Forecast

The climate for economic growth

The recent volatility in global financial markets has also affected Indian capital markets as India is now open to global capital flows. In fact, the present high level of foreign exchange reserves of $ 222 billion (as on July 20), reflects the attraction held out by Indian markets to foreign capital. Net foreign capital inflows in 2006-07, counting only FDI, FII and commercial borrowings, amounted to $31 billion. Though not all capital inflow constitutes investment in terms of plant and machinery or construction, it is likely to impact directly or indirectly on industrial activity. In the current year, foreign capital inflows have maintained their momentum and industrial production activity could see sustained growth during the current year.

The high rate of global economic growth has provided an ideal environment for accelerated growth in the Indian economy over the past three years. The average rate of growth in Real GDP was 8.6 per cent during the past three years, climbing to 9.4 per cent in 2006-07. This is a goal articulated by the Eleventh Five-Year Plan's Approach Paper for the next five years. The usual constraints to sustained high rates of growth do not appear to be insurmountable from the recent experience. While the relatively high rate of growth in the global economy indicates remarkable complementarity across economies, it is also a sign of India's ability to participate in this mutually reinforcing process. There is also evidence of a more responsive supply infrastructure than ever before. While inflationary pressures did emerge, growth has not suffered significantly.

Global economic growth was expected to be satisfactory in 2007, albeit at a slower pace than last year. In fact, the overall trade volume and capital flows to emerging markets were expected to be at a slower pace in the current year than in 2006. There were expectations that the US economy would experience slower growth and yet the overall global demand conditions would remain positive because of the strong demand from emerging economies. Global inflation rates have remained high, exacerbated by crude oil prices returning to rule at levels above $70 per barrel after a gap of 10 months.

The prospect of a good monsoon in the current season has raised hopes of improved supplies of agricultural commodities and relief in the prices of primary articles. Though the conditions affecting prices of manufactured products have not changed significantly, inflation is expected to be lower in the case of primary articles. In the case of fuel prices, however, the prospects are not as benign as they appeared at the beginning of the year. International crude prices, as noted earlier, are at a high level. And the system of administered prices for petroleum fuels leads to delayed passing on of higher prices to domestic consumers. Thus, the fuel price increase that may be necessary to offset higher international crude prices would have the effect of increasing overall price levels during the year.

The latest review of the monetary policy has left the interest rates unchanged but increased the Cash Reserve Ratio (CRR) by 0.5 percentage of the total deposit liabilities of the commercial banks. As a result, commercial lending rates may not increase in the short term, but they would not decline either. The excess liquidity in the financial system is a source of inflationary pressure and attempts to withdraw it through higher CRR may help reduce these pressures. The excess liquidity in the context of slower growth in commercial credit is indicative of the reduced pace of growth in economic activity. However, this may still be a reflection of seasonal easing of the growth momentum, as the first quarter of the economy is usually one of slower output growth.

The Rupee has strengthened relative to the Dollar by about 8 per cent between February 2006 and May 2007 (average for the months). Capital inflows have enforced the Rupee, though RBI interventions have kept it from rising further. While a stronger Rupee has the ability to increase imports leading to a large trade deficit, the volume of capital inflows have offset this external current account imbalance. At $222 billion, the foreign currency reserves are now about a quarter of GDP. The pressure that these reserves put on the monetary policy are significant and the response is likely to ease the restrictions on outflow as well, so that investments abroad by Indian companies and entrepreneurs could also maintain the balance on the capital account. As capital inflows could continue at this high pace, the liberalisation of the capital account would be needed to maintain the pace of the integration of domestic with the global market.

The growth expectations

Within the above overall setting, the expectation of many observers has been that GDP growth would be 8 to 9 per cent in the current year, with the annual inflation rate of about 5 per cent. The growth expectations are based on the rapid expansion of the manufacturing sector in the past year.

The manufacturing sector registered an estimated 12 per cent growth in Real GDP in 2006-07, up from 9.1 per cent in the previous year. The push to overall GDP growth by 0.4 percentage points has come mainly from the industrial sector. The agricultural sector's GDP growth actually declined. For services, the growth was by 1.2 percentage points, similar to the increase in industrial GDP (Table F.1). Thus, performance of the manufacturing sector was critical for sustaining the growth of overall Real GDP in 2006-07 above the 9 per cent mark achieved in the previous year.

Table F.1: Growth acceleration is maintained: Real GDP growth, (Y-O-Y (%)

Sector	2005-06	2006-07 RE
Agriculture and allied sectors	**6.0**	**2.7**
Industry	**9.70**	**10.94**
- Manufacturing	9.1	12.3
- Mining	3.6	5.1
- Electricity, gas and water supply	5.3	7.4
- Construction	14.2	10.7
Services	**9.84**	**11.07**
Total	**9.0**	**9.4**

The growth of exports, rise in investment and higher consumer spending provided the necessary impetus to industrial growth. Capital inflows have sustained investment spending as they have helped in the expansion of industrial capacity. The GDP of the construction sector increased by 10.4 per cent in 2006-07 over the previous year, a considerably lower pace than the

14.2 per cent growth seen in the previous year. Thus, acceleration in manufacturing growth was a key to sustaining the high growth rate of the economy.

Can the past two years' heightened GDP growth rate be sustained in the current year? More specifically, can the growth performance of the manufacturing sector continue for another year? The main drivers of manufacturing growth in the past year have been investment demand and export demand. In the case of the former, inflationary pressures and consequent monetary tightening have led to higher costs of financing investment. The higher interest rates may have a dampening effect on investment spending, although it would only mean that there would be some moderation in the pace of growth. The underlying factors influencing investment growth remain intact. Urbanisation, a young labour force, financial sector reforms in terms of expansion of financial services to larger sectors of the economy and fiscal reforms in terms lower tax rates, have all meant that the demand for consumer goods and services would continue to rise, providing the necessary impetus to new investment. More importantly, investment demand in infrastructure industries could be expected to remain at a high level, given the inadequate supply of these services even at the current level of economic activity.

On the export front, the main dampener has been the strong Rupee. Just as higher interest rates have meant higher interest costs, a stronger Rupee has meant lower realisation on Dollar earnings. The profit margins of exporters who rely mainly on inputs sourced from domestic producers would be lower than before. If this leads to higher scale of operations to preserve overall earnings, the impact on exports would not be significant. However, in the short run, this response may not be forthcoming. Therefore, the current year is likely to see a slow down in the growth of manufactured goods exports.

The domestic demand for transport, trade and communication may be expected to retain last year's momentum.

It is in the construction sector that the momentum of growth slipped during 2006-07: from 14 per cent to about 10 per cent. High interest rates alone may not be the cause. Sluggish demand too would have contributed to this state of affairs. It is not clear from available data whether the current housing sector boom is spread across all segments of the market. To sustain high growth, this would be necessary. In this sense, the growth of the construction sector may be expected to retain its momentum at about 10 per cent, provided the housing sector growth is not broad based. The prevailing, higher interest rates would then add to the downward pressure on demand.

Business expectations

The Business Confidence Index (BCI) constructed by NCAER on the basis of quarterly surveys of the business sector shows a decline by 8.8 per cent in April-June 2007 over its level in the preceding quarter. Against a backdrop provided by strong growth in the manufacturing sector and expectations of a near-normal monsoon, the decline appears to be largely due to seasonal factors. The strengthening Rupee and high interest rates could also have been factors. All four components of the BCI registered a decline indicating that the concerns may not be only seasonal factors.

The drop in BCI was seen across the major manufacturing goods sectors as well as in the service sector. A summary of the BCI across sectors, regions, size and class of firms is provided in Table F2.

Table F.2: Business Expectations decline in April-June quarter: BCI components and BCI across sectors and regions

Components/ Region/ sector	% Change over previous quarter
Components of BCI	
Overall economic conditions over next six months	-10.25
Financial position of the firms over next six months	-11.75
Investment climate now	-17.47
Capacity utilisation now	-0.72
Regional Level BCI	
East	-11.67
West	-6.24
North	-12.69
South	-3.48
Sectoral Level BCI	
Consumer non-durbales	-2.77
Consumer durables	-4.06
Intermediates	-6.91
Capital goods	-15.56
Services	-12.15
All	-8.86

Political Confidence Index

While the business sector is not optimistic about business prospects in the next six months, it appears to be more satisfied by the government's performance on a number of criteria. The "Quarterly Business Expectations" survey was also used to track the assessment of the government's handling of a number of issues and the findings for April-June quarter are reported in Table F3. The overall Political Confidence Index has increased in April-June quarter (July 2007 survey) relative to its level in the previous quarter.

Table F.3: The Political Confidence Index and its components

Issue	April 2007 Survey	July 2007 Survey
% of Positive Ratings on		
Managing overall economic growth	51.2	52.2
Managing government finances	40.7	43.2
Managing inflation	21.4	27.4
Managing unemployment	20.0	25.3
Managing exchange rate	27.5	31.3
Managing conducive political climate	19.7	20.7
External trade negotiations (bilateral and multilateral)	42.0	35.8
Pushing economic reforms forward	41.0	36.7
Overall Assessment		
Political Confidence Index (PCI)	104.0	107.6

Note: PCI is calculated first by averaging the positive ratings on each of the components and then scaling the Index using the findings of the October 2004 survey as 100.

On core issues like managing the inflation and exchange rates, the respondents have expressed greater confidence in the government now than in the previous quarter. Thus, while the high interest rates and stronger Rupee seem to have dampened business optimism, it has not led to the further erosion of political confidence. However, it should be noted that the overall positive rating on these core issues is relatively low to begin with. This suggests that there is indeed a low level of approval for policies on these issues. The issue on which the largest proportion of respondents has expressed positive views on government performance is in managing overall economic growth.

A reassessment of macroeconomic prospects for 2007-08

A forecast for the economy was provided in April this year. It was based on the fiscal parameters available from the central government's budget proposals for 2007-08 and other information on national and international economic parameters. With another quarter's data is now available, we have re-examined the scenario for 2007-08 based on NCAER's macroeconometric model for the Indian economy.

The key assumptions are:

- Monsoon rainfall will be such that the average rainfall during the June-September period would be 5 per cent higher than in the monsoon period for 2006.
- Net foreign capital inflows in the form of foreign direct investment, portfolio investment and external commercial borrowings would be higher by $3 billion as compared to the levels achieved last year.
- The average interest rate (PLR) for the year would be higher by one percentage point as compared to 2006-07.
- The Rupee-$ nominal exchange rate would remain stable during the year.

Table F.4: The Macroeconomic Forecast for 2007-08

Variables	2005-06	2006-07RE	2007-08 Apr Forecast	2007-08 Aug Forecast
Real GDP				
- Agriculture	6	2.7	2.6	3.35
- Industry	8.7	10.0	8.7	9.00
- Services	10	11.2	9.9	10.09
- Total	9	9.2	8.3	8.53
Exports ($-terms)	24.7	21.0	15.7	17.13
Imports ($-terms)	31.5	21.6	18.5	19.18
Inflation (WPI)	4.4	5.4	5.3	5.11
As Percentage of GDPMP				
Fiscal Deficit	4.1	3.7	3.2	3.15
Current Account Balance	-1.3	-1.7	1.3	-1.80

Note: RE= Revised estimates by CSO.

- The average fuel price index (WPI for fuel, power, light and lubricants) will increase by five per cent over the average price level for the previous year.

- Net invisibles would rise by 20 per cent as compared to our previous assumption of a 30 per cent increase.

Based on these key assumptions, we obtain the growth rates for Real GDP from the major sectors of the economy, inflation rate, trade variables and the two aggregate deficits: current account and Central government's fiscal account. The estimates are provided in Table F2.

The revised forecast has increased the Real GDP growth estimate to 8.5 per cent as compared to the previous estimate of 8.3 per cent. The increase is on account of the projected improvements in the growth of all the three sectors of the economy, but more particularly in the cases of agriculture and industry. For agriculture, the improved rainfall scenario provides the impetus for acceleration in output growth. In the case of industry, it is essentially the higher foreign capital inflows that ease some of the constraints posed by higher interest rates and stronger Rupee.

The inflation rate is projected at a slightly lower rate than our April estimates. A lower rise in agricultural prices has meant a slightly lower inflation rate. The Centre's fiscal deficit is projected to decline relative to GDP as GDP growth has also increased by 0.2 percentage points.

In the case of current account balance, there is a significant change in our revised estimate as compared to the April projections. We are now projecting a current account deficit of 1.8 per cent of GDP as compared to our estimate of a surplus in the April forecast. Although export growth is now expected to be stronger, imports are also projected to rise at a faster rate of 19.2 per cent in comparison to the projected growth rate of 18.5 per cent in April. The main reason for the significant change in the external account is the slower projected growth in net invisibles.

The revised projections point to a sustained growth momentum in the current year. Global demand conditions have not changed significantly. On the domestic front, agriculture is expected to do better than last year. An important impetus to growth in the current year would be foreign capital inflows.