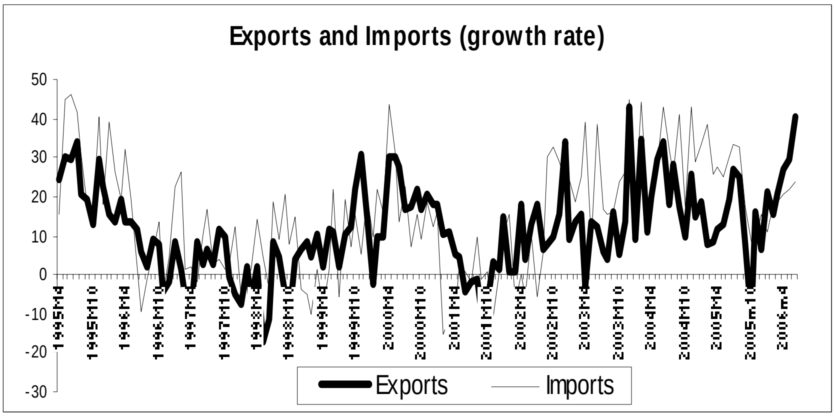
In June 2006, exports have registered a whopping growth of 40 percent compared to 19 percent in the same period last year. The continuous upward movement in the world economic growth and in particular the trade partners such as EU and East & South East Asia seems to be a major factor for the high growth in exports. On the other hand, the imports have also grown at 24 percent in this period. While the oil imports have become costlier, the raise in the imports of intermediate goods seems to have led to this high growth in imports. This trend in exports and imports has resulted in widening trade deficit. For the first three months of current financial year the deficit stood at over US$ 12 billions. With the presence of strong positive sentiments in the economy, the high growth in both exports and imports might be sustained for some

Collapse of trade negotiations to affect trade

more time. The collapse of the recent round of WTO negotiations and suspension of India-ASEAN FTA talks might marginally drag the current pace of export growth.

Forecast:

Based on the data up to June 2006, we forecast the average export growth to be 25 percent and the average import growth to be 20 percent for the next three months.



BSE Sensex

BSE Sensex falls

First quarter corporate results might improve the stock market activity

After reaching peak levels in April 2006, the BSE sensex fell sharply and is currently at around 10800 points. Although this sharp fall in Sensex did affect the investors' sentiments, better than expected corporate results, inflows from FIIs, and positive outlook in the economy are expected to increase the stock returns and also the Sensex. But the recent hike in the domestic interest rates might to some extent shift the investments from stocks to other low risk instruments.

Note:

The forecasts that are presented in this report are based on the time series model that is presented in "A Short-term Time Series Forecasting Model for Indian Economy" available on our institute website at **http://www.iegindia.org/dis_bhanu_72.pdf**