Subir Gokarn: The merits of the status quo

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The roots of the global food situation lie far beyond the scope of interest rates and cash reserves.

Monetary policy actions are relatively easy to specify when the growth rate and the inflation rate are both moving in the same direction. If, with reference to a "neutral" or "comfort" zone for the two indicators, implying a sustainable balance between the two, both are to move up, this constitutes overheating and the unexceptionable response by the central bank is to increase interest rates, reduce liquidity or do both. If, relative to the same reference zone, both are to move down, the appropriate response would be just the opposite "" enhance liquidity, decrease interest rates or do both.

It is when both these indicators move in opposite directions from the reference zone that complications arise. Obviously, a situation in which the inflation rate declines while growth accelerates will not be perceived as a problem warranting any kind of monetary policy response. But let's turn to the contrary situation, in which inflation is accelerating while the growth rate declines. This is what India "" for that matter, the rest of the world "" appears to be in at the moment. What should a central bank do? Address inflation and risk growth slowing down even more? Or, try and sustain growth but risk unleashing inflationary forces that might prove to be extremely difficult to rein in later on?

The choice depends entirely on the context. However, some general principles that should guide the choice can be laid down. Two principles provide a foundation for deciding on an appropriate response. First, the response should be based on the significance of the risks to the two indicators. If the risk that inflation will accelerate in the absence of appropriate monetary actions outweighs the risk that growth will decelerate if those actions are taken, they should be taken.

Second, the response should be sensitive to the probability of success. If potentially anti-inflationary measures are highly likely to reduce the growth rate while not very likely to have an impact on the inflation rate, they should not be implemented. Conversely, if potentially pro-growth measures are highly likely to exacerbate inflation while not having a very significant impact on growth, they should be resisted.

Let's now consider the three choices that confront the Reserve Bank of India "" tighten liquidity, ease liquidity or hold steady "" with reference to these principles. Tightening liquidity is being both recommended and widely anticipated as the likely outcome in the next policy announcement. In terms of the first principle, relative risks, while the risk that growth will decelerate even more is very much there, inaction by the central bank now could cause inflation to accelerate, requiring a much more heavy-handed response in the not too distant future. Gradual, calibrated steps are far more palatable.

However, on the second principle, the probability of success, the evidence appears to go against tightening for the moment. The dominant contributors to the recent inflationary surge are food items and minerals, especially iron ore. Both these categories are being significantly driven by global demand-supply mismatches, something which domestic monetary policy actions will not have much of an influence over. As far as minerals and metals are concerned, the global slowdown may have a favourable impact on prices in the coming weeks; more importantly, slower growth in China will almost certainly contribute to softening prices over the next year or so. In other words, if a tight monetary policy cannot have much impact on circumstances that are, in any case, likely to be transitory in nature, why do it when it will almost certainly exacerbate the growth slowdown?

Turning to the second option, easing liquidity, at this point, it is widely believed to be impossible. However, it is worth examining the case for and against, particularly because it would have been seen as a legitimate course of action had the inflation numbers been less intimidating. With reference to the principle of relative risks, the growth slowdown is real and, more importantly, the sectoral pattern is closely related to the interest rate cycle. On the other hand, it could stimulate domestic demand pressure prices, reinforcing the global forces that are already so malignant. In terms of the principle of probability of success, the issue is essentially one of timing. Going by our understanding of response lags, an easy liquidity stance will probably have a quicker impact on inflation, through its influence on expectations, than it will have on growth.

So, if tightening liquidity does not convincingly satisfy the tests of appropriateness while easing liquidity somewhat more convincingly fails them, at least for the moment, the status quo emerges as a default option. However, this is not entirely satisfactory. If there is a concrete case for the holding course, even as the clamour to tighten liquidity, it must be brought into the discussion.

In terms of the principle of relative risks, non-intervention will very likely allow the growth deceleration to consolidate and widen across sectors through linkages and multipliers. This will, in turn, ease pressure on prices of various products and services, offsetting the global inflationary forces to some extent. On top of this, if at least some of the commodity price patterns are transitory, as suggested above, the inflationary pattern should become more tolerable in a few months. With reference to the principle of probability of success, the eventual objective is to stabilise the economy in the zone around 8.5 per cent growth and 4.5 per cent inflation. Given this, if the current inflation surge is transitory, a status quo policy today provides a little more room to manoeuvre in the next couple of quarters as far as the growth slowdown is concerned.

The critical question, therefore, is whether the recent inflationary pattern is more likely to be transitory or persistent. With respect to minerals and their downstream products, global business conditions will eventually dictate prices. However, energy and food prices are being driven by factors other than purely cyclical. There are some important linkages between them, notably through the diversion of food crops to bio-fuels and the rising prices of fertilisers, which are contributing to lower yields globally. The point, however, is that if these are structural problems with long-term implications, how much impact can a short-term policy instrument, which is essentially what monetary policy is, have?

This leads us to a third guiding principle, perhaps the most important, appropriateness: understand the cause of the problem and make sure that the policy instrument being contemplated can deal with that cause. Unfortunately, the roots of the global food situation lie far beyond the scope of interest rates and cash reserves.

The writer is Chief Economist, Standard & Poor's Asia-Pacific. The views are personal