Edited Transcript of Reserve Bank of India's Post Policy Conference Call with Researchers and Analysts

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MODERATOR:

MS. ALPANA KILLAWALA – PRINCIPAL CHIEF GENERAL MANAGER

Moderator: Ladies and Gentlemen, Good Day and Welcome to the Fourth Bi-Monthly Monetary Policy Governor's Teleconference with Researchers and Analysts. As a reminder, all participant lines will be in the listen-only mode and there will be an opportunity for you to ask questions after the presentation concludes. Should you need assistance during the conference call, please signal an operator by pressing '*' then '0' on your touchtone phone. Please note that this conference is being recorded. I would now like to hand the conference over to Ms. Alpana Killawala. Thank you and over to you Ma'am.

Alpana Killawala: Thank you, Karuna and we will straight away go on to questions. We have received some questions from the question link already. I will take one by one.

Abhishek Bisen:
Kotak AMC

We believe that payment banks will lead to significant reduction in currency in circulation and therefore moving to surplus liquidity in the system gradually. Do you agree? If yes, how will you manage the same? And if no, why?

Dr. Raghuram G. Rajan: This is Raghu Rajan. I think if you look at what is happening in western countries, the use of currency in circulation is falling modestly and I presume that has a lot to do with electronic payments. Now with the payment banks things are a little different, in the sense that they are reaching areas of the economy which are not so payment-intensive, cash-intensive as of now and presumably even as those accounts emerge there would be a combination of cash and mobile payments which will take off initially. In the longer run, of course, we should expect that the usage of cash will fall and that is something that the RBI has been trying to encourage moving to a "Less Cash Societies" is what we call it. But, anyway, that will have a number of positives - more transactions will come into the formal sector, more transactions will get taxed, tax stake will go up. Negatives for us, of course, is that we lose in our seigniorage and we will have to find some way for the government to pay for us. But I think that is a problem which is 5 to 10 years away.

S. Subramanian:
Oaktree

With 50% of MFIs becoming small finance banks, how does RBI view rest of the NBFC-MFI segment?

Shri R. Gandhi: It is not 50% of the MFIs are getting converted into small finance banks. Of course, those MFIs who have got the license they have a big balance sheet, that way sizeable assets they do have. But that does not mean that when they become banks other MFIs cannot continue as NBFCs or new MFIs may not come on as NBFCs. That will continue. So long as there is a need for micro financing, we do expect that further players will come under this.

Promit Sengupta:
AIWMI

Do you think this present positive real rate of interest is hurting growth stories, because it is not sustainable if US Fed hikes rates and we reduce rates?

Dr. Raghuram G. Rajan: Today, the real interest rate in a number of industrial countries is probably close to zero. In India what we believe after this policy with the policy rate about 6.75 and the 364-day T-bill rate about 25 basis points higher, that means 7% nominal. And we expect inflation over the next year to be in the low 5s, so that would give us a real interest rate of about 2% and if inflation is on the higher side of say 5.5% that would give us 1.5%. So that is why we say we are still within the corridor of 1.5% to 2% real interest rate which is approximately I think appropriate for this stage of the cycle in India.

A. Prasanna:
ICICI Securities

Does today's policy action indicate that the RBI is worried about inflation under shooting the targeted disinflation path in FY17? On a related note, the statement mentions that RBI will be vigilant to keep the economy on a target disinflationary path. Does this vigilance apply symmetrically to the target path?

Dr. Raghuram G. Rajan: I think yes, we intend to be on the path and avoid over or undershooting. Some would argue that given the past history of failing to deliver on low inflation one should be more worried about having excessive inflation, an overshooting, and others would say, given the state of the world economy, given the state of the domestic economy, one should be worried about undershooting, that is too low inflation and some people are actually talking about deflation. So long as there are enough voices on both sides we are pretty happy staying in the middle.

Manoj Unni:
Paterson Securities
Private Limited

We understand RBI intends to target the CPI and not the WPI. Then why this 0.44% IIP 2023 are either not converted to CPI linked or given premature redemption? Please explain the thought process behind the same.

Shri H.R. Khan: We have made a reference to government and we have also discussed in yesterday's cash and debt management group. We have sent a proposal. Government is examining. Once there is some agreement, we will try to come out with some way of providing an exit option to this or converting to the CPI linked.

Swapnil Dhotre:
Rabobank

RBI has allowed local banks to issue market funds to fund their infrastructure lending. It is not clear whether foreign banks can do so given the nature of the constitution, i.e., branch of a foreign MNC. Therefore, is it possible to allow foreign banks to borrow from overseas lenders including their HO specifically for onward lending to infrastructure, with borrowings being exempted from CRR/SLR? How this is different from ECBs? This makes lending more credit efficient in our view while eliminating the FX and IR risk on the borrowers balance sheet as well and transferring it to the bank which is better equipped to manage these.

Shri R. Gandhi: Foreign banks in India the way they are functioning is today branch which is not a local legally approved entity like a corporate and for it to issue bonds, SEBI regulations would apply. So that would mean that foreign banks branches in India they do not today have the capacity or the authority to issue bonds and debentures. That is why the current provisions relating to issuance of bonds for supporting infrastructure funding, that kind of option is not available to foreign banks as of today. The question is that, "Whether foreign banks can be permitted?" That brings in quite a few other issues, not just this SEBI related permission, ECB related, Forex related also and banks' exposure to foreign exchange. All those things come into play. So it is not going to be easy to solve this issue as of now.

Bekxy Kuriakose:
Principal Mutual Fund

In RBI's assessment, are PSU banks on track to achieve their capital raising requirement under Basel-III guideline? Would the limited appetite for hybrid bonds in debt market pose a serious challenge to the relatively large capital requirements?

Dr. Raghuram G. Rajan: I think there is a game plan which the government has for the process of raising capital in the public sector banks. Step 1 of that game plan is to improve the governance structures in the bank; Step 2 which we are currently engaged in cleaning up the bank balance sheets; after which Step 3 is raising more capital at hopefully more favourable prices given the clean-up and the better governance which will allow these banks not just to meet the requirements but exceed them as they go on towards further growth. Now, we are working our way through Step 2, Step 1. There has been some change; we need to do more on the professionalisation of the bank boards. Government clearly has indicated its desire not to intervene as perhaps was done in the past and to make the banks more independent; the Finance Minister reiterated in his speech yesterday. I think that this combination of actions over time will allow them to raise capital to meet the needs of Basel-III. So the last element which could be thought of is a change in the organisational structure of the banks. We have advocated moving towards a holding company structure. And if they go towards that which eventually they will for variety of reasons including prudential, banks have the capacity to raise capital at two levels, both at the holding company structure level as well as the bank level. That will also contribute some to easing the pressure on the government. But all this is predicated on having greater access to markets, having the ability for the government to unload its shares and so on, which means the first two steps are needed.

Alpana Killawala: We will go on to open the line.

Shubhada M. Rao:
Yes Bank

Two small questions actually; one, would like to know from here on the role of household inflation expectations because I see from the monetary policy report that they still remain in double-digits at 10.5 and one year ahead at 10.8. But simultaneously you have also mentioned that there is an element of backward-lookingness in the household expectations. So from here on, how do we read the expectation numbers or shaping of the monetary policy stance? The second question is on the real policy rates. Are we to look at now T-bill rates and not the repo rates for looking at a ballpark of 1.5-2% of real rates?

Dr. Raghuram G. Rajan: Let me answer the second one, it was actually at a discussion like this may be few policies ago when somebody sort of asked the question, "are you talking about the instantaneous rate, are you talking about the 1-month rate, are you talking about the 10-year rate", and I think the guidance we gave then was it is the 1-year treasury rate and the expectations of inflation over the 1-year. So that is why I gave you the calculation at the beginning of this. Just to all be on the same page going forward that is what we can do. Let me say that the natural rate or the natural real rate is a moving object also. It depends on the state of the economy, it depends on the state of the global economy. So this 1.5% to 2% was something we suggested was appropriate in the recovery stage of the economy. Now going forward over time I do not think this thing is cast in stone, but I think it is appropriate given the current conditions. Urjit, would you like to say something on the other one?

Dr. Urjit R. Patel: Just to add on the real interest rate that this is a reasonable rate to look at the 1-year treasury because in some ways that is where the depositor is making his marginal decisions and so it is a good benchmark to look at. Not only in India but elsewhere the range of the real interest rate is largish, if not large, and it does vary according to the cycle. Coming to the issue of inflation expectations, yes, inflation expectations are an important data point for us to look at and has been the case the RBI for some time, and it does provide us with some information on almost a real time basis, if one quarter lag can be called that, on the pulse at which people feel that prices are rising. In one of the paras in the policy we have this situation where on a year-on-year basis vegetable prices have come down, but on a momentum month-to-month they have gone up and we think that is what affected the inflation expectations the most and it is something that we do have to keep in mind and it also is a cautionary tale that after 5 to 6-years of almost double-digit inflation prior to the current disinflation, people have embedded expectations which are high enough and serious enough for us to reduce.

Prakash Sharma:
CLSA

Just wanted to have a clarification on the regulatory part. Regarding the base rate draft exposure that was put up, there has clearly been a lot of noise around the marginal cost approach versus the reality for the banks in general in terms of how their effective cost move. Just wanted to understand the context in which it has been put out because banks do not really agree with that approach fully and based on the representation that you might have received so far, do you see some ground into the representations that have been made?

Dr. Raghuram G. Rajan: We live in a marginal cost world; we do not live in an average cost world because incremental loans are made in response to competition from markets which do not have any memory. So they are making loans based on what yields prevail in the market at that current point. Given that there are pressures on the banks to respond and you can see those pressures, I would say in the incremental loans that they are making, way interest rates are often more favourable than in the legacy loans that they have in the balance sheet, even though we say there should be no discrimination. The truth is that you cannot write off history and banks have typically become used to a reasonably slow moving base rate which gives them time to adjust the deposit costs before they adjust lending. Nevertheless even given that slow moving base rate they have been quite fast in the cycle to adjust deposit cost downwards. We have seen interest rates come down quite substantially even though lending rates have not come down that much. I think the bottom line is the market pressures and competitive pressures from a fast moving bank like HDFC would force other banks to move towards a more marginal cost based rate. We understand they have legacy issues, we are examining some of them. Over time if you look at what western banks do, clearly, they use asset/liability management to make sure that they do not have a huge mismatch between the interest rate sensitivity of their assets and the interest rate sensitivity of their liabilities. But also if there is still a residual sensitivity they use the derivative markets to balance that sensitivity so that they are hedged. I think our banks will have to move towards that. You cannot continue protesting that your costs are moving but the incremental loans require faster movement. Also we will have to move towards benchmark which is set by the market rather than by the banks themselves. This is something that will be the next step after marginal cost pricing. But, we are looking at some of the bank concerns and we will think about how to respond to those concerns in a way that moves the system forward.

Shankar Raman:
Centrum Wealth

I have two questions; first one was on the need for larger than 25 basis points rate cut since your last policy. If one were to try and bucket the various factors that drove this into three baskets so to say, first is are you foreseeing a much greater accelerated slowdown in the local economy and is that what has been the primary driving force or No.2, is it that our inflation management skills have improved vastly, be it on food or fiscal deficit or the output gap or No.3 being you wanted to give a shock and awe kind of a thing so that you get an accelerated response from the system in the economy and therefore chose to go for 50 basis rather than 25 basis. That is the first question. The second question was just wanted to understand are we kind of building some cushions for any kind of eventuality that can happen in terms of meeting any eventualities through probably a global volatility or a global meltdown or anything of that sort?

Dr. Raghuram G. Rajan: I am not sure what you meant by cushions in the second question. We clearly have some reserves we also are trying to sort of improve the quality of our policy making and we are also trying to create some growth, ultimately I think growth is the best defence in a world where growth is extremely scarce around. That goes to the first point that what are the reasons that we did more than 25. First, of course, the conditions that we had set in the previous policy as guidance were largely met. So I think almost everybody expected us to do 25. The question is why did we pick the extra 25. I would say two of the reasons you suggested are germane here. One, of course, is there have been a significantly greater worries about the global economy since our last policy especially with what has been happening in China, but also the troubles that Europe seems to be having now with the car companies but before that with the immigration; it seems to be a sequence of issues which could impinge on growth. Of course, there are bright sparks also like the United States which still seems to be on track. But the general sense is there is a downgrading of global growth with some worries about deeper concerns in some areas in the emerging markets. So that was probably the most important reason. I think we have also learnt over the last few months even given the tough monsoon conditions that there has been some check on food price inflation except perhaps for certain aspects of vegetables and pulses where some of it is a seasonal component also. So there is a sense that if this has been done for the second time in a row in a second near-drought situation, it suggests that at least some aspects of food management are getting internalised both preventive in terms of dealing with the planting and so on and then management of the output including imports to keep inflation under check. I think those were the most important. I have said repeatedly that shock and awe if we do something which is not warranted the effects last for a day, after which people start questioning the details, and then if they do not see the underlying support, then any shock and awe can dissipate very quickly. So that really is not the style of the RBI, we are trying to move based on fundamentals.

Shankar Raman: On the second question I was referring more to a banking system cushion in terms of building up some reserves to meet any eventuality typically in a slowdown NPA-related and stuff like that.

Dr. Raghuram G. Rajan: I think that the Government has put aside more money for recapitalisation which was announced recently, the Rs.25,000 crore. But going forward we do have to continuously revisit the issue of bank capital given the kind of strategy that I spoke about earlier in the program.

Aditya Badami:
Copal Amba

I have two questions; the first being on the Rs.50,000 crore Discom loans that are currently outstanding, what are your views on any governmental progress on it? Would it not make sense to restructure those loans into bad bank mechanism? I know that the Governor is against that. The second question is that closer to home, countries like Malaysia and Indonesia currencies plummet of late. Do you anticipate a contagion to India's banking system and dare I ask repeat of Asian crisis?

Dr. Raghuram G. Rajan: I will try and answer both. On the Discom, effectively, the liabilities of the distribution companies, most of these are State-owned will be of the States. And if the States take over the liabilities or significant portion, that is virtually creating the bad bank that you want, but it is basically the State taking over the liabilities and leaving a cleaner Discom. That is one, but it is more than just taking over the debt, it is also the issue of ensuring greater efficiency in distribution in dealing with the line losses and making sure that the line losses are brought down rapidly, ensuring these entities become cash flow-positive quickly. Those are all actions that have to be taken. The central government is very serious about cleaning up the Discom problem and we are certainly on the RBI side intend that this problem be resolved once and for all and not move down the road for others to take care of. One aspect of this resolution will also be power tariffs which will have to be moved to a point where they make sense, the Discom becomes viable. You ask if the Asian crisis could happen again. I am hopeful that market participants have become more discerning and can understand what is a good growth opportunity and what is not. At the same time I think that countries themselves across Asia have built a variety of buffers and policy also is much better and finally exchange rates are floating exchange rates rather than fixed exchange rates. All of which will make a difference and ensure that the kind of contagion we saw certainly does not repeat verbatim. Now that said, these are periods of high volatility and I think we have to navigate these very treacherous periods carefully. So I have refrained from ever saying that we will not experience any volatility, but I do think after bouts of unthinking volatility when people get their brains on again I think they start differentiating between the weaker and not so weak economies, and my hope is that we continue to do enough that differentiation takes place.

Rakesh Chelapareddy:
Karvy Stock Broking

I have one question regarding the currency limits especially when you refer to increasing the limits for currency hedging for sophisticated investors to participate in the currency market without any underlying. This could actually lead to speculation in short-term and also is in sharp contrast to earlier moves from the central bank when such facilities were curtailed or investors were stopped from participating in the currency market. So my question is what were the motives for such relaxation and what results do you see from such a move?

Dr. Raghuram G. Rajan: In every market you have a combination of hedges and speculators. You cannot have only hedges somebody has to take the other side. So in any such market it cannot be only banks taking the other side, it has to be private participants who have a variety of reasons for taking a bet. So what we are trying to do at least in my mind is explore the possibility; nothing is yet determined but explore the possibility of allowing more investors who want to take a position in a currency because they think it will go in one way or another. Yes, these are speculators but they are not market manipulators. What we do not want are market manipulators who move the market in particular direction, but if somebody wants to take a bet in the same way as they take a bet on a stock, they provide some depth to the market and therefore allow the hedgers, the ones who actually want to sell dollars, there is somebody else willing to buy dollars or vice-versa as the case may be. So if we are to have deep domestic markets we have to allow a variety of players with different views and that means allowing what you just called the ‘speculative element.’ So long it does not overwhelm us to begin with, I think over time depth will provide enough possibilities for all manner of investors. So we are just exploring at this point and we will take a first step as and when we decide it is appropriate.

Anjali Verma:
Phillip Capital

My question is on the statements in Para.15 and Para.16. It basically reads that after accounting for today’s 50 basis points cut and given the projection of 5% March 2017 inflation, real effective exchange rate should be around 1.5-2% which would basically mean that no further accommodation should happen. However, in the following line it says, while the Reserve Bank stance will continue to be accommodative. So can you please help me understand this?

Dr. Urjit R. Patel: I do not think there is any tension between those two paragraphs. What is being stated is that if the inflation turns out the way we expect and that is a central projection, then the real interest rate that falls out of that given the 1-year rate is 1.5 to 2% points. If things were to evolve differently, then monetary policy will respond and that will respond both ways. So I do not think there is any tension in those two paragraphs.

Anjali Verma: So basically what you are saying is if at all it pans out differently, only then accommodation will continue?

Dr. Urjit R. Patel: If things go the other way round then there will be something other than accommodation.

Devika Mendiratta:
ANZ Bank

I just wanted to know that what are the key drivers for inflation to fall as per your projections from about a little below 6% in Jan 2016 to a little below 5% in Jan 2017, the 4.8% is what I am referring to. Also, what are your assumptions on the impact that GST implementation could have I do not know whether you are assuming that would be implemented anytime next year? And also what about any upside risks from possible tariff increases by the power Discoms?

Dr. Urjit R. Patel: There are several factors which could help bring inflation down further; one that the output still continues to be negative, the capacity utilisation is still in the early 70s in terms of percentages and global commodity prices continue to be soft. On top of that another assumption on the inflation front is that the fiscal deficit targets are adhered to this year, next year and the year after. So I think there are enough reasons for this projection to be the baseline projection. And of course, it is a confidence interval at the end of the day. So if things turn out differently, then that is what the width of the funnel shows.

Devika Mendiratta: Any comments on GST implementation or tariff increases, do we need to watch out for those factors at all?

Dr. Raghuram G. Rajan: Yes, GST implementation, there is certainly a hope that it will be done this year and be ready to roll by March 2016. Of course, there are positives and negatives for prices from that; it may be there is better collection of some of the taxes and they go into increase the price of commodities, on the other hand, there are some efficiency gains which may reduce the cost in terms of logistics, transportation, etc., which may have some offsetting effect and then if there is more production and better unified markets in India, there are wide variations in prices across India and a more unified market could bring down prices. So there are a variety of factors. I do not think anybody knows on net what GST would do for inflation. I have seen some numbers floating around, but I am not sure that I give it a lot of credence given that we do not know the size of all these effects. Tariff increases if they come through will be similar to what we have always been seeing about petroleum subsidies, because effectively not passing through the full price of the electricity is on the one hand encouraging consumption which then creates some shortage, etc., and creates a fiscal deficit which then effectively implies more spending, and on the other hand if the prices are increased then the fiscal deficit reduces and consumption will also become more moderate and appropriate, freeing up supply for other more demand. Here again I would say short run effect would probably be more inflation, medium run would actually mean lower inflation. Many of our projections are really about the medium term, but medium term whether it is 1.5-2-years we will have to see.

Prakash Agarwal:
Vidushi Financials

I would like to ask you that a lot of students, a lot of unemployed and a lot of youth connect with you very well and they look at RBI policy as a very blockbuster, Hollywood and Bollywood release. How do you connect with them and how do you feel that RBI is important in creating employment for them?

Dr. Raghuram G. Rajan: We are part of the bigger government process which is about creating an economy with a sound framework where business wants to invest and create jobs, farmers want to produce more output, and of course a variety of self-employed people want to do more. We are engaged in doing that. If you start thinking every time my ‘thus and such’ policy will affect so many people, you can get overwhelmed very quickly and be paralyzed. So I think the way one actually connects, I think that was the thrust of your question, is by meeting people, you go around to schools, you go around to villages, you go around to different towns in the country and meet people and find out what is happening. We visit various NGOs, we see what they are doing, we visit various banks and we get a sense of the pulse of the country but that is the best I can offer to your question.

Prakash Agarwal: Do you not think that it is important that whatever your interaction, whatever your meetings on the ground reality situation, you should be sharing that also online with the youth so that they can have a realistic view of what is ahead for them?

Dr. Raghuram G. Rajan: I think we try and communicate as best as we can, but my sense is a lot of our youth are not living in cocoons, they actually subject very quickly to the harsh realities of life much more so than some of us were in our childhood. So I am not sure we need to educate them, sometimes they need to educate us.

Nandita Mittal:
SBI Mutual Funds

My question is considering the growth and inflation outlook for the year, what is the reserve money expansion that the RBI would be comfortable for this financial year?

Dr. Michael D. Patra: The reserve money growth that we envisage is the nominal growth of the economy, it is growth and inflation put together and that should meet the transactions demand in the economy.

Nandita Mittal: Is there any particular number that you are looking at?

Dr. Michael D. Patra: It is about 11%- the nominal growth, it is also reflected in the union budget.

Alpana Killawala: Thank you very much, Karuna, and thank you very much to all of you who join this conference call.

Moderator: Thank you very much, ma'am. Ladies and Gentlemen, with this we conclude today’s conference call. Thank you for joining us. You may now disconnect your lines.