Forecast

Introduction

The momentum of real GDP growth accelerated to 8-9 percent band in the last four years making the objective of similar growth over the next five years a feasible proposition. What has been a cause of concern over the last one year is the rising rate of inflation despite the success on the growth front. The year- on-year (YOY) rise in Consumer Price Index for Industrial Workers measured at close to or above six percent since May 2006 on a monthly basis. Although the pace of price rise has been slower in the case of All Commodities WPI, the increase in WPI for primary articles has now touched double digit level in February 2007. While some of this inflation has the 'base effect' of lower level of Indices before the price rise began in May 2006, and likely to ease after May, this phase of inflation experience has pointed to the bottlenecks to accelerating growth.

At the global level, predictions by international agencies point out that although the overall growth momentum in 2007 and 2008 is expected to be slower than the experience in the year that has gone by, the pace of growth still remains high. The IMF World Economic Outlook, April 2007 projects world output to increase by 4.9 per cent over the previous year both in 2007 and 2008. While this is 0.5 percentage points lower than in 2006, it is the same rate of increase as seen in 2005. The current key drivers of global growth, the United States, China and India are projected to grow at a slower rate in 2007 and 2008 than in 2006. Trade volume growth is expected to be much slower in 2007 than in 2006, as imports of advanced economies are projected to grow at a slower pace. However, on price front, there is an expectation that commodity price rise will be smaller in 2007 as compared to the high rates of increase seen in the last two years.

The Union Budget 2007-08 highlights the success in fiscal consolidation in recent years. The tax to GDP ratio (Gross Central Taxes) for 2007-08 has been projected at close to 12 per cent even with a slower growth in tax revenues as compared to the rise in 2006-07. The revised estimates for 2006-07 placed the gross tax revenues of the Centre at 27 per cent over the previous year. For 2007-08, the budget estimate for gross tax revenue works out to 17 per cent indicating that should the current momentum of economic growth continue the revenue position could improve even further. The other half of the reason for keeping the fiscal deficit in check has been the slower pace of growth in government spending.

As the rise in the rate of inflation raises a number of concerns including the sustainability of high rate of economic growth, it is important to understand the causes of this price rise. The price rise began with the increased in international oil price shock and then the rise in food grain prices, wheat and pulses. These price shocks have come at a time when the economy has experienced acceleration in industrial output including construction, sharp rise in exports and a sharp rise in FDI. The abundant liquidity in the financial system has permitted the growth in demand and output despite the rising rate of inflation. The large capital flows and other forex inflows have made the task of controlling the rate of increase in money supply more difficult as output or supply response in the economy has not matched the rise in demand. In other words, the supply shocks played an important role in triggering the price rise but the experience also highlights the constraints that inhibit the supply. The constraints are well-known such as the slower growth in agriculture and infrastructure. Policies will have to address these concerns if high rate of economic growth is to be sustained over the medium-term.

Forecast for 2007-08

The forecast we have provided here is based on an econometric model for the Indian economy that requires specification of a number of exogenous parameters to arrive at the forecasts. We note below our assumptions on some of the main parameters.

Assumptions

The current momentum of growth, the Union Budget 2007-08, available assessment of the prospects for the global supply and demand conditions provide one set of exogenous parameters for arriving at a forecast of the macroeconomic aggregates for the current year. The other set of parameters relate to the likely pattern of monsoon and the monetary policy measures.

The current momentum of economic growth shows that the economy is currently reaping the benefits of positive global demand, reforms that have allowed greater space for entrepreneurial activity, a large, young work force and more efficient telecommunication system besides a more liberalised financial system. There is a positive investment climate.

- The global economic growth is expected to be slower in 2007 indicating that export growth based primarily on general rise in demand is likely to be more subdued. Acceleration in growth can come from improved competitiveness rather than overall increase in demand. There is an expectation of slower rise in the commodity prices in the international markets and would soften the domestic inflationary pressures. Taking into account the projections by IMF global outlook we have assumed that the world GDP growth, in real terms would be 0.5 percentage points lower in 2007-08 and international oil prices would be lower by 5 per cent as compared to 2006-07. The domestic energy prices are assumed to rise by 5 percent.
- The Union Budget has led to some decreases in tariff rates as well as excise rates. However, there has been additional educational cess of 1 per cent on all taxes for funding secondary and higher education. We have assumed that there is no change in the rate of average direct and indirect taxes would be lower by one percentage point.
- The budget has proposed an increase in total spending by 10 per cent over the previous year, after we adjust for the notional expenditure of Rs 40,000 crore associated with the transfer of SBI shares from RBI to the government. There is an increase in plan outlay by 31 per cent over the revised estimates for 2006-07. While this is an indicator for the public investment expenditure some of this expenditure does not translate into fixed capital formation. Taking into account the higher levels of plan outlay, we have assumed that public sector investment

in nominal terms would increase by 20 percent in the current year.

- A key factor that affects investment spending is the interest rate. The policy rates have increased during the course of 2005-06. The increase in the average interest rate for the year as a whole in the 91-day treasury bill rate or 364- day treasury bill rate is one percentage point. We have assumed that for the current year the average interest rate would be one percentage point higher.
- On the balance of payments, we have assumed that the net capital inflows will be the same in 2007-08 as in the previous year and the net invisibles would increase by 20 per cent over the previous year. The IMF has projected that net private capital flows to Developing Asia would actually be lower in 2007. We have assumed that the average nominal exchange rate will depreciate by one per cent. While this may contradict the current upward pressures on the exchange rate, much will depend on what policies are likely with respect to exchange rate.
- We assume that the monsoon for 2007-08 would be normal.

Findings

The results of our analysis are summarised in Table F1. The results point to a deceleration in the economic growth momentum than what has been the experience in the recent two years. The acceleration in growth in 2005-06 was on account of the rise in the growth of agricultural output and in 2006-07, industrial sector sustained the growth momentum.

The monsoon in 2006-07 was unsatisfactory because of its poor distribution across the monsoon period. It is difficult to capture the impact if the distribution were better during this year as compared to last year. Therefore, in our estimate of agricultural output, we are not capturing the impact of a substantially better rainfall.

The slower growth in industry and services is a result of slower external demand, slow down in the pace of capital inflows and higher average interest rate. The slower export growth is a reflection of lower growth of external demand and also easier international prices. On the strength of growth of net invisibles, we are projecting a current account surplus.

The inflation rate, based on a WPI related measure, is projected to be at the same level as in 2006-07.

The overall scenario that emerges for 2007-08 is that of slower output growth, but still in the same band of 8-9 percent. The slower growth in external demand suggests that it is important for the domestic economic conditions to be stable and favourable.

Table F.1: Forecast of Macroeconomic Indicators for 2007-08

Variables	2005-06	2006-07AE	2007-08 Forecast
Real GDP	9.0	9.2	8.3
- Agriculture	6.0	2.7	2.6
- Industry	8.7	10.0	8.7
- Services	10.0	11.2	9.9
Exports ($-term)	24.7	17.0	15.7
Imports ($-term)	31.5	25.0	18.5
Inflation (WPI)	4.4	5.3	5.3
As Percentage of GDPMP			
Fiscal Deficit	4.1	3.7	3.2
Current Account Balance	-1.3	-1.7	1.3

Note: In the case of Exports and Imports, and WPI the projections for 2006-07 are based on monthly averages for the first 12 months of the year. In the case of current account balance, projections for 2006-07 are based on merchandise trade data as projected above and our projections of net invisibles receipts.