Subir Gokarn: Case for a cut

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Recent global developments reinforce the signals from emerging domestic patterns.

A fundamental question that has been raised in the debate on macroeconomic policy response to unfolding events in financial markets over the past several months is: should central banks take asset price movements into consideration? Former US Federal Reserve Chairman Alan Greenspan did, in fact, aggressively inject liquidity into the financial system when it seemed to be under threat. In doing so, he clearly set precedents for his successors and counterparts, but also bequeathed a rather contentious issue for them to deal with. Proponents of response to financial market conditions argue that if turbulence threatens overall macroeconomic stability, then it is incumbent on the central bank to respond. Opponents contend that central bank actions in this situation constitute a bail-out of players responsible for the turbulence, thereby aggravating the moral hazard and setting the stage for problems in the future.

I think that central bank interventions during financial instability are warranted if such instability threatens the fundamental objectives of the bank's policies, which can be broadly described as "macroeconomic stability". More precisely, a central bank should use its policy instruments to minimise deviations of the economy from a long-run growth trend, while ensuring that the inflation rate remains low. Anything that threatens to disrupt that balance, whether by pushing the inflation rate up or by forcing the growth rate to move significantly away from its trend, is justification for a policy response. Consequences, such as the moral hazard, certainly need to be accounted for, but the solution most likely lies in the use of other instruments, such as tighter disclosure and prudential norms. In short, if macroeconomic stability is under threat, no matter what the source, it is incumbent on central banks to respond.

There are widespread expectations of an interest rate cut in the Reserve Bank of India's (RBI's) quarterly monetary and credit policy announcement tomorrow. The basis for these is, mostly, the rather substantial action by the US Federal Reserve Board, which cut its main instrument, the federal funds rate target, by 75 basis points to take it to 3.5 per cent. However, the fact that the US Fed cut rates is not enough, in and of itself, to justify a similar response by the RBI. Any decision, whether to cut rates or maintain the status quo, needs to be justified in terms of the criterion laid out above, viz. is it consistent with the objective of keeping growth as close to trend as possible, while simultaneously keeping the inflation rate low?

Within this framework, we have to consider all possible factors that are currently either causing the growth rate to deviate from trend or putting upward pressure on the inflation rate, regardless of whether these are of domestic or foreign origin. As far as domestic factors are concerned, the pattern of industrial production in recent months, as revealed by the index of industrial production (IIP), is the most important indicator of deceleration. The significant volatility during the last few months, with a growth rate dropping to almost 5 per cent during November, is a clear indication that the momentum is flagging.

The transportation equipment sector has been limping along for the whole of the current year, while the growth in consumer durables has slowed noticeably in recent months, crossing into negative territory in the latest numbers. These are among the industrial segments relatively sensitive to interest rates. The impression of sluggishness is reinforced by the slowdown in credit growth, which is translating into growing investments by banks in government securities.

Overall, while GDP growth during the current year will almost certainly be between 8.5 and 9 per cent, which is

close to the trend and does not, therefore, warrant an interest rate response, it is important to point out that this will be achieved by agriculture growing somewhat faster than anticipated, offsetting the deceleration in industry. In this sense, the negative deviation from trend in the industrial sector provides a justification for an interest rate cut, if not immediately, then certainly in the near future. My colleagues at CRISIL have recently been analysing "growth gaps" in the industrial sector, using econometric techniques to estimate the deviation between trend and actual growth rates. Their analysis suggests that this deviation turned negative during the last quarter, making an analytical case for an interest rate cut now, rather than later.

Of course, this has to be balanced against the objective of keeping the inflation rate low. As things stand, it is well within the comfort zone, even if we factor in the medium-term objective of 4 per cent, as measured by the wholesale price index. However, there is an element of unpredictability on the inflation front. One, as we all know, domestic prices of key petroleum products are way below what they should be, given the current (and expected) international price of crude. Two, we are in a favourable food price situation, mainly as a result of the good monsoons; however, global patterns of food prices are ominous. Several Asian countries are already grappling with spiralling prices of staples and we are unlikely to remain immune for long. The question is: what impact will fuel price revisions and potential food shocks have over the next year or so? If the combined threat is moderate, the argument shifts in favour of an immediate cut rather than one later on in the year.

That argument is strengthened considerably when the global financial situation is factored in. The Indian growth story is a predominantly domestic one, driven by equitable contributions from consumption and investment spending. Volatility in asset prices caused by global portfolio re-allocations can, through a variety of channels, threaten both these drivers, resulting in a significant negative deviation of growth from its trend. A rate cut now will achieve two objectives. It will reinforce the growth momentum by reversing the deceleration in the two key industrial segments referred to above. And, by reinforcing expectations of growth stability, it will contribute to stabilisation of investment flows. Given that recent domestic market movements are largely the consequence of external factors, the moral hazard argument is not really relevant.

The bottom line is that a change in the RBI's monetary stance by cutting rates is imminent. The choice is only one of timing. Recent global developments reinforce the signals from emerging domestic patterns, tilting the case of a rate cut now rather than later.

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