Edited Transcript of Reserve Bank of India's Third-Bi-Monthly Monetary Policy Governor's Teleconference with Researchers & Analysts

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MODERATOR:

ALPANA KILLAWALA – PRINCIPAL ADVISER

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

Alpana Killawala: Thank you, Margret. As always, we have received some questions online.

Kaushik Das:
Deutsche Bank

He has a question on potential output. A recent RBI paper titled 'India's Potential Output Revisited' estimated India's potential growth for the most recent period to be about 6.8% with the band of plus and minus 50 bps at 95% confidence interval. Is this view endorsed by Reserve Bank of India?

Vipul Mathur:
YES Bank

Question on potential growth. What is the potential growth rate against which the output gap is evaluated while formulating the interest rate policy?

Dr. Raghuram G. Rajan: I will ask Dr. Michael Patra and then I will give a few comments after that.

Dr. Michael D. Patra: So, the RBI looks at a variety of methodologies, surveys, indicators and even contributions to the literature to evaluate the state of the economy in relation to its capacity. Typically, this assessment is in terms of the level of output so that we determine where the economy is on the business cycle. Having obtained a fix on the level, the rate of growth becomes implicit. So these estimates have to be constantly updated and refined because their time vary. Now this paper that you mentioned is a study on the period from the second quarter of 1980-81 to third quarter of 2015-2016.

Dr. Raghuram G. Rajan: I think the issue of potential output and what we take into account in Monetary Policy is an important one, but as you recognized, measures of potential output are in many cases fraught with problems. And being overly convinced about a particular number, given the kind of evidence we have is really very hard. So, sometimes your sense of the potential output of the economy really comes from trying to see what kind of inflation you have, given the growth. And to the extent that we have at this point relatively stable inflation, given the growth rate of about 7.5%, one could conclude that we have sort of near about potential output. Of course, how near how far is, I think within the realms of noise at this point.

Rajeev Radhakrishnan:
SBI Mutual Fund

In the process of transitioning from a deficit to neutral liquidity stance, given the lags between Fx forward purchases and eventual outflows under FCNR combined, with other autonomous factors such as currency circulation and also Government cash movement, will there not be a prolonged period of surplus liquidity that forces the system to operate between the interest rate corridor as against the policy stance of operating closer to the policy repo rate (as seen over last month and half)?. Would this not amount to indirect easing given the persistence of this for a reasonable period as well sharp movements in wholesale market levels as well as credit spreads?

Dr. Raghuram G. Rajan: See, I think what we explained in Policy Statement in April, was essentially there are two aspects of liquidity, one is a more prominent component which is affected for example by cash demand, currency demand by the public, as well as a seasonal component which varies depending on say the occurrence of festivals or the government tax collections and the buildup of the government balances over the course of the year. So what we are trying to do is get to a more neutral position as far as the permanent component of liquidity goes. And then allow the seasonal fluctuations to happen around that. Of course, we will accommodate the seasonal fluctuations, if there is surplus liquidity we will suck it out through reverse repos and if there is a shortfall we will lend from our various windows as well as the repo transactions. So essentially, through that medium, through the short-term actions we try and accommodate the seasonal fluctuation and through either the purchase and sale of government bonds and the purchase and sale of foreign exchange we accommodate long-term liquidity. Dr. Patel, would you like to add anything?

Dr. Urjit R. Patel: Thank you. If you notice during the current phase, call rate has on an average traded 15 basis points below the repo rate, if Saturdays are excluded. Likewise, in the period of liquidity tightness during January to May of this year, the call rate traded 5 basis points on average above the repo rate. In both situations the call rate traded reasonably tightly around the repo rate rather than between the corridor. And the medium term objective to manage permanent liquidity in a manner that takes the structural deficit of around 1% of NDTL to a position of broad balance, consistent with the stance of Monetary Policy, this will necessarily have to be achieved over a period of time. And when this is achieved the call rate will be closely aligned with the repo rate, although transitory phases of surplus and deficit will inevitably occur and will have to be managed with liquidity instruments that we have deployed. These transitory phases will have to be endured because they are for almost behavioral reasons, in some cases consumer demand on account of festival and on the other on account of how the government manages its revenues and monthly expenditures, which also varies over the year. But the broad objective is to ensure that we are fairly close to the policy rate and not deviate and as the Governor pointed out this morning that on average the phases of being below the repo rate are canceled out by phases when we are above the repo rate.

Saurabh Dhole:
ICRA Limited

Is the RBI looking at reopening the FCNR (B) window to garner fresh deposits in this year in order to make up for the possible US dollar shortfall caused by the redemption of older FCNR deposits?

Dr. Raghuram G. Rajan: Absolutely not.

Raghavan M J:
SBI Life Insurance

Sit, I congratulate you on an unforgettable stint as the Governor of RBI. I wish you all the best for your future and hope to see you soon back in India in an even bigger role. Most central banks operate on a dual mandate, so they employ inflation indices like CPI and unemployment figure as proxies for inflation and growth. Why is that RBI functions based on indicators like GDP, IIP, etc., (both of which have questionable dependability) and not on unemployment or jobs data.

Dr. Raghuram G. Rajan: It is a good question. I mean, we would love to have better data on all fronts, certainly on unemployment but also on GDP, IIP and so on. I think this is work in progress, the Labour Ministry is collecting better data on labour, on employment. But you are absolutely right, we have to work on this. Currently, I think given the frequency of overall labour data for India, it would be difficult to base policy on that, but going forward we hope it will become more frequent and more reliable.

Dr. Urjit R. Patel: Just to add that of course there is now rural wage growth data which is given out every month which was not the case not far back, and we also look at the corporate payroll figures, including the average remuneration as part of the information set that goes into the policy making.

Vipul Mathur:
YES Bank

Do you believe that there is evidence of yield-oriented investors in India? And to that extent, does the monetary policy transmission also happen on the long end of the yield curve?

Dr. Raghuram G. Rajan: Let me ask Mr. Gandhi if he wants to comment on that, then I will ask Dr. Patel to answer.

Mr. R. Gandhi: Investors are always there for yield only, so all investors are primarily in for better yields only, so India also has such investors.

Dr. Urjit R. Patel: Monetary Policy transmission encompasses the whole continuum of interest rates, of course the central bank only determines the overnight policy rate. And a well-functioning transmission should at some point go from the overnight right up to 40 years and that is the ultimate objective in having monetary transmission that affects the whole gamut of borrowing tenure.

Dr. Raghuram G. Rajan: I mean, hopefully it is not just the expectation of monetary policy over time which affects the longer-term yields but also expectation of inflation. And in India, probably the latter is more important at this juncture while in industrial countries the expectation of monetary rates, policy rates over time is probably more important. I think given that the work we are doing on trying to tighten inflation probably has had a beneficial effect on long-term yields and certainly today we are seeing some of the lowest yields in recent memory.

Bekxy Kuriakose:
Principal Mutual Fund

Can the issuance of UDAY bonds be streamlined and handled by RBI in the similar way as for SDL issuance? At present respective state governments follow different/arbitrary processes and it's difficult to get information/give bids/etc. A common uniform transparent approach would make it easier for investors to invest in these bonds

Dr. Raghuram G. Rajan: Again, let me turn to Mr. Gandhi.

Mr. R. Gandhi: UDAY Bonds are not forming part of the normal borrowing programs of the state governments, so it is treated outside the normal procedure. And since the market reacted in the last fiscal little negatively towards the UDAY Bond announcement, it was considered by various state governments to follow a private placement method. So that is why the procedure has been different from the normal SDL auction methods. So, here the Reserve Bank in consultation with respective state governments announced, we had a separate process, in this when we do it is always a common one across all the various state governments. So more transparency we will be aiming for. Going forward we believe we should be able to get more and more of this kind. Thank you.

Gautam Singh:
Spark Capital Limited

Thanks a lot Governor Rajan for helping India break away from the fragile five currency tag to one of the most stable currencies in the last three years despite highly volatile times. My question is there any analysis RBI has done on the sharp Rs. 2.5tn surge in currency in circulation in the last 12 months? Does it partly reflect a pick-up in rural activities, as maximum transactions in rural India take place in cash?

Dr. Raghuram G. Rajan: Yes, we have done some analyses; let me ask Michael to reply on it.

Dr. Michael D. Patra: As Governor mentioned, we have undertaken some analysis of this increase in currency. You will find it presented in the forthcoming annual report. So without trying to preempt your reading of the report, I will summarize by saying that there are several factors at work, the jewelers strike, reactions to increase in service tax rate, festival demands, election related spending and yes also the factor that rural activities could be spurring an increase in demand for currency. But these factors are difficult to disentangle with precision. Also, we need to note that since the last week of June there has been a return of currency to the system, Rs. 25,000 crores already and still flowing in. The underlying determinants of currency demand such as activity, inflation, interest rates and the relationship they bear is a stable one and has stood the test of time.

Madan Reddy:
HSBC

First, thanks a lot for your services to this nation so far. During your term enough importance was given to smooth currency volatility. In your view, how are the capital flows going to be during the rest of the year? Also, what do you think would be a competitive level for USD - INR given the current inflation level on one side and the push for 'make in India' on the other side?

Dr. Raghuram G. Rajan: On the first issue of stability of capital flows, it is very hard to give a firm view on that because it depends so much on external factors and how they play out and there are sufficient geopolitical concerns as well as financial market concerns for anybody to be, I think, a little aggressive in sticking the neck out and saying there will be no volatility. In fact, the opposite is probably true, there will be volatility. The real question is, how much we can do to buffer ourselves from that and there I think we have made substantial progress over the last few years. One, of course, we have got very good macroeconomic policies on both the growth front as well as the current account deficit, the fiscal deficit as well as inflation. So, given all that and the possibility that growth is likely to pick up with a strong monsoon and increasing positive sentiments, I think we are well buffered, but I would not say we are perfectly buffered, we will suffer volatility when the rest of the world suffers volatility. As far as the appropriate level for the exchange rate goes, I think that it is fair to say that throughout we have said the current level is a reasonable level and I do not think I want to change that, the current level is a reasonable level.

Kashyap Modi
Reliance Industries Limited

While on one side RBI wants banks to transmit rates effectively and hence has conducted OMOs to neutralise the liquidity deficit in the system. Post that, what is the logic/rationale of conducting Term reverse repos daily and absorbing liquidity? Why not let market determine overnight rates and RBI can absorb any excess at the reverse repo rate. This consistently lower fixings on overnight rates will further pull down money market rates and hence FD rates and hence aid more effective transmission

Dr. Raghuram G. Rajan: I think as we have said, we perceived a difference in bank reaction to permanent liquidity and temporary liquidity. If there is a significant permanent liquidity shortage, somehow our infusing all the temporary liquidity in the world through our various facilities did not seem to dispel the notion that banks felt there was a shortage and behaved commensurately. That is why we changed our policy towards neutralizing the permanent deficit and working with the windows towards tackling the short-term or seasonal deficits. Now, if we allow the short-term rate to fluctuate based on how much seasonal demand there was for liquidity, we would have a very variable short-term rate. And then you would have to ask a question, what is the policy rate? The policy rate is really what we are trying to fix, and if there is too much liquidity, if we allow that to play out in markets that will pull the rates down in the call money markets significantly down. To prevent that we suck out liquidity at appropriate times so that we have money market rates basically hugging the policy rate.

Kapil Punjabi
HSBC Global Asset Management

This is regarding 14 day variable rate term repo auction. Since 15th July 2016, there have been continuous attempts to discourage borrowing from this window by announcing higher cut-off rates. Cut off rates have increased from 6.52 on 15th July to 6.59 today. Is there any signal through this 14 day term repo regarding discomfort on the Short term money market rates?

Dr. Raghuram G. Rajan: Let me ask Mr. Mahalingam to respond.

Mr. G. Mahalingam: As it was mentioned sometime back, the term repo window is also one of the instrument which is used to adjust the short-term liquidity excesses and short falls. The term repo window is being very actively used by RBI now to modulate the liquidity in the system. We keep the evolving liquidity in the next 14 days in mind so as to keep the weighted average call rate closer to the policy rate. So it may not be appropriate to consider this term repo cut off as a signaling mechanism given this function of the term repo window.

Tarang Hora:
SBI Life Insurance

Can CRR cut be an option for permanent liquidity injection along with OMO?

Dr. Raghuram G. Rajan: Yes, it can be an option, I think statutorily we have limited room there because statutes.. you are okay with reducing down to zero. Okay, well then we have potential room, somebody might think of using it in the future but at present there is no examination of this particular tool.

Dhaval Ghade:
Sundaram Mutual Fund

The first question was, with several large MFIs converting into small finance banks, there is uncertainty in the market as to whether MFI lending norms would continue to apply on them. Now for instance, borrowers who have loans outstanding with two MFIs and one MFI is converting into small finance bank, currently there is a scope for a third MFI to come in and lend money to the same borrower, and thereby increase the leverage position. So is the RBI looking to formulate any policies on this issue?

And the second bit was, Sir in the December policy meeting you mentioned that bank balance sheets would be clean by March 2017, so are we on track in terms of meeting adequate provision cover on the bad loans? Thank you.

Dr. Raghuram G. Rajan: Let me ask Mr. Vishwanathan for the first question and Mr. Mundra for the second question.

Mr. N.S. Vishwanathan: See, the eligibility for a loan to be treated as MFI loan are very clearly specified, and it is in terms of the total exposure that the financial system or financial system players have on a borrower because we do not want to borrow to over leverage it is not a question of who will lend to them. So the question is therefore, an MFI borrower who has been continuously lent by a MFI which becomes a bank, having a chance to get replaced by another MFI does not help because overall it is entities of the borrower is the material issues which we are not making any changes.

Dr. Raghuram G. Rajan: I mean, to the extent that some of our credit agencies collect data on MFI loans but not on loans from banks, that particular issue when people transform may have to be looked at. It is more an issue of guiding the rating agencies to collect that information also so that we have an overall sense of the borrowing by the individual.

Mr. S.S. Mundra: As far as cleanup of bank's balance sheet is concerned, there were two clear components. One was which was operative till March 2016 and second for the four quarters of the year in which we have entered. Based on the data which were there for December and March, banks have followed the roadmap which was laid out, June quarter result, whatever was received. So Banks, our sense is that they are very much on the track of the cleanup. As far as the provision coverage is concerned, of course we have not mandated any particular PCR for the banks, but obviously with the provisions, the additional provisions which have entailed the cleaning up. And going forward the requirement of provisioning which will come with the ageing of the loan book as also the continuous cleaning up of process, it would be normal to expect that the overall provision coverage ratio in the industry would be improved.

Priyank Choksey
Wealth First Portfolio Managers

As you mentioned in your media interaction that you had covered your positions in the forward markets for FCNR (B) redemptions, but in case the 80% to 90% of which you have covered FCNR based redemptions, if the seller does not fulfill the commitment then are we likely to see a rupee depreciation as in August 2013?

Dr. Raghuram G. Rajan: Look, I think the environment is greatly different now than August 2013 when there was a lot of concern about macro stability in India, even while there were concerns about the global environment, which is why many other emerging markets were hit at the same time. I think in relative terms, the FCNR (B) redemptions should be seen as a much smaller eventuality. And not only do we have forward positions, we also have plenty of reserves. So if we see some stress in currency markets, of course the RBI will make an appropriate decision at that time on how many dollars to infuse into those markets, depending on the situation. I think we are very-very far away from the taper tantrum period and I do not think we should talk about these two possibilities in the same breath.

Aditya Badami
Copal Amba Research
(26:45)

My question for you is as an academic and as a policy maker. Do you think major central banks globally are caught in the trenches when it comes to the forever open tap of money available? Is India vulnerable to this in the long run or are we in a sweet spot till this goes on? Second, do you see any fault lines coming up?

Dr. Raghuram G. Rajan: I will answer the first question, second could take a few weeks. On the first question, I have been concerned about the fact that exit from these easing monetary conditions is very difficult, since the central bank that proposes to exit first immediately sees its currency fluctuate and therefore immediately sees headwinds to the very growth that it was basing its exit on. And we have seen a couple of times this effect, at least implicitly, the thinking in some of the central banks. So, given that, I do worry that we may stay low for longer than perhaps warranted by economic conditions, and to some extent somebody has to bite the bullet and lead the way out otherwise we will be all stuck in this for a long long time. And of course, excessively easy financial conditions breed the fragilities for the future and we can already see in a variety of markets that credit has become perhaps a little easier than one would wish.

Anupam Surana
Citibank

The first question I have is really on the real rates. The policy today talks about looking at space for more easing or more policy action, if your target of inflation for March is 5% and assuming the real rate of 150 to 200 basis points that you have talked about, even referencing to the one year bill, where do you see the scope for further action?

And secondly, do you see the new MPC actually relooking the whole 150 to 200 basis points and probably settling for a lower rate, do you foresee that possibility?

Dr. Raghuram G. Rajan: I think that when we made this comment of 150 to 200 basis points and I sort of elaborated on it over time, the idea was it was something like the one year forward or one-year treasury rate, less the inflation rate or the expected inflation rate. And there is a little bit of fuzziness there, but different people would interpret it differently. But generally, if we are getting further along in the year and we see inflation coming down, presumably if that has some momentum and the idea is to go towards the 4% target by 2018, even with a 5% in 2017 looking forward there may be some room to cut. So I think what you are doing is subtracting 5% from the policy rate of 6.5% right now and getting 150 and concluding there is no room, but if 5% is going below 5% as part of a disinflationary trajectory and is likely to go further in that direction, there may well be room especially if you add a little bit of premium to the 6.5 for the one-year rate.

Swati S
Bharat Corporative Bank

I would just like to know, like what is your long-term view on the rupee looking at the different global aspects like where do you rate our currency, whether it is at a proper level or we can expect a more of the appreciation in the rupee level? And if there is an appreciation in the rupee levels, what do you feel, how is it going to impact our exporters? And in fact, everyone is saying that there is a lot of positivity coming up in the Indian economy and we can expect more of the positive, the currency can more appreciate. So how would you think from the exporters' point of view?

Dr. Raghuram G. Rajan: See, I think it is a fool's game, even for the Reserve Bank to predict what the medium term value of the rupee will be, I think this paper by Kenneth Rogoff which says that "it is really impossible to predict exchange rate levels and we typically can tell a good story in hindsight of why the exchange rate moved away it did, but it is very hard to predict." That said, I think the general theorem which governs exchange rates is the Balassa–Samuelson theorem which basically says that emerging market currencies appreciate in real terms over time for all the reasons that Balassa–Samuelson point out, and I do not want to give you a lecture on that here. So basically I think most emerging markets have followed that route as they get richer and I do not see a reason why India should be any different. What that says about the nominal rate next year and what the real appreciation will be next year, I do not know.

Sonal Varma
Nomura

My question was on the 4% inflation target that has been notified and its interpretation, so is this a target for each year for the next five years or is this a target to be achieved on an average over the next five years? I mean, there cannot be smoothing over a cycle. Also, the RBI communication so far has been in terms of point target, so we had a 6%, 5%, going down to 4% and now we will sort of have a range of 4% plus minus 2%. So if we look at the current situation where CPI is at 5.8%, it is almost 1.8% points above the target, but within the range. So, in such situation what really determines the policy reaction? I mean, in a sense it seems to be quite open to interpretation, so just wanted to get your thoughts on that.

Dr. Raghuram G. Rajan: Look, I think this is something that the Monetary Policy Committee will have to give more guidance on over time. As far as my thinking on this goes, it is that we move towards the center point of the range over a reasonable period, which is why we said 2017 would be 5% and 2018 would be 4%. And the idea is, once we get to the central point of the range, yes, then we try and balance over time. Essentially both the upper limit and the lower limit are wide enough that you can go off-track for a little while but the idea is over the medium term you will bring it back to the center of the range. So you can get buffeted by shocks and you do not react immediately with great violence so as to bring the inflation rate back in a very-very short period to the target, but you do it over time. I think therefore if I were to interpret the mandate, it would be, let's get to the center point of the range, staying within the bounds of course during that time, and once we get to the center point let's stay broadly balanced around that. Let me ask Dr. Patel, if he wants to add to that.

Dr. Urjit R. Patel: Just that it is called flexible inflation targeting for a reason and it is our failure only for three successive quarters we are piercing the upper bound or the lower bound. And therefore, the issue of this being an average inflation rate over the next five years does not arise. It is a range and therefore a tad bit of flexibility is endowed even in the definition of what constitutes a failure that the Monetary Policy Committee or the RBI needs to explain.

Naveen Sharma:
HDFC Life

I just wanted to understand one thing, when the currency in circulation or the currency in public is going up, it will stoke inflation but at the same point in time to reach to the neutral liquidity RBI has been doing QE of sort in India and buying long-dated bond. So I just wanted to understand that that what leads to the choice of the bond, because initially RBI started buying short end of the bond and now increasingly they have started buying bonds which are of 10 to 15 year maturity.

Dr. Raghuram G. Rajan: I would not attribute a whole lot of design to the maturity of the bond that is being bought, because in general we are trying to, we are not tailoring that to monetary policy consideration. But let me ask Mr. Gandhi to comment.

Mr. R. Gandhi: Bond purchases, the selection of the bonds depends upon the market condition, the liquidity and the yield curve that we want to fix on. So, so many considerations go into selecting that. So that is not directly related to the way you are asking for.

Vikas Agrawal:
Prokens Financial

Sir, before I ask my question, I just wonder that if RBI has really institutionalized the process of engaging with the alumni going forward and how people like us will be having access to your rich experience in the future, so you may wish to respond to this, but now my question is related to privatization of bank. So what we are seeing that initially there used to be discussion how our public sector bank should be privatized, now we are seeing the whole industry itself is getting privatized, private sector banks are growing and public sector banks are there on sidelines because they do not enough money to grow. So, I am trying to understand, if the strategy used by the government of the day or different governments around the world to do such things, because if that is the case even as an analyst, I keep expecting high growth rate from a public sector company or a good balance sheet, we will just be left waiting till eternity and without any recourse. So what is your view on that?

Dr. Raghuram G. Rajan: I do not think the intent is privatization by stealth or anything of that sort. I think we do want to have a competitive banking system so as to provide customers, both corporate as well as individuals, the best service possible and reach out to every Indian in the process. So, this is not an anti-public sector more in any way, as the public sector sort of deals with its bad loan problems, I have no doubt that they will come back with greater competitive fervor and compete in the same markets that some of these private banks are competing. Right now I think the relative subdued growth of the public sector has to do with the fact that they are cleaning up the balance sheet and focused on that rather than some sort of inherent advantage that is being given to the private sector. So, I would not be overly pessimistic. Of course what we should do is let competition take place and let institutions learn as a result of competition and fix their deficiencies and there are deficiencies as much in the private sector as in the public sector.

Vikas Agrawal: Prokens Financial

And sir any comment that how we will be enjoying any sort of access to your rich experience in the future?

Dr. Raghuram G. Rajan: That is a very complimentary phrase, but I think that there will be various channels through which whatever little experience I have will be re-inflicted on the system.

Sunil Toshniwal: Edelweiss Financial

This is regarding the volatility in bonds. So, generally we always talk about the volatility in currency, but no one focuses, there is hardly anyone who focuses on that volatility which is in interest rates. So, RBI came up with some draft guideline in January or February but there is no clear timeline when this will be introduced and when we will be seeing any instruments which can help us for this to curb the volatility.

Dr. Raghuram G. Rajan: So, I do not think we have any intend to curb volatility through direct action in bonds, we are not going to buy bonds to reduce interest rates or engage in explicit QE of that kind, that is I think not on the cards. If your thought is on perhaps various forms of hedging, interest rate futures already exist, but going forward there is certainly an intent to strengthen the money market futures and we are looking at how we can make a difference there. One of the issues that has come up is what benchmark we use and we are looking at that carefully.

Moderator: Thank you. Ladies and Gentlemen, that was our last question. With that, we conclude today's conference call as well. Thank you very much for joining us. You may now disconnect your line.