Subir Gokarn: Hold, hack or hike?

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The quarterly monetary and credit policy announcement is due next week. It comes amidst high levels of uncertainty in the global economic arena. A slowdown in the US economy, a sharp spike in oil prices in response to heightened tensions in West Asia, a persistent dollar decline and the surge of portfolio investments into Indian equities have all created a rather complicated backdrop to an announcement which, based on strictly domestic considerations, should have been relatively straightforward.

Let's first take stock of what the current domestic environment indicates for monetary policy. GDP growth during the first quarter was 9.3 per cent, significantly outside the apparent comfort zone around 8.5 per cent. Agriculture contributed more than proportionately with a growth rate of 3.8 per cent. In the Indian context, good growth in agriculture is itself an effective anti-inflationary force, moderating food prices.

However, clearly, despite this, industry and services continued to grow at rates higher than those implied by the comfort zone. Second-quarter numbers will be available only at the end of November, but meanwhile, the Index of Industrial Production numbers for July and August provide the most current information on how the industrial sector is doing.

Unfortunately, from the policymakers' perspective, the signals from the two months are mixed, perhaps even contradictory. During July, industrial production was estimated to have grown by barely over 7 per cent, a significant deceleration even after accounting for a high base in 2006. Amongst major industrial segments, the one which saw the sharpest slowdown was transportation equipment, which barely grew at all during the first four months of the current year.

Just when people thought that the slowdown was upon us, the August numbers showed renewed buoyancy. Mining contributed disproportionately, growing by 17 per cent during the month, but transportation equipment rebounded considerably, growing by over 10 per cent during August and taking the first five months' performance to a still modest but nevertheless positive 2.9 per cent. In the aggregate, the manufacturing sector grew by 10.4 per cent during April-August 2007, compared with 12.2 per cent during the same five months last year; slower, yes, but still showing considerable momentum.

If growth does not give enough evidence of having come down to more comfortable levels, inflation certainly does. Wholesale price inflation has been below 4 per cent for several weeks now, touching a low of 3.07 per cent for the first week of October. Even if one were to adjust this for the incomplete adjustment of fuel prices in response to the rise in international crude oil prices in recent weeks, it would still be reasonably close to the short-term comfort zone of around 5 per cent. Keeping in mind the fact that there are different drivers acting on the main components of the basket used to measure wholesale price inflation "" food, fuels and manufactured goods "" from a monetary policy perspective, the pressure is clearly quite mild at the moment.

While the July slowdown in production and the low headline inflation numbers have motivated some calls for a cut in the policy rates to stimulate domestic demand, the five-month industrial growth performance does not suggest the need to provide immediate stimulus. Neither do the inflation numbers warrant further monetary contraction. The advisable course of action, therefore, is "hold".

But, let's not forget the various developments on the external front. The fact that the US economy is slowing down and the US Federal Reserve Board has responded to such signals quite strongly does make a case for cutting policy rates to stimulate domestic demand to offset a potential decline in exports to the US. Of course, this approach has a stronger justification for countries whose exports-GDP ratio is relatively high. The rationale may be slightly weaker in the Indian context, but, nevertheless, it shouldn't be ruled out entirely. Going by this argument, the recommendation for monetary policy is to "hack".

Oil prices are a much more serious and direct consideration. The recent surge up to $90/barrel was in response to the mounting possibility of a Turkey-Iraq showdown in Kurdistan, a large oil-producing region of Iraq, potentially disrupting supplies. Having been approved by the Turkish Parliament, this action can take place at any time over the next year, which will keep oil prices high for some time to come. The Indian consumer cannot be insulated for very long from prices at these levels; as and when the adjustment is made, the domestic inflation scenario will obviously be affected.

In the face of this threat, there may be a case for proactively raising policy rates. This will both moderate growth and consequent energy consumption and further quell inflationary pressures, which should provide more room for the government to make the necessary and inevitable adjustments to retail prices of petroleum products. The fact that a mid-term election is no longer a prospect in the immediate future should allow the government the leeway to make at least some adjustments in the immediate future.

With the US Federal Reserve Board cutting its policy rate sharply, global liquidity has been stoked and some of it is obviously finding its way into the Indian financial system. The proposal to deter some of this by imposing limits on investment through participatory notes, floated last week, caused significant volatility. This is the third in a series of measures intended to stem the flow, after the restrictions on external commercial borrowings and the enhanced limits on outward investments by Indian companies and individuals. The odds are that, as long as the Indian economy continues to grow at current rates and global liquidity is high, none of these measures is going to make a material difference to the quantum of flows.

From a macroeconomic perspective, the only thing that will moderate the capital inflows is a slower growth rate, which will divert investments to other markets. Incidentally, this will also contribute to the easing of the pressure on the rupee to appreciate, if that is indeed a policy objective. Thus, if the oil price threat and the deluge of capital inflows are critical issues, the appropriate monetary policy action as far as interest rates and liquidity restricting measures could well be "hike".

So, what is it going to be? Typically, when there are strong arguments in favour of movement in opposite directions, the status quo prevails. So, I would guess "hold". However, let's not ignore the rationales for alternative courses of action and the potential costs of not taking them.