MONTHLY MONITOR

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IIP growth is at 9.7% in August 2006.

Infrastructure output grows at 9.9% in September

Credit to commercial sector declines

Lending rates expected to go upwards.

April-September exports growth at 21%

Trade deficits widens to US$24.1 billions.

WPI inflation started rising – at 5.41% in third week of October

High money supply growth causing inflation

Rupee/US dollar exchange rate appreciates

TOP STORIES

Backed by strong growth in manufacturing sector output, the IIP growth continues to be robust. In August 2006, it is at 9.7%. But this is less than 12.4% growth registered in the previous month. Both mining and electricity sector output growth declined. Expected fall in the external demand might restrain the IIP growth to some extent in the coming months.

The growth in broad money supply continues to be higher at 19%. The strong growth in credit off-take, although it is less than last year growth, must have contributed to this high growth in money supply. On the contrary, the growth in reserve money is at 20.4, which is higher than the growth of broad money. Recent hike in the Repo rate might lead to decline in the money supply growth and rise in lending rates in the coming months. With this, in our view, the upward movement in the interest rate cycle is peaked.

Buoyancy in the trade sector continues. For the month of September the exports registered a growth of 21.9% and for April-September 2006, it stood at 21%. On the back of high growth last year, this figure is highly impressive. While it is necessary, the sustenance of this growth momentum would be a challenging task given the signs of slowdown in the US and other major economies. On the other hand, imports also grown at 24.8% in September.

After moderating for some time, the WPI inflation started rising. Based on latest information, inflation reached to 5.41% in third week of October. This high inflation is majorly contributed by the rise in the prices of primary articles. Further, the high growth in money supply, which is above the RBI's targeted level for a long time, seems to be reflecting on the inflation from the demand side. Due to same reason, we expect inflation to go up further in the coming months.

The Rupee/US dollar exchange rate appreciates. As we have rightly predicted in our earlier issue, Rupee/US dollar exchange rate has appreciated to 44.9 in the first week of November 2006. This could be mainly due to weakening of

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Expected to appreciate further ***Forex reserves declines***	US dollar in the international market and also due to net inflow of short-term foreign funds in the recent months. We expect further appreciation of exchange rate in the coming months. But the widening trade deficit, which resulted in fall in the forex reserves to US$166.15 billions in mid-October 2006, would restrain the rupee from sharp appreciation.

Mid-term Monetary and Credit Policy, 2006-07: A comment

In the recent review of the Monetary and Credit Policy, the RBI has retained the policy interest rates such as reverse Repo rate and Bank Rate, which are used for monetary policy signals, while hiking the Repo rate from 7 to 7.25 percent. It has also retained the existing level of CRR at 5 percent. Going by the current domestic and international economic trends, the RBI increased the GDP growth forecasts for the year 2006-07 to 8 percent, while retaining the inflation target at 5-5.5 percent. More importantly, the apex bank pushes forward the liberalization of capital account to some extent, based on Second Tarapore Committee report, through slew of measures. It reemphasizes the risk affiliated to the housing loans and also the importance of credit quality.

In the recent review many had predicted a hike in the policy interest rates such as reverse Repo rate. Contrary to that, the RBI did not hike as it seems to be hesitant to derail the current growth momentum in the economy that reflected in the robust credit off-take and the GDP growth (particularly in the manufacturing sector) in the past few quarters. In our view this monetary policy stance would help in increasing competition and efficiency in liquidity management among the banks. This would also ensure quality in the loan allocation and lead to 'performing assets'. But only glitch could be that this increase in competition among banks could put constraints on the smaller ones. This might result in consolidation of banks.

On the interest rate front, in our view, if the current pace of credit demand sustains, the hike in Repo rate would also put upward pressure on the lending rates in the coming months. At this stage, it may be remembered that we have predicted in mid-2005 that the current upward movement in the interest rate cycle would peak by the end of 2006. It appears that our forecasts are going to be realized.

IEG-DPC Forecast

Variables	Latest Information available	Forecast for next Three months
Inflation rate (WPI)	5.41% on October 21, 2006.	Expected to be around 5.5%.
Inflation rate (CPI)	7.2 % for September 2006	Expected to decline marginally.
Growth rate of IIP	9.7 % in August 2006	9.2 % (average)
Growth rate of M3	19 % on October 13, 2006.	Current high growth is expected to steady soon
Prime lending rate	11 – 11.50 % in October 2006.	Lending rates to rise marginally
Re/$ exchange rate	44.9 in November 1, 2006.	Appreciate further to 44.5
Forex reserves	US $ 166.15 billions on October 13, 2006.	To reach US$ 180 billions by December 2006.
FII inflows	US $ -595 million in July 2006	Positive inflows
Growth rate of exports	21.91 % in September 2006	19.1 % (average)
Growth rate of imports	24.76 % in September 2006	21.9 % (average)

Inflation

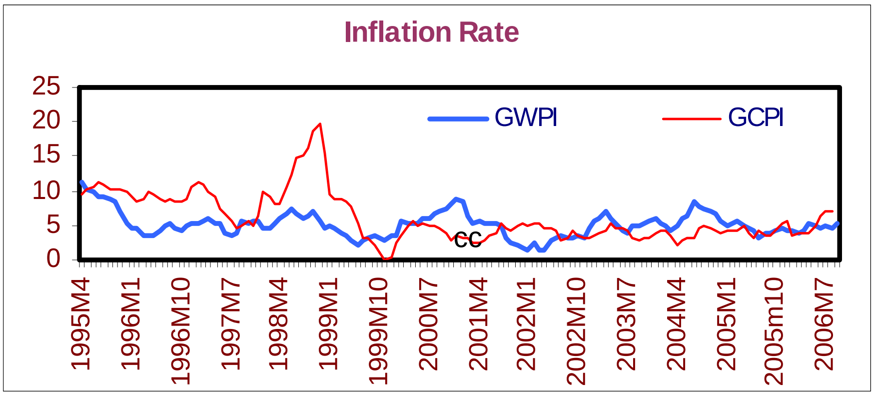
After subdued for some time, inflation started rising.

Demand side factors causing inflationary pressure

After some ease, the inflation rate based on WPI has started rising. By the middle of October 2006, the inflation rate stood at 5.2 percent. This rise is prompted by a continuous rise in the prices of primary articles, particularly the prices of fruits and vegetables, and also due to sharp rise in the prices of Cement, which is growing at 18.2 percent. Fuel group prices are also increasing at 5.2 percent. The rise in primary article prices could be due to three reasons: due to demand side issues backed by high growth in money supply; due to spin-off effects of hike in domestic oil prices and due to festival demand. But the inflation rate based on CPI (industrial workers) is much higher and it at 7.2 percent in September 2006, reflecting the continuing divergence in the coverage for estimating wholesale and retail market prices in India.

Inflationary expectations still persist in the medium term.

As RBI stated in its recent Credit policy, the complete pass-through of high world oil prices on the domestic prices is yet to take place, the inflationary pressure still persists. Further, the sharp rise in money supply growth also augments the inflationary pressure in the economy in the coming months.



Forecast:

The WPI inflation forecast for the next three months to be 5.44, 5.5, and 5.6% and the CPI inflation rate to hover around 7%.

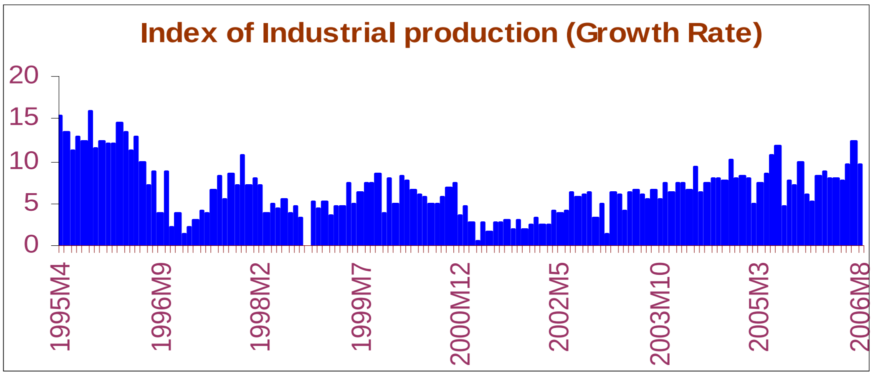
Industrial Production

IIP growth declined marginally in August 2006

As predicted in our earlier issue of Monthly Monitor, the IIP growth in August 2006 has declined to 9.7 percent compared to 12.4 percent growth in the previous month. But this is much higher than 7.6 percent growth in August 2005. Although manufacturing sector continued to grow at double-digit, it is the decline in the growth of mining and electricity sector output that led to this decline in overall IIP growth. Despite this performance, for April-August 006, the IIP growth is still at buoyant 10.6 percent. Both capital and consumer goods output continue to show high growth.

Expected to decline further in the coming months

The forecasts based on our model shows that IIP growth could further decline marginally in the coming months. The reasons could be the expected slowdown in the external demand due to imminent slowdown in the developed economies and due to some cyclical factors, which are exhibiting downward movement in the medium term.



Forecast:

Based on the available information we forecast the IIP growth rate for the next three months to be 9.8,8.3 and 9.4 percent respectively.

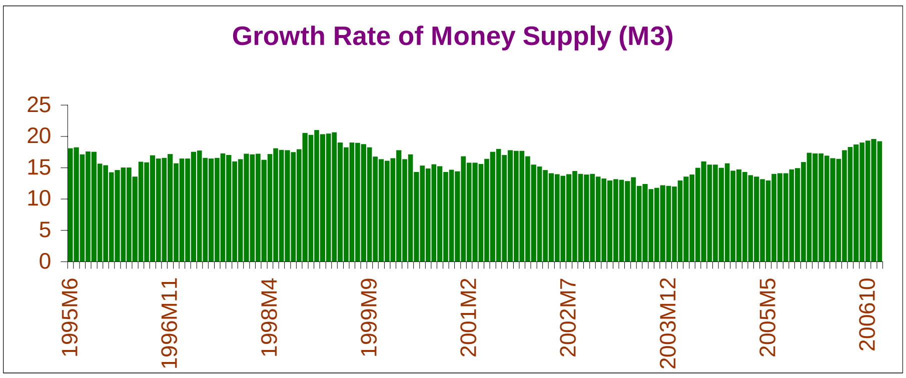
Money and Credit

Following Repo rate hike, there could be a decline in the credit supply

Reserve money growing faster than broad money

Growth of bank credit to commercial sector declines

The money supply growth by the middle of October 2006 is at a high of 19 percent. On the components side, this high growth is contributed by the growth of demand deposits. On the sources side, it is the rise in both credit off-take (although it is less than last year's) and net foreign exchange assets of banking sector that contributed to the large money growth. On the other side, the reserve money is growing (at 20.4 percent) faster than the broad money. Overall, the RBI credit to central government, which was negative for long, seems to have resulted in this high overall money supply growth. The partial liberalization of capital account might lead to outflow of forex reserves to some extent. Together with this, the hike in the Repo rate recently, would results in marginal fall in money supply growth.



Repo rate hiked and lending rates are expected to follow

Domestic interest rates to peak in the third quarter of 2006-07

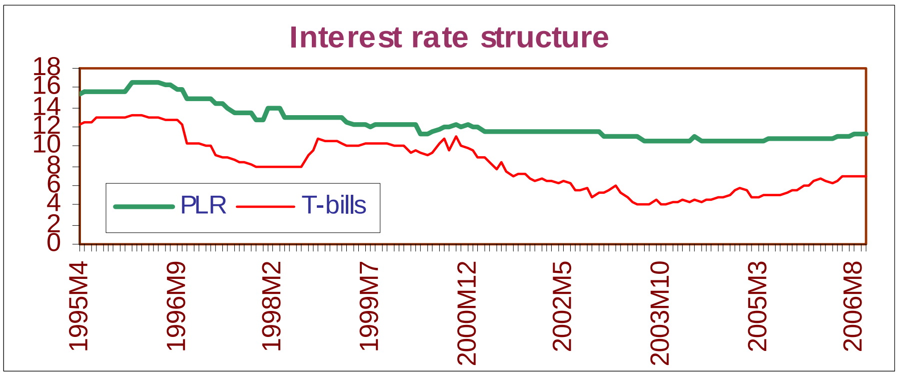
Exchange rate appreciates

Forecast:

We forecast the growth rate of money supply (M3) to be at 18.5 in the next three months.

Interest rates

The interest rates (lending rates) of five major commercial banks remain same at 11-11.5 percent. But recently, given the pressure of liquidity, some banks have hiked their deposit rates for different maturities. Recent hike in the Repo rate would eventually result in hike in the lending rates atleast in the smaller banks. Although the international oil prices are subdued, the inflationary pressures in the domestic economy continue to persist purely due to domestic factors. This in turn, is expected to push upward pressure on the domestic interest rates as well. In the past we said that the current upward movement in the interest rate cycle to peak in the third quarter of financial year 2006-07. We seem to have realized the same.



Forecast:

Based on the data up to October 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 appreciated sharply from 45.7 in October to 44.86 in the first week of November 2006. It may be noted that in our last issue we have predicted this appreciation in exchange rate. This is despite the widening trade deficit, which is at US$24.6 in April-September 2006. This appreciation of domestic currency is due to weakening of US dollar in the international markets and strong inflows of foreign exchange reserves through both short term and long-term investments. As RBI has partially liberalized the capital account, one needs to wait and see the extent of outflow of forex reserve. This trend would have significant impact on the exchange rate in the coming months. Overall, we predict a marginal appreciation of exchange rate in the coming months.

Forecast:

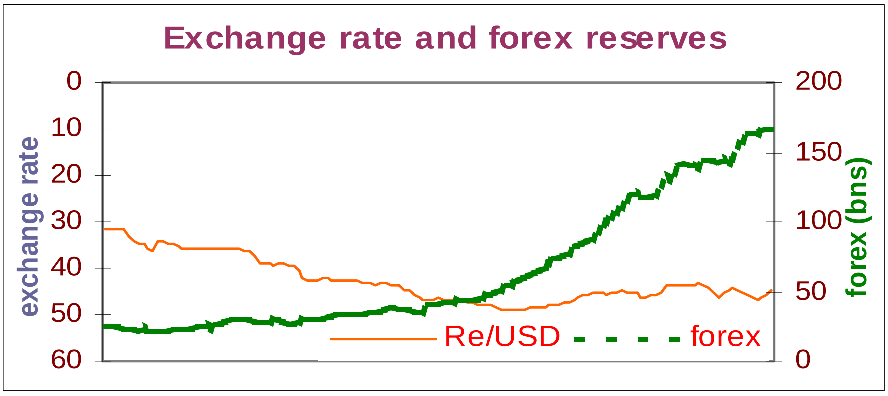
The Rupee/US Dollar exchange rate is expected appreciate to 44.5 in the coming months.

Foreign Exchange Reserves

Forex reserves declines marginally due to widening trade deficit

Foreign exchange reserves have declined marginally from US$166.5 billions in September 2006 to US$166.15 billions by 20th October 2006. This fall in reserves is despite the huge inflow of short-term foreign investments occurring in the stock market. One possible reason for this fall could be the widening trade deficit, which is at US$24 billions in the current fiscal year. The recent partial liberalization of capital account might result in further outflow of foreign currency. But the strong positive investment sentiments would result in net inflow of foreign currency through both short-term and long-term investments. Expected widening of interest rate differentials might also strengthen our forecasts.

Strong positive sentiments in the economy would lead to rise in forex reserves



Forecast:

Forex reserves to cross US$ 180 billions by the end of December 2006.

Foreign Institutional Investment

FIIs continue to be net sellers

In July, FII investment is US$ -595 millions

The foreign institutional investors continue to be net sellers. In the month of July 2006, based on the RBI data, the FII outflow was at US$ 595 millions. This could be due to profit-booking by the FIIs in the stock market. Given the buoyancy in the stock market and the robust growth in the domestic economy (as visible in GDP growth and also in the second quarter corporate results), this behaviour of FIIs could be a temporary one. Due to same reasons, we expect the FIIs to be net buyers in the coming months. Added to this, the imminent slowdown in the US economy might lead to some shift away of investable funds from US economy to emerging markets such as India.

Expected positive inflow of FII investments in the coming month

Forecast:

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

Exports and Imports

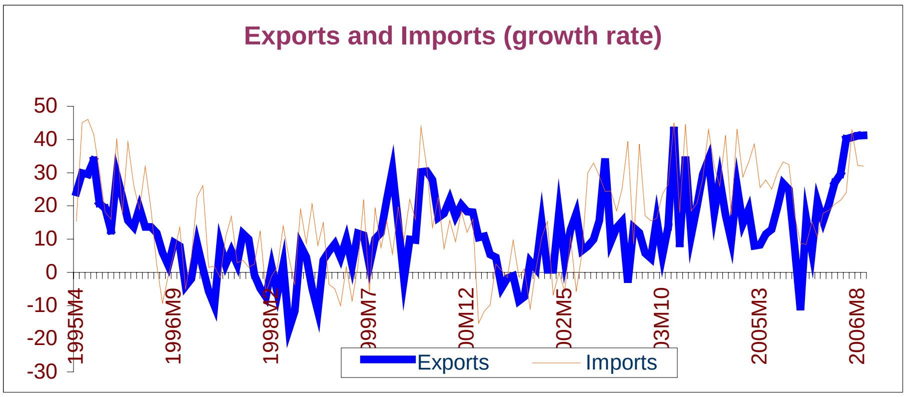
Buoyancy in trade sector growth continues

Trade sector continue to sustain its robust growth. Exports for the month of September 2006 is at 22 percent. With this for April-September 2006, the exports have grown at 21 percent. This huge growth despite its large base last year, is a very impressive one. Given the strong growth in both manufacturing and services sector, this growth in exports could be sustainable in the next quarter also.

Sustaining this trend in trade might be difficult

On the other hand, imports are also growing at a same pace. In September 2006, the imports growth is at 24.8 percent. The large growth in non-oil imports only proves the hypothesis of import-led export growth. Some studies have also shown that the import content in exports, particularly in the manufacturing sector, is increasing in the recent years. The future growth in both exports and imports largely depends on the sustenance of current growth momentum in the Indian economy. But the imminent slowdown in the developed economies, US in particular, would hamper the export growth to some extent.

Trade deficit widens to US$ 24.6 billion



Forecast:

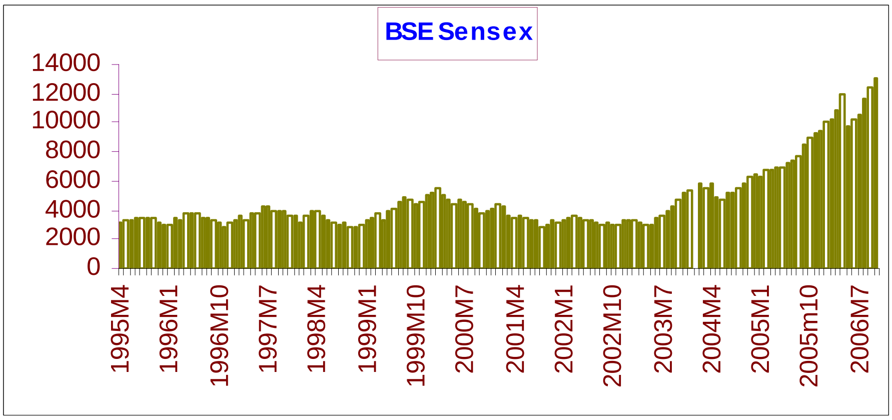
Based on the data up to September 2006, we forecast the average export growth to be 19.1 percent and the average import growth to be 21.9 percent for the next three months.

BSE Sensex

Sensex crosses 13000 mark

BSE sensex has touched to all time high of above 13100 in October 2006. The causes for this strong growth in share prices are quite obvious. The second quarter corporate results, which were higher than expected, and robust growth in the all sectors of domestic economy has resulted in this strong movement in the sensex. From the preliminary information, it appears that the foreign investors, who were net sellers until recently, have become net buyers. Recent hike in the Repo rate and partial liberalization of capital account, might tighten the liquidity situation in the short-run, and would affect both short-term money and stock market.

Second quarter corporate results and robust growth in all sectors must have led to this bull run



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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