MONTHLY MONITOR

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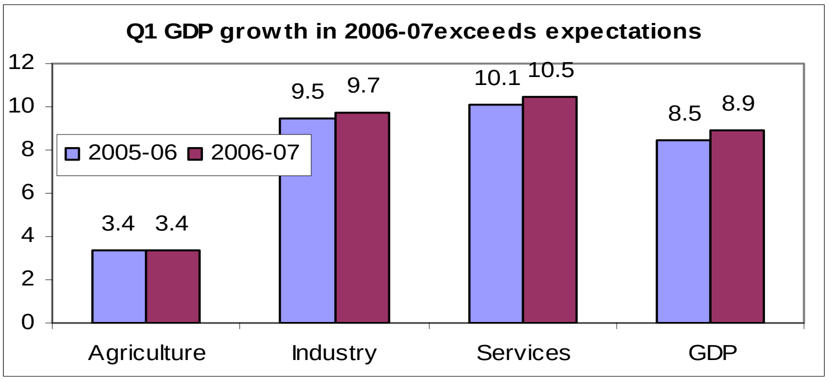
TOP STORIES

Indian Economy logs an impressive 8.9% growth in the first quarter of 2006-07

The growth momentum in the GDP sustains. In the first quarter of 2006-07, the Indian economy registered a growth of 8.9% compared to 8.5% in the same period in 2005-06. This growth is contributed by the rise in growth of both industrial and service sector output. Although agriculture growth remains same at 3.4%, it is still an impressive performance compared to its trend growth in the last few years. We expect the growth momentum to continue in the coming quarters. But for the whole of 2006-07, we forecast the GDP growth to be between 7.5 to 8%, which is slightly less than last year's growth.

GDP Growth to be around 7.5 to 8% for 2006-07



North Korea nuclear tests would not have any impact on the Indian economy

North Korea conducts nuclear weapons test. Although this has been on the cards for quite some time, it was only the timing of tests that surprised. The impact of these tests would be felt on the Asian financial markets only in the short-term. Although there could be some opposing voice on the Indo-US nuclear deal, we don't expect any significant long-term impact on Indian economy and also in most of the Asian economies.

Industrial Output rose to 12.4% in July, highest in the decade

Industrial sector continues to register high growth for the fourth consecutive month. In July 2006, it increased by 12.4%. Although there could be a low base impact (4.7% in July 2005), it is the continuation of the growth momentum, which has been witnessing for the past few months, has led to this robust performance. This high growth may not be sustainable due to expected fall in the exports growth in the coming months. The early indication of this has been seen in the decline of core sector growth recently.

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Credit to commercial sector declines

Interest rate expected to peak any time from now

Money supply continues to grow at 19.6%, which is much higher than the targeted growth. The rise in the bank credit to the government and increase in the foreign exchange assets with the banking sector must have led to this high growth. Surprisingly, there is a mild decline in the growth of credit to the commercial sector. On the other hand, although there is no change in the lending rates, there is a rise in the deposit rates of most of the commercial banks. In our view, given the recent trends in the international interest rates, the domestic interest rates are expected to peak any time from now.

Sustaining high growth in exports would be challenging

Buoyancy in the trade sector continues. For the month of August the exports registered a growth of 20.5% and for April-August 2006, the growth stood at 20.72%. On the back of high growth last year, this growth 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 11.7% in August. For the first five months of current financial year, the trade deficit has already reached to US$18 billions.

Falling world oil prices moderates inflationary expectations

The inflationary pressure in the economy has been moderated, though not eliminated, by the falling international oil prices. In the month of September 2006, the inflation rate stood at 4.7%. The huge rise in the money supply is expected to sustain the inflationary pressure in the medium term to some extent. In the short term, it is the festival demand and supply constraints in the primary articles that would lead to rise in the inflation levels.

Rupee/US dollar exchange rate appreciates

Expected to appreciate further

As predicted in our earlier issue, Rupee/US dollar exchange rate has appreciated to 45.58 in the first week of October 2006. Although rising trade deficit was supposed to lead to depreciation, the supply of foreign exchange reserves through short term investments has led to rise in dollar supplies and hence the appreciation. Weakening of US dollar in the international market must have also contributed to this appreciation. Due to same reasons we expect further appreciation in the coming months. Foreign exchange reserves have also increased to US$166.8 billions by the end of September 2006. With this, India has accumulated nearly US$15 billions since end-March 2006.

Infrastructure deficit in India: A comment

It has been widely agreed among the policy makers, researchers and politicians that to sustain the current momentum in the GDP growth in the coming years, in the 11th Plan period in particular, there is a need for huge investments in the infrastructure sector. Towards this end, recently the Prime Minister himself has led the discussion on the needs, challenges and opportunities in investing in infrastructure. He pitches for a huge sum of US$320 billions of investment in infrastructure in the 11th plan through a mix of public, public-private partnerships, and exclusive private participation in some sub-sectors. As this infrastructure deficit cannot be substituted by the fiscal deficit, these resources need to be generated by increasing domestic savings by 4-5% from its current level and through FDI. Given the existing situation, one may be pessimistic to mobilize such a huge resources within the five years time frame. To realize this investment targets, lot more needs to be done at the domestic level such as revamp and strengthening of existing financial markets, which does not have any instrument for long-term savings.

Although it is possible to finance through public equity, there is a discussion of developing a corporate debt market to finance long-term infrastructure needs. At this stage one needs to remember that debt markets are non-transparent, non-regulated markets, and are not tested well till now. The recent collapse of some of the hedge funds in the West is only discouraging. It is predicted that the next financial crisis could be triggered through the debt markets, where the risk gets accumulated through various stages. Further, to develop the debt market in India, we need to undertake reforms in pension and insurance sector that are pending for a long time.

Currently the discussion in India is limited to the physical infrastructure and not the social sector such as education. It is necessary to remember that the current growth story is majorly service-led and was possible due to the comparative advantage that India had in terms of skilled manpower,. Hence, it is necessary to give equal, if not more, focus on improving educational infrastructure, if we need to sustain the high growth path in the long term. There are some confusing signals emerging regarding the GDP growth target in the 11th plan. While Planning Commission pitching for 8.5% growth, as it appears the cost of infrastructure needs to the tune of US$ 320 billions have been made for 9-10% GDP growth prospects. It is necessary to have clear targets in order to have private sector participation in a big way. Off-the mark forecasts might lead to miscalculated returns on capital.

Comment on the “Draft National Policy on Subsidies”

The draft Cabinet note on the national policy on subsidies is part of the commitment that the UPA government has made in its NCMP. This note is based on the Finance Ministry’s document *Central Subsidies in India: A Report* that was brought out for public debate in December 2004. As the main focus of the policy was ‘containment and targeting’ of subsidies to the poor and truly needy, the draft seems to provide some measures towards this direction.

Off late, the explicit subsidies (which is 38% of total Government subsidies) have become a contentious issue between the proponents of fiscal management and welfare state. Although in the initial phase of economic reform, the subsidies (as a percentage of GDP) declined from 1.6% to 1% by the middle of 1990s, it continued to rise since then and currently is at 1.5%. At the disaggregate level, it is the food subsidy, which is growing (at 0.8% in 2005-06 compared to 0.4% of GDP in 1991-92) while other components such as fertilizer and fuel subsidies as percentage of GDP are declining.

It is widely known and many studies have also shown that the subsidies in India are poorly targeted and have lot of leakages. This has also resulted in relative price distortions in the economy. The above report itself estimates that the farmers' share of fertilizer subsidy is just 49% of the total while the rest is for industry!! Also it is uncomplicated to understand that the subsidy on LPG largely benefits the non-poor and is regressive. On the other hand, rising costs in terms of growing World oil prices and other input cost is putting pressure on the Government finances through increase in the subsidy bill. In addition to this the Government's need to comply with the FRBM Act has resulted in for re-look at the current subsidy policy. Towards this direction the measures put forward in the Draft is welcoming and makes good economics.

Needles to say that both economics and politics in India move in opposite directions, and one may be highly pessimistic whether this Draft could successfully go through political institutions. One of the policy statements in the Draft is that of doing away with the subsidy on LPG. We cannot forget that the Indian middle class, who is currently the strongest 'interest group', is the largest beneficiary of this subsidy. After all the subsidies in India, particularly in 1980s, increased due to expansion in the 'interest groups'. For the other policy suggestions in the Draft such as introduction of smart cards, strong institutions are necessary. But they are not sufficient. The CACP is a good case where the Minimum Support Price (MSP) in the recent period is fixed above the CACP suggested price. Ultimately it is the 'interest groups' that influence the subsidy policy.

IEG-DPC Forecast

Variables	Latest Information available	Forecast for next Three months
Inflation rate (WPI)	4.6% on September 9, 2006.	Expected to be around 5%.
Inflation rate (CPI)	6.9 % for August 2006	Expected to decline marginally.
Growth rate of IIP	12.4 % in July 2006	9% (average)
Growth rate of M3	19.6% on September 15, 2006.	Current high growth is expected to steady soon
Prime lending rate	11 – 11.50 % in September 2006.	Lending rates to rise marginally
Re/$ exchange rate	45.75 in October 3, 2006.	Expected to appreciate
Forex reserves	US $ 166.5 billions on September 22, 2006.	To reach US$ 180 billions by December 2006.
FII inflows	US $ -1157 million in June 2006	Positive inflows
Growth rate of exports	20.53 % in August 2006	18.1 % (average)
Growth rate of imports	11.67 % in August 2006	10.6 % (average)

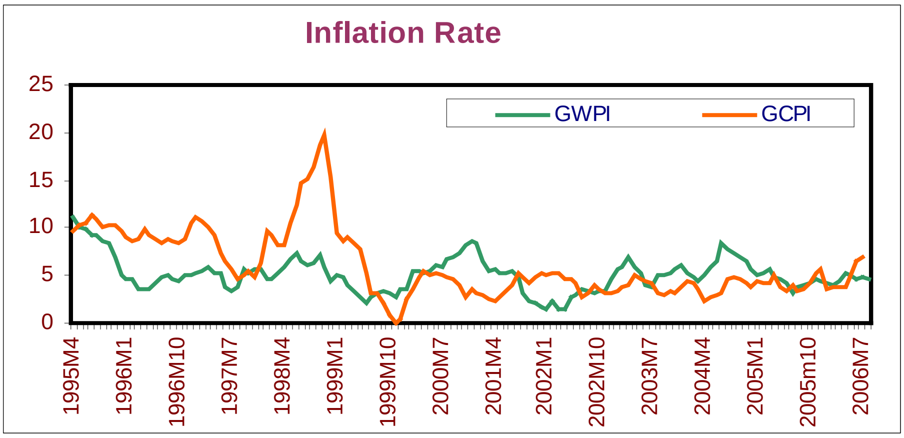
Inflation

Inflation declines marginally.

Inflation rate based on WPI has declined marginally to 4.6 percent in early September 2006. But still the prices of primary articles and cement continue to rise at 7.5 and 17.9 percent respectively. Although fuel group prices are growing at 4 percent, the spin-off effects of recent fuel price hikes must have started showing on the prices of primary articles. High money supply growth also must have led to rise in prices from the demand side. On the other hand, the retail prices are growing much faster than the wholesale prices. The inflation rate based on CPI (industrial workers) is 6.9 percent in August 2006, reflecting the continuing divergence in the coverage for estimating wholesale and retail market prices in India.

Inflationary expectations still persist for the medium term.

The high inflationary expectations, although moderated due to falling international oil prices, it is not eliminated. The huge growth in money supply still poses problem for inflation in the coming months from the demand side. Festival demand would also add to price rise to some extent. The future inflation depends significantly on the monetary policy stance in controlling the huge money supply growth in the coming months and also on the agricultural sector performance in the kharif period.



Forecast:

The WPI inflation forecast for the next three months to be 4.8%, 5%, and 5% and the CPI inflation rate to hover around 6%.

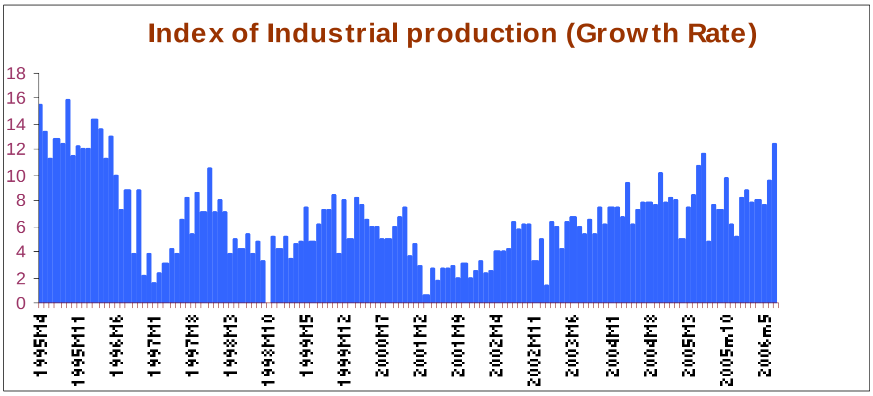
Industrial Production

IIP growth in July 2006 is highest in the decade.

The robust growth in industrial sector continues. In July 2006, it registered a growth of 12.4 percent compared to 4.7 percent in the same period last year. Although low base could be one reason, the sustained high growth in the manufacturing sector (which is growing at 13.3 percent) has helped in the overall industrial performance. Mining and electricity sectors, which grew negatively last year, have registered a growth of 6 and 8.6 percent respectively. Among the use-based classification, the impressive growth is visible across the sub-sectors. Consumer and capital goods are growing at 17.9 and 15.4 percent respectively.

High growth experienced in all the sectors

Our predications show that the current high growth in industrial output may not be sustainable in the coming months. This could be due to three factors: there are some signals showing the imminent slowdown in the external demand due to expected slowdown in the developed economies due to inflationary pressures; rising production costs due to hike in both oil prices and interest rates; and due to some cyclical factors.



Forecast:

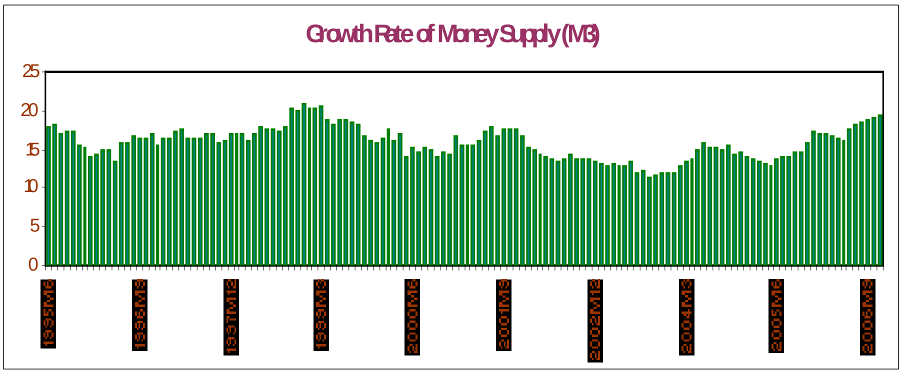
Based on the available information we forecast the IIP growth rate for the next three months to be 9.5,9.2 and 9.3 percent respectively.

Money and Credit

Broad money continues to grow above targeted level

Bank credit to commercial sector declines

High growth in money supply continues. The broad money supply (M3) registered a growth of 19.6 percent as on 15th September 2006. This is despite sharp rise in the net non-monetary liabilities of the RBI, which is growing at 63.9 percent. On the components side, it is the jump in time deposits and currency with the public that led to high money supply growth. Among the sources side, it is the rise in bank credit to both commercial sector and government that resulted in large money supply. It may be noted that, against the general perception, there is a decline in the bank credit to commercial sector from 28.8 percent last year to present figure of 27.6 percent. The forex assets of banks are also shown a high growth of 22.5 percent compared to 15.6 percent. 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 future growth depends largely on the stance of monetary policy.



Forecast:

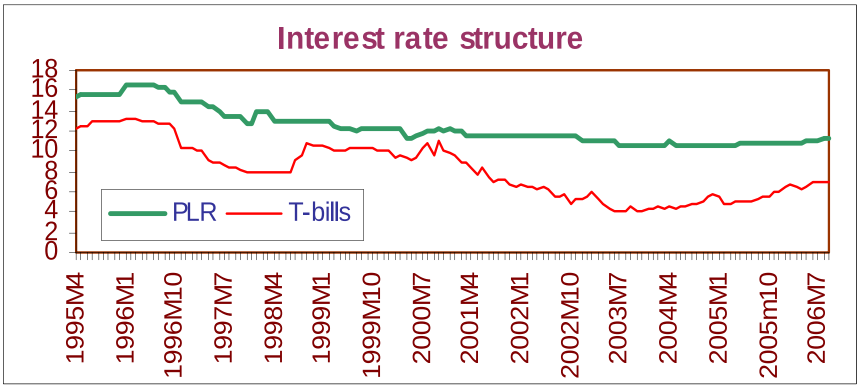
We forecast the growth rate of money supply (M3) to decline marginally in the next three months.

Interest rates

Deposit rates are rising

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

At present, the lending rates remain same at 11-11.5 percent, while there is an increase in the deposit rates across the banks for different maturity periods. There is a pressure for liquidity, and hence on the interest rates to go up, due to rise in the credit demand. The banks could meet this demand by reducing the SLR holdings, without tinkering the interest rates. As there is a limit to reduce the SLR holdings, the banks could raise the interest rates to control the credit demand. Although the international interest rates are not rising further, there is still a pressure on domestic interest rates to go up due to liquidity constraints. We expect that the RBI could hike the interest rates for one last time in the forthcoming quarterly review. 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 still hold this view.



Forecast:

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

Exchange rate appreciates

Expected to appreciate further

Exchange rate

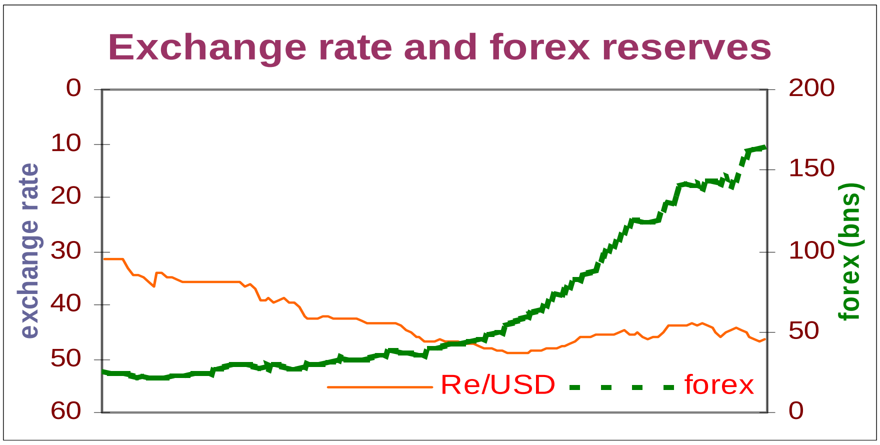
As predicted in our earlier issues, the Rupee/US dollar exchange rate continued to appreciate and reached 45.73 by the first week of October 2006. Although trade deficit was expected to result in depreciation, weakening of US dollar in the international markets and positive flow of foreign exchange reserves through both short term and long term investments has led to strengthening of Rupee. We expect the further appreciation in the coming months due to expected widening interest rate differentials as US Fed holds the interest rates while there is a case for hike in domestic interest rates.

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

Forex reserves rise despite widening trade deficit

Foreign Exchange Reserves

Since end-March 2006, the foreign exchange reserves have increased by nearly US $15 billions, mostly due to rise in long term investments. Currently the reserves are at US$166.5 billions. This is despite the huge trade deficit incurred (nearly US$18 billions in April-August 2006) and also with the presence of high volatility in the international financial markets that kept short-term foreign investors away from the domestic market. As we expect the interest differentials to widen and expect further rise in both long term and short-term foreign investments, the foreign exchange reserves are expected to increase further. This is despite expected rise in the trade deficit in the coming months.



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

Foreign Institutional Investment

FIIs are net sellers in June 2006

Recent data on FII inflow shows that FIIs are net sellers to the tune of US$ 1157 millions in June 2006. The decline in the BSE sensex and widening interest rate differentials at that time could have resulted in the FII outflow. Now that the BSE sensex has bounced back and foreign interest rates not longer increasing and the domestic growth momentum is quite intact, we expect positive inflow of FII investments in the coming months. In addition to these factors, as there is already the signs of slowdown in the US economy, the investable funds might shift away from the US to some of the Asian economies such as India.

Expected to have inflow of FII investments in the coming month

Forecast:

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

Exports and Imports

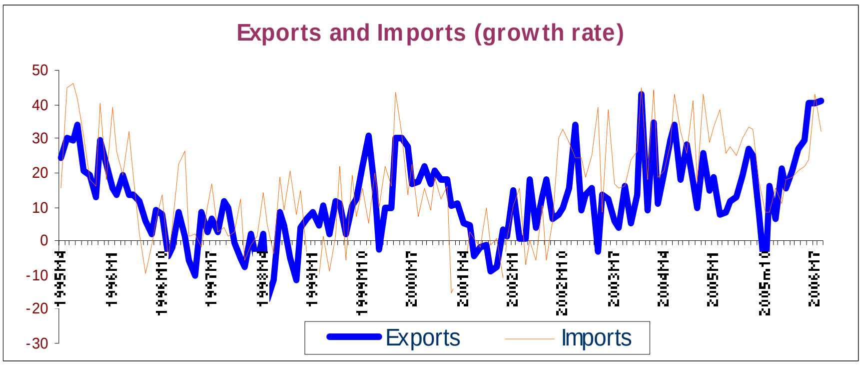
Exports growth continues to be robust

Buoyancy in the trade sector continues. In August 2006, exports have registered a whopping growth of 20.53 percent. With this for April-August 2006, the exports have growth at 20.72 percent, which is an impressive one as it has large base last year. On the other hand, imports also continue to grow at 11.67 percent in August and 17.7 percent for the period of April-August 2006. Due to this trend, the trade deficit has widened to US$18 billions during this period.

Sustaining this trend in trade might be difficult

Trade deficit widens to US$ 18 billion

As there is a sign of slowdown in the US and other developed economies, sustaining this trend in exports might be difficult. Added to this, the appreciation of exchange rate, although it does not have large impact, might also adversely affect the exports to some extent. Falling international oil prices might bring down the oil import bill. But the overall imports in the future depend on the sustenance of current growth momentum in the Indian economy. Further, the uncertainty in the trade negotiations might marginally drag the current pace of export growth.



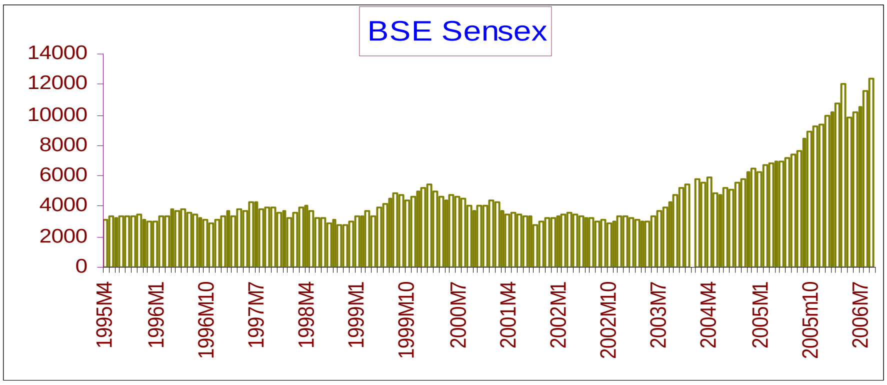
Forecast:

Based on the data up to August 2006, we forecast the average export growth to be 18 percent and the average import growth to be 10.6 percent for the next three months.

BSE Sensex

Good corporate results and Positive sentiments in the economy lead the bull run.

After declining for some weeks, the BSE sensex bounced back and reached to 12365 by the first week of October 2006. More than expected first quarter corporate results and the increase in the foreign institutional investments led to this rebound in the sensex. As we expect the growth momentum to continue in the Indian economy, stock markets are also expected to experience bull run. But the rise in return on other financial assets such as term deposits, might lead to portfolio shifts from stocks to bonds. This would contain the bull run to some extent.



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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