MONTHLY MONITOR

Prepared by N. R. Bhanumurthy | October 2005

TOP STORIES

RBI hikes the short term interest rates.

Rate hike not to affect the industrial performance

The recent Mid-year Review of Monetary and Credit policy of the RBI has hiked the reverse repo rate by 25 basis points to 5.25% while retaining the Bank rate and CRR at their current levels of 6% and 5% respectively. These measures are on expected lines due to raising inflationary expectations and narrowing interest rate differentials. But this rate hike may not have any significant adverse impact on the overall industrial performance as industry depends heavily on the demand-side factors and also the output elasticity with respect to interest rates has been found to be low in India. As the apex bank cautioned the commercial banks on having high exposure to real estate loans, this might restrain the pace of credit off-take to real estate and also the growth in core sector.

Industrial growth in 2005-06 to be 7.2%.

The index of industrial production grew at 7.4% in August 2005 compared to 8.6% in the same period last year. For the second consecutive months, mining sector registered negative output growth. As we predicted in our earlier Monthly Monitor, the overall industrial growth in the current year is expected to be 7.2%, which is less than last year.

As predicted, inflation rate rises.

Spin-off effect of fuel price hike started reflecting

The inflation rate based on WPI continued to rise. It has reached to 4.5% by the middle of October 2005. This rise in inflation is contributed by prices of most of the commodities and not just by the fuel price hike. The spin-off effect of fuel price hike is expected to reflect on the price of other commodities with a lag. Added to this, high money supply growth would only ensure the presence of high inflationary expectations in the economy in the coming months.

Money supply growth touches 17.2% despite fall in growth of forex accumulation

Money supply growth jumped to a high of 17.2% in October 2005. This is despite a fall in the growth of net foreign exchange assets with the banking sector. Following the recent monetary policy stance and the maturity of IMD funds by the end of November 2005, we expect a marginal fall in

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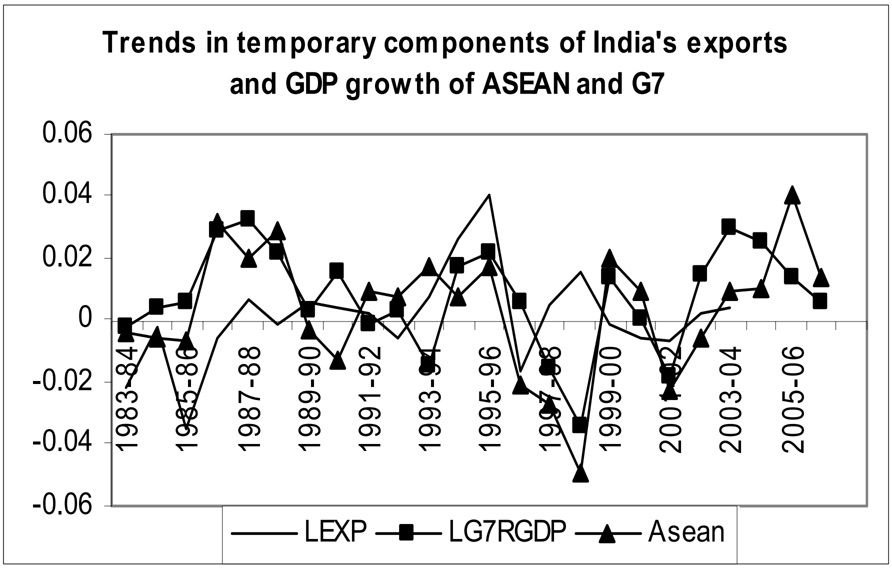
the growth of credit off take, particularly to the real estate sector, and expect a decline in the growth of money supply in the coming months.

Exchange rate depreciated and expected to depreciate further.

As expected, the exchange rate depreciated to nearly 45.5 by the end of October 2005. Widening trade deficit, narrowing interest rate differentials and strengthening of US dollar in the international market has led to this depreciation in Rupee/US dollar exchange rate. Due to same reasons, we expect further depreciation in the coming months, while we expect a fall in the forex reserves.

First time in FY2005, exports growth register single-digit

For the first time in the current financial year, exports registered a single-digit growth. In September 2005, the exports grew at 7.51% while imports grew at 17.25%. The sustenance of high growth in exports depends heavily on the growth performance of the Global economy. It may be noted in the below graph, where we plotted the temporary components of India's export growth, GDP growth of ASEAN and G7 countries, that our exports are highly positively correlated and moving in tandem with the ASEAN and G7 output. As per the forecasts based on World Economic Outlook, the output growth in ASEAN and G7 are expected to dip in 2006 and 2007 compared to 2005. Following this we expect a fall in India's exports growth in these years. Overall, the exports growth in the rest of current financial year could be in single-digits.



IEG-DPC Forecast

Variables	Latest Information available	Forecast for next Three months
Inflation rate (WPI)	4.49% in October 2005.	Expected to be 5%
Inflation rate (CPI)	3.45% in August 2005	Decline marginally
Growth rate of IIP	7.4% in August 2005	7.5% (average)
Growth rate of M3	17.2%in October 2005.	Decline to 16.5%
Prime lending rate	10.25 – 10.75 % in October 2005.	Lending rates to rise
Re/$ exchange rate	45.4 in October 2005.	Expected to depreciate to 45.9 by the end of December 2005
Forex reserves	US $ 143.09 billions in October 2005.	Expected to decline marginally
FII inflows	Inflow of US$1,645 millions in July 2005.	Positive inflows
Growth rate of exports	7.51% in September, 2005	12% (average)
Growth rate of imports	17.25% in September, 2005	18% (average)

The WPI inflation continues to rise.

Spin-off effect of fuel price hike to be felt in coming months.

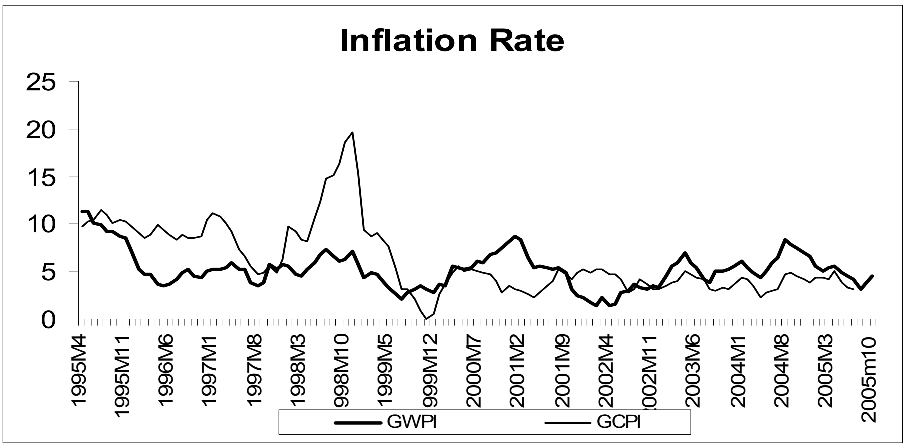
Inflation

The WPI inflation rate continues to rise. By the middle of October 2005, the inflation rate has gone up by 4.49 percent compared to less than 4 percent in August 2005. Although this rise in inflation rate is majorly contributed by the hike in the domestic fuel prices, which has increased by 12 percent, the prices of most of the commodities have gone up. The prices of Sugar group, cement, iron & steel have gone up by 9.3, 10.6 and 8.9 percent respectively. Even the fruits and vegetables prices have also gone up by 5.1 percent. Only the prices of edible oils have declined, mostly due to high imports. As the hike in fuel prices would have spin-off impact on other commodities, and the hike in fuel prices are also partial, we may expect further rise in the inflation rate in the coming months. Added to this, the festival demand and heavy rains in most part of India might lead to rise in inflation rate of consumer goods, particularly the non-durable goods. Further, high growth in the money supply would only ensure the presence of high inflationary expectations in the economy in the coming months.

High growth in money supply leads to high inflationary expectations.

Forecast:

Based on the available information we forecast the WPI inflation to cross 5% mark by the end of December 2005, while not much change is expected in CPI (industrial workers) inflation rate in the coming three month.



IIP grows at 7.4% in August 2005.

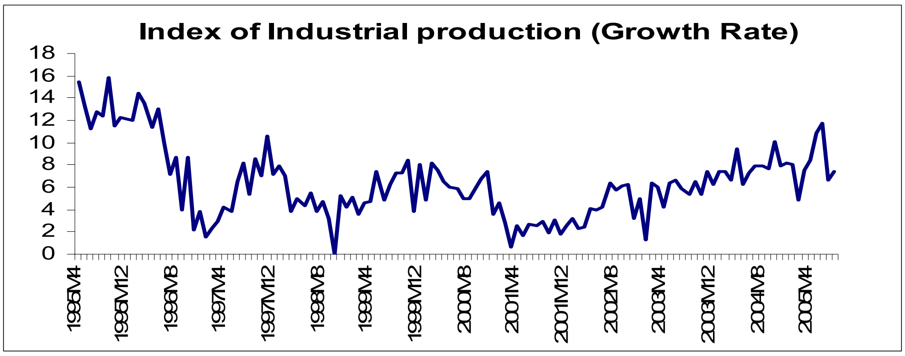
Industrial Production

Industrial sector registered a growth of 7.4 percent in August 2005. This is despite the high base growth of 8.6 percent in the same period last year. For April-August 2005, the growth is 8.8 percent higher than 8 percent growth in the same period in 2004. Mining sector registered a negative output growth for the second consecutive month. The growths of both capital and intermediate sector output have declined compared to last year. But the

Consumer durable goods continue to grow at double-digit.	consumer goods continued to grow at double digit. Although festival demand would help the industrial sector to maintain the current growth, the decline in the growth of exports would raise doubts about its sustenance. On balance, we expect the industrial sector to perform well this year, but its growth would be less than last year's growth.
Recent hike in interest rates may not affect industry.	

Forecast:

Based on the available information we forecast the IIP growth rate for the next three months to be 7.2, 7.4 and 8.2 percent respectively.

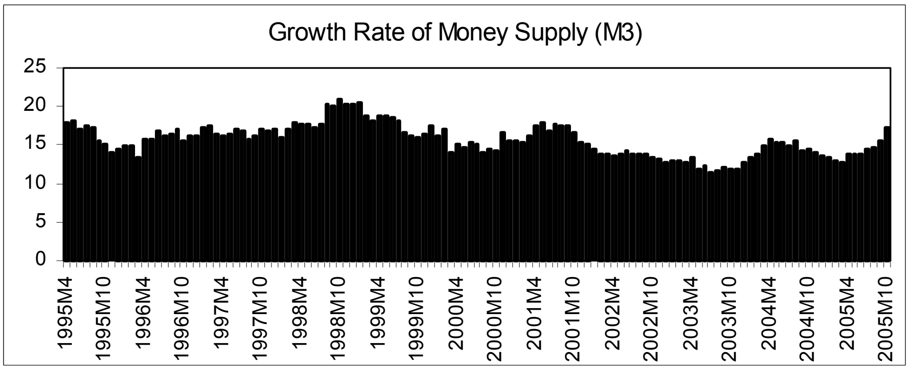


Money and Credit

Money supply growth jumped to 17.2% in October 2005

Money supply growth jumped to 17.2 percent in October 2005 compared to around 15.6 percent in September 2005. This is much higher than the target growth rate. Growing bank credit to the commercial sector (by 27 percent compared to 24 percent last year) seems to have led to this high growth in money supply. This high growth in money supply is realized despite decline in the pace of growth of net foreign exchange assets with the banking sector from almost 30 percent to currently 16 percent. Following the Mid-Year Review of RBI and the maturity of IMD funds by the end of November 2005, we expect a marginal fall in the growth of credit off take, particularly to the real estate sector, and expect a decline in the growth of money supply in the coming months.

Money supply growth is expected to decline marginally due to expected fall in forex accumulation.



Forecast:

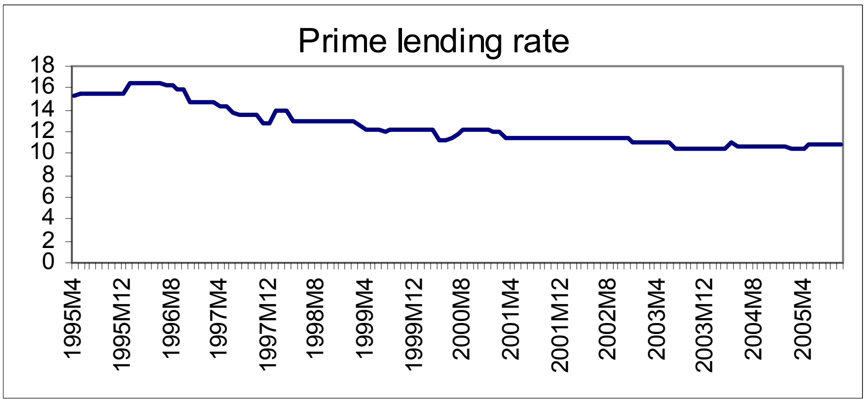
Based on the data up to October 2005, we forecast a decline in the money supply (M3) growth to 16.5% in the next three months.

RBI hikes the short-term interest rate by 25 basis points.

Interest rate differentials narrowing further.

Interest rates

Reserve Bank of India, in its Mid Term Review of the Monetary policy, has hiked the short-term interest rates (reverse repo rate) by 25 basis points. Given the situation of rise in both international interest rates and the inflationary expectations in the domestic economy, this interest rate hike was inevitable. The impact of this policy hike was also reflected in the growing yields on medium-term government securities. As the international interest rate cycle is moving upwards, India has limited option other than hiking the interest rates across the board. Hence, we expect the medium and long term interest rates also to go up in the coming months.



Forecast:

Based on the data up to October 2005, we forecast a marginal rise in prime-lending rate from its existing rate of 10.75 per cent in the next three months

Rupee/US dollar exchange rate depreciates to 45.5.

Exchange rate expected to depreciate further.

Exchange rate

As we rightly predicted in the previous issue of Monthly Monitor, the Rupee/US dollar exchange rate continued to depreciate. It reached to 45.49 by the beginning of November 2005. Rising trade gap, narrowing interest rate differentials and strengthening of US dollar in the international market has put downward pressure on the Indian Rupee and led to this depreciation. Recent hike in the domestic interest rate, which is very small compared to hike in international interest rates, may not have any significant impact on the exchange rate. We expect further depreciation of exchange rate in the coming months.

Forecast:

Depreciation to continue and to reach 45.9 by the end of December 2005.

Foreign Exchange Reserves

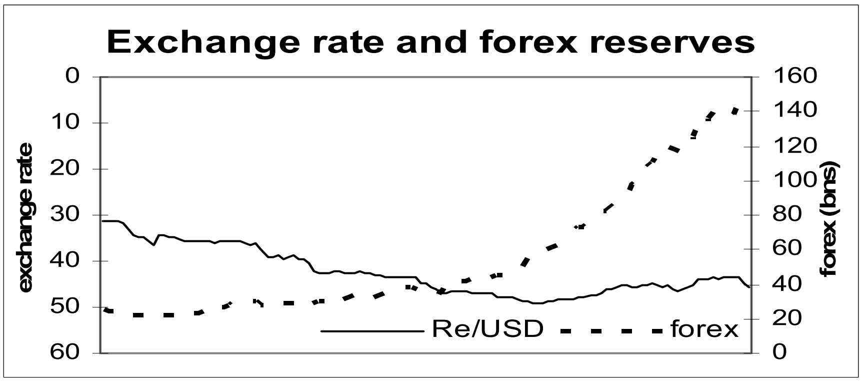
IMD funds to mature in December 2005.

Marginal decline in reserves predicted.

There is not much change in the foreign exchange reserves position in India. For the past three months, the reserves are stagnant at around US$ 143 billions. This year the reserve accumulation has reduced very sharply. Between April-October 2005, India could accumulate the reserves to the tune of US$ 1.5 billion compared to US$ 12 billions in the same period last year. Rising trade gap and narrowing interest rate differentials must have contributed to this fall in the pace of accumulation. Expected further widening of trade deficits and the maturity of IMD funds might lead to a fall in the reserves in the coming months.

Forecast:

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

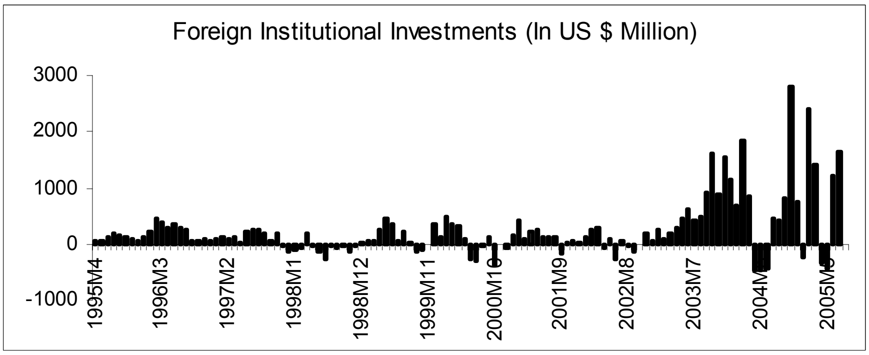


Foreign Institutional Investment

FIIs are net buyers in July 2005

Future behaviour depends on risks and returns in the stock market

In the month of July 2005, the FII investments have seen a huge net inflow of US$ 1,645 millions. This is despite the narrowing interest rate differentials. Strong positive sentiments in the economy, impressive results of corporate sector and boom in the domestic stock market, the FIIs have turned net buyers in the domestic capital market. Although RBI has recently hiked the interest rates, the future behaviour of FIIs would majorly depend on the risk and returns in the stock market. Further, as US FED continues to hike the short term interest rate, it might reduce the FII inflow to some extent in the coming months.



For the first time in 2005-06, exports grew at single-digit.

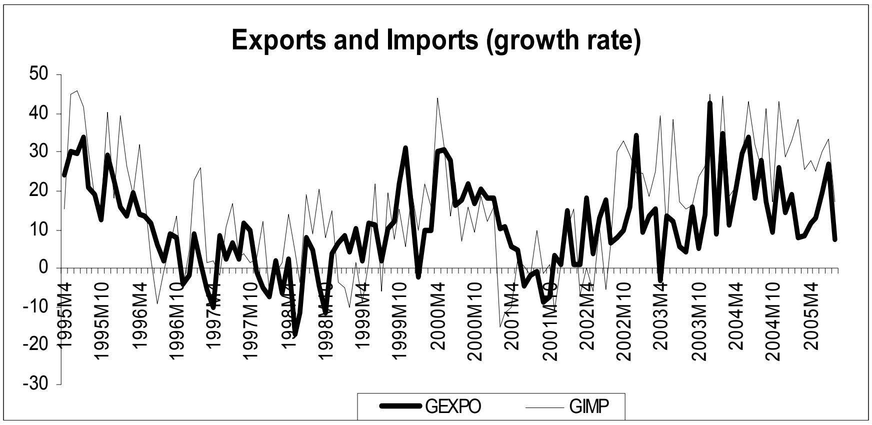
Trade performance in current year to be less than last year's.

Exports and Imports

As we predicted in our earlier issue of Monthly Monitor, exports growth has declined and reached a single digit growth of 7.51 percent in the month of September 2005. For April-September 2005, it has registered a robust growth of 20.5 percent. This high growth in exports could be due to growing trade ties (like FTAs and BTAs) with neighbouring countries in Asia and also due to recovery in the Global economy. On the other hand, despite high oil imports, total imports also grew at a lower rate of 17.25 percent in September 2005 compared to 33.09 percent for April-September 2005. This fall in imports growth must have been due to fall in non-oil imports growth. At this point we continue to reiterate that the overall trade performance in the current fiscal year could be less than that of last year's growth.

Forecast:

Based on the data up to September 2005, we forecast the average export growth to be 12 percent and the average import growth to be 18 percent for the next three months.

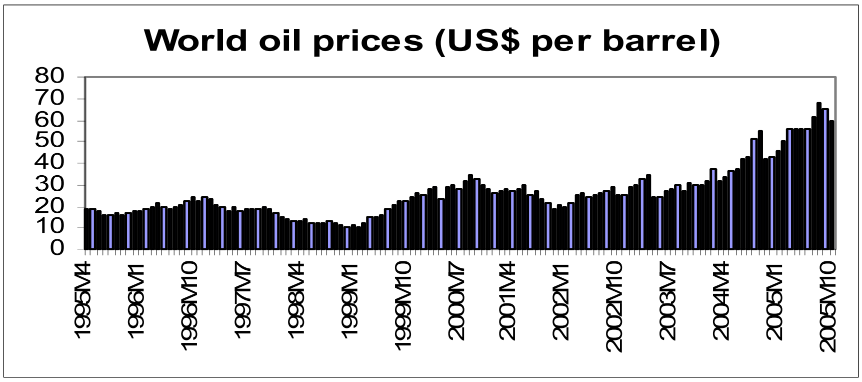


World oil prices remain stable at US$ 60 per barrel.

Expected to remain high as the current rise is not due to supply constraints.

Oil Price

The world oil prices are oscillating at around US$ 60 per barrel. Expected rise in winter season demand and continuous Hurricanes in and around USA has kept up the pressure on the world oil prices. 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 following expected recovery in the Global economy will ensure the crude oil prices to remain high. Following this it is expected that India also has to hike the domestic fuel prices to cover the cost at some point if not in the short run.



BSE Sensex

After reaching historic high, Sensex fell below 8000 mark.

After reaching to a historic high of 8800 in the beginning of October 2005, BSE sensex has seen sharp correction and fell below 8000 mark in the end of October. Selling by the FIIs following the eminent hike in the domestic interest rates in the Mid-term Review and shift in the portfolios from stock market to foreign exchange and money markets has led to fall in the Sensex. But the presence of strong feel-good factor in the Indian economy and huge short-term liquidity, we may not see any further downward correction in the Sensex in the coming months.