

Forecast

Review of the Current Economic Scenario

This section provides a brief review of the overall current economic scenario and presents a revised macroeconomic forecast for 2006-07, and a medium-term macroeconomic scenario.

Output Growth

The estimates of GDP for the first quarter have pointed to the continuation of the growth momentum seen in the past three years. The growth was seen in both industry and services sectors. The manufacturing sector showed remarkable pace of growth registering a rise of 11.3 percent Y-O-Y basis over a 10.7 percent rise in the first quarter of 2005-06. Within services, GDP from transport, storage and communications sector rose by 13.2 percent in Q1: 2006-07 on the back of a 11.7 percent growth in Q1 of the previous financial

year. Even agricultural and allied sectors registered a growth of 3.4 percent in Q1: 2006-07 (Table F.1). Thus, if the current trends continue, the year will extend the run of above eight percent annual growth over the last four years.

Prices, Interest Rates and Exchange Rate

The price scenario was a concern during the first six months of the financial year. Although on monthly average basis the Y-O-Y rise in the all commodities WPI was below five percent in the first two quarters of the year, the rise in primary articles and energy group was above six percent. The sector level supply side effects were primarily responsible for the rise in the price index as the international oil prices and domestic foodgrain prices experienced unusual movements due to supply shortages. In the case of oil prices the reasons have been complex ranging from the

Table F.1. Strong growth momentum continues: Real GDP Growth Rates (% Y-o-Y)

Sector	2005-06				2006-07
	Q1	Q2	Q3	Q4	Q1
Agriculture, Forestry and Fishing	3.4	4.0	2.9	5.5	3.4
Mining & Quarrying	3.1	-2.6	0.0	3.0	3.4
Manufacturing	10.7	8.1	8.3	8.9	11.3
Electricity, Gas & Water	7.4	2.6	5.0	6.1	5.4
Construction	12.4	12.3	11.5	12.0	9.5
Trade, Hotels, Transport & Communication	11.7	11.0	10.2	12.9	13.2
Finance, Insurance, Real Estate	8.8	10.5	8.9	10.5	8.9
Community, Social & Personal Services	7.3	8.0	8.4	7.6	7.4
Overall GDP	8.5	8.4	7.5	9.3	8.9

rapid growth in demand for energy from fast growing economies such as China and India to global security concerns with its origins in the Iraq conflict.

In the case of international oil prices there appears to be some respite as the prices have begun to decline, the prices still continue to be well above the levels seen two years back (Fig F.1). The oil producers' cartel appears keen on maintaining the high prices by restricting the output while the consumers show no signs of restraining demand. In the immediate medium-term, therefore, relatively high oil prices in the international markets are likely to continue putting a pressure on external balances of oil importing countries.

The slow adjustment in the domestic energy prices to the sharp rise in international crude prices has continued and the rise in energy prices can be expected to be significant in the medium-term future. For example between April 2005 and April 2006, the WPI for fuels, power and lubricants increased by about nine percent while the international crude oil price (Brent) increased by 36 percent. There is, thus, considerable amount of price increase that has been delayed.

In its mid-term review of the Annual Credit Policy Statement, the RBI has raised the fixed repo rate by 25 basis points, in effect raising the cost of short term funds to the commercial banks. All other main monetary instruments have been left unchanged. The impact of higher repo rate on overall interest rate may not be significant but it does indicate that the monetary policy will continue to watch price trends closely. The real interest rates have also not shown any sign of decline (Fig F.2).

The only concern with respect to liquidity now is the fact that there has been a significantly higher growth of reserve money in the second quarter, mainly result-

Fig F.1: Trends in Crude Oil Price in International Markets

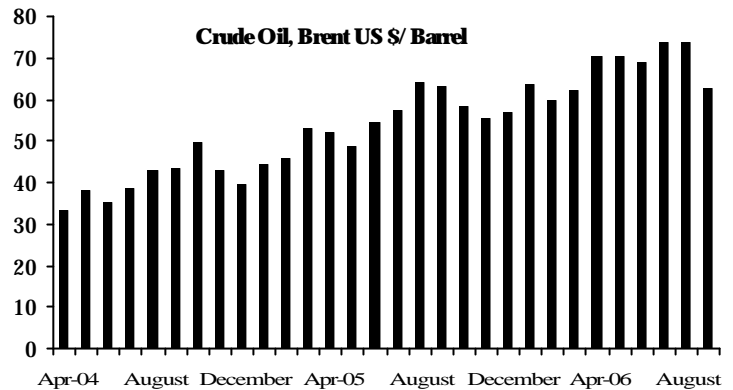


Fig F.2: The 364-day T-Bill rate (%) and the Inflation Rate (WPI%)

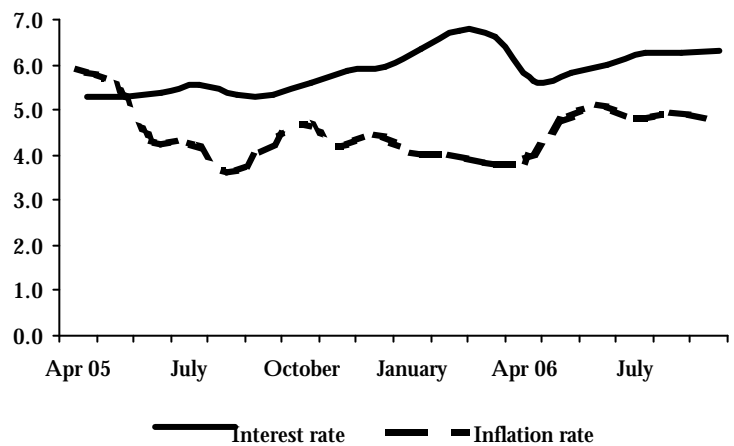
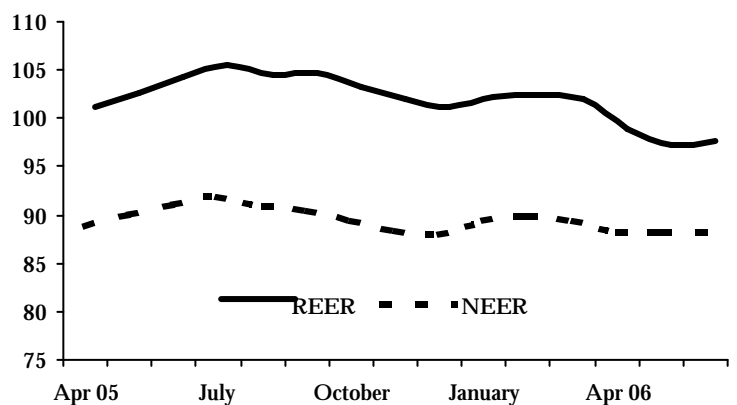


Fig F.3: Trends in Exchange Rates



ing from RBI credit to government. As the offtake of credit is rising at a high rate the potential for demand side pressures on prices is likely to emerge only when economic activity shows signs of slowing while the money supply continues to build up.

One source of pressure on prices is the changes in exchange rate. The rupee has depreciated for about one year (Fig F.3). In terms of rupee versus US dollar, the rupee has depreciated by about five percent between April-September 2005 and April-September 2006. The trade deficit, now at \$24.6 billion for April-September, is higher than its level last year. Although the net invisibles reduce this gap, from the data available for the first quarter of 2006-07, the current account deficit for this year is likely to be greater than in the last year.

The trends in interest rates and exchange rate indicate that the inflation rates are likely to be under pressure until there is relief from a favourable agricultural output.

The Global Environment

The strong growth of the first quarter has been supported by both external and domestic demand for goods and services. The export growth of 22.9 percent in the first half of the year (in \$ value) is impressive as it comes on top of the 34.7 percent growth in the same period last year. India's exports registered a growth of 23.4 percent for the year as a whole in 2005-06 and going by the first half numbers for 2006-07, the performance in the current year is also likely to be similar. The indications of acceleration in global growth should also drive India's exports in the current year.

The imports have shown a marked deceleration in the first half of 2006-07. The deceleration is in the non-oil imports. However, it should be noted that this decline in growth rate to 11 percent in non-oil imports for the first half of

2006-07 is on the back of a sharp rise of 50.1 percent in the same period last year. Continued growth in industrial production, exports and general economic activity implies that import growth should pick up in the course of the year.

The Monsoon 2006-07

The aggregate rainfall during the period June-September averaged across all the rainfall subdivisions of the country indicates close to normal conditions. However, some regions have received less than normal rainfall and some have received rainfall in excess of the normal. Bihar in the east, UP, Uttaranchal and north-western states of Panjab, Haryana and HP, eastern MP in the Central region, Tamilnadu and parts of AP and Karnataka in the south received below 10 percent of the long-term average rainfall during the monsoon season. Much of north-eastern region also experienced well below normal or long-term average rainfall. From the perspective of foodgrain production, the overall pattern suggests that the rainfall was slightly better than the previous year's level. The weighted average June-September rainfall in 2006 was 5.8 percent higher than 'normal' and in 2005, the same was 2.2 percent above normal. The overall impact on agriculture, however, would depend on the performance of other sectors of agriculture.

The Business and Political Confidence

NCAER's quarterly surveys of Business Expectations provide some insights into the current business environment. The survey carried out in the months of September-October 2006 captured the resurgence of business confidence through the increase in Business Confidence Index (BCI) by 7.6 percent over previous quarter (Fig F.4). We note that the BCI had declined by about nine percent in the previous quarter. The fall in the previous quarter

appears to have been linked mainly to the crash in stock prices in June.

The rise in BCI has been on the back of expectations of a benign or favourable economic environment in the next six months and an assessment that the present investment climate is positive. Considering the strong industrial growth and the overall economic growth in the first quarter of the economy the results are not very surprising. However, the findings on the four main components of the BCI also highlight the fact that firms are operating today at fairly high levels of capacity utilisation. About 97 percent of the respondents say that they are operating at close to or above 'optimal level of capacity utilisation'. This shows that investments to create additional production capacity are necessary to enable future output growth. Retaining a favourable investment climate would be important for achieving higher levels of production capacity.

In the current round of the survey the political confidence index (PCI) also partially regained its lost ground. The PCI increased by 15.6 points mirroring the improvement in BCI (Fig F.5). The PCI that we have constructed rates the

Fig F.4: Business Confidence Index

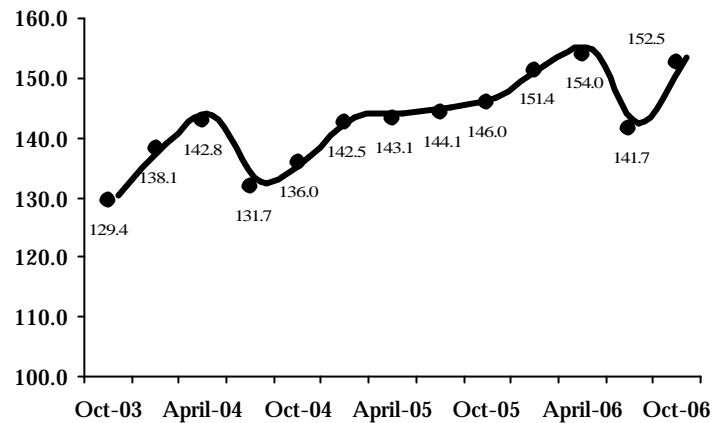


Fig F.5: Political Confidence Index

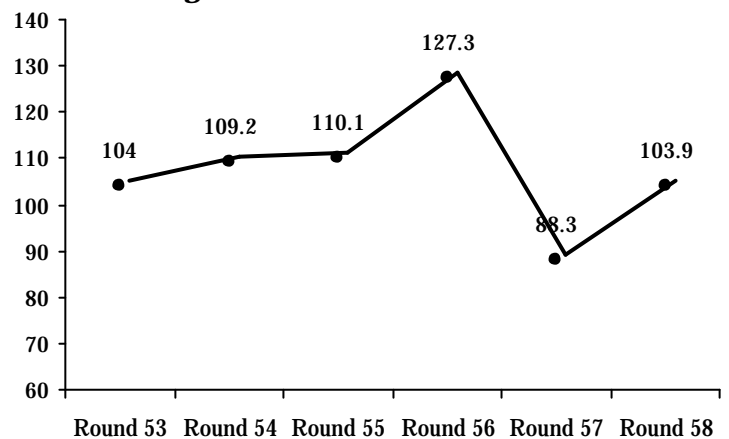


Table F.2. The Business Confidence Index and Its Components (% of respondents)

Components of BCI	Survey Period				
	Oct	Jan	April	July	Oct
	2005	2006	2006	2006	2006
Overall Economic Conditions will be Better in Next 6 Months	69.7	72.8	75.3	66	73.6
Financial Position of the Firms will Improve in Next 6 Months	69	70.2	69.5	66.5	71.9
Present Investment Climate is Positive	55.5	61.1	63.3	52.3	59.2
Present Capacity Utilisation is Close to or above Optimal Level	95	95.9	97	95.9	97.5
Business Confidence Index	146	151.4	154	141.7	152.5

business community's outlook with regard to the overall effect of the Government policies on macroeconomic factors such as inflation, unemployment, exchange rate, and external trade environment.

Although business sentiments are closely linked to political stability and policies the impact of local and national level concerns may also influence overall assessments of business climate by the business sector. Some of the moderation in business

our second forecast for 2006-07. We now have information on the performance of the economy in the first quarter and information on rainfall in the monsoon season. Taking into account the various exogenous variables, we have estimated the values of key macroeconomic indicators for 2006-07. In addition we have also projected these indicators over a five year period into the future to obtain a description of the medium-term scenario for the economy.

Table F.3. The Forecast for 2006-07 and a Medium-term Macroeconomic Scenario

Variables	2005-06	2006-07 August Forecast	2006-07 October Forecast	Forecast for Average of 2007-08 to 2011-12
Real GDP Growth %				
Agriculture	3.9	2.1	2.7	2.4
Industry	8.7	8.5	8.6	8.2
Services	10	9.8	9.9	10.0
Total	8.4	7.9	8.1	8.2
Other Indicators				
Merchandise Trade (% change Y-o-Y)				
Exports (\$ terms)	24.7	17.8	21.3	17.1
Imports (\$ terms)	31.5	24.3	26.2	17.0
Prices (% change Y-o-Y)				
Inflation (WPI)	4.4	4.6	5.0	5.2
As% of GDPMP				
CAB	-1.3	-1.8	-2.1	-2.3
Fiscal Deficit (Centre)	4.1	4.1	3.7	2.6

expectations and political confidence is also related to the present uncertainty over the trade establishments in the metro region of Delhi arising from the land use regulations.

The overall findings of the survey suggest that the business activity levels are high and expectations for the near term are favourable. The survey was based on 590 respondents from the major cities in the country.

Revised Forecast for 2006-07 and a Medium-term Scenario

In August 2006 we had presented

Some of the key assumptions for obtaining the estimates for 2006-07 are,

1. The rainfall during the current monsoon period is slightly better than in the last monsoon period (rainfall index 5% higher than in the previous year).
2. The domestic energy price index (WPI for fuel, power and lubricants) to rise by eight percent over the last year.
3. The world real GDP to increase by 5.1 percent over the previous year.
4. The average policy interest rates to increase by 25 basis points.

5. Depreciation of the rupee by three per cent over the previous year.
6. Foreign direct investment to be higher by \$ 1 billion as compared to 2005-06.

The resulting forecast is presented in Table F.3. For comparison we have noted the latest available information for 2005-06 and our August Forecast for 2006-07 also in the same table.

The real GDP growth for 2006-07 is projected at 8.1 percent over the previous year. This is slightly higher than the August forecast mainly due to the improvement in all three producing sectors. The higher growth in industry and services is attributable partly to the projected higher levels of FDI and higher exports.

With a higher growth of industry and services sector, we project a reduction in the fiscal deficit of the Centre as compared to the estimate provided in August.

The key concern is, however, with respect to current account deficit. The export growth is projected to be higher at 21.3 percent but the imports are also projected to increase at a higher rate of 26.2 percent.

The Medium-Term Scenario: 2007-08 to 2011-12

The period we have chosen for projecting a medium-term scenario coincides with the Eleventh Five Year Plan. While the Five Year Plan will incorporate many policy changes and reforms, we have attempted to provide a conservative scenario of what may be termed "Business As Usual". However, several of the key underlying assumptions reflect the current momentum of the economy. The projections are also dependent on the positive effects of FDI and infrastructure development on the productivity of other production sectors. The key assumptions in developing the medium-term scenario are:

1. Gross irrigated area to increase by two million hectares per annum
2. Rainfall to be at the long-term average throughout the period
3. FDI to increase by \$1.5 billion per year
4. The net invisibles in the external current account to increase by 20 percent in nominal rupee terms
5. Rupee to depreciate by an average of two percent per year
6. World real GDP to increase by 4.9 percent in the first two years and then by four percent per year
7. Domestic energy prices to increase by eight percent per year
8. The bank rate to remain at the base level
9. Central subsidies to increase by 10 percent per year in nominal terms
10. Public investment to increase in real terms by 12 per cent per year and in the other sectors by 5 to 15 percent per year
11. The exogenously specified government revenue parameters and variables are assumed to follow the recent trends

The projections of real GDP for the medium-term scenario given in Table F.2 point to a sustained growth of above eight percent per year. The business as usual scenario then seems to have shifted to eight percent per year. However, the growth is still driven by the non-agricultural sectors. Agriculture is unable to raise its performance beyond 2.5 percent growth per year based on the 'business as usual' policies. Strong productivity enhancing measures combined with market development are essential to break from this impasse.

The projections also show that Central government's fiscal position is likely to be within the three percent mandated by the Fiscal Responsibility Act. The improvement is based on improvements in tax revenues and modest increase in spend-

ing.

The current account deficit is projected at 2.3 percent of GDP. The export growth of 17 percent is close to the projections of draft Approach Paper of the Eleventh Five Year Plan. However, the projected import growth here is well above the projections of the Draft Approach Paper. The differences in the estimates may lie in the different specifications of the trade sector.

Two main down side risks to this BAU medium-term scenario may be noted. One is that the productivity improvements on account of FDI and

infrastructure development. It is necessary for investments to take place and more importantly such investments should lead to improved performance of the other production sectors. In the absence of such well designed investments to achieve the same output growth even higher investments may be needed. Second, a favourable external environment is important for economic growth. Sustained strong export performance is critical to achieving a high real GDP growth of eight percent per year.