Transcript of the Reserve Bank of India Post Policy Conference Call for Researchers and Analysts

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Participants from Reserve Bank of India:

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Moderator Ladies and gentlemen, good day and welcome to the Reserve Bank of India Post Policy Conference Call for Researchers and Analysts. As a reminder, for the duration of the conference, all participants' lines will be in the listen-only mode, and there will be an opportunity for you to ask questions at the end of today's presentation. Should you need assistance during the conference call, you may signal for an operator by pressing '*' and then '0' on your touchtone telephone. Please note this conference is being recorded. I would now like to hand the conference over to Ms. Alpana Killawala from RBI. Thank you and over to you, Ma'am.

Alpana Killawala Thank you, Laveena, and welcome once again from the Reserve Bank of India for this post policy teleconference for researchers and analysts. I will request the Governor to make a short statement and then we can start question-and-answers.

Dr. D. Subbarao Thank you very much. Good afternoon to all our listeners and all our analysts. As I have said in the past I want to say once again that we attach a lot of value to this teleconference because it helps us understand a number of questions that we should be thinking about. I presume that you have all read the statement very carefully, so I will just make a very brief statement just so that we all get warmed into this conference.

Yesterday, we did two actions: we cut the repo rate by 25 basis points from 8% to 7.75% and the CRR by 25 basis points also, bringing it down from 4.25% to 4% of NDTL. This decision was informed by three considerations. The first was the moderation in inflation both headline and core. We also looked at all the indicators of inflation. Some of you keep writing and saying that we have a bias towards one index of inflation but that is not true, we look at all indices of inflation, including the CPI. Indeed, as the CPI shows, CPI was in double-digits for December but if you knock out food it remained at 8.4% for the last three months. So the first consideration was the decline in inflation. The second was clearly the deceleration in growth. And the third was the liquidity situation.

Just on liquidity there was as per our assessment shortage because of three factors. First, the build-up in the government's cash balances. The second was the festival related currency demand. And the third factor was the wedge between deposit growth and credit growth; credit growth was 16.2% whereas deposit growth was at 13.3%.

Those of you who have been keeping numbers would have noted that we took a number of actions over the last four months to manage liquidity, in particular our reduction in CRR in September and October has added systemic liquidity of Rs. 350 million. Yesterday's action of another 25 basis points would add Rs. 180 billion. So that is taking total increase in liquidity because of CRR actions to Rs. 530 billion. On top of that during the months of November and December we had done OMOs of Rs.470 billion. So the total injection of liquidity as a result of reduction in CRR and Open Market Operations has been a trillion rupees. Regardless of that we found that average LAF borrowings during the month of January were Rs. 910 billion clearly above the indicated target of (+/-1%) of NDTL.

Just a short explanation on why we had to do the CRR action in addition to the rate action. Because our staff who have done the analysis have told me that rate action by itself would not have resulted in the necessary transmission of the policy rate to the banks' lending rate, so we had to do a CRR action on top of a rate action.

The last thing I want to say is about the guidance that we have given. We have said that there is a scope for a rate reduction going forward, indeed for the larger monetary easing going forward but the space is quite limited. Limited because of how we see the inflation trajectory, a number of upside risks to inflation. Most importantly, the suppressed inflation that will come off coal prices, electricity prices might be adjusted in the next few months. Depending on how much they are adjusted and when that will have implications for the trajectory of inflation.

By far the biggest risk to inflation trajectory, to monetary policy and indeed to the macroeconomic management will be the current account deficit which for the first half of this year was 4.7%. The second half is likely to be higher and this year's currency account deficit is likely to be significantly higher than last year's current account deficit. So we have to take into account the implications of the size of the current account deficit in our monetary policy action. I will stop there. Thank you very much.

Alpana Killawala We can start the questions, Laveena. Can I make a little request to all the participants? Please be brief in the question so that we can take in more questions.

Moderator Thank you. Participants, we will now begin the question-and-answer session. The first question is from the line of Mr. Srinivasan Varadarajan from Mount Nathan Advisors. Please go ahead

Srinivasan Varadarajan I have a couple of questions really on growth and inflation and here it goes. If one accepts that a large trade deficit really represents aggregate demand and in India's case when we report a GDP number of 5.5% or 5.3% the trade deficit being a negative number actually dampens the reported GDP given the fundamental identity of GDP. And the point is that in the case of countries like Korea and Germany they run a trade surplus; the trade numbers have an upward effect on the reported GDP. I mean given this should we not focus on aggregate demand as a combination of the reported GDP number and the trade deficit? The point I am trying to make here is that a low growth number does not corroborate with such a high trade deficit as is the case in India. And the other thing is really on inflation and policy rates. I mean, I was just thinking how does one square up cutting rates on the basis of a pretty labile WPI momentum, CPI in double-digits, a growing current account deficit, large gold imports being symptomatic of negative real rate for savers and very high inflation expectations. We have inflation expectations of 12% three month forward and 13% for one year forward and these have been pretty sticky for the last two years and it seems to me that these inflation expectations have become quite unanchored in India. And the point is that by giving the stimulus and the fact that our potential growth rate has actually come off from 9% to maybe about 7% given our savings rate of 32% and acceptable current account deficit of 2% and an ICOR of 4.5%. If the potential itself has come down to 7%, given these actions would it not actually overheat pretty quickly because all these have a pretty significant implication for the currency and confidence for foreign investors. So how would you respond to this?

Dr. D. Subbarao Thank you for those questions, Srinivasan. I will first answer your second question about our assessment of current inflation and inflation trajectory which have informed our policy decision. First thing inflation has come off from double-digits and we have also said more than once in the statement that it is probably peaked. If you look at WPI it has come off from about 10% to 7.2%, core inflation is just above 4%, CPI inflation as I said in my opening statement is high but if we knock off food it is plateaued and the momentum of inflation indicators also show that the momentum is weakening. However, we take your point and we recognize ourselves that inflation upside risks are still there and we have pointed to them in the statement that explained them in detail in yesterday's media conference. First, food inflation is still high and that could endanger inflation expectations, there is the diesel price adjustment which will also have an impact on inflation, inflation expectations and therefore on the monetary policy response. I want to add here that we have always maintained that adjustment of diesel prices is important for long-term inflation management but in the short-term we will have pressures. Then there is the risk from global food prices which have plateaued but we would have liked them to soften and there was expectation that they would soften further because of the global demand conditions, the fact they only plateaued shows that there are upside pressures. If you combine that with the exchange rate movements we might have higher rupee price of diesel, of crude prices, then there is the dimension of suppressed inflation, especially in coal and electricity, some adjustment will take place there which will have implications for inflation and finally, there is the wage pressure; rural wages have gone up last year by about 18% which means that in real terms they have gone up by 6 to 7%. And as you mentioned yourself there is the big risk of the current account deficit which will have implications for larger macroeconomic management but also for inflation and for monetary policy decision. We have taken all this into account in calibrating our policy yesterday. We have one variable, the interest rate. We have to manage several objectives. We got to support growth which requires lower lending rates, we have got to restrain inflation, which requires higher interest rates, we have got to restrain the current account deficit which means that interest rates have to be high for importers and at the same time we have to encourage savings through higher deposit rates. So our decision yesterday was informed by managing these conflicting considerations. On the first question you asked about the national accounts identity I did not understand your question.

Srinivasan Varadarajan The point I am trying to really make here is that we have a very large trade deficit which even abstracting for gold and oil, represents aggregate demand. And the fact is that while we report a very low growth number of 5.5%, a low growth number should usually corroborate with insignificant trade deficit but we have a low growth number with a very high trade deficit. So something is not squaring off over here. So, the point is that as I have been observing you have this whole interest rate cut brigade which persistently kind of keeps invoking interest rate cuts and pointing out to a low growth number. But the point is that a low growth number should be corroborated by a low trade deficit which is not our case. I mean one is happy that obviously policy is not appeased to such invocations but clearly, this is something that needs to be pointed out.

Deepak Mohanty Despite why the trade deficit eased, because traditionally the trade deficit has been high in our case, bordering around 10% and if you go by the national income identity itself C+I+G+(X-M) so automatically the import component is subsumed in C+I+G so already it is there. If you have to add it on top of that there would be a double counting. So ultimately we would have to see that aggregate demand again would be represented by GDP whatever way you see, of course, the aggregate demand numbers the way that we do in our case in India, as you know, are not very good, but still it has to be approximated by the overall GDP. Adding the other number would be erroneous. At the same point we do take your concern that in a slowing economic growth the high trade deficit is a matter of concern and show some imbalance. So partly, this could be that a lot of domestic production is getting substituted by imports. For example, if you see capital goods imports are quite high and whereas you look at the domestic production component in the IIP that you would see that capital goods is a big negative there. Same is the case of steel. You can have many instances happening there. But why that is happening is also difficult to explain. So we do take your concern on the expanding trade deficit side but we cannot say that this itself will show that the aggregate demand is too high.

Srinivasan Varadarajan Mr. Mohanty, the only concern that foreign investors have is that somewhere down the line given the huge current account deficit and the pressure on the currency one should not get into a scenario where you actually begin to raise interest rates to defend the currency and invert the yield curve.

Dr. D. Subbarao No, we do not do that. We do not manage the currency, foreign exchange market for any other purpose except to manage volatility. In any case while Deepak was talking I just pulled out the numbers of net exports. In the demand side GDP the share of net exports both in 2010-11 and 2011-12 was negative but contribution of net exports to GDP was positive in 2010-11 but negative in 2011-12. So I do not know if that has any implication for the question you are asking but I think it has an implication.

Srinivasan Varadarajan Right, absolutely. One last bit, really in terms of this liquidity situation, I was just thinking, do you think it would have made sense in 2009-10 when there was an opportunity for you to collect the FX inflows and sterilize those inflows. One should have done so because that would have kind of represented a stock of potential primary liquidity, that could have been unwound and the system is currently undergoing this reserve money shock right now and you need to kind of keep creating primary liquidity through your open market purchases. So the composition of your domestic assets is increasing compared to your foreign exchange assets in your balance sheet. While you need to create primary liquidity that is understood but one can see this is actually accommodating the fisc in a very high inflation environment. So how do you balance this out actually?

Dr. D. Subbarao Are you talking about Forex intervention?

Srinivasan Varadarajan Yeah, I am talking of Forex intervention if you sterilize that, the reserve money actually created could be unwound in periods of stress like this without actually resorting to OMOs.

Dr. D. Subbarao But as I said in answer to your question earlier we intervene in the foreign exchange market only for purposes of managing volatility and not for bolstering our reserves. That has been the policy and that still is the policy.

Moderator Thank you. The next question is from the line of Ms. Garima Kapoor from Aviva Life Insurance. Please go ahead.

Garima Kapoor I wanted to just understand the rationale behind usage of OMOs as an instrument to create liquidity vis-à-vis CRR because in the entire year you have seen you have the options whereby there was only CRR cuts then followed by OMOs, then again there will be OMOs being undertaken and again CRR. And in this context would it be fair to assume that because the stress on the deposit and credit rate gap seems very endemic, the CRR cut could largely have helped to cushion the margins of the banking system currently more than and making it much more easier for them to pass off rates and if that is the case and if the structural liquidity problem is likely to persist then are we expecting RBI to forever remain in the liquidity injection mode next year as well?

Dr. D. Subbarao A larger answer to your question is that we have several instruments for liquidity management, there is the CRR, and there is the Open Market Operations (OMO) with or without an accompanying reduction in SLR. As part of larger liquidity management we have also expanded at one time the export refinance for rupee export, rupee credit. And also as we just talked about liquidity in the system changes because of the Reserve Bank's FOREX operations not because we intend to do it but that is a byproduct. What instrument we use depends on our assessment of the liquidity situation, our assessment whether it is structural or temporary or tax payment schedule, about the government's spending program and also whether the liquidity problem is across the banking system or pertains only to some of the banks. We take all this into account in determining what instrument to use and how much to use it for. So while you can make some inference from what instrument we have used, I am not sure interpretation is always correct.

About how we will manage liquidity next year and whether it will always be in the deficit mode it is not clear but what is clear is that as long as we are trying to contain inflation it will be a deficit mode. How much deficit is cannot be said at this time except that will be within that -1% of NDTL.

Garima Kapoor So there is no clear cut demarcation whether or not if the assessment of liquidity scenario is frictional in nature that one would resort to OMOs, if it is structural in nature one would resort to CRR, because the current CRR cut was at a situation where the government has still quite a bit of cash balances with RBI. And then in the previous instances when you did OMOs worth of Rs.47,000 crore that time it seemed more often effective trying to balance the stress which was coming because of advance tax and because of festive related stress. So that is why I am trying to understand whether it is frictional or structural in nature which defines your instruments?

Dr. D. Subbarao Not really. If liquidity is a function of one variable only, then we can demarcate, in Chinese wall sense that you are looking at it. But at every point of time systemic liquidity is a function of a number of frictional and structural factors. So what instrument we use depends on our assessment of the liquidity situation going forward.

Garima Kapoor So in that context you are not looking at any lower bound for CRR at all?

Dr. D. Subbarao The lower bound is set by the law.

Moderator The next question is from the line of Amey Sathe from JM Financial. Please go ahead.

Amey Sathe One question on the SEB restructuring. What is the RBI's position on the SEB restructuring?

Anand Sinha Discom, the central government has come out with a very comprehensive restructuring plan and in that they had one aspect to do with RBI in particular. That was about whether to treat it as a second structuring or not, obviously, their request was not to. We have agreed to that because the first restructuring which was done in three states had just been done, I mean, not even one year is over and that restructuring one cannot say has failed. What has happened is that a much more comprehensive restructuring plan has been put in place, and which is much better for the banks. So that is why we have not considered it as a second restructuring and given the benefit of asset classification.

Amey Sathe And will the bonds to be given the SLR status?

Anand Sinha No.

Moderator Thank you. The next question is from the line of Shyam Poddar from Forex Capital. Please go ahead.

Shyam Poddar I am also calling on behalf of as a Co-Chairman of Economic Advisor Committee of the PHD Chamber. I have got two questions. One is the currency volatility. And second, about our declining export despite of the rupee value decline in the last year up to Rs. 57. And when we are talking about the volatility and curbing the volatility do you not feel that the external factors are more responsible of creating artificial volatility than the real volatility. For example, when we have got freedom for any – without underlying to hedge the currency risk in the MCX or NSE and the foreign investors they do their currency volatility and demand and supply mismatch which is being created in the NSE or MCX whereas there is a lot of restriction in the OTC. My second question is about the interest rate. The cost of fund is a determinant for boosting the export, where RBI has guidelines that 2.5% below the base rate, but the base rate when it is not uniform, rather why do not we look at the issuing a benchmark rate as a bank rate and then put the cap of 3% or 4% or 5% over the bank rate so that the small and the medium exporters can also be benefited instead of having a differential base rate of the different banks.

H R Khan I only like to tell you that currency future we have put some restriction on banks you are aware. In the recent past, we have put some restrictions of how much position they can take and the connect between currency future and OTC has been also taken up because we have said that you cannot offset the position of currency future in OTC market. So that link is no longer there. But as you know this whole thing came about to facilitate small and medium exporters, SMEs, those who find difficult to hedge in OTC. So this is a product which has come but as you have seen though there is without underlying the terms and conditions are different, neither the currency future nor the NDF has not that significant impact on the OTC market which as you said is driven by underlying and we have put in place controls. So from that side we do not see major problem. Although it is a fact that currency future does not require underlying and there is scope for speculation but we have tried to curtail by doing this that you cannot take position in one, and offset that in another segment.

Shyam Poddar May I interrupt you here for a minute? Once we are talking about the currency future there is no liquidity beyond two months or three months about the currency future. So it is very wrong to say that the smaller and medium exporters they are being benefited in the exchange for hedging the risk because number one, that is a fixed dated contract which is being done in the exchange whereas any exporter and importer when they want to hedge they want to have auction delivery, number one. Number two, in the future market and the options market, if you look to hedge the risk that is not beyond the one month's liquidity, so it does not help really to the small exporter and importer rather in the line of the NDF, which is the volume has gone up more than $24 billion, daily average volume in the NDF market, and this is not my figure, this is the figure of BIS. So if you look at that volume and definitely it has got a greater impact on the currency volatility in the Indian market.

Dr. D. Subbarao Thank you Mr. Poddar, we will keep that in view and we will reflect on that. I am going to request the Deputy Governor, Sinha to answer your second question.

Anand Sinha You are advocating a uniform base rate or a mandated base rate?

Shyam Poddar Yes.

Anand Sinha Base rate by definition cannot be mandated.

Shyam Poddar I am not talking about the base rate sir. I am talking about the benchmark rate, because some banks, their base rates may be 11%, some banks base rates may be 12%. Even by going by that standard, if the 9% less than the bank rate is there, however the 9% if they are allowed to charge up to maximum 5% or 4%, then all the prime banks, they can charge to any customer as per their credit worthiness of the customer. At least any small customer or the big customer, everybody, they have got the uniformity over the prime bank rate, the bank is free to charge up to this much from any customer.

Anand Sinha No, but in this case, first of all the base rate of different banks does not vary, there is not a very large band around it, so I don't see it.

Shyam Poddar It is always like private banks, the other banks it is very easy to say to switch over the bank, but in practice it is impossible. So, I don't understand if the bank rate can be as a benchmark rate for all the banks and for their cost of fund. If the cap can be made, let us say 9% over 4% or 5%, maximum one bank can charge from the exporter. So he may charge 1% over the bank rate, he may charge 2% over the bank rate as per their cost of fund.

Anand Sinha So there will be a differential still, is it not?

Shyam Poddar Definitely, there will be no differential I mean.

Anand Sinha I do not think that the linkage to base rate is going to create too large a differential or there is going to be too much of a difference between what you are saying and the present system.

Shyam Poddar Sir, it is in the present system, it is a practice. Practically it is there.

Moderator Thank you. Our next question is from the line of Mr. Prasanna from ICICI Securities. Please go ahead.

Prasanna My question is regarding the hierarchy of variables. I know that RBI has multiple indicator approach, but just to try to get some clarity. You flagged off current account deficit risk in yesterday's statement. I think previously you have flagged off fiscal deficit. But my understanding is inflation is still the primary variable in driving your decision. Just wanted to get clarity from you. Basically my hypothesis is if inflation does come down, a surprise much more than what you estimate, then RBI will be more willing to cut rates irrespective of where the current account deficit or the fiscal deficit ends up. Is that hypothesis correct?

Dr. D. Subbarao No, it is not correct. We will take into account what the current account deficit is. It will not be driven just by the inflation number or the inflation trajectory.

Prasanna I have one more question. This is on the OMOs basically. Since it has become an annual feature, OMO seems to be the primary way in which RBI can infuse liquidity into the system. I was just wondering is there any way it can be done or RBI has been thinking about doing it in a much more nondiscretionary manner, like the beginning of the year or the beginning of the quarter if you assess that this much of OMOs have to be done, can it be done on a monthly basis, say a standard amount or a fixed amount, instead of being it in an adhoc manner that every two months you announce OMOs and do it and then you stop it?

H R Khan We do not have that scientific basis of calculating how the liquidity thing will progress during the year. We do not have that fixed, what will be the shortage at what point of time, we cannot commit to a calendar.

Moderator Thank you. Our next question is from the line of Mr. Tushar Poddar from Goldman Sachs. Please go ahead.

Tushar Poddar I also wanted to ask a question on the issue of the current account deficit. You have rightly flagged that it is one of the key macro risks for the economy and something that you will take into account in your monetary policy. Now, we know the relation between the fiscal deficit and the current account deficit is pretty clear. My question is, can and should monetary policy be setting interest rates to meet a current account deficit objective? And I ask that because as you said, the RBI has one instrument, which is the interest rate, and it has multiple objectives. So, are we adding now to that suite of objectives by including the current account deficit? Does that not complicate your ability to meet any of those objectives or should you not segregate fiscal policy to deal with current account deficit and monetary policy to deal with the growth inflation tradeoff?

Dr. D. Subbarao That is really a seminar topic, Tushar. So, it is difficult to assign instruments to each policy in the real world of policy making. So, as much as price stability is the main concern of monetary policy, we have to be sensitive to growth concerns, to external sector concerns because they have implications for price stability and that is what we were trying to convey yesterday that current account deficit has macro economic implications, but it has importantly implications for the price situation for inflation movements and therefore for monetary policy. So it will be difficult to say that monetary policy will just look at the inflation number and remain blind to all other variables. Urjit**,** you want to say anything?

Dr. Urjit Patel I would concur with what the Governor has said. Only to add that monetary policy and fiscal policy, both impact aggregate demand and therefore both have implications for the current account deficit and similarly the fiscal deficit, you pointed out should be used as the main instrument for current account deficit management. The fact is that fiscal policy also affects inflation and inflation expectations as we have found in the Indian economy, so it is not a clear cut objective to instrument mapping.

Deepak Mohanty Tushar, just to supplement what the Governor and Deputy Governor said, we should not see it in a water tight compartment because in a multiple indicator approach certainly the external balance and exchange rate are also important indicators and they are indeed interrelated, because the interest rate has an impact on the exchange rate, to that extent the external balance. And similarly, inflation has also impact on the exchange rate and external balance. So, it has to be seen in that particular frame while formulating the interest rate policy.

Tushar Poddar If I may just take 30 more seconds on this issue, I completely agree with the explanations given. My question is can it actually compromise your growth inflation tradeoff if monetary policy is being used to control the current account deficit and it is especially problematic when we don’t have any set targets or a sort of a road map as to what current account deficit is a comfortable one for monetary policy to be on the easing mode or on the tightening mode. So, if you have any comments on that.

Dr. D. Subbarao I have a short comment, which is that we are not targeting the current account deficit rate for, by way of monetary policy. What we all try to convey is that the current account deficit has implications for inflation and therefore for the conduct of monetary policy. So we have to take into account the implications of the current account deficit for monetary policy and the implications of monetary policy for current account deficit. It is not that we are trying to target CAD by way of monetary policy.

Moderator Thank you. Our next question is from the line of Sonal Varma from Nomura. Please go ahead.

Sonal Varma Hi Sir, I have three questions, so I will be brief. First, how will RBI react when suppressed inflation is released. Will it be seen as tightening fiscal policy, so should we expect monetary policy to become accommodative, or will the RBI be cautious in the interim? Second, I was wondering whether drawing comfort from following WPI is perhaps misplaced because it seems to be driven more by global commodity price cycles. I mean we have seen similar divergence between WPI and CPI in 2009 as well, so is the RBI thinking about moving from WPI to CPI which is a true reflection of the underlying inflation in the economy and not really WPI. Third, if you could throw some light on RBI's thinking around the neutral rates and how far are we from that?

Dr. D. Subbarao First on our response to release of suppressed inflation. We recognize that if it is a one-off impact, monetary policy should not normally be responding, but it depends on how much is the impact, and what impact it might have on inflation expectations. But, I do want to say that we have factored in, we made some assumptions about how that suppressed inflation might be adjusted in the months ahead. Therefore, I don't think there will be major surprises there. There is some trajectory of inflation. Unless we are surprised very much, monetary policy will be consistent with the guidance that we gave yesterday. Then about whether we are drawing too much comfort from falling WPI? No, we have indicated that WPI has come off from the peak, it is just above 7% now. It will be around the current levels, around the current levels is certainly above the Reserve Bank's comfort level, therefore we need to bring it down further. Certainly there is no comfort from declining WPI or the current level of WPI. The second subset of that question was, whether we should be looking more at CPI. Well, we are looking more at CPI, indeed we always have been and we are even now looking at CPI in that we become more sensitive to that after you analysts have told us that we must convey that impression that we are looking at all indicators more convincingly and we have tried to do that. So, once again I want to say in this teleconference that we look at all indicators including the CPI, and we are not guided just by the WPI. But, you must recognize also that looking at just the CPI, will be inappropriate for monetary policy response given the inadequacies of our inflation measures; we have to look at all of them. About the neutral rate, that will depend on what our estimate of potential growth rate, etc. We have talked about it before, we do not have at this time any indication of a neutral rate that it will be that rate at which inflation will come down to our projection or our aspiration of 5%. So it will be difficult to lock ourselves into a specific neutral policy rate.

Moderator Thank you. Our next question is from the line of Rajeev Malik from CLSA. Please go ahead.

Rajeev Malik I have two sets of questions, one around what motivated the actions in policy and second one with the guidance. With the first one there seems to be the same, when RBI wants to sound a bit hawkish, it focuses on the high CPI, when it wants to do something in terms of easing, it actually tends to ignore. So I just want to find out in that sense, what is the justification for ignoring a core CPI reading that is sitting at 8.4%? It was interesting you characterized in response to one of the earlier questions that it has been stable for the last few months. I would actually interpret that it has actually stabilizing at an exceptionally high level, which should be a negative. So, just want to understand, in all the recent months including yesterday's action, how come core CPI has not really played any role which sometimes as simply as in the December meeting was also used as a reason for staying on hold. Second, in terms of the CRR cut that you indicated, reasons about structural deficit. Could you give us a sense of what is Government's cash surplus sitting with RBI. Our sense and this could be incorrect, is that it is around Rs. 900 billion mark, which means that the bulk of last deficit is actually because of Government's slowdown in spending. So what exactly is the structural situation there and more importantly come the new fiscal year when Government spending picks up, how is the liquidity situation going to be managed? In relation to this in response to your earlier question that you were not sure whether liquidity would remain in deficit or not, I was actually somewhat surprised because can RBI maintain repo rate as a target rate if LAF is in actually huge surplus? Thank you.

Dr. D. Subbarao Thank you Rajeev for those questions and the opportunity to clarify. First about your question on the motivation for yesterday's policy, and about how we are sending confusing signals or actually acting opportunistically, depending on what action we want to take. Perhaps that is the impression you get, but that is not the impression that we want to create. We have looked at all indicators WPI, CPI, and core CPI, and justified or explained our action based on the current levels of these indices as well as our assessment of their future trajectories. So it is not as if we are conveniently choosing a specific instrument to justify specific action or inaction. Once again I want to convey that we looked at WPI, we looked at CPI, we looked at core CPI, core WPI, the momentum indicators, and having looked at all that, and given that we had to balance growth and inflation and other concerns that we talked about including the current account deficit concerns, we took yesterday's action. About your second question, I said, thank you for this opportunity to clarify, because I actually wanted to say what you had said. If I had said something else, it is wrong which is that given that we have got to combat inflation, we want to keep LAF in a deficit mode. Okay, but we don't want to keep it in such extreme deficit or such extreme tightness, that monetary transmission does not take place. So, it is certain that as long as we are in an anti-inflationary stance, it will be in a deficit mode, but within that (+/-1%). The most substantive part of that question was about the Government's cash balance we don't disclose, so Khan is telling me that we don't disclose that. We have requested Government's permission to disclose that in the interest of transparency and in the interest of our interlocutors and analysts and stakeholders having as much information as we do, but we are yet to get the clearance from the Government.

Rajeev Malik Just to clarify on the issue about LAF deficit in tightening mode, etc., I thought that was really the play before RBI moved to a single policy rate like the repo rate. Now the system is obviously untested because we have not seen an easing mode in the new operational setting.

Dr. D. Subbarao We hope to soon. Sorry, I interrupted you. What I said was that we are hoping to see so.

Rajeev Malik Absolutely, so my question really was, can repo rate remain the operational policy rate if LAF is in surplus while you are in an easing mode and the reason I ask is, there is still a lot of confusion compared to what used to be the procedure prior to RBI moving to repo rate as a single policy rate.

Deepak Mohanty Rajeev, just to supplement what Governor said, because of course you are concerned about the government's cash balance and the question if I understand correctly. If the Government starts spending, is the LAF window going to turn into surplus, the answer to that question is, no. Because then you would be into a new year. So you know that, if you are not doing anything on the Forex side, it is without the Reserve Bank's intervention, primary liquidity creation will not happen, unless we think that the economy is growing at a breakneck speed, there is a lot of credit growth and multiplier is just increasing like anything, but that in the current ambience is unlikely to happen. So, given that scenario at least in the near future, future you know, long term what happens we don't know. So, despite government draw down of cash balance, our understanding is that the LAF window would not turn into surplus.

Rajeev Malik So, basically repo remains the operational policy rate and to justify that LAF would have to be in deficit. Do I understand that correctly?

Deepak Mohanty Yes, that is right, the way that we had articulated, because in terms of monetary transmission, we said that when the liquidity was in surplus mode, monetary transmission was not gaining traction. Once the liquidity went to the deficit mode, monetary transmission has improved, we will not say it is perfect, but it has certainly improved. So to improve monetary transmission, the liquidity indeed would have to be in deficit, But how long we could maintain, that depends at least as I said, in the near term, one would feel that, that would remain in deficit.

Rajeev Malik One quick question if I may Sir, which is in terms of the guidance about current account deficit and monetary policy implications, I mean, it is interesting, throughout RBI's tightening cycle, the current account deficit rather than narrowing has actually increased, which highlights something very idiosyncratic with the Indian situation in the same side. It is not because growth is exceptionally strong, I mean, we have seen growth come off dramatically partly because of the investment slowdown, despite that the current account deficit has actually worsened. My question really is one understands the vulnerabilities of large and worsening current account deficit, but to what extent do you think monetary policy can actually fix it when as part of your monetary policy itself, you are trying to boost growth.

Dr. D. Subbarao Yes, as I said, a short while ago, we take into account the external sector developments including the size of the current account deficit and the composition of the current account deficit into the monetary policy action. But, we are not trying to target a certain CAD. What action we take will have implications for the current account deficit, but we are not certainly targeting a CAD. We want it to come down from its current level, but that will depend on a number of other policy actions not just the monetary policy action.

Moderator Thank you. Our next question is from the line of Samiran Chakraborty from Standard Chartered Bank. Please go ahead.

Samiran Chakraborty I actually have a pretty similar question to what Rajeev had and just wanted to understand this once more very clearly that while you were saying in the policy that the tipping point has changed from growth to inflation, and you have also mentioned that only in the anti-inflationary stance will you keep liquidity tight in the LAF deficit mode. Can we think of a situation in 2013 when because monetary policy is now shifting more towards growth that liquidity will come into a surplus mode and the monetary policy operating procedure on repo being activated into call, that will change.

Deepak Mohanty I am not very clear if I understood you correctly, because the system being in deficit in terms of liquidity, and operating instrument still being the repo monetary tightness could happen or even accommodating monetary policy can also be accommodated in that sense. Just to give you an example that if you have to accommodate monetary policy suppose one were to reduce the rate, so the repo rate can go to any extent, and to that extent the liquidity provision will have to made, so this can really operate in both modes. It is not necessary that one has to get into a liquidity surplus mode. Just responding to the previous question from Rajeev, that you have to go to the reverse repo kind of window to be more accommodative.

Samiran Chakraborty Let me rephrase the question then, what I am trying to understand is that in an inflation fighting stance, it is well understood that a tight liquidity accentuates the monetary transmission mechanism. In a growth accommodative stance will surplus liquidity accentuate the transmission mechanism of easing monetary policy.

Deepak Mohanty It is again how you define the tight or easy liquidity, so we say the comfortable liquidity situation as what we have put in public domain and the way that we have defined, that (+/-1%) of NDTL. So, that remains from the liquidity side more like a neutral mode. So beyond that, and much below that, then we can say, it is too easy a liquidity or too tight a liquidity.

Samiran Chakraborty Within (+/-1%) you were saying that the transmission mechanism will be best under both scenarios.

Deepak Mohanty Yes, because it is not etched in stone because that is how, was our determination, but as the system develops and the system gets used to different liquidity modes so that relationship could change. So as of now, the way it is understood by market participants, the way it is understood by us, the analytics suggests that remains appropriate level of liquidity.

Moderator Thank you. Our next question is from the line Santosh Kamat from Franklin Templeton. Please go ahead.

Santosh Kamath I am Santhosh Kamath from Franklin Templeton, at the risk of being repetitive my question is again regarding the current account deficit. Over the last few years, we have seen the savings rate in the country coming down. Typically the financial savings have come down much faster and I would want to believe that the difference in investment and savings is showing up in the current account deficit. In such a scenario cutting rates again provides more disincentives for financial savings and at the same point in time we are trying to revive investment, which will lead to this gap widening further, and therefore I would want to believe that the current account deficit will again go up higher than the current levels. So, if we are so concerned about the current account deficit does it not make sense to revive savings and lower investments rather than lowering savings and increasing investments? My second question would be on the open market operations. We typically have seen OMOs being conducted only at the long end of the curve. Do you think consistently doing OMOs at the longer end of the curve actually distorts the yield curve and kind of makes it much more difficult to predict on the longer end because a lot depends on the OMOs and the choice of securities.

Dr. D. Subbarao Thank you very much for those two very clear questions. First, on the impact of a monetary easing yesterday on the current account deficit. We debated that question internally, first about what impact it will have, whether more equity flows will come in or interest sensitive debt flows will go out and what will be the net impact of our easing on the net capital flows? We debated that. It is not very clear, but yes, we have to watch and see how this behaves. We don’t have a very clear view, but as I said a short while ago we have taken into account that concern on the current account deficit together with the growth, inflation, and savings rate dynamics. We do hope that yesterday’s easing will increase investment and also attract equity flows into the market, so that the current account deficit is reduced.

Santosh Kamath The earlier question was on the current account, and I understand that it is good for the capital account, it may look very good in the shorter end, because the capital account will look more better, but my question was concerning on the current account, are we not aggravating the situation rather than helping the current account.

Urjit Patel Well that may not be the case if you already have excess capacity in the economy. As you know, we have surveys and data that suggest that we do have an output gap, and that capacity utilization is nowhere near 100% so it need not spill over into higher imports.

Santosh Kamath: The open market operations?

H R Khan Open market operations, we take the combination of securities, and one reason why we go for long-term bonds is that, long-term bonds are more in supply. So long-term, more in supply is that PDs will be holding that, so that is one reason why we go for long-term bonds.

Sachin Desai I understand that, but do you think it distorts the yield curve?

H R Khan There are several other reasons for distorting the yield curve, OMO is not the only reason. But then, when you do OMO, it has to be effective. We should be in a position to absorb what you have targeted. That is why we go to that segment. But as I told you, it is a combination, it is not that we go very long, we have combination of medium to 10 years, plus more than 10 years also. It is not that we go always for 10 years. We go for 3 to 4 to 5, securities, at least 3 securities we go. It is a combination of that.

Moderator Thank you. We will take the next one from Kamalesh Chand from Rabo Bank. Please go ahead.

Kamalesh Chand I had a rather simple question, given that RBI has reduced the CRR to reduce liquidity and in some ways it also does reduce the stat cost, would RBI be reviewing the various components as a part of NDTL for CRR computations. For example I immediately can think of say, borrowing from head office, would it be possible for RBI to review the incidence of CRR and SLR on borrowings from HO.

Dr. D. Subbarao No, I believe not.

Moderator Thank you, Ma'am would you like to add any closing comments here.

Alpana Killawala Okay sure, thank you very much for joining us for this teleconference. As Governor always says, it is very useful. Thank you very much.

Moderator Thank you. On behalf of Reserve Bank of India, that concludes this conference. Thank you for joining us and you may now disconnect your lines.