

Forecast

Real GDP growth during the second quarter of 2005-06 has been estimated by CSO as 8.0 per cent (Table F.1), up from 6.7 per cent during second quarter of 2004-05 and marginally lower than 8.1 per cent in the first quarter of FY 2005-06.

Manufacturing, 'trade, hotels and restaurants, and transport storage and communication' and 'finance, insurance and real estate' pulled up first quarter growth, whereas agriculture and 'mining and quarrying' pushed it down.

The manufacturing sector after growing at 11.3 per cent in the first quarter grew at 9.2 per cent in the second quarter. This was mainly due to the base effect as manufacturing sector had grown at 9.6 per cent in the second quarter of 2004-05.

Similarly, 'trade, hotels and restaurants, and transport, storage and communications' grew by 12.0 per cent in the second quarter. This growth was over the 12.3 per cent growth in the second quarter of last year. This sector has been growing at more than 10 per cent since the second quarter of 2003-04.

During the first half of 2005-06 GDP grew by 8.1 per cent, the highest half yearly growth — barring the second half of 2003-04 — since 1997-98 (quarterly GDP data is available only from 1996-97). This performance is good news because the second half growth in 2003-04 was due to the subdued growth performance in 2002-03 which was a drought year and the second-half GDP in 2002-03 grew only by 2.8 per cent).

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Table F.1: Quarterly GDP Growth (per cent)

Year and Quarter	Agriculture	Industry	Services	Total
2002-03: Q1	-1.2	5.5	8.1	5.1
2002-03: Q2	-4.7	7.5	8.5	5.6
2002-03: Q3	-12.1	7.1	7.5	1.8
2002-03: Q4	-8.2	7.0	7.6	3.8
2003-04: Q1	0.1	5.8	7.8	5.5
2003-04: Q2	7.2	6.4	10.7	8.8
2003-04: Q3	18.2	6.4	9.8	11.0
2003-04: Q4	10.4	7.7	8.0	8.4
2004-05: Q1	3.8	7.1	9.5	7.6
2004-05: Q2	0.0	8.2	8.1	6.7
2004-05: Q3	-0.5	8.8	8.9	6.4
2004-05: Q4	1.8	6.7	9.3	7.0
2005-06: Q1	2.0	9.7	9.8	8.1
2005-06: Q2	2.0	7.5	10.1	8.0

In the last nine quarters, both aggregate and industry GDP growth have been in excess of 6.4 per cent. The services sector has been posting a growth in excess of 6.2 per cent for the last 18 quarters.

Agriculture, with its heavy reliance on rainfall is dragging down the overall growth of GDP.

The Current Scene

This year after initial sluggishness, monsoon rainfall (June-September) was only 2.4 per cent below normal. The water level in major reservoirs is satisfactory and the prevailing low temperature in the northern India augurs well for the Rabi wheat crop. But it may have an adverse effect on vegetables.

The reverse repo and repo rate has been increased again by the RBI by 25 basis points. But the bank rate and the prime lending rates have remained flat at 6 and 10.5 per cent respectively. Treasury bill rates for 91 days and 364 days increased from 5.187 per cent and 5.623 per cent respectively in April 2005 to 5.860 per cent and 6.089 per cent, respectively, in December 2005.

Crude oil prices have increased to \$64 per barrel. According to the International Energy Agency (IEA), global oil demand is expected to grow at 2.2 per cent in 2006 and 85.18 million barrels per day. At present world oil supply is around 85.0 mb/d.

But the future direction of prices remains unpredictable and may well depend on speculators in New York.

The rupee has once been depreciating vis-à-vis the dollar. Between April and December 2005 it had depreciated by 4.2 per cent. However, since the beginning of January it has started appreciating again. It is now in the Rs 44 range after having gone down to Rs 46 in December. There was a decline in exports in November, the first time since March 2002. But in December exports growth bounced back and cumula-

tive exports growth for April-December 2005 stands at 18 per cent.

The six-country nominal and real effective exchange rates (NEER and REER, 2003-04=100) have been depreciating since July 2005. The REER appreciated a bit in November but NEER continues to depreciate.

The current account deficit (CAD) in first half of 2005-06 shot up to \$ 12.956 billion from \$ 0.485 billion in first half of 2004-05. The major reason for the increase in the CAD is the unprecedented rise in crude oil prices, and increase in imports of intermediate and capital goods. Crude oil prices are expected to remain high for another year or so, until global refining capacity increases. The increase in intermediate and capital goods imports is because of the growth in manufacturing.

Is this level sustainable? India can sustain such high level of CAD as long as foreign exchange inflows from portfolio investment, exports and remittances continue to grow. But there is now an increased vulnerability to external and internal shocks.

The fiscal position is not very good. Fiscal deficit growth in the first eight months has overshoot the yearly growth target but the growth in the revenue deficit has been lower. With committed expenditure on rural employment guarantee programme and Bharat Nirman, central government finances will remain stretched.

Leading Indicators

In the absence of monthly data on GDP, which reflect the state of the economy, the Index of Industrial Production-Manufacturing (IIP-M) is taken as a coincident indicator for the economy. It has been observed that the turning points of the cyclical component of the IIPM, obtained by removing the trend, seasonal and the random components from the series coincide with almost all the turning

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points of the GDP. Although it does not capture all levels of economic activities, it does act as an effective proxy in the absence of a more comprehensive measure available on a monthly basis. A time series of economic variables which measures different aspects of the present economic activity and tends to reach its turning point before the corresponding turning point in the coincident indicator, is called a 'leading indicator.'

The cyclical components of most of the monetary variables have been experiencing an upward trend since January 2005. Currency with Public being an exception, the movements in the cyclical component have been lacking consistency. In the latest month data, Bank Credit to Commercial Sector has also shown a fall but the fall is insignificant. The confidence in the ongoing economic activities in the economy is restored with the upward movement of cyclical component of the monetary variables (Table F.2).

Non-POL imports (dollar terms), another important leading indicators has shown an upward trend in the last two months after falling continuously for five months shows continuous improvement in domestic industrial activities.

The upward movement in the cyclical component of BSE-Sensex, which started in April 2005 has been maintained for the entire period till December 2005. The highest growth of 91 percent was registered in April 2004 and a growth of 42 percent was registered in December 2005.

The cyclical component of 'Production of Commercial Vehicles' is also experiencing an upward trend since April 2005 but has posted a marginal drop in the month of October 2005.

Business and Political Confidence

The Business Confidence Index (BCI) for October-December 2005

gained 3.7 per cent over the previous round, and increased to 151.4, which is the highest since November 1994. Despite high oil prices, shrinking profit margins, the increase in BCI reflects general optimism. After a gap of three rounds, all four components of the BCI have shown an improvement. The rating for macro indicators — overall economic conditions and the investment climate — increased by 3.1 and 5.6 percentage points respectively. The rating for firm level indicators — the financial position of the firm and capacity utilisation — also increased by 1.2 and 0.9 percentage points respectively.

Barring consumer non-durables, the rest of the sector exhibits strong positive sentiments. The services sector witnessed the maximum gain followed by the intermediate goods sector.

Firms' belonging to the less than Rs 1 crore category show the highest gain, of 16.6 percentage points in business confidence. Public sector firms and public limited firms are dragging down the growth of BCI in this round, whereas partnership/individually owned firms pulled it up.

In comparison to previous rounds, at the aggregate level, 0.7 per cent more firms expect their sales to increase in the next six months. 1.5 per cent more firms believe that their production will go up in the next six months. After two rounds of subdued expectations on exports growth, the picture has improved marginally. Nearly one per cent fewer firms expect exports to decline in the next six months. Overall, 0.4 per cent more firms expect an increase in their exports in the next six months.

On the profitability front, 63 per cent of the firms believe that their pre-tax profit (PBT) in the next six months will increase, compared to 59.6 per cent firms in the previous round. The percentage of

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**Table F.2: Growth in the Cyclical Component of Selected Time Series
(Percentage Change over the Previous Year)**

Months	Bank Credit (Rs Crore)	Bank Credit to Commercial Sector (Rs Crore)	Credit Deposit Ratio	Currency with the Public (Rs Crore)	Non Food Credit (Rs Crore)	Non-POL Imports in Dollar terms	Production of Commercial Vehicles ('000)	Production of Cement ('000 Tonnes)	BSE Sensex (Index)
April 2004	-0.8	-3.0	-0.9	2.5	2.2	14.9	52.9	-0.5	79.5
May 2004	0.4	-2.3	0.8	2.0	3.3	16.4	54.9	-3.2	60.5
June 2004	1.2	-1.1	1.8	1.6	3.9	25.6	38.3	-5.5	43.7
July 2004	2.8	0.7	3.5	1.4	5.3	26.0	22.8	-4.7	34.6
August 2004	4.2	1.9	5.3	1.6	6.3	27.7	14.7	0.0	32.1
September 2004	6.5	3.8	7.6	0.9	8.4	22.8	14.5	1.6	24.9
October 2004	8.5	5.6	10.1	1.3	10.2	31.6	13.5	4.7	25.5
November 2004	10.8	7.2	11.7	0.9	12.4	33.9	20.2	4.1	21.1
December 2004	11.1	7.9	12.3	1.2	12.6	53.4	17.7	2.9	20.8
January 2005	10.7	7.9	11.9	0.1	12.2	42.7	17.9	-0.3	19.3
February 2005	10.1	7.9	12.7	-0.2	11.7	37.8	16.8	-0.9	20.4
March 2005	10.0	7.8	12.7	-0.3	11.9	32.5	8.6	-0.7	18.3
April 2005	10.7	8.5	13.3	0.3	12.8	36.8	6.7	3.7	25.3
May 2005	11.1	8.9	13.1	0.6	13.4	34.8	2.8	6.8	36.9
June 2005	12.2	9.4	13.7	1.0	14.6	33.1	9.6	4.9	51.3
July 2005	12.1	9.1	13.3	1.2	14.6	26.1	14.1	6.0	54.3
August 2005	12.9	10.2	12.5	0.5	15.3	15.9	17.6	2.1	55.9
September 2005	11.7	9.5	10.8	0.7	13.9	7.6	22.5	3.6	52.8
October 2005	11.0	8.8	9.2	0.2	13.1	4.2	18.0	0.4	49.4
November 2005	9.1	7.4	8.3	1.4	11.3	2.1	NA	NA	45.6

firms expecting profits to go up in the next six months is the highest in last four rounds.

An increase in volumes is the major consequence of business changes of the last five years. 82 per cent of the firms said that changes in business operations have led to an increase in sales volumes. Nearly 74 per cent said that both labour and capital productivity of their firms has increased after adopting these changes and 64.3 per cent are of the opinion that their profit margins have improved. Greater import competition as a driver of change was identified by only 37.6 per cent of the firms.

The Political Confidence Index (PCI) improved marginally by 0.9 percentage points and at 110.1 reflects a stable outlook from the business community

with regard to the overall performance of the government. In comparison to the previous round, the performance of the UPA government has improved with regard to managing overall economic growth, government finances, the exchange rate and pushing economic reforms forward. However, performance has deteriorated with regard to managing inflation, unemployment, the political climate and external trade negotiations.

Forecast for FY 2005-06

This is our final assessment of GDP growth for FY 2005-06. Benign inflation, the bullish stock market, a robust industrial and export performance (with fluctuations) and the good monsoon have all helped brighten prospects.

The key assumptions are:

- Gross irrigated area will increase by two million hectare per annum;
- Foreign direct investment of six billion dollars in 2005-06
- The rupee is assumed to depreciate vis-à-vis the dollar by two per cent in 2005-06;
- World GDP will grow by 4.3 per cent in real terms in 2005-06;
- Domestic oil prices would grow by 10 per cent per annum;
- The bank rate will remain at the same base level as in 2004-05;
- Central subsidies will grow by 8 per cent over last year;
- Public investment in agriculture will grow by 12 per cent per annum. In rest of the sectors it will grow by five to 15 per cent per annum;
- Net invisible would grow by 18 per cent.

Growth in real GDP in FY 2005-06 is forecast to increase to 7.8 per cent, up from 6.9 per cent last year (Table F.3). The main source of this improvement is expected to be agriculture, which grew by just 1.1 per cent in FY 2004-05 and expected to grow at 3.4 per cent this year.

The services sector is expected to improve its performance marginally. We expect industry and services to grow at 8 and 9.3 per cent, respectively, this year. Exports are expected to remain buoyant but export growth in dollar terms is expected to decline from over 24 per cent to 19.5 per cent this year. Similarly, import growth is also expected to decline from nearly 36 per cent to more than 24 per cent.

Prices are expected to rise more slowly this fiscal compared to last year. Average inflation is expected to be 5.3 per cent down from 6.5 per cent last year. The fiscal deficit is expected to increase, but higher GDP growth may leave it at 4.4 per cent of GDPMP. The faster growth of imports, as compared to exports, may result in current account deficit of around 2.8 per cent of GDPMP. Although this is high, it may not pose any serious problems. The high level of foreign exchange reserves, the continuing flow of foreign exchange from portfolio investments, the buoyant goods and services exports are good cushions.

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The fiscal deficit is expected to be 4.4 per cent of GDP

Table F.3: Growth Prospects of Indian Economy in 2005-06 (Per cent)

Variables	2004-05	2005-06
Real GDP	6.9	7.8
- Agriculture	1.1	3.4
- Industry	7.7	8.0
- Services	8.9	9.3
Exports (US \$)	24.4	19.5
Imports (US \$)	35.6	23.9
Inflation (WPI)	6.5	5.3
As percentage of GDPMP		
Fiscal Deficit	4.1	4.4
Current Account Balance	-0.9	-2.8