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

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MODERATOR: **MS. 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, 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: Welcome once again from the Reserve Bank of India to this post policy researchers teleconference. As always, Governor will make a short statement first and then question-and-answers. Governor please.

Dr. D. Subbarao: Thank you very much and once again a hearty welcome to this conference. As I said before we attach a lot of value to this because we take away a number of important messages from our conference with researchers and analysts. Just so that we warm up I am going to summarize the statement that I read out yesterday. We kept all the policy rates unchanged; the repo rate, the reverse repo rate and the CRR. The MSF rate too stayed at 10.25% with a mark-up of 300 basis points above the repo rate. There were mainly two considerations behind this policy; the first was the external sector concerns, especially those stemming from global financial markets over the last 10 weeks; the second was the standard concern of any central bank including the Reserve Bank of maintaining a balance between growth and inflation. We recognise that downside risk to growth had increased, and we also had to keep a vigil on inflation and inflation expectations. So the second consideration was that balance between growth and inflation. We looked at both the global and domestic macroeconomic situation. On the domestic situation, the silver lining today is that the monsoon so far has been above long period average and the spatial and temporal distribution has been largely very good except for some pockets in the East and the Northeast. However, industrial production is lower than we thought before and services sector activity is also subdued in part because of adverse spillovers from tepid recovery around the world. Keeping all this in view we revised downwards our growth projections for the current year from 5.7% to 5.5%. Then we did review of inflation, both Wholesale Price Index inflation and CPI inflation, and as you all know even as WPI inflation as well as the non-food manufactured products inflation within WPI had come down; the CPI inflation remains close to double digits, largely because of high food inflation. There are risks to the inflation outlook which we indicated in our Macroeconomic and Monetary Developments document that came out day before yesterday. By far the biggest risk to inflation stems from the depreciation of the rupee and the pass-through from there. Reserve Bank's study shows that the coefficient of pass-through has increased. Now every 10% depreciation results in a 1.2% increase in inflation. Also, I have been advised by our staff that in spite of low demand, producers might pass on high input prices as high output prices because they will not be able to absorb this. Then there is always that risk from oil prices, they have remained firm in the last few weeks. Both the IMF and the

World Bank said that they might soften going forward but oil prices will be subject to both economic factors as well as the political situation in the Middle East.

We have indicated four risk factors and biggest and the first risk factor stems from our vulnerability in the external sector, in particular sudden stop and reversal of capital flows that we saw over the last 10 weeks. It is not clear if financial markets have factored in the full impact of the prospective tapering of QE or whether we will have some spillover impact every time there is some announcement from advanced economies, in particular the US Fed.

The second risk factor is the large CAD, above the sustainable level for 3 years in a row which has affected our external payment situation. Most external vulnerability indicators have deteriorated indicating that the economy's resilience to external shocks is eroded.

The third risk factor is the continuing weak investment environment which remains weak because of a number of factors such as cost and time overruns, high leverage, deteriorating cash flows, erosion of asset quality and muted credit confidence.

The final risk factor is something that has stayed with us for the last several policy reviews, which is the supply constraints in the economy. India is unique among major countries in the world that we are a supply-constrained economy. There are a number of supply constraints especially in the food and infrastructure sectors which affect our growth and inflation and it is very important that these constraints ease in order that our growth improves and inflation remains subdued.

I now want to turn to the guidance that we gave yesterday which attracted a lot of questions in the media conference yesterday as also a lot of attention in the media comment both yesterday on the TV and this morning in the newspapers. What we said in the guidance is that over the last 2 years our policy stance has been informed by the growth inflation dynamic. However, over the last 1 year, the external sector concerns have had a growing influence on the policy calibration. We said that based on the current situation characterised by moderating wholesale inflation, prospects of softening food inflation consequent on a good monsoon, and decelerating growth, there was a reasonable case for continuing on the easing stance notwithstanding what we said in the earlier policy about the limited room. We believe that, that limited room had actually yielded some room if only because inflation is less uncomfortable and growth is more worrying than it was in May. However, the external sector concerns kept us on pause. As we said we are caught in a classic 'impossible trinity' trilemma. We are having to forfeit our growth inflation dynamic, informed monetary policy stance, in order to take care of external concerns. We have instituted some liquidity tightening measures first on July 15, second on July 22. They have had some impact over the movement of the currency over the last 2 weeks.

There have been a lot of questions about when we might roll them back and that is why we thought that it would be an obligation on our part to indicate in the policy guidance about when we might roll them back, it is difficult to attach a time frame to that. All we said was that

these measures will be rolled back in a calibrated manner as stability is restored to the foreign exchange market. Nuancing is quite important, we said they will be rolled back in a calibrated manner, and they will be rolled back only after we determine that stability is restored to the foreign exchange market. We have not used the word 'temporary' very advisedly and very deliberately because our understanding was that 'temporary' might be interpreted in different ways by different people. They would attribute a length of time to temporary and we did not want that sort of miscommunication to go. Our roll back of these measures will be done only after the Reserve Bank determines that volatility in the exchange rate has been curbed and it is the intention and objective of the Reserve Bank to stay the course with these tightening measures until we achieve the intended result. Thank you very much, I will stop there.

Moderator: Thank you very much Sir. Participants, we will begin the question-and-answer session. We have our first question from the line of Mr. Srinivasan Varadarajan from Mount Nathan Advisors. Please go ahead.

Srinivasan Varadarajan: I have one suggestion and a couple of questions. Here is my suggestion to start with. In my opinion I think critics of the RBI have unfairly pointed out that the RBI has not done enough on the policy rate front to promote growth. I think it would be useful for the Reserve Bank to respond by indicating the monetary accommodation has to be looked beyond the 125 basis points reduction in the policy rate to also include the OMO purchases of the last 3 years which have amounted to almost around one third of the gross borrowing program each year. And in the absence of these OMOs, long term yields would have hardened and would have impacted the cost of capital for industry. Here is the beginning of my first question. In my opinion, the root of the problem as I see it is negative real rate for savers. This is impacting deposit growth, creating issues on the exchange rate and impairing policy transmission. Why is there reluctance in allowing the real rate correction at the long end of the yield curve, especially I think as it is warranted by fundamentals? This will correct the issue of negative real rates in my opinion. In fact if one looks at the ratio of gross central and state borrowings to deposit growth fair value on the 10-year bond is closer to 10.5%. Will the RBI now look at a programme of OMO sales especially since you indicated on the 15th of July that the FX issues were largely due to domestic liquidity? And if you do so, how will you balance OMO sales to the borrowing program? The reason why I ask this question is, if one applies a Taylor rule framework to policy rates then if you look at a blended CPI-WPI it does indicate that policy rates were accommodative before of course the measures that you took during the last month. And my second question is really coming from the MMDR wherein it was indicated in the price section of the MMDR that global commodity prices eased in the second quarter of 2013 and this has had kind of a salutary impact on WPI. Now does this imply that WPI inflation in India is largely a function of the tradable sector and it is really levered to the global commodity cycle? And if that be the case then is CPI largely an outcome of the non-tradable sector? And I would assume that, that would be clearly in the remit of monetary policy. The reason I ask this is we all know that CPI has been sticky and inflation expectations have been high. Does it make sense to move to targeting the CPI and this might actually have a beneficial impact on the exchange rate. Of course it is a long drawn out process.

Dr. D. Subbarao: Thank you Srinivasan, thank you for that analysis as well as the questions. About your first question about deposit rates, yes, we believe that deposit rates must be attractive because raising deposits is an important consideration but it is also important for us to balance the interests of depositors and borrowers. Banks have told us that if they raise deposit rates they have to raise lending rates. No matter how you calculate, no matter how you argue that real lending rates are low or negative or whatever, people look at the nominal lending rates and borrowers complain that lending rates are high. Banks say that there is pressure on them to reduce lending rates, and they cannot at the same time keep lending rates low and increase deposit rates. So it is a perennial dilemma that banks have, a perennial dilemma that central bank has, but we are sensitive to the concern you raised. A corollary to that question is that you asked whether there will be OMO sales. There might be in the future, OMO sales is part of this package of tightening and we will look at that. And if as a consequence - the intention now is to invert the yield curve- but if as a consequence some long rates go up that is the inevitable part of the process. On the second question about shifting to CPI, we have answered that question several times that we will look at all indicators, WPI, the CPI, the new CPI, the disaggregated CPI, etc. But as all of you analysts know, the new CPI does not have a long enough history for us to depend entirely on that. But increasingly within the Reserve Bank, we are analysing the inferences from the CPI, and they are feeding into our policy stance. Thank you. And I would request all the others to please keep your questions brief.

Moderator: Thank you sir. Our next question is from the line of Kaushik Das from Deutsche Bank. Please go ahead.

Kaushik Das: Hi, my question is regarding India's reserve adequacy. As per the latest data reserves can still cover about 6-7-months of imports but when you take into account the short term external debt which has increased very sharply then the reserve adequacy position does not look at all, giving any kind of confidence. So particularly worrying is the sharp increase in the short term external debt on a residual maturity basis which has touched $172 billion odd. So how concerned is RBI about this reserve adequacy position of India, especially when reserves are expected to go down further due to FX intervention? The second question is regarding the potential growth rate of economy. Last year the expectation was that the potential growth rate has come down to about 6.5 to 7%. Does RBI think that the potential growth rate has fallen further in the wake of the developments of the last few months?

Dr. D. Subbarao: Thank you Kaushik I am going to request our Deputy Governor Urjit Patel to answer that.

Dr. Urjit Patel: We actually feel that our reserves are adequate; 6.5 to 7-month of import cover is good, our short term debt has increased but the short term debt has been comfortably rolled over and refinanced over the last 3 years despite the high CAD. So not only do we feel but international agencies like the IMF and so on, by the criteria they use, they feel that our reserve position is adequate and comfortable and we certainly feel that is the case. On the potential growth, the RBI's calculations and models suggest that it is about 7% now.

Moderator: Thank you. We have our next question from the line of Sudhir Agarwal from UTI Mutual Fund. Please go ahead.

Sudhir Agarwal: My question is that RBI has mentioned in the policy that the recent liquidity tightening measures provides a temporary breathing space and the government will have to follow with the reforms, right? So whatever the steps the government takes, what if those are not sufficient? In that case, will the RBI still continue with the liquidity tightening measures or would they like to replace it?

Dr. D. Subbarao: That is a hypothetical question Sudhir. We have said that we will continue and we will persist with the liquidity tightening measures until the Reserve Bank has come to a determination that volatility in the exchange rate has been controlled. That continues to be our resolve and that is the way we are going to go forward. Meanwhile, both the Reserve Bank and the government will try to see how to adjust the current account deficit. Adjustment in the current account deficit inevitably by its very nature takes time. But sending out the right signal that we are making an effort to adjust itself will make financing of the current account deficit easier.

Sudhir Agarwal: Do you think the repo rate high also can be an option in case these measures are not sufficient?

Dr. D. Subbarao: I do not want to comment on one particular instrument, but there is a lot of arsenal with the Reserve Bank. We will use all of that as might be necessary, as might be warranted by the situation.

Moderator: Thank you. Our next question is from the line of Prithviraj Srinivas from HSBC. Please go ahead.

Prithviraj Srinivas: I have two quick questions; the first one is what needs to happen more specifically on the global and domestic front before you expect to see the degree of stabilization of exchange rates that would allow for a roll back of liquidity measures? The second question is if Fed related tapering fears weigh on the emerging market capital flows for the remainder of the year and India's current account deficit does not narrow noticeably and structural reforms move forward too slowly, how would that change the trade-off between catering to the currency and catering to growth?

Dr. D. Subbarao: Prithviraj, thank you for those very short but very important questions. Global situation is uncertain and we have no control over it. We are trying to improve our ability to understand and assess the global situation and assess the spillover impact of that on our domestic economy. On the domestic front, we know a lot of things that need to happen in order to revive the investment sentiment; we do not have to go through the list now. The investment sentiment as we said in the policy document is weak and by far the biggest factor affecting growth today. So we need to revive investment under both domestic investment and foreign investment into India that needs to happen. As I said in answer to a question earlier from Sudhir Agarwal, we also need to send the right signals about making the adjustment on the current account deficit side. Your other question was hypothetical, Reserve Bank will respond

to the evolving situation with all instruments at our command. It is difficult at this point of time and it is also inadvisable to imagine a particular scenario and say how we might respond but be assured that we are monitoring the situation on a continuous basis and we respond to it as we think best.

Moderator: Thank you. Our next question is from the line of Rajesh Agarwal from Bank of America. Please go ahead.

Rajesh Agarwal: Sir, you have said yesterday that monetary policy is the first line of defence in a currency crisis. To my knowledge there are two channels through which monetary policy can have an impact on the currency. One is the short term impact wherein speculative buying is curtailed or made expensive and this forces the leads and lags to change in favour of inflows. Second is the medium term channel wherein real rates are raised, which shrinks savings investment balance and hence current account. In our case there is an issue in targeting both these channels. One is for the short term, the RBI restrictions are already in place in terms of speculative activity, which means that currently there is little speculative activity in the onshore markets and the spot is really moving because of supposedly genuine flows. As you all know oil companies need to buy about a $1billion a day. The second is that tightening liquidity leads to higher real rates but has a side effect. It makes it more difficult to address supply side bottlenecks. So what I would like to know from you Sir is that which of these two channels you are targeting? And depending on which channel you are targeting will also determine the timeframe for which these measures will last. Thank you.

Dr. D. Subbarao: Thank you for that analysis. I request you to please send it to me, I will study it, and I can have our people study that. But I suppose what we are going to look at is not which channel, we are going to look at the overall impact on the volatility of the currency and respond to that. Of course, we would like to understand the dynamics of how that is happening but that is something that we do internally. It is difficult for me to say in a binary way in answer to your question which channel are we looking at. But please do send your analysis to us.

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

Sonal Varma: I wanted to ask what is the risk that these measures can precipitate into a bigger problem for the banking system because of asset quality stress. What is the RBI's view on that?

Dr. K. C. Chakrabarty: Anyhow banks' asset quality we will be not able to protect. Suppose, if you allow the exchange rate to depreciate, then the corporates, the borrowing, those who have gone for ECB borrowings they will default and banks asset quality will deteriorate. And if the rate has gone up then definitely because of the portfolio depreciation they will be affected. We feel that HTM is more manageable because banks must understand the risk and we allow lot of amount to be put in the HTM category so this is a better option, that is our assessment. But with all these things our own analysis indicates that banks' profit and loss account may little bit adversely affected but they will be able to absorb the shock in this count, and as I said that we feel that HTM route depreciation is a better route.

Sonal Varma: I wanted to ask a variation of a question that has been asked. If the FX volatility continues and the INR depreciates, then is the RBI prepared to reverse its monetary policy stance? Because the government actually has been highlighting that these measures should not be confused as a change in RBI's monetary policy stance. So at what point does the monetary policy stance change? Can we directly look at a policy rate hike instead of the focus right now on the reversible liquidity tightening measures?

Dr. D. Subbarao: It is difficult to define in objective terms that which point we will shift from this to another stance, Sonal. So as I said being more lucid on this might in fact restrain our flexibility. All I want to say is that we will use all instruments that are available to us but we will use them judiciously and whether it is seen as a change in stance, a change in the instruments used, that is for market people like you to interpret. We are now focused on curbing volatility in the exchange rate because we believe that that is detrimental to our growth prospects and to our stability prospects.

Moderator: Thank you. Our next question is from the line of Indranil Pan from Kotak Mahindra Bank. Please go ahead.

Indranil Pan: My question is basically on the extent of the change in the policy rate. In the sense in an upcycle as well as in a downcycle the RBI had always been indicating a calibrated move. What was the thought process behind the 300 basis points increase in the overnight rate because anyways the MSF was standing at 100 basis points higher than the repo which was the policy rate of the time? Your thoughts on this.

Dr. D. Subbarao: Indranil, the short point is that we raised the MSF rate mark-up to 300 basis points above the repo rate because we wanted to make the short term money costlier and scarcer. The idea was to invert the yield curve, raise the interest rate at the short end and we thought that raising the rate for this purpose was necessary and in fact it has been found to be an effective instrumentality.

Moderator: Our next question is from the line of Naveen Sharma from Bajaj Allianz. Please go ahead.

Naveen Sharma: I just wanted to understand one thing that it seems the situation demands for a more dollar supply and we see just three options: NRI bond, a sovereign bond and probably money through IMF route. So does RBI prefer any one route to the other route, as you said yesterday that you do not prefer sovereign bond at this point in time?

Dr. D. Subbarao: Yes, I did say yesterday that the Reserve Bank has reservations about sovereign bond issue because the costs outweigh the benefits. And you indicated some of the possibilities of raising money. So there are all possibilities, they are all on the table. Among these the menu of options sovereign bond issue is still least preferred. That is the Reserve Bank's view.

Moderator: Our next question is from the line of Amit Khurana from Dolat Capital. Please go ahead.

Amit Khurana: On the sovereign bond issue, I just wanted to understand is your reservation more from a timing perspective or do you think it is a structural issue that we should not be going in for this?

Dr. D. Subbarao: It is both of them, it is a structural issue and also from doing it now when we are vulnerable. We should do it when we are much stronger and when fiscal deficit is much lower.

Moderator: Next question from the line of Simon Flint from Dymon Asia Capital. Please go ahead.

Simon Flint: Governor, yesterday, in your statement to the press, you suggested that because of the large current account deficit, the rupee depreciation in some senses would be warranted. And on the other hand you do have some economists, I think including some in the Ministry of Finance who have argued that if you compare the present value of the rupee to the real effective exchange rate, let us say which prevailed over 2004-2005, then the rupee is actually overshooting and is now undervalued. So I guess can you give us a sense of where you see rupee today relative to its fair value?

Dr. D. Subbarao: Thank you for that question. Actually my answer to your very well argued question is quite short, which is that the Reserve Bank does not take a position on the level of the exchange rate. The depreciation of the currency has costs for the economy, but that is a different matter. We do not take a position on the exchange rate; there are various ways of calculating it including the way that you have indicated from the Ministry of Finance. All we said yesterday was that because of the current account deficit, the rupee would have depreciated and that has not happened because we have been able to finance it, and now that there is capital flow issues, those strains are coming into play, and the rupee is depreciating.

Moderator: The next question from the line of Kumar Rachapudi from ANZ Bank. Please go ahead.

Kumar Rachapudi: The question is regarding the interest rate hikes which you have done. Obviously, one of the impacts of this would be to curtail imports, but the question is at current low GDP levels, how much of the current imports are a part of a discretionally consumption basket which are actually leveraged. In other words, do we think that high interest rates will actually help in reducing import basket?

Dr. D. Subbarao: I would think so, because interest rates affect the cost of money and therefore affect the aggregate demand, and therefore affect the import demand. So in a way, yes, our interest rates affect import demand. You are right; they affect the non-discretionary component of the import demand more than the discretionary component. But my understanding is that they do affect the import demand.

Kumar Rachapudi: Just as a follow up, one of the other things which was being repeatedly mentioned is that the RBI will also concentrate on the ways of funding the current account deficit. In that sense, we all know that the equity capital markets attract a lot more inflows than the bond markets.

Towards that end is there any action which the RBI would be willing to take to prop up the equity markets?

Dr. D. Subbarao: Our efforts at curbing volatility in the exchange rate are aimed among other things to make investment in equity attractive and promising, that more inflows must come, inflows that are already here should stay here, and we believe that a stable exchange rate is important for that purpose.

Moderator: The next question from the line of Raghavan M.J from SBI Life Insurance. Please go ahead.

Raghavan M.J.: I have a question with respect to the measures that were taken on the 15th and the 23rd of July. My assumption is that these measures were taken to as you have explained later on- that you wanted the short term rates to move higher, thereby disincentivising any speculation in the currency market. And there was also a ban later on in the futures and options market with respect to currencies. Now here, when I look at one of your Working Paper by Somnath Sharma, I guess this was regarding analysis of the relation between currency futures and volatility of exchange rate. I guess the investigation was found to be little limited and inconclusive. And they said that actually there was a two way causality as in not just exchange rate volatility being caused by activity in the futures market but also the other way around where you have spot exchange rate moving and thereby increasing futures activity. So now my question is if there is no evidence in this aspect do you think this measure was required? Why I am asking this because in case the currency starts appreciating, since there is a two-way causality, do you not think freeing few futures and options activity will probably help the currency move down further as in appreciate further? That is one question. The other question is with regards to the measures of trying to hike up short term rates and across the yield curve you want rates to go higher. There was another paper by Anand Shankar, trying to find out whether interest differentials actually are causing any sensitivity to capital flows inside India. Except for ECBs, FII flows and FDI flows according to that particular paper are absolutely insensitive to any interest rate differential, and there is a marginal sensitivity for NRI deposits. So if this is the case, do you think these measures will be helpful in bringing about any kind of excess capital flows or preventing flows to go outside?

Dr. D. Subbarao: Thank you for those questions. Since you have quoted extensively from RBI research, I am going to request our Executive Director, Deepak Mohanty to answer your questions.

Shri Deepak Mohanty: Of course we can negotiate bilaterally and discuss these issues, but as you know the working papers are again the opinion of those authors not really the Reserve Bank of India. But again how do you read those papers, because my reading is slightly different, not very different from the way that you think. The Somnath paper in terms of the futures market and the exchange rate volatility clearly suggests that with the introduction of the futures market, the volatility has increased, it coincided. It is not suggesting any kind of causality, because once you have done, this will happen in the post-crisis period, and the same time the volatility has gone up. And of course, causality could be two way, so that is one. And the other paper, my recollection offhand is that it suggested that the equity flows are not very sensitive to interest

differentials the way it should be, but certainly in the debt flows. But once you add up equity and debt, the overall capital flows to interest rate differential; my understanding was that it was inconclusive. So these are broadly the issues, but thank you for your interest, we can always engage with you with the research department to take this idea further.

Dr. D. Subbarao: I am also interested in this question, because when we reduced rates in May, a lot of you asked this question about whether it runs counter to our efforts to keep capital in and attract more capital flows. So now we will be interested in your thoughts on this question.

Moderator: The next question is from the line of Indranil Sengupta from DSP Merrill Lynch. Please go ahead.

Indranil Sengupta: As you know that India's FX results are down to 7 months import cover, which was last the case in 1996. And one way in which the RBI solved the problem at that time was to issue RIBs and IMDs, then that became a game changer for the currency. Sir, is there a plan to do that now so that you can actually stabilize the currency and cut rates to protect growth going forward?

Dr. D. Subbarao: Yes Indranil, all the options are on the table, under consideration and we are engaged in discussion with the government, and we will do whatever is best. It is difficult in a conference like this to indicate which particular measure might actually be decided upon in the discussions.

Moderator: The next question is from the line of Ashish Kumar from Elara Capital. Please go ahead.

Ashish Kumar: The majority of indicators of INR volatility, that were referred to by Mr. Patel yesterday I think in a teleconference, have misbehaved since yesterday. So in view of that, do you commit into the liquidity tightening moves from the present conditions can go in both the directions as INR evolves?

Dr. Urjit Patel: We have indicated fairly clearly in the statement including the Governor's introduction that we stand ready to use further measures including liquidity tightening but not necessarily only those to ensure that volatility is curbed in the market and speculation is reduced considerably going forward. So, all measures are on the table and nothing is ruled out.

Ashish Kumar: Second question is basically on the central bank communication part. Yesterday, you must have watched the intraday INR volatility. So does the move since yesterday signal that central bank communication per se has not been taken in by the markets in a way you would have wanted? So where is the gap do you think, your comment on that?

Dr. D. Subbarao: My comment is that we have communicated and as I said in one of my speeches we cannot dictate how the market responds to that. However, we are trying to evaluate what has happened since yesterday and what lessons there might be for improving our communication.

Improving what we do is a continuous activity in the Reserve Bank and we will certainly study what has happened since yesterday.

Ashish Kumar: So basically there was one point which caught my attention. So you are talking about whether financial markets are factoring the full impact of prospective tapering of QE, I am just quoting the report and whether they will react to every future announcement of tapering. So my question is, does the RBI believe that equity markets stand to see incremental sharp outflow like the debt market, something which has not happened till now, in a manner it should have happened?

Dr. D. Subbarao: It is difficult for the Reserve Bank as it is for you to really foresee that. As I said earlier in this conference, our efforts, our policies to curb volatility in the exchange rate are intended among other things to keep India as an attractive destination for FII inflows both in debt and in equity.

Moderator: Thank you. The next question is from the line of Pankit Shah from Axis Securities. Please go ahead.

Pankit Shah: My question is on the fundamental side. In a country like India where short term flows finance 40% of our current account deficit, what in the view of the Reserve Bank of India governs the currency movement? Do rate hikes really help benefit the currency because given the fact that close to 40% of our current account deficit is funded by short term flows. So rate hike would really dent the sentiments of the FII investors looking at investing in the equities. And given the fact that India per se is more equity funded economy, what in your view would be more essential?

Dr. D. Subbarao: Thank you for that question. That question occurred to me several times over the years, in particular in the last one week. And I have asked our staff to please give me an answer and they wrote me a paper indicating the link between monetary policy and the current account deficit. I am trying to absorb that and I have some synopsis of that paper in front of me, but this forum is not very appropriate for a lengthy discussion on that. But in the Reserve Bank's view monetary policy will have an impact on the current account deficit through a variety of channels.

Pankit Shah: So just to put it very shortly, do rate hikes in your view actually help the currency to appreciate or do rate hikes help the currency to depreciate?

Dr. D. Subbarao: At the moment, we have not resorted to rate calibration for this purpose. If and when we do that it will be because we have determined that rate adjustment will have an impact on currency.

Moderator: Thank you. The next question is from the line of Soumya Kanti Ghosh from SBI. Please go ahead.

Soumya Kanti Ghosh: I have two questions; one question is a continuation from my question last time. There was a question on this growth inflation trade-off and the sacrifice ratio which the RBI had calculated at 2. And there was a recent paper by RBI which calculates the sacrifice ratio at 2.36 in the post-crisis period. So given that in a situation of declining interest and this higher sacrifice ratio which has been with given by RBI, do you not think there could be a downside to the 5.5% growth projection which the central bank has put out yesterday? And my second question is basically regarding the policy trilemma which you have talked about last week and yesterday that financial integration increases stability and monetary autonomy. So do you not think that what could be at this point of time, basically after the crisis of this growing exposure of developing countries to capital flight and deleveraging crisis, it could be a classic case of the monetary policy quadrilemma where the cost of the financial stability may have become more important than it was earlier?

Dr. D. Subbarao: On your first question about the sacrifice ratio having increased, I am going to request Deepak Mohanty to answer.

Shri Deepak Mohanty: As I said earlier, because the working paper again that is the personal view of the author, so that goes with that. Having said that but analytically because it is a nonlinear relationship as you know and it holds a different combination of inflation and growth. So the 2 which was put out earlier is the kind of average relationship. And subsequently the latest paper which has come out, has suggested that the average relationship has shifted slightly up 2.3. So that essentially also we have been referring in a different way in our policy also gets articulated. If the moderation in inflation has not been commensurate with the slowdown in the growth that we have seen and partly which were attributing to various supply constraints and all that which is there in the system.

Dr. D. Subbarao: Your second question about the fourth variable in the impossible trinity. Can you please repeat that?

Soumya Kanti Ghosh: Sir, apart from the three variables, there is now a new variable which recent literature suggests that basically the cost of developing countries, growing exposure of developing countries to capital flight, the deleveraging crisis. So basically there is a significant cost associated with this crisis and which may have added financial stability to the trilemma and made it quadrilemma. So my point was that is that a monetary policy quadrilemma is now more important than trilemma which we are talking about?

Dr. D. Subbarao: I get the gist of your question. Actually, this is something that the Reserve Bank has been studying and someone who follows for the Reserve Bank is putting out, you must have participated in or read about our international conference last year in 2012 which was exactly on this trilemma about financial stability, price stability and sovereign debt sustainability. Of course, we did not look upon that as the fourth variable in the impossible trinity. We formulated that as a separate trilemma. But it is interesting the way you put it, certainly there is a cost to preserving financial stability and maybe it is reasonable, it is logical, there is a case

to argue that we might lose some discretion on the other three variables in the process of preserving financial stability. But it is something that we must study further.

Moderator: Thank you. The next question is from the line of Anjali Varma from PhillipCapital. Please go ahead.

Anjali Verma: I have two to three very small questions. My first question is if you could define the currency stability. When you say stability do you also mean stability along with appreciation or you would be happy if let us say currency stabilizes at a level of 60? My second question is currently your bigger objective is to curtail currency volatility. But going ahead if you see the growth decline aggravates, would growth become a greater priority over currency stability? And my third question will be what are your thoughts on banks passing on the higher rates as in implementing the transmission considering that there is liquidity tightness in the system?

Dr. D. Subbarao: Thank you, Anjali for all those three questions. What we try to prevent is volatility and disorderly movement of the exchange rate. We are not targeting any particular rate, any number that you suggested. So that is what we will be looking at. The number of indicators that Urjit indicated, that I indicated in the media conference yesterday. But that is just a sample of the variables that we will look at in order to determine that the volatility has been brought under control. The second question about the balance between growth and volatility in the exchange rate. I do not see tension like you are seeing between growth and the currency volatility. In the Reserve Bank's view volatility in the exchange rate actually hurts growth. So it is important that we control volatility in order to support growth. So, I do not see the tension that you are talking about. On the third question about banks passing on the short term costs through higher lending rates, we believe that did not happen, that should not happen, because our intention is to raise costs at the short end. There will be that banks have not reduced rates as much as they should have when we reduced the policy rate. In other words, the monetary transmission of the reduction of the policy rate by the Reserve Bank over the last one year is still in progress. So, banks do have some cushion. And I believe that they do not have to raise lending rates.

Moderator: Thank you. The next question is from the line of Vibha Batra from ICRA. Please go ahead.

Vibha Batra: Sir, actually continuing with your comment on cushion in the banks P&L, really speaking the recently released data by RBI says that net NPAs of banks are very high, at around 1.8% for public sector banks. And if we look at the slippages, they are not getting arrested. The environment is not looking any better. And we can see similar or maybe high level of slippages this year also. So, apart from trading profits, which Dr. Chakrabarty mentioned that banks would have to bear, even core operating profits are under tremendous pressure. And government at this point of time may not allow banks to increase the base rates. So, is there a possibility to give some relief to the banks maybe on relaxation of priority sector targets or the recast packages implemented for the Discoms that the exposure gets guaranteed by the state governments, relaxing the provisioning norms or that is not a possibility?

Shri Anand Sinha Banks' balance sheet maybe under some pressure. So, we will study what kind of pressure they are in, what are the quantum involved in different kinds of pressures and then we will see if something needs to be done, but if at all we do something it should be in such a manner that the balance sheet strength does not go down.

Vibha Batra: But if we look at even the multiples of share market, good public sector banks are trading at 0.3 to 0.4 times of price-to-book value. So the concerns there are on earning and also on asset quality. The restructured accounts for public sector banks are 7.1%. Now, we know a large percentage of this is state distribution utility. So if one can enhance the disclosures there and say that okay, this is restructured but this restructured is definitely different from a weak restructured account like a GTL. So, there also one could possibly have some confidence building in the banks.

Dr. D. Subbarao: I am going to request Anand to answer. Anand says that he has answered your question. You have done a lot of research, you are very much on the ball. So if you have any further concerns, please e-mail us and we will try and get you an answer for that. Okay?

Moderator: Thank you. The next question is from the line of Dr. Siddhi Nadal from Sikkim Manipal University. Please go ahead.

Dr. Siddhi Nadal: Right now what are the measures that are going to tackle this current account deficit because of the rupee appreciating further and because of the changes, how do you control the volatility; do you think we are going to weaken in this front?

Dr. D. Subbarao: Your question was about controlling current account deficit, that has to been done by increasing exports and reducing imports. So our effort will be to do that and largely it has to be done by the government. Over the last 2 months, we have taken a number of measures both in the Reserve Bank and in the government, restrained the import of gold which should contribute to improving the current account deficit.

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

Rajeev Malik: I have a very simple, but I guess a relevant question. RBI has consistently maintained that it does not target any particular level and it is really only concerned with the volatility. The government on the other hand, every time the rupee slips, begins to get palpitations partly although not entirely, because of the impact on the fiscal front. How do you marry the two? At the end of the day a lot of that worsening because of rupee depreciation also has a feedback loop into how monetary policy is being conducted.

Dr. D. Subbarao: The answer is that we are trying to communicate as consistently as possible within the Reserve Bank. To say that we are focused on containing volatility. The government of course has said this but I think there is lot of analysis behind what they are saying. But both the government and the Reserve Bank are really on the same page as far as larger objective is concerned which

is to control volatility. Neither the government nor the Reserve Bank is targeting any particular rate. And that is the message I think everybody listening in must take away.

Rajeev Malik: But just a follow up to that, low volatility does not mean the currency does not depreciate. And if the level is not something that is targeted by RBI, a practice I think is correct one, the government will still have to deal with the knock-on impact from the currency depreciation.

Dr. D. Subbarao: Oh yes, absolutely, it is as I said in the media conference yesterday, there are costs to be paid for this and different actors in the economy have to pay that cost. This is not cost less, and our actions distribute the cost across different people, including the government.

Moderator: Thank you. Participants that was the last question. Ma'am, would you like to add any closing comments here?

Alpana Killawala: No, I think I would just like to thank everyone for participating in this and making it so useful for us. Thank you very much.

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