Overview

The average annual rate of real GDP growth has now crossed the 8.5 per cent-mark for the three-year period ending 2006-07. The non-agricultural sectors are growing at 10 per cent per year. The manufacturing sector's GDP grew by 12 per cent in 2006-07 as compared to 9 per cent in the previous year. Thus, while higher inflation rate, stronger rupee and tight money policy have been hurdles from the perspective of accelerating economic growth, they have not yet slowed the growth momentum. In terms of overall growth, agriculture, which for long has been stuck in a slow phase, is still awaiting a breakthrough.

Global demand conditions remain favourable, but the momentum may be slowed during 2007 in comparison to 2006, with respect to both output and trade volumes. Low inflation on the oil prices front was expected to be a salutary factor, but there has been a setback on this front recently. Global oil prices are climbing again.

The annual inflation rate, measured in terms of WPI (average for the period over the average in the previous period) was 5 per cent in 2006-07, nearly the same as in 2005-06. It was 6 per cent in 2006-07 as measured by CPI for industrial workers, up from 5 per cent in 2005-06. The primary articles' WPI rose by 10 per cent during 2006-07 because of the tight global supply conditions coinciding with poor agricultural harvest in India.

Net foreign capital inflows surged in 2006-07 to $46 billion, from $19.4 billion in the previous year, and this growth has continued into the current fiscal. Gross FDI inflow amounted to $19.5 billion. This is one factor keeping industrial investment spending at a high level, despite the pressures of a stronger rupee, higher interest rates and inflation. The foreign exchange reserves (excluding gold) are now above $222 billion or 25 per cent of GDP. Export growth appears to have slowed in the first five months of the current calendar year. The import bill has grown thanks to higher import of non-oil items in addition to an enhanced oil bill. The merchandise trade deficit for 2006-07 was at a high of $65 billion (based on BOP data). Net invisible earnings, at $55.3 billion, narrowed the current account deficit to $9.7 billion. The growth of net invisible earnings by about 30 per cent in 2006-07 was critical to keeping the current account balance to below 1.5 per cent of GDP.

The 12 per cent growth of the manufacturing sector was induced by both domestic and export demand. Domestic investment and consumption demand were buoyant as evidenced by the rapid growth of the consumer goods and capital goods production indices. Higher interest rates during the year, combined with a more watchful monetary management by RBI, sent out the signal that investment activity would have to manage the available credit lines more carefully. The net external commercial borrowings, which touched $16 billion, have financed overseas investment activities and acquisition of assets by Indian companies. The role of investment spending in providing favourable demand conditions has been critical to the rise of growth of the manufacturing sector. Higher interest rates may not be favourable to investment spending, but they could lead to more efficient use of financial resources.

The construction sector, a key source of growth since 2003-04, slowed its momentum in 2006-07. The higher interest rates on housing loans may have led to a demand crunch. The housing (personal) loans from the banking sector increased by 22 per cent in 2006-07 over the previous year.

The service sector's GDP grew by more than 11 per cent in 2006-07. Trade, hotels, transport, storage and communication provided the impetus for growth in this sector. Infrastructure sectors, including electricity, grew at a faster rate in 2006-07 as compared to the previous year. It is not only the communications sector that has surged, but there are now indications of significant changes in the trade sector as well. Although these are early days, the entry of organised retail could provide new opportunities for the suppliers as well as consumers.

Real GDP from agriculture and allied sectors registered an annual growth of 2.6 per cent in 2006-07, as rainfall was not well distributed during the monsoon period. Prices of primary articles rose sharply during the year as even global commodity markets experienced short supplies.

The agricultural production outlook for 2007-08 has improved, thanks to expectations of a better monsoon than last year. The weighted average index of rainfall during June-July 2007 is 18 per cent above normal rainfall, as compared to eight per cent for the same period in 2006.

Thus, the overall setting for the current fiscal year is one of high growth and high rate of inflation. The fiscal position of the central government, as reflected in Budget 2007-08, indicates an improving tax revenue position and consolidation of the budgetary deficits to fall in line with the FRBM targets. The high rate of output growth seen in the non-agricultural sector implies that the rate of tax collections has also been high. The gross fiscal deficit of the Central government declined to 3.7 per cent of GDP in 2006-07, and is budgeted to decline further to 3.3 per cent of GDP in 2007-08. The same narrowing of the fiscal deficit may be seen in the states as well.

Business sentiments, as tracked by NCAER's quarterly surveys of the business sector, show a decline in the Business Confidence Index by 8.3 per cent in July 2007 (covering the quarter April-June) over its level in April 2007. The decline, though in line with the seasonal trend, also conveys the impact of higher interest rate, strong rupee and more cautious credit growth on business sentiments. Thus, while output and price expectations do not appear to be pessimistic, the overall sentiments have dampened.

The Doha Round negotiations have not led to agreement so far on the contentious issue of agriculture as well as non-agricultural trade barriers. The lack of a resolution of these issues could hurt the prospects of reduction of trade barriers, and, lead to losses for the economies of both the developed and developing worlds.

Taking into account the trends in various indicators, we have provided a reassessment of the macroeconomic prospects for 2007-08. The first such assessment was provided in April this year. The revised forecast places overall real GDP growth at 8.53 per cent as compared to the previous forecast of 8.3 per cent. Higher growth has been largely due to agriculture and industry. Expectations of better monsoon and the impact of higher capital inflows have led to higher growth estimates for these two sectors. The projected fiscal position of the Centre is close to the Budget expectations. On external balances, we are now projecting a current account deficit of 1.8 per cent of GDP as against the surplus that we had anticipated in our April projections. The key reason for the change is the lowering of projected growth of net invisibles.