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

October 01, 2014

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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, all participant lines will be in the listen-only mode. There will be an opportunity for you to ask questions after the presentation concludes. Should you need assistance during the conference, please signal an operator by pressing * then 0 on your touchtone telephone. Please note that this conference is being recorded. I now hand the conference over to Ms. Alpana Killawala. Thank you and over to you Ma'am.

Alpana Killawala: Thank you Inba. Since the Policy is out on the website and most of you would have seen it, we will straight away go onto the question-answers. As we have been doing for the last 2-3 conferences, we have received some questions on the website. We will start with them.

Alok Sahoo: Alok Sahoo, Baroda Pioneer Mutual Fund. As per RBI's projection of CPI of 7% by Q4 of FY15-16, there is a significant upside risk to RBI's to target of 6%. Do you see any rate hike by RBI to bring down the CPI to the target level?

Dr. Raghuram G. Rajan: I think we have tried to explain this yesterday in the press conference. What we have is a new inflation report which is called the Monetary Policy Report and clearly what that is trying to do is give our best projections given our models. But as you know, monetary policy committees around the world make monetary policy not just based on the models but also subjective assessments of the members of the monetary policy committee. For example, in the US Fed you have the famous dots and where the dots are and how the dots are moving, it is not just what the technical inputs to the committee are but also the assessments of committee members. Some of which are based on technical inputs but also on judgments about what else is happening in the economy. So our judgment superimposed on all the model inputs that we have is that we are at least where monetary policy is set now on line to hit the 6%. But because our models are suggesting higher, but also because there are some risks we have highlighted, we think the balance of risks are still to the upside. So while this is what would suggest that our policy stance today is reasonable and we see no reason to alter it today based on the information we have. As data comes in, we will have a better view of what is happening and will adjust accordingly. So I should not presume that we are either biased towards raising rates or cutting rates at this point.

Nitin Daga: Nitin Daga, Microsec. In the current policy, you have indicated that the inflation threshold may not be at the point where the central bank can start cutting rates. Moreover US may start raising rates before the end of 2015 which could pose a threat of imported inflation. Hence will it be safe to assume that there may not be softening policy stance in near future?

Dr. Raghuram G. Rajan: Let me ask Dr. Patel to answer that.

Dr. Urjit R. Patel: I think that what we need to look at in this context is exactly what we have said, that if inflation, the 2016 January inflation objective is under threat in any serious manner, then we would look to

tighten. The flip side is that if inflation comes down earlier than that on a durable basis, then we would look to be more accommodative. Hence the implication of a US interest rate hike on ours with regard to inflation, I think there is a fair distance between that, in terms of transmission for us with regard to hike in the US interest rate. Now of course the fact is that a fair bit of the bond prices have priced in what is likely to happen in the US. So the amount we are talking about is what has not been priced and there are judgments on how much and how quickly the interest rates in the US will rise. But our policy will be determined solely by reading our inflation data points and projections thereof.

Rohan Juneja: Rohan Juneja, Seawolf Capital. 49.7% of the CPI index comprises food and another 9.5% in-housing. Is there a plan or roadmap to adjust the CPI index to be less 'food heavy' and include manufacturing or other components?

Dr. Raghuram G. Rajan: I will ask our Principal Adviser, Michael Patra to speak to this.

Dr. Michael Patra: The CPI is based on the weightage which is drawn from the family expenditure survey. Families are surveyed to see what they spend on. So the weight will be drawn out of these surveys. These surveys are evolving. They are updated every 2-3 years. So we do not have a roadmap to adjust the CPI, but we will try to reflect the way families spend their incomes.

Rajesh Raman: The next question is from Rajesh Raman, Dymon Asia. Dr. Rajan in your assessment, what is the lag in quarters for any rate action to help palpable effect on CPI inflation?

Dr. Raghuram G. Rajan: Let me ask Executive Director, Mohanty. I am trying to give you a sense of all the people who work together to prepare monetary policy report and contribute to setting policy.

Shri Deepak Mohanty: I think lot of technical work including what we have done, what others have also done on the interest rate channel of transmission is already there in the public domain. So essentially the way it would show that at least lags are two quarters. Essentially it happens from third to fourth quarter because you first see that the growth coming down and then that impacts inflation. So that is about four quarters and these lags again persist. The full impact takes about a couple of years to really fructify.

Prithviraj Srinivas: Prithviraj Srinivas, HSBC. Solving issues in food can be a multi-year effort. Will this impinge the RBI's ability to achieve its 6% and 4% CPI target? Do you think a modest hike in MSP will be enough to contain food inflation next year? What are the other factors that would make you comfortable about the outlook for food inflation?

Dr. Raghuram G. Rajan: See, food inflation is not just about MSPs. That does reflect and cause a certain amount of food inflation, but clearly there are other aspects. For example, the seasonality in vegetable prices perhaps could be reduced through better cold storage, perhaps some better transportation,

logistics, even newer markets, better access to markets. So lot can be done over and above this simple act of moderating MSPs to reduce the volatility in food prices.

Arvind Chari: The next question is from Arvind Chari, Quantum Advisors. My question is more academic Governor. I learned a great deal about global imbalances through your work at the IMF. Given that US twin deficits continue to shrink with resultant dollar strength, where do you think we are in the global imbalances or global liquidity cycle and its outcome on global monetary policy? Are currencies the only balancing factor?

Dr. Raghuram G. Rajan: It is a good question. I do not have a quick answer. Imbalances I think as measured by the IMF have come down substantially. There are still some of the countries that used to run large surpluses, still running large surpluses, but far fewer than they were 7-8 years ago. One of course is Germany sitting in the middle of the Euro area and there is a lot of pressure on Germany even from within the Euro area to moderate its balances. But how that can be done is an entirely different question. Simply the German government running larger fiscal deficits does not necessarily bring down its current account balance and this is something that is going to be an interesting debate for some time. I think that the current account surpluses of the emerging markets have also come down somewhat in recent years. Some like Brazil have turned to even running moderate deficits from running surpluses. So I think the world is balancing, but I think emerging markets were in a good place from a risk perspective when they were running surpluses. Now that they are closer to balance, so in some cases running moderate to large deficits we live more in the world of the 1990s than in the world of the 2000s and that carries its own risk.

Abhishek Upadhyay: Abhishek Upadhyay, ICICI Securities Primary Dealer. His first question is about CPI inflation index, so I am keeping that. His second question is about our FX policy. He asked would there be a relative deemphasize on unsterilized FX interventions in the de-facto inflation targeting regime currently guiding RBI's monetary policy stance. Is RBI feeling any constraints on the lack of suitable durable sterilization instruments in the monetary policy tool get currently?

Dr. Raghuram G. Rajan: Let me ask Dr. Urjit Patel to answer.

Dr. Urjit R. Patel: As you know that we intervene in the forex market only to smooth out undue volatility and therefore the implication on our monetary stance with regard to the inflation objectives does not really come into the picture when we make this decision. At the moment we have no constraint on the lack of suitable durable sterilization instruments. As you know in the past, instruments have been forthcoming as and when necessary and I do not think it is a constraint in the current scenario at all. Thank you.

Amit Agarwal: Amit Agarwal, Societe Generale. The RBI is keeping rupee volatility lower by intervening in both spot and forward markets. The rupee has got a tag of best carry currency in the region, and

lower rupee volatility has made long rupee trade attractive. In the onshore markets, the rupee forward premia has moved higher than Repo rate on forwards buying. The importers and corporates having foreign currency liability have supposedly stopped hedging due to the high cost in the onshore market which is probably leading to large long rupee positions. How do you see these risks in the currency markets going forward?

Dr. Raghuram G. Rajan: The part of your question that I am a little concerned about is if forward premia expands to an extent that it inhibits hedging, I would say that is not the primary reason why corporates are slowing down on hedging. My sense is that some of course historically have taken bets assuming they have natural hedges. Sometimes they think they have strategic hedges. But also I would guess that the fact that we have had a large depreciation after which some stability gives them some comfort that the things will remain stable going forward. That may or may not be a good assumption but I would emphasise that it is rarely good to take a position on a particular direction of exchange rates. I think every model that we have suggests exchange rates are hard to predict and therefore in the interest of financial stability, it is important that corporations hedge.

Devika Mehndiratta: Devika Mehndiratta, ANZ Bank. The model generated inflation projection (fan chart) suggests inflation by March 2015 at 7% with risk balanced around it. But then you mentioned at the press conference that although the fan chart is showing 7%, you actually think it is likely to reach 6% with risks skewed in to the upside. In that case, why not simply show 6% as a central case on the fan chart (not 7%) and show risks to be skewed to the upside.

Dr. Raghuram G. Rajan: I have answered this in three ways, but I think may be Dr. Urjit Patel can answer it in a different way right.

Dr. Urjit R. Patel: The fan chart communicates our model based baseline forecast and the uncertainties surrounding it without any policy change and without any change in the structural characteristics of the economy. And any model has to be contingent on assumptions regarding initial conditions for it to generate forecasts of any kind and that is what the fan chart shows. We have listed our assumptions on the initial conditions in the monetary policy report in Table 1.1. With these assumptions, the model projects an inflation rate of 7%. However, we also know from our assessment of incoming data and our expectation of that, some of these assumptions could change in the period ahead. For example, international crude prices could soften much more than our assumption of $100 per barrel which we have taken for this report. Secondly, it is possible that the government may take many more steps with regard to taming food inflation and in fact the budget has indicated a fairly aggressive posture in that regard and therefore it is inevitable that model based projections do need to be adjusted for these qualitative factors which essentially are about changes in assumptions regarding the future. And I do not think it is inconsistent to do that. If you look at Chart 1.4 in the monetary policy report, the 6% is shown with risks on the upside and the 7% as the baseline. So I think it is fairly clear.

Saugata Bhattacharya: The next question is from Saugata Bhattacharya, Axis Bank. The monetary policy report emphasises the need for a careful scrutiny of the sources of inflation persistence. The persistence is true even for non-food components, that is, inflation herding. Our question pertains to one aspect of this persistence. RBI's OBICUS and IOS Surveys both show capacity utilisation trending down since early FY12. So first, where might non-food pricing power be coming from? If by cutting into saving, as the evidence suggests, might the output gap actually not be negative? Second, particularly in Q1FY15, falling capacity utilisation seemed to coexist with rising sales. One way this can be consistent is through a drawdown of inventories. But both GDP data and the sample of corporate results suggest that inventories were on the contrary, accumulated. Would you have a view on this?

Shri Deepak Mohanty: Yes, one question that from the survey itself that we have seen the capacity utilisation lower than what can really be considered optimal as we have seen on the survey history. See, that could arise for two factors. One is that there is a lack of demand and also it could be that capacity is there, but they are not able to produce because there are input constraints which were quite severe sometime back that suppose coal shortage is there, power shortage is there. So they are not coming up to the capacity. But in that process with a lower capacity utilisation, we did see that it put a downward pressure on the corporate pricing power so that we had seen from a high of 6%-7% non-food manufacturing WPI inflation, it did come down significantly so to about 4% now. And the other aspect that what we have seen that beyond a point once the bottom-line gets hit, the corporates also price their product in such a way that they prefer cutting down on their production rather than compromising on the price. So that kind of oligopolistic behaviour also we have seen in the market. It may not be across the board, across all industries but overall behaviour would suggest that beyond a point corporates still retain their pricing power to some extent while cutting down the production.

Ashish Goyal: Ashish Goyal, Bajaj Allianz. My question pertains to FII limits. There is reluctance in increasing FII flows in government securities. Off late, there is increase flow in corporate bonds. If there is reluctance in getting these flows in government bonds, why RBI seems to be comfortable with these flows moving in corporate bonds?

Dr. Raghuram G. Rajan: I think the word uncomfortable is probably misplaced here. We want a steady increase in limits, a measured increase so that we understand what is happening and we see the market develop as these limits are increased. We do think FPIs are extremely important to market development. We recently increased the limit for government bonds by 5 billion. Also, as short term debt flows over, that frees up more space in government bonds and so it is not as if that space is completely shut out for the moment and over time we will re-examine the limits and see what we can do. On the corporate side, I think more flows coming into the corporate debt side do also help develop the corporate debt market which has been one of our aims. So given that we set the limits for both markets carefully, I do not see why just because the limit for the government debt market is

filled up right now. We should diminish the limit for the corporate debt market. We want to see both flourish and I think over time both will expand in a regular way.

Ashish Goyal: In borrowing calendar for H2FY15, there was a mention of issuance of securities in nonstandard maturities. Can you please elaborate?

Dr. Raghuram G. Rajan: Let me ask Mr. Khan to answer this.

Shri H. R. Khan: This is mainly because we have historically seen in the first half of that borrowing period there are a lot of redemptions. So, we want to spread it so that part of the redemption moves to the next half year so that why we will have a nonstandard maturity. That will help in smoothening this redemption pressures.

Kumar Rajapudi: Kumar Rajapudi, ANZ Bank. How does the RBI intend to tackle the liquidity today due to increase in currency demand during the festive season. Previously, the RBI used to inject primary liquidity via OMO purchases of the bond to offset currency demand. Is it still under consideration for this year or do you intend to provide liquidity only via term Repo. Also, is there any limit on the amount offered or drained under the daily term Repo-Reverse Repo?

Dr. Raghuram G. Rajan: I think when we are talking about festival demand, we are talking about temporary demand and we deal with temporary demand for liquidity through either overnight Repos which now we have started on a daily basis or longer term Repos of 7-day, 14-day Repos and I do not see why that would change as we go into the festival demand for cash period. When we deal with permanent liquidity, we think about OMOs and as the need for more permanent liquidity emerges we will think about that.

Sonal Varma: Sonal Varma, Nomura Securities. It is about rural wages. What is your outlook on rural wage growth in 2015 and why?

Shri Deepak Mohanty: You know the rural wage series what was being put out by the Labour Bureau that series has changed since last October. The new data that what we have seen, we do see a little bit of a moderation in the rural wage growth compared to close to 18%-19% that we had. But we do not know what the outlook could be. Perhaps one suggestion is that, one view is that once the construction activity picks up, industrial activity picks up, and then it puts a pressure in terms of rural labour force moving to the other activities. So in that process, the rural wages could perhaps go up, but we do not know as of now how things will turn out.

Amey Sathe: Amey Sathe, JM Financials. For the last 9-12 months, banks as well as NBFCs have been growing loans against property portfolio aggressively. Does the significant increase in Loans against Property portfolio worry RBI? Does RBI intend to increase risk weight or provisioning requirements for LAP products or procedure for valuation of property?

Shri R. Gandhi: A constant review will be there.

Shri P. Vijaya Bhaskar: At the moment, we do not think that is a major issue. In case we come to that flash point, we will definitely think in terms of adding more risk weightages so that we control the pace of credit to that particular area. At the moment it is fine.

Dr. Raghuram G. Rajan: Right, as we said in yesterday's press conference also that at this point while there are certain spots in-housing where you might think that house prices are very highly priced. There are number of reasons why those areas exist but broadly speaking, we do not see excessive house prices at this point and in fact the broader pressures for house prices to come into alignment so that demand can meet supply and so at this point I do not think it is a cause for worry. Of course, we keep our eye on the pace of credit growth to these areas. We have very strict control on loan to value ratios and as I said yesterday, over and above fairly conservative loan to value ratio we also have the fact in India that number of transactions are done with additional buffers and so at this point I think it is premature to worry about the excessive credit growth.

Bekxy Kuriakose: Bekxy Kuriakose, Principal Mutual Fund. Would RBI agree with the view of some bankers that India's inclusion in the JP Morgan Emerging Bond Market Indices can actually help in bringing stable FII inflows? If so, can we expect such an inclusion in the near future? Secondly, concerns on the recent gush of FII money into debt investment and fears it may be hot money, preventing RBI from increasing the FII G-sec limits further.

Dr. Urjit R. Patel: You know, this sort of inclusion in global indices of course has some advantages, the obvious ones being that we become part of a portfolio that gets automatically invested in by a large number of foreign investors. However, we also know that there are issues with respect to increasing our vulnerability when things turn the other way. At the moment as far as I know, there are no plans to be part of this index. It also requires some changes from our side in terms of regulation and policy. So it is not an event that can happen very quickly. It is a process. Of course, we did get a fillip most recently from an upgrade in the outlook from the last credit rating agency to do so. So I think we are in pretty good shape even without being part of the index.

Dr. Raghuram G. Rajan: That was Dr. Patel; let me ask Mr. Khan to also say a few words on this.

Shri H. R. Khan: This index issue has been in the news for the last almost two years. Main issue about this index which people are asking is to totally remove the ceiling on FPI investment in government bond which because of our capital account management issue as the Governor explained, we are not in a position to do that but in a progressive manner, gradual manner, we will increase. But what they want is totally remove the ceiling which is not currently possible. One variant of which has come is that at least some securities you allow full freedom, but that also has some risk in sense and you have FPI enabled security and non-FPI enabled security, then there will be two sets of yield curves, there will be two sets of markets, and there again volatility will be there. But what

we are trying to do is facilitate FPI investment into India in the debt segment. Three-four things have been done. One is government has continued that withholding tax relaxation from 15% to 5%. We have in the last policy announced that FPIs can directly buy security instead of coming through broker and this policy we have stated that we are moving towards T+2 which was a major demand of FPIs. I think this will facilitate investment in government sector by FPI and as Governor mentioned, as we go along in a calibrated manner we look to open up the limit as and when it comes.

Dr. Raghuram G. Rajan: One additional possibility is that we are talking to people like Euroclear to see if trading can be done via those organisations but in India. And so the actual trades will be conducted in India but the investor can work through a front elsewhere. So let us see how that plays out. But as Dr. Patel said, a complete abandonment of limits on debt securities would be hard for us at this stage and that may take a while or it may require the indices to change their routes.

Moderator: Ladies and gentlemen, we will now begin the question and answer session for the audio participants. Our first question is from Arpit Malaviya of Reliance Life Insurance. Please go ahead.

Arpit Malaviya: My question is regarding your concern on the exposure which FIIs are taking and the flow which we are receiving and your concern is, you have been sounding very hawkish that these rates can be a risk when these are unhedged kind of exposure taken into India. So I would like to take your input on that, what is your threshold? Is there any threshold limit or is there any threshold which is there in your mind that this should be the rate where comfort should not be moving right?

Dr. Raghuram G. Rajan: You are talking about exchange rates?

Arpit Malviya: Exchange as well as the interest rates?

Dr. Raghuram G. Rajan: I do not know about interest rates. Interest rates are where we set them. But all I am arguing is that in a world which is full of surprises where there are macro risks, for example potentially from a faster tightening of policy in some industrial countries, from geopolitical risks, from abrupt adjustments in oil prices either way. I think all those major factors do affect exchange rates. So given that it is really impossible to predict the direction of exchange rates in the short term, I think you are playing Russian roulette if you leave your liabilities unhedged unless you have natural hedges. I am not saying 100% is where you should be but you should not leave it largely unhedged. This is the caution we have been giving corporations for a long time. We have pushed banks to try and ensure that the corporates they lend to are more hedged. This is part of the natural prudential cautions that we give but I do not think it should be taken lightly.

Moderator: Our next question is from Mehul Shah of Rajkot Nagarik Sahakari Bank. Please go ahead.

Mehul Shah: The question is you have cut SLR limits and also now going forward HTM will be cut to 32%. This way the supply will be more in the market from bank side. So any plan to increase the demand of the bonds and Sir second question is exposure of FII is just above 2% as far as G-sec is concerned but still it seems they are ruling the market and when they are coming with a bang or going with a bang, so many uncomfortable situations occurs in the market. So is there any plan to control that kind of thing?

Dr. Raghuram G. Rajan: So let me start with the second question first. I do not know whether what you are saying is right, but we have benefitted tremendously from FIIs. They do add liquidity to the market. They do help develop certain markets which I talked about earlier, the corporate debt market. At the same time, we have taken some precautions to reduce short term debt in the government debt markets which I think significant amounts of short term debts leaving those markets last July-August perhaps helped increase volatility. But there are no plans beyond that to restrict any participation. We welcome participation and we have to increase it steadily at a rate that I think we feel comfortable with. The first question was SLRs and HTMs and so on. I mean, clearly we have to develop the market for government bonds further. Let me emphasise that at least at this point given the low credit off take, I do not see bank holdings of government securities coming down fast in a hurry. I think it will come down slowly. All we have done given that they typically have excess SLRs is reduced the eventual constraint that they might face once they bring it down substantially. But at this point nothing is really binding on them. So I do not think you should expect the market will diminish substantially in the very short run. But it also implies that we have to build up the market for government securities which means more presence of insurance companies, of pension funds. I think some of the budgetary fillip to these kinds of savings will help increase the volumes and therefore increase the flows into government securities markets. But also do not forget FIIs are also part of that market. So expanding the limits for FIIs overtime will also help bolster those markets. So I think all this is part of a package.

Alpana Killawala: That will be it from our side. Thank you very much for participating. Inba, you can close the conference.

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