# “Reserve Bank of India Post-Policy Conference Call for Researchers and Analysts”

## December 18, 2013

**PARTICIPANTS FROM RBI:**

**DR. RAGHURAM RAJAN – GOVERNOR**
**DR. K.C. CHAKRABARTY –DEPUTY GOVERNOR**
**SHRI ANAND SINHA, DEPUTY GOVERNOR**
**SHRI H. R. KHAN – DEPUTY GOVERNOR**
**DR. URJIT PATEL – DEPUTY GOVERNOR**

**MODERATOR:**
**ALPANA KILLAWALA, CHIEF GENERAL MANAGER**
**DEPARTMENT OF COMMUNICATION**

**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, all participants' lines will be in the listen-only mode and later we will conduct a question and answer session. To ask a question, please press '*' and '1' on your touchtone telephone. Please note that this conference is being recorded. Should you need assistance during the conference, please signal an operator by pressing '*' then '0' on your touchtone telephone. I now hand the conference over to Ms. Alpana Killawala from RBI. Thank you and over to you ma'am.

**Alpana Killawala**: Thank you Inba. As Governor arrives, let me request all the participants. Please restrict your question to one per person so that many people can ask questions and also be brief in your comments or questions so that we can get more into the conference. This conference will last about 30 minutes, so let us get the best out of it. One question per person, no follow-up.

**Dr. Raghuram Rajan**: Maybe I can start with just reiterating the short statement I made and then we can take questions. First, good afternoon to everybody on the call. Recent readings suggest that headline inflation, both retail and wholesale, have increased mainly, but not exclusively on account of food prices. While core CPI and core wholesale price index inflation have been stable, despite a steady and necessary increase in government administered prices towards market levels, the high level of core CPI inflation leaves no room for complacency. There is, however, reason to wait before determining the course of monetary policy. There are indications that vegetable prices may be turning down sharply, although intermediaries could impede the full pass-through into lower retail inflation. This comes (across through) our own surveys of metro areas where we do see a significant fall in vegetable prices both at the wholesale and retail level in recent weeks. In addition, disinflationary impact of recent exchange rate stability should play out into prices. Finally, the output gap including the recent observed slowdown in services growth as well as the lagged effects of effective monetary tightening since July should help contain inflation.

All this said, the policy decision is a close one and I presume all of you know the policy decision is one of status quo. Current inflation is too high. However, there are wide bands of uncertainty surrounding the short term path of inflation from its high current levels. Given the weak state of the economy, the reluctance to engage in overly reactive policy action as well as the long lags with which monetary policy works, there is merit in waiting for more data to reduce uncertainty. There are obvious risks to waiting for more data including the possibility that tapering of quantitative easing by the US Fed may disrupt external markets and that the Reserve Bank of India may be perceived to be soft on inflation. Let me assure you that the Reserve Bank will be vigilant. Even though we maintain status quo today, we can help guide market expectations through a clearer description of our policy reaction function. If the expected softening of food inflation does not materialise and it does not translate into a significant reduction in headline inflation in the next round of data releases, or if inflation excluding food and fuel does not fall, the Reserve Bank will act including on off-policy dates if warranted so that inflation expectations stabilise and an environment conducive to sustainable growth takes hold. Now I said "or" which means both conditions need to be met. The Reserve Bank's policy action on those dates will be appropriately calibrated.

Finally, I would add that following our commitment to restore economic value to financially distressed projects and to clean up problem assets in the financial system, the Reserve Bank has put out a discussion paper for comment yesterday. After the comment period of two weeks, we will issue the appropriate circulars. Perhaps I should end with a description of what we have been doing in the last few months; I think it follows Horton the elephant. It is we say what we will do, and we do what we said. Open to questions.

**Alpana Killawala:** Sir this time we had asked participants to send their questions. Only one has come so far. As people get familiar, probably more will send. This question is from Gautam Rajesh Kumar, Trust Financial Consultancy. He wants to know: Given the fact that stability in Forex market has returned, CAD has come down, liquidity in the banking system is relatively comfortable, what is the comfort level of inflation for RBI to act on policy rate?

**Dr. Raghuram Rajan**: I think what we need to see is a disinflationary process which is firm and established. I think at this point trying to specify a final target is probably premature, but what we do want to see is both headline and core inflation come down. Certainly as far as CPI goes, CPI core is too high. WPI core is still at a comfortable level, but has been trending up and we would like to see that stabilise. So over and beyond that, of course when food inflation is so persistent, ignoring food inflation is not something we can do. So we are also interested in seeing headline inflation which includes the food and fuel component also stabilise and fall.

**Alpana Killawala**: Inba, can we go to the queue now?

**Moderator**: Sure ma'am. Next question is from Srinivasa Varadarajan of Mount Nathan Capital Management.

**Srinivasa Varadarajan**: Thank you Governor. This is just one question. Over January-March of 2014, it is estimated that about $15 billion of the oil swap will come up from maturity and this will obviously increase the rupee liquidity in the system. In the event overnight rates drift to the lower end of the corridor on account of this increase in rupee liquidity, what will RBI's response be in terms of the corridor at that point in time? And if this kind of eventuates, will the period be used to actually push through the government debt swap at that point in time and how will RBI actually balance its role as a debt manager of the government and conduct a monetary policy given where the corridor actually settles at that point in time and Rs. 50,000 crore of long end supply through the debt swap is almost about Rs. 35 crore or $5.5 million of DVO on risk infusion to the market. If the market demands the concession and yields are driven up, will this be allowed and how will this be balanced against new year's supply of bonds?

**Dr. Raghuram Rajan**: First on the oil swap, the numbers that total amount of the oil swap is that we engaged in with the oil companies is less than $12 billion and to some extent they have also built up the capability to repay us over time. So the net amount is I think at this point less than $10 billion.

So $15 is overstating the amount significantly. Actually the net amount is less than $7 billion right now. So that is approximately what will have to be repaid overtime as I have said. As and when the time comes, we will take a view as to how that repayment happens and it could be settled through an exchange of rupee funds based on the settlement amount. It could also be, the swaps could be rolled over if necessary and of course if market conditions permit, it can also be repaid. Now in terms of liquidity when you are talking about the corridor, let me ask Dr. Urjit Patel if he has any views, if he can give you his views on that.

**Dr. Urjit Patel**: As you know, part of the normalisation of monetary policy that has been undertaken is to ensure, as closely as possible to ensure that overnight LAF and the call money rates hug each other, but that would not necessarily mean that there would be no volatility in the call market and we are committed to having the corridor of 100 basis points between the LAF and the MSF. And as you know in the past few weeks, in fact as recently as last week, we had a special term repo of Rs.10,000 crore to ensure that any temporary liquidity mismatch that threatens to pierce the MSF in a substantive way will be addressed through the instruments that are our disposal.

**Dr. Raghuram Rajan**: Let me turn to Deputy Governor, H. R. Khan to talk a little bit about the Rs. 50,000 crore debt maturity transformation.

**Shri H. R. Khan**: This will be a switch only. There will be a buyback also, but what you said the duration will increase. It will be calibrated in a manner and it will not be disruptive and the point to be noted is that large number of the long tenure bonds are held by insurance companies. So they will be possibly switching and not the banks so much. So duration risk of bank will not happen to that extent what is apprehended. And as written in our policy, we will be doing it in a calibrated manner and the final schedule is yet to drawn up. So I think based on that account, there need not be any worry that there will be sudden spike in the long end because of switch.

**Dr. Raghuram Rajan**: In other words, basically it would be investors with the same maturity appetite would redeem their bonds and take up the new bonds. So it is not going to be a disruptive situation where you would be looking for new investors in this market for the most part. So in that sense and I think seeing it as a need for Rs. 50,000 crore more of new money is vastly overstating the case. It is more money which is coming back in terms of repayment being redeployed and to the extent that is the same investor that is going to be fairly small disruption in the market.

**Alpana Killawala**: We have received three more questions on the question link. The first one is from Namrata Narkar of IDBI Bank. She says WPI inflation forecast is being placed largely between 6% and 7% for March 2014. How much of deviation from this forecast is tolerable and if the deviation is above the tolerable level, would the composition of such a deviation then hold significant?

**Dr. Raghuram Rajan**: I think at this point, this kind of question is going into more detail than we can possibly answer in the precise sense of how much deviation will be tolerated and how much will the response be? Clearly it depends on not just the WPI, but a whole set of other measures. And this is why giving the precise reaction function of a central bank is very hard, because I can tie to a particular indicator, but it is more than a particular indicator, it is a bunch of things which go in together including the dynamics of those things. It is not just the level at that point, but how it is moving and how different elements play in. That said, I think we would like to bring inflation, on the WPI we have been very clear on bringing headline below 5 and core below 3. That we have not deviated from the target. Where I have resisted putting a target so far until we are more sure of the dynamics of the index itself and its responsiveness is CPI, but clearly overtime and especially with the help of the Urjit Patel committee report, I think we will develop targets there also.

**Alpana Killawala**: The next question is from Prasanna, ICICI Securities. You have mentioned the negative output gap as a key factor in helping to contain inflation. Does that mean you do not expect the output gap to narrow in coming quarters and therefore you expect FY15 growth to remain around levels observed in H1FY14?

**Dr. Raghuram Rajan**: This is a very good question. To some extent, it asks what we think the output gap is at this point. And of course as you know there is a huge debate about how to measure the output gap and I am sure put three economists in a room, they will come up with three different answers as to what the output gap is at this time. My personal sense is that with growth at let us say around 5%, we have somewhere between 1.5%-2% output gap at this point. Of course that is we do in that assume that potential growth is not held back by serious policy implementation of the kind that we have seen, which may add a further constraint on potential growth than we currently assume. So with that kind of situation, I think it will take a year or two to get back to potential and therefore we have some room or some time in which the output gap I guess depending on which direction you define it, will continue to be negative and exert downward pressure on inflation.

**Alpana Killawala**: And the next question is from Badri Niwas, Citi Bank. You have referred to possibility of Fed taper disrupting external market. In July, when there was pressure on the rupee post tapering talk the RBI used monetary policy as a defense for the currency. There are some who believe that move probably accentuated the problem by worsening sentiment. Given you have the experience of July, would you give some guidance to the market on whether the RBI will again use monetary policy tools as a defence for the currency in event of disruption risk that you mentioned manifesting?

**Dr. Raghuram Rajan**: This is a hypothetical question. Let us first wait for taper to happen and then see what the consequences are and then we will deal with it accordingly. Clearly we are always informed by experience and we will draw from those experiences. But at this point it would be premature for me to say exactly what we will do conditional on the hypothetical that (a) the Fed tapers and to some extent, a large part of the globe wishes the Fed would make up its mind one way or the other instead of debating this back and forth, but beyond that I think the issue really is what the disruption will be. There are some people who argue the disruption this time will be more limited, partly because people have already reacted somewhat over the last 3-4 months. And of course from India's perspective, I feel that we are in a better position both because our current account deficit is much more contained than it was earlier 1.2% in the last quarter. Our reserves have grown and we have shown an ability to raise funding if necessary and third, bond funds, certainly the short maturity bond funds which have the ability to leave more quickly, we have lost a fair amount in those maturities. What remains are the longer term funds and so to that extent, I feel more confident. Interestingly I should add in the last few days, we have seen a return of some money into debt markets. FII flows on net since April at this point are just negative two billion which gives me some confidence that investors also perhaps will retain that confidence through any possible tapering.

**Alpana Killawala**: The next question is from Anjali Verma, PhillipCapital. RBI is in favour of removing gold import restrictions. Is it the right time to the remove restrictions and what adverse impact it can have on CAD as we understand that CAD has come under control primarily due to gold restrictions?

**Dr. Raghuram Rajan**: I do not think it is right to say the RBI is in favour of removing gold restrictions at this point. I think the point we have been making and I will make again is gold restrictions are distortion and they are a necessary distortion at this point to restore balance to the current account deficit which you correctly point out. But going forward we would not like this distortion to persist and we would like to remove it. When we do so, in conversation with the government and at what form, how we unwind these restrictions, is something we will have to deliberate over time. At this point, it would be premature to withdraw these restrictions for variety of reasons. Once we see the current account stabilise of its own over and beyond the gold restrictions that we impose, and there are elements which beyond the gold restrictions including rising imports, slowing non-gold, non-oil imports as well as some restoration of commodity exports including iron ore exports, that was stopped for a variety of judicial reasons. Once we feel more comfortable with the current account deficit, once we have a sense that tapering, at least the threat of it is behind us, we will certainly consider unwinding some of these distortionary actions.

**Alpana Killawala**: The next question is from Ashish Kela, Birla Sun Life Asset Management. Dr. Rajan had highlighted the need to provide real returns to savers. What is the plan on this front? Will this play a role in the monetary policy?

**Dr. Raghuram Rajan**: The question of providing real returns to savers is very much on our minds. We do want to restore savings growth and move towards financial savings by households and I think we have to bring inflation down to make sure that these returns are positive. And if that requires monetary policy actions we have said we will undertake those. So absolutely that is still on the agenda and in the meantime there are stop gap arrangements that are part of a longer term strategy. One example of that is inflation indexed bonds. We are coming out with inflation index certificates tied to the CPI this month and that will give savers an opportunity to invest in assets that produce a real return. The real return is being fixed at 1.5% for this first roll out of inflation indexed certificates and let us see going forward as appetite for them develops, we will also tie them more to the market.

**Alpana Killawala**: The next one is from Abhishek Gupta, DSP Merrill Lynch. Good afternoon, my question is regarding the implications of CPI inflation indexed bond and the increase in the cap from term repo to 0.75 basis points of NDTL, rather than providing that liquidity through OMO on government's cost of borrowing. Are these steps to be taken as signaling government's borrowing cost to be determining more by market forces and CPI inflation going forward?

**Dr. Raghuram Rajan**: I think that the RBI has allowed market forces to determine the government's cost of borrowing. The open market operations that have been undertaken have been essentially to provide the necessary liquidity to the markets so that growth in credit and so on can take place at the appropriate pace. As you know the central bank's assets have to grow for the central banks liabilities to grow. In an environment where your net foreign assets were not growing, the only way to grow the central bank's assets is to increase net domestic assets which mean in large part increase your size of government bond holdings. Now of course these could be seen to have an impact on interest rates and so on and one could intervene in ways that make the central bank's actions less dispositive or determinate in the interest rate setting process. So I think again let me emphasise the central bank is not trying to determine the government's borrowing rate and that policy will continue.

**Alpana Killawala**: The next one is from Rajeev Malik, CLSA. Given widespread macro level demand supply imbalances, what is the efficacy of a blunt instrument such as interest rate in loading CPI core inflation in the supply constrained economy? The level of interest rate needed may not be palatable or acceptable.

**Dr. Raghuram Rajan**: First some of the supply constraints are slowly being addressed. If you think about some of the areas where we have had high inflation- pulses and milk- some of that inflation has come down considerably which means there is a supply response that is kicking in and higher prices are a way to activate that supply response. So let us not forget that these things also do happen. As far as vegetables go, I think that this is a short term phenomenon, it is not the same thing as that longer term supply constraint and our sense is already from the numbers that we see that vegetable prices are coming down pretty rapidly. Of course we need to see this beyond the places that we survey into the more generalised numbers that the government collects and that is why we cannot be fully certain about this. More generally, I think even in a situation where there are supply constraints of one kind or the other, to the extent that demand exceeds supply, it creates inflationary pressures, some of it is a necessary price adjustment or relative price adjustment, but some of it feeds into more widespread wage inflation. It is that source of inflation, the second round effects if you will, that we are certainly concerned about. You can see it in higher rural wage inflation for example and that is something that we have been focused on heading off. So to argue that monetary policy has no role even in a situation where there is supply constraint is I think overstating the fact.

**Alpana Killawala**: The next question is from Arvind Chari, Quantum Advisors. He wants to know the breakup between the bank borrowing and FCNR deposits under the swap window.

**Dr. Raghuram Rajan**: Let me give it to Mr. Khan, the breakup in bank borrowings.

**Shri. H. R. Khan**: The total amount in bank borrowing is $8.35 billion and FCNR is $25.97. So it is basically $26 is FCNR (B) and 8 is bank borrowing.

**Dr. Raghuram Rajan**: So that is a total of $34 and in that, the FCNR is for a minimum of three years maturity and some of it is up to five years and that is not a inconsiderable portion, which is five-year maturity. Bank borrowing is largely one-year maturity.

**Alpana Killawala**: The next question is on liquidity from two people, Jayant Rao of Apostles Advisory and Tirthankar Patnaik of Religare. They want to know how will you provide liquidity to the system as M3 is trailing at 6.4%?

**Dr. Raghuram Rajan**: I will hand it over to Dr. Urjit Patel on this one.

**Dr. Urjit Patel**: Actually we are providing ample liquidity. If you see what is being provided on the LAF at the policy rate that is half a percent of NDTL and the export credit refinance which is also at repo rate is actually is almost 0.6% of NDTL. So we are providing more than 1% of NDTL in terms of liquidity at repo rate. On top of that, we have a term repo window and that is another 0.5% of NDTL. So there is ample liquidity. We must also be cognizant of the fact that if the economy is growing slower than in previous years and as we gradually bring inflation down, the overall M3 growth of the past is not necessarily a good indicator of the kind of monetary environment that is needed to support the nominal GDP growth that we have in mind.

**Alpana Killawala**: The next question is from Aastha Gudwani, Birla Sun Life. Are we done with the rollback of exceptional measures taken in July, is the cap on LAF here to stay? If yes, then how do you intend to reinstate repo as the permanent operative rate?

**Dr. Raghuram Rajan**: I think Dr. Patel answered that by and large, I would say that yes, we will certainly wait for the Dr. Urjit Patel Committee report to give us more guidance as to what we might think of in terms of the operation of monetary policy. But as far as the rollback of measures go at this point I think we have ample liquidity in the system which was the primary reason for rollback; we have ample liquidity and we are largely, with a little bit of volatility, near about the repo rate as being the operational rate. So in that sense I think we have gone back to normal monetary policy at this point.

**Alpana Killawala**: The next question from Abhishek Gupta, DSP Merrill Lynch. Our research shows that even though CPI inflation is significantly impacted by nonagricultural GDP output gap, the quantum of impact is negligible. For instance a 1% increase in output gap raises CPI inflation only by 2 basis points. Also you have been saying that demand is higher than supply, but how can the central bank control vegetable price inflation given that demand for food products is likely to be highly inelastic? Your comments.

**Dr. Raghuram Rajan**: I mean, your sense is that the only thing determining CPI inflation is food inflation and food inflation is beyond the control of the central bank. I do not think so, but let us wait and see.

**Alpana Killawala**: The last question from Varun Awtani, India Ratings and Research. Given the high inflation and weak consumption environment along with no major near term improvement expected in the GDP in the event of QE tapering that CAD might increase due to outflows and the currency might take a hit again. Based on RBI's research, what levels of CPI inflation would one see in case of such kind of an event occurs?

**Dr. Raghuram Rajan**: Again, this is a string of hypotheticals. First the CAD itself would not be impacted by tapering, it would be the financing of the CAD which could possibly be impacted and I think that was the sense of your question. Of course the financing of the CAD if it were impacted, if there was volatility in financial markets, that would be imply volatility for the exchange rate. I do not think we are going to see anywhere near the volatility we saw in the past for the reasons I have stated earlier. I think the rule of thumb that is around is that a 10% depreciation in the exchange rate results in something near about a per cent increase in inflation. That is the rule of thumb that people have worked with. Of course every situation can be a little different depending on the pricing power in the economy at that time, the extent to which the importers can pass through higher cost into output prices; all those issues matter. So I would not swear that this would be the exact impact, but this is a rule of thumb.

**Alpana Killawala**: So that would end the conference. Thank you very much for participating. There are a few people in the queue, but I guess we will stop here.

**Dr. Raghuram Rajan**: Thank you very much everybody for participating and I appreciate your listening in and getting the message out. Thanks 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.

**Vibha Batra:** Would really appreciate if we could get more clarity on the following: External equity requirements for some of the PSBs are very large for FY 2016-18 (in relation to their current common equity Tier 1), additionally some of them have large 'restructured accounts as well standard weak accounts', Could RBI put restrictions on lending of the some of banks over next two years so that there is no disruption in FY 2016-18?

(Question received through email after the researchers/analysts teleconference)

**RBI Response:** No restrictions are contemplated.

**Note:** We tried to better organize the conference this time by requesting for questions on policy announcement in advance. We would appreciate your feedback on this improvement. Kindly email your feedback.

**December 19, 2013**