Overview

The first quarter's GDP growth numbers suggest another year of eight percent growth following the last year's growth of 8.4 percent. The optimism on the output front is also echoed in the rise in the Business Confidence Index that was observed in NCAER's survey of Business Expectations conducted in September-October 2006. The rise in BCI was also mirrored in the increase in the Political Confidence Index. Both these indices had declined sharply in the previous quarter, with the fall apparently triggered by the crash of stock prices towards the end of the first quarter in 2006.

The accelerated pace of economic activity is reflected in several indicators. The industrial output performance for the first five months of the current financial year is better than in the same period last year. Growth of IIP for April-August 2006 is more than 10 percent as compared to 8.7 percent last year. The financial performance of the corporate sector in the current year's first quarter has exceeded the performance in first quarter of 2005-06.

In the services sector, the telecommunication revolution has continued. Growth in new subscriptions, rise in non-food credit, growth of the civil aviation sector, performance of the railways indicate that the momentum of the service sector growth will be maintained. In the case of construction the pace of growth appears to have slowed but this may well be transitory given the current emphasis on infrastructure development.

The rainfall during the current monsoon season has turned out to be slightly better than last year from the perspective of foodgrain production. There are, however, several regions in which rainfall was well below the long-term average for the season. Some of the regions where the rainfall was below normal include the north western states of Punjab and Haryana where the irrigation coverage is extensive.

The high rate of economic growth has benefited from favourable global capital flows and demand conditions. The merchandise exports have increased by 23 percent in the first half of the current year. The FDI inflows in the first quarter at $ 1.7 billion suggest that last years' mark of $7.8 billion is likely to be exceeded this year.

The high fuel prices suffered throughout the last year appear to be softening but the fact that major economies of the world are expected to see continuation of economic growth trend implies that demand pressure on energy supplies will remain. Moreover, there has not been a complete pass through of the high international crude oil prices yet within the economy. The overall rate of inflation captured in WPI remains below five percent mark. But the prices of sensitive items such as foodgrain and energy have increased at a much higher rate in the first six months of the year.

The policy interest rates, the repo and reverse repo rates, had increased in the first quarter by 50 basis points in the context of rising interest rates globally and the concerns over rising inflation rate. There was also a concern that the consumer credit is rising at unprecedented rates and there is a need to ensure better quality of credit at such pace of expansion. The rise in interest rates has been a cause of concern in the context of the adverse impact of higher interest rates on investment spending. In the mid-year review of the monetary policy, RBI has increased the repo rate by 25 basis points raising it to 7.25 percent while keeping the bank rate, reverse repo rate and CRR unchanged. The increase in repo rate raises the cost of short term funds to the banks. However, whether this is passed on to lending rates would depend on a host of other factors such as availability of liquid funds from other sources. It may also lead the banks to use funds more efficiently.

Taking into account the various developments in the economy so far, we have estimated the key macroeconomic indicators for 2006-07. This is the third forecast for 2006-07 after our earlier estimates in April and August 2006. The revised forecast for 2006-07 places the real GDP growth at 8.1 percent. This represents an increase in growth rate as compared to our August forecast by 0.2 percentage points. The forecast is based on higher growth in all three major production sectors. Agriculture, industry and services are projected to grow by 2.7, 8.6 and 9.9 percent, respectively.

The revised projections for 2006-07 indicate a higher current account deficit of 2.1 percent of GDP and lower gross fiscal deficit of the Centre at 3.7 percent of GDP. The inflation rate is projected at 5 percent.

In this Quarterly Review, we also provide a medium-term scenario for the period 2007-08 to 2011-12. The projections place the average real GDP growth at 8.2 percent per year during the next five years. At the sectoral level, we project annual average growth rates of 2.4 percent for agriculture, industry growth of 8.2 percent and services sector growth of 10 percent. The export and imports growth of merchandise trade is projected at roughly the same rate of 17 percent per year. The fiscal deficit is projected to be within the 3 percentage points of GDP at market prices.

The medium-term scenario projections take into account the productivity enhancing effects of FDI and infrastructure development. In other words the policy framework should be such that such positive spill over effects are harnessed. This places greater importance in the design and location of infrastructure projects efficiently and allowing greater interaction between the FDI projects and the rest of the economy. The medium-term projections also note that more conscious efforts will be necessary to move agriculture to a higher growth trajectory.