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Subir Gokarn: Stress scenario

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The Indian economy is beginning to look like it is on a slippery slope. Although there have been signs of stress in several indicators for the past few months, a kind of discontinuity seems to have occurred in recent weeks, when mere possibilities of instability have escalated into probabilities. In my view, these probabilities are still relatively low. However, it is important to start thinking of how some of these stress scenarios would play out and what kind of evasion or mitigation measures different businesses would have to take to survive the turbulence.

Policymakers also have to look at alternative responses to different sources of instability and start to prepare both the technical and political ground for them. In this article, I try and develop a stress scenario that is based on the adverse impact of both global and local factors.

Paradoxically, a key contributor to potential instability in India, as well as Asia in general, is what appears to be a relatively mild recession in the US. For many months now, we have focused on the US recession as the main trigger of a regional slowdown. During this time, however, the prices of oil, food and natural resources have surged to levels that render them serious threats for any economy that is primarily an importer of one or more of these commodities. If the US slowdown is as mild as the first quarter GDP growth numbers suggest (-0.2 per cent, if we ignore inventory build-up), the chances of commodity prices, particularly oil, decreasing significantly from current levels, are low. As the US economy reverts to its trend growth rate, the world economy is likely to face even firmer commodity prices.

The risks to food prices are not that great because every country that has had to deal with rising food prices in recent months will do all it can to raise production in the coming months. High prices combined with other incentives should ease the situation considerably. However, oil and natural resources could combine to put enormous pressure on prices across the board, thus impacting adversely on both demand and profitability. Investment activity is likely to be affected as a result of this.

The ability of central banks to deal with this situation is rather limited in the short run. Raising interest rates as an anti-inflationary strategy would work to reduce demand and, eventually, commodity prices, but this will happen over some months; meanwhile, inflation rates may well continue to rise in response to pressure from commodity prices. Further, issues of time lags aside, raising interest rates is not an easy choice in a situation in which growth is already showing signs of flagging. This was the case in the US towards the end of last year and it is the case in India now, notwithstanding the revised GDP estimates for 2007-08, which put growth at 9 per cent.

Manufacturing, a significant driver of the high growth over the past, slowed from 12 per cent in 2006-07 to 8.8 per cent in 2007-08; most significantly, it grew by less than 6 per cent during the fourth quarter. Given the sensitivity of several key manufacturing sectors to interest rates, raising them to fight inflation poses a serious dilemma to the Reserve Bank of India.

If growth slows, so do tax revenues, compounding the fiscal problem that has arisen from the government's attempt to protect domestic consumers from high oil prices. If the gap persists, the oil subsidy could by itself exceed the estimated fiscal deficit by the end of the year. The obvious solution, raising prices, becomes even more difficult when the inflation rate is already so high. If the right thing is done and prices are hiked, it will inevitably exacerbate the growth slowdown, while raising the inflation rate even higher.

And finally, the balance of payments, completely off the warning radar for several years, could come back into the picture. If growth slows appreciably, capital inflows are likely to slow, increasing the risk that a widening current account deficit, caused partly by high oil prices, will no longer be financed by them. If the situation is aggravated by capital outflows, from both foreign and domestic investors, rupee depreciation could further aggravate balance of payments pressures by raising import bills without an immediate offset in export growth, given the still sluggish conditions in the global economy.

In a nutshell: slowing growth, either a significantly higher inflation rate or fiscal deficit, quite possibly both, and a widening balance of payments deficit, compounded by a depreciating currency. This, in a situation where conventional macroeconomic stabilisation policies are not likely to be very effective. A scary thought and in striking contrast to the India opportunity story that many of us have come to accept as real over the past four years. Is this the end of that ride?

It could be, but doesn't have to. In situations like this, the most direct approach, the one that deals with the root cause of the problem, is also likely to be the most effective. Raising the prices of petroleum products must, therefore, be at the core of any policy response. It will not solve the problem by itself, but no other measure will make any difference without this critical step. If global prices soften over the next few months, monetary policy can begin tackling the growth slowdown. If this doesn't happen, the slowdown induced by higher energy prices will take a little longer to tackle by lowering interest rates, but the opportunity will arise sooner or later.

Meanwhile, the threat of a spiralling fiscal deficit will abate, getting public finances back on track as far as critical investment expenditures are concerned. Lower imports of oil will ease current account pressures. Capital inflows may still be deterred by the lower growth rate, but are likely to return to trend as soon as the monetary policy signals a turn in the interest rate cycle.

Essentially, the trade-off is between some pain in the immediate future and the possibility of far more pain a few months or a couple of years down the road. The more the necessary actions are postponed, the higher the probability that the scenario described above will materialise. As long as we continue with the status quo, the prospects for macroeconomic stability will depend entirely on a favourable global environment. The more we are willing to make changes domestically, the greater the control we will have over the prospects.

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