"Reserve Bank of India Post-Policy Analyst Conference Call"

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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 participants' lines will be in the listen-only mode. There will be an opportunity for you to ask questions at the end of today's presentation. If you should need assistance during this conference call, please signal an operator by pressing '*' and then '0' on your touchtone telephone. Please note that this conference is being recorded. I would now like to hand the conference over to Ms. Alpana Killawala from RBI. Thank you. And over to you, ma'am.

Alpana Killawala: Thank you, Marina, and welcome on behalf of RBI to all of you. We have the Governor and four Deputy Governors with us along with the Executive Directors. May I request the Governor to start?

Dr. D. Subbarao: Thank you very much and once again welcome to all our analysts who are connected to this conference call. I just will take about three minutes to give a synopsis of our policy decision yesterday. As all of you know we left the policy rate and the CRR unchanged; however, we reduced the SLR by 1% point from 24% to 23% of NDTL. We also gave the rationale for our decision and the guidance for the way forward. The guidance in particular said that there are several factors responsible for the growth slowdown and that monetary policy is only one of them. And that we will adjust monetary policy stance as the multiple constraints to growth are addressed. We have also said in the guidance that we will respond to liquidity pressures including through open market operations.

We are sensitive to the external situation and the shocks that can come from outside and we assured everyone that we stand ready to take swift action as per the external developments.

We gave a detailed assessment of the global and domestic macroeconomic situation. We revised the projection for growth to 6.5% and for inflation to 7%.

We also indicated the risk factors governing our growth and inflation outlook. That is all I have to say at this point of time and we look forward to answering your questions.

Alpana Killawala: We can start with the questions, Marina.

Moderator: Sure, ma'am. Thank you very much. Ladies and gentlemen, we will now begin the question-and-answer session. Anyone who wishes to ask a question may press "*" and then "1" on your touchtone telephone. Participants are requested to use only handsets while asking a question. The first question is from Srinivas V Please go ahead.

Srinivas V: I have two questions and one suggestion if I maybe asked. I go ahead with the question. The first one is really on the OMOs being conducted by the RBI. The reserve money which is getting created from the OMOs, the reserve money so created is really zero duration, while the

government bonds that the RBI buys on account of the OMOs are really duration heavy assets of 10-15 years. If the objective of OMOs is to augment liquidity or create reserve money, I am just wondering whether other alternatives can be explored, such as the three-month or a six-month term repo, something on the lines of what the ECB LTRO is doing. The point here is that what starts off with good intention of creating liquidity or reserve money, morphs into form of quantitative easing and really accommodating the government. The question is, is the RBI really worried about the continued accommodation by the government through OMOs and this having some rating implications? The second point that comes out of this is continued OMOs tend to depress real sovereign yields and in turn from a portfolio perspective this contributes to low real rates of return for savers and clearly, this has implications for deposit growth. So, I wanted your thoughts on this. And the second question is on inflation. Clearly, the RBI communicated time and again that they look at a range of indicators to gauge inflation. If one looks at the quarterly survey that you conduct, the latest readings indicate that the forward inflation expectation, three month and one year forward continue to be high at 12 and close to 13%. And since the time you have turned hawkish in October of 2009, the average three month and one year forward inflation expectation is continued to be pretty high at above 11.5% and more than 12%. And these numbers are possibly closer to a sticky CPI. So, given this, does it make more sense to give more weightage for CPI rather than WPI and again, CPI kind of include services as well, in terms of conducting monetary policy. And if I maybe, just one suggestion that I like to kind of put forth to you all and that is on so far as the market is concerned. I think clearly, transmission in India will kind of get a fillip if we see the emergence of a term money market. And towards this I was just thinking about this, why not allow or encourage the emergence of double ready forwards in the market. Clearly, misuse of this instrument is not possible, quite unlike 1992 given that we have much more robust settlement system, we have got DVP III, etc. Again, a double ready forward actually helps market participants with different time horizons, execute views, and clearly, it is something that will go a long way towards creating a term money market and help the RBI in terms of its transmission policy. That is about it.

Dr. D. Subbarao: Thank you, Srinivas, thank you for those two questions and one suggestion. I will attempt an answer and then I will request my colleagues to supplement that. First, your suggestion or your question on the OMOs. We are doing the OMOs or we will do the OMOs to manage liquidity and not to manage the yields from the government securities. So, our decision on the quantum of OMOs and on the timing will depend on an assessment of the liquidity situation. Your second sub-question on that topic was about term a repo window. I am not sure about the appetite for a term repo in India. We tried that during the crisis. We opened a 14-day repo window and there was not much demand for that. In fact, the export credit refinance that we have allowed actually is up to 3 months is a proxy for a term repo and I believe there is quite a lot of demand out of that. On your second question about what inflation indicators we track and whether we should be studying CPI more closely than WPI. Indeed, we study all of them very closely and in this document that we released yesterday we have also tried to give some

analysis of why CPI and WPI diverge. About the inflation expectation service, Subir will answer this, but what he told us several times in the past was that the survey should be taken as should be more of a guide for a direction in which the expectations are moving rather than for the absolute quantum or the rate of inflation. But I do want to say once again that we are studying all the indicators; CPI, WPI and the core inflation.

Subir Gokarn: I think on the first question, if OMOs are not an unconditional action based on broader market conditions, they are based entirely on our judgment of what the liquidity situation is. So, when you look at what government yield should ideally be, driven by market conditions, the way we look at is they should be what they are when liquidity is normal. By normal, I mean, are now explicitly defined comfort zone of a deficit of not more than 1% of NDTL. So, if we are using OMOs to enhanced liquidity, it is to bring it within the zone and not an unconstraint injection of liquidity into the system which is when the problem that you suggest might arise which is that monetary policy essentially becomes unconditionally accommodating of fiscal policy. So that is not the scenario we are in. We are managing, we are using OMOs to manage liquidity and that is if you look back over the last several months, that has essentially been the driver. When liquidity has come back into that zone, which it was for some part of 2000 level we have stopped doing OMOs and if the situation were to reemerge then we would obviously consider them. On the inflation front, I think you are right, that inflation management ultimately is a welfare objective, apart from other macroeconomic implication and the CPI then become the index of choice when we are focusing on managing inflation from the welfare perspective. The new CPI offers some opportunity which the old ones did not. In the sense that it is an all India consumption basket based index as opposed to a segmented consumption basket based index. But it is now only about four or five months old and I do not think we have enough of a history to be able to judge whether it is amenable to the kinds of actions we take. So, this is an ongoing research internally to assess the properties of this index and it may at some point become a substitute. On the double-ready forwards, there is a working group that has submitted recommendations, it is on the web site, perhaps Srinivas, if you want to look at the working group on increasing liquidity in government securities market, and you have some thoughts on the recommendations please get back to us, there is a feedback opportunity there.

Srinivas V: Sure. Just one question, Mr. Gokarn, is that, not being hawkish here but clearly continued accommodation of the government clearly given where inflation is right now sticky, I understand the need to create liquidity and to create reserve money to meet M3 objective, but the point is that continue to do this now when inflation expectations and inflation is sticky, could have actually rating implication for India, international implication for India, how do you balance it? I know it is a very difficult job.

Subir Gokarn: The balancing act essentially comes from the definition of comfort zone. What would have implications perhaps is if liquidity were to move into surplus but we are still managing our liquidity situation in deficit mode. Only that we do not wanted to become large enough deficit

to destabilize normal credit operations or credit flows. So that is the judgment that we made. There is 1% threshold differentiates between a desirable liquidity, deficit and potentially disruptive liquidity deficit and that is what is driving our decision. So, it is not accommodation by any stretch of imagination.

H R Khan: SLR decision, we have taken, SLR we have reduced….

Subir Gokarn: That is also a way to increase liquidity. So, we are….

H R Khan: Because the yields have gone up.

Dr. Subir Gokarn: In that sense, that is offsetting the notion of accommodation.

Moderator: Thank you. The next question is from Kaushik Das from Deutsche Bank. Please go ahead.

Kaushik Das: I have a couple of questions. The first question is regarding current account deficit. The current macro development report points out that given the slowdown in growth, the sustainable current account deficit for India has reduced to 2.5 percentage of GDP, and obviously, last year was a record high of 4.2%. Now, the latest monetary policy statement talks about current account deficit still being a risk in this year and despite the slowdown in trade deficit in June due to slowdown in service exports, there could be problems related to current account deficit. So, is it possible to know what is the current account deficit forecast that RBI is working with for FY12-13? And in deriving that forecast what is the average oil price that has been assumed for 2012-13 as a whole. The second question is regarding the assumption behind the growth forecast that you have given, the latest one which is 6.5. I can see that from the professional forecasters survey that the 6.5% is the latest forecast average for the professional forecasters. Over there, agricultural growth has been assumed at 3%, industry at 4% and services at 8%. So, now we know that the monsoon is going to be pretty bad for 2012. So, in RBI forecast of 6.5% headline growth can we get some idea what is the composition of growth that you assumed in each of the sectors?

Dr. D. Subbarao: Very good, Kaushik. On the first question about our estimate for current account deficit, we have an internal estimate which we do not put out in the public, so I am afraid I cannot disclose that to you, but it is possible that this year the current account deficit might be lower than it was last year. And as we said we need to bring it down, the challenge is to bring the current account deficit down in the medium-term and in the short-term to be able to finance the CAD with relatively stable flows. The numbers for the first quarter however show that the non-oil trade deficit has improved, which means that the deficit has come down, which is a result of a number of factors, including response on the import side. Growth forecast, did we disclose the composition?

Dr. Subir Gokarn: No, but I think the qualitative aspect is important even though the professional forecasters survey generally assumed a t normal monsoon, because this survey was done before the bad news about the monsoon became well known. Impact of the monsoon on growth is I think less important, less significant than its impact on inflation. We have firstly the impact of the monsoon deficiency, largely concentrated in the central part of the country, and of course it has a disproportionate impact on certain crops but not necessarily on the aggregate, it will have some impact on those but it is not as dramatic as one might imagine. And secondly, the kharif-rabi mix has now turned more or less even, so the monsoon direct impact on agriculture is concentrated obviously, in the kharif season. It impacts rabi to some level because of reservoirs and down waters and so on, but again, its somewhat indirect impact. So, I think our signal and our message in the policy statement was more on the inflation side, inflation risk that monsoon poses coming on the back of an already problematic food price situation.

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

Garima Kapoor: I just had one question, but it is divided into two parts. The current deposit mobilization I think is quite sluggish and we have been seeing this for quite sometime. Do you see this somewhat structural in nature? And if so, do you foresee a fundamental change in these monetary policies likely to be conducted in the near-term, especially in context of liquidity management because we know the FIIs flows are becoming quite sluggish and they are kind of drying out. So, do you see a monetary conduct in terms of liquidity management changing?

Dr. Subir Gokarn: I would make a distinction between liquidity management and the monetary stance with respect to the growth inflation dynamics. That is the distinction we have been making more and more explicit from the time we did OMOs in late 2010 in a scenario where our monetary stance was still towards tightening. So, that is when we decided that this 1% margin was acceptable margin, a zone of comfort and to manage liquidity within that zone was essentially an independent objective. Obviously, it could not be contrary to the monetary stance but it was so independent objective. And that is the way we have been operating for the last several quarters and the same approach will continue. The difference between deposit growth and credit growth is clearly a structural contributor to liquidity pressures. We have seen it have its impact over the last year and a half at times and it is a possible pressure point in the months ahead. So, the SLR action that we took was actually one cushion that we provided to the banks if such a pressure point were to emerge and we will continue to address liquidity as a distinct objective, in a sense, independent of, but obviously, correlated with our monetary stance. Our monetary stance, as you know, is now that interest rate cycle has peaked and the growth inflation dynamic is going to be influence the pace and the sequence of adjustment but the approach to liquidity remains, the objective remains to keep it within that 1% zone for as much as possible.

Garima Kapoor: So in that context, RBI's liquidity accommodation is likely to stay for quite sometime in this particular phenomena of deposit mobilization structure….?

Dr. Subir Gokarn: It is a response to pressure. So, as the liquidity situation evolves for whatever reason, I do not exactly understand why you are drawing the connection with FII flows, because that is essentially a matter of whether there is intervention in the FOREX market or not. But whatever the reason for the liquidity pressure, if it is a persistent source of pressure, then obviously we will respond to it with whatever means are appropriate at that point.

Garima Kapoor: The FII flows will flows come into system is largely from the intervention as you pointed from…?

Dr. Subir Gokarn: Right, so that is one potential source of pressure on liquidity and it will essentially evoke the same response.

Moderator: Thank you. The next question is from A. Prasanna from ICICI Securities. Please go ahead.

A. Prasanna: I have two questions. Both related to inflation and how it affects your decision. First question is I think last year RBI had an inflation estimate of 7% for March of 2012 and again, in April, when you cut rates by 50 bps you had estimated 6.5% and now that you have increased to 7%. Should we understand then that this will constrain RBI from cutting rates further and this is in the context of RBI publicly saying that there is a threshold level of inflation and above which there is no trade-off between growth and inflation. So, are we to understand that as long as inflation is at 7% RBI will not react irrespective of where the growth rate goes. The second question is again related to April rate cut. At the time when you cut rates, the provisional March inflation number was 6.9% and now we know the final March number is 7.7%. So, looking back would there be any regrets from your point of view that probably you acted a bit hasty in cutting rates in April based on provisional data? Thank you.

Dr. D. Subbarao: On the first question of inflation estimate for March 2013, 7%, your question is whether we will be steadfast without cutting rates until inflation comes below that. 7% is clearly beyond our comfort zone, our comfort zone we indicated is around 5%, indeed in the medium-term we must bring it down even below 5%. The threshold level of inflation is not variable in estimating – it is a variable of course but is not directly relevant to your question about how that might determine our monetary stance. All I want to say is that we will take into account both the movements, our assessment of growth and our assessment of inflation in calibrating our monetary stance and I do not think we want to be tied down to a specific number of inflation or a specific number for growth. On the second question about whether our action in April was hasty, I believe not, it was best decision based on the situation at that time. It was necessary to frontload the rate reduction. That was based upon the expectation that some action

will follow from the government side in the event that did not happen, but I believe that to term that as hasty now with the benefit of hindsight would be inaccurate.

Moderator: Thank you. The next question is from Babita Rana from CMI. Please go ahead.

Babita Rana: This is regarding recent comfort and liquidity line. We have seen liquidity easing off late. This is particularly possible because of recent increase in deposit mobilization and no corresponding increase in credit if we see the latest data till mid-July. So, I would just like to have some light on where this source of deposits mobilization is coming from when we have a scene of credit not growing up and there seems to be no real pick up in government spending also in the recent months. Besides there is no real increase in FOREX assets of the country, so deposit source is coming from the currency, currency in circulation coming back into the system or what else it could be if you can throw some light on that it will be very good.

Dr. Subir Gokarn: Not sure we followed your question, what was the specific question?

Babita Rana: If you see year-to-date incremental credit and deposit….

Dr. Subir Gokarn: That is okay. That is the factual background you provided but from that what is the question you raise?

Babita Rana: If the credit not happening, the incremental credit is some 0.2 lakh crore that we have and incremental deposits that we have is about 1.2 lakh crore and I would like to know what is the source of this deposit coming into the system, is it some FOREX money coming into the system because the data is not showing that and has there been a sudden increase in government spending, some acceleration in government spending, some currency coming back into the system or…?

Deepak Mohanty: I can respond to that. As you would see that the deposit growth has improved slightly, because earlier we were seeing in the range of around 13, 13.5, so it has gone to 14.5. But that still remains below our projection, so deposit growth really has not caught up to that extent, at the same time the credit growth has also increased from the range of 15.5 to 16, currently, as you know, the rate is 17.4, so still there is a big gap between the deposit growth and credit growth. So to say that there is an excess deposit in the system and they are not finding where to deploy, so that would not be a correct position. Of course, not much can be attributed to fortnightly variation because they tend to be volatile because of various factors but overall deposit mobilization is less than expected and credit growth continues to see on an expected trajectory.

Moderator: Thank you. The next question is from Indranil Sen Gupta from DSP Merrill Lynch. Please go ahead.

Indranil Sen Gupta: Also, would like to say that the SLR cut was a very innovative way of handling the wedge between deposit growth and credit growth. A question essentially is that now that you have about $10 billion of forwards that will mature presumably in the next three to six months and you have around $6.5 billion of FX repayments that are going to come up for renewal in September-October. What kind of liquidity plans would you have both in terms of rupee liquidity as well as FX liquidity? Would you consider doing OMO again when these forwards hit? Is there a plan to float NRI bonds somewhere in the future to take care of these outflows?

Dr. Subir Gokarn: The immediate plans for liquidity management remain the use of instruments that we have already used whether it is OMOs or CRR, SLR, all three have now been brought into play. The time structure of forwards is quite evenly distributed, there is no bunching, so the individual impact of monthly commitments will not be terribly high, of course, we got the FCCB redemptions and so on but we have seen actually over the last few weeks the refinancing has been relatively regular I would say. No surprises there. So, we do not expect either of these to be a source of pressure on the system. If they do impact on liquidity then given the quantum of impact that they are likely to have I think the conventional instruments that we have already used will be in play. There isn't any plan specifically for long-term external sovereign debt.

Speaker: I would like to supplement what Dr. Gokarn just mentioned, the forward market intervention is basically to ensure that we do not have to sterilize that, liquidity has been tightening mode, the policy is intended that banks remain in borrowing mode, not in the other side as was the case couple of years back. So, once we intervene in the **forex** market we are neutral to whether we intervene in the spot or intervene in the forward, the forward gives the additional flexibility that we do not have to replicate sterilizing by doing the opposite transaction. It is not that Reserve Bank cannot meet their commitment. We could have intervened in the spot market as well, but they would have to do an opposite transaction to sterilize that operation.

Indranil Sen Gupta: But if the forward does not get rolled over, then you would still have to…

Dr. Subir Gokarn: That takes us back to my point which is that there is a relatively even time distribution of those commitments. So the impact of any one settlement on liquidity is not going to be very significant.

Moderator: Thank you. The next question is from Kartik Gupta from TVS Motor. Please go ahead.

Kartik Gupta: My question is, are we staring at the stagflation scenario? And if yes, what are the methods RBI is thinking of dealing with it and do you think that RBI has to change its stance from targeting inflation to targeting growth in future and where do you see government role is in this scenario?

Dr. D. Subbarao: That is a simple question but a very big question. I do not believe we are going through a stagflation. Stagflation is characterized by an extended period of low growth and high inflation. I do not believe we are in that sort of a situation. It is true that growth has moderated from 8.4% to 6.5% last year. But that has to be seen in the context of what is happening around the world. In Europe there is recession, America's growth recovery is stalling and Japan has not picked up. So in the context of what is happening or what is not happening around the world, I believe our growth rate of 6.5% is quite sizeable and I think it will be inappropriate to term this as stagflation.

Kartik Gupta: And where do you see government role in dealing with the high inflation and falling growth rates?

Dr. D. Subbarao: Government's role is to generate the supply response because at least some of our inflation is coming from supply shocks in food, so government needs to address that. Also on the fiscal deficit side the cost of the administered oil prices, the necessary fiscal correction is not taking place. So, there has to be a fiscal consolidation as well from the government side. Then there are the infrastructure bottlenecks that the government has to meet and create the necessary conducive environment for investment to take place.

Moderator: Thank you. The next question is from Manas Paul from Axis Bank Limited. Please go ahead.

Manas Paul: I have one question. The thing is that your output gap estimate that has been reduced from 8% to 7.5% and your growth estimate for FY12 has also been reduced and now your output gap given your estimate of same growth and FY13 growth would be around 1%. What is the level of output gap that is perceived to be serious? As you said in the policy, the output gap remains relatively small. So what level it is perceived to be serious in nature and no longer relatively small?

Deepak Mohanty: This has to be seen in the context that output gap along with what is happening on the inflation side, inflation gap and so in this output gap again that the global factor also plays an important role that with the global slowdown there is bound to be some bit of cyclical slowdown on our part. The other aspect again how is the supply response. There might be technically the output gap, of course, one can debate for that 1% is big or small but if the supply response even for that is not forthcoming and it is impacting on inflation. So, one really would have to take a view on balance that how this is happening.

Dr. Subir Gokarn: The issue is that you cannot look at the output gap in isolation. It also has to be seen in terms of in relation to the inflation gap. So, not only is the output gap of factoring the policy decision, also the extent to which inflation is above the comfort level to be seen. So that is the standard policy rule, depending on of course you can assign different weights to each gap but that is the broad framework.

Manas Paul: If I may be allowed to ask one related small question, RBI stance has been to see to it that the inflation expectations get controlled. Now, just wanted to know what is the RBI's perception right now from April policy to this June policy? Does RBI continue to see the same strength in demand, if it that strong as it were in April or are there any kind of low signs or softening in the demand per se?

Dr. Subir Gokarn: The fact that we have lowered our growth rate projection from 7.3 to 6.5 would suggest that we are seeing a softening in demand. But the fact that we have also raised our inflation projection from 6.5 to 7 suggests that some new inflationary pressures or some potential inflationary pressures that we saw then have now materialized. So, that has really been the balancing act even though the growth expectation has come down, at the same time, the inflation expectation or the inflation projection has gone up. So, when we put the two together the argument for status quo policy was really made.

Moderator: Thank you. The next question is from Shubhada Rao from YES Bank. Please go ahead.

Shubhada Rao: I had a one simple straight question that it is well known that inflation expectation rule high and likely inflation by March would be around 7% or perhaps even upside risks. Assuming that it does indeed play out, what level of the growth trajectory would prompt RBI to review its stance? To put it simply, if growth does for two quarters trend around 5, 5.5, even two percentage points below the new trend growth of 7.5%, would it prompt the Reserve Bank of India to move a size away from inflation and review the growth supporting argument?

Dr. D. Subbarao: We will look at both inflation and growth. Certainly, if the growth slips as rapidly as you are suggesting we would take that into account but I do not think we want to lock ourselves into specific numbers or specific corridors in which we will act. Certainly, any rapid movement on either side will be a matter of concern and we would tailor our monetary policy stance to that.

Moderator: Thank you. The next question is from Samiran Chakraborty from Standard Chartered Bank. Please go ahead.

Samiran Chakraborty: A similar question to Shubhada, but in a different way, in a statement in the policy repeating it in June and July both you were saying that in the current circumstances, lowering policy rates will only aggravate inflationary impulses without necessarily stimulating growth. I am just curious that what change in circumstances will lead you to change this assumption that interest rates will not stimulate growth but will start stimulating growth, what changing circumstances from that, and is there any empirical evidence to suggest that the situation is like this now where interest rate cut is not going to stimulate growth?

Dr. Subir Gokarn: Addressing the second part first, yes, actually, both these statements are made on the basis of some ongoing empirical analysis of the relationship between interest rates and growth and we

have cited just for historical context the experience of the high growth periods of '03 to '08 comparing the real weighted average lending rate then with now and we see that in fact they are lower now than they were then. So, if you take real interest rates as a determinant of investment, then clearly the argument that they are so high now should deter investment as opposed to having it so low then as to stimulate it does not really hold. So, that is just one dimension of the research that we are engaged in, there is a much more rigorous empirical project going on to determine this. But, out of that comes this argument that interest rates are contributing to slowdown but they cannot explain the whole of it. And when we then look at what other factors maybe contributing to it is these are the factors that are being regularly debated in the public discourse, whatever there maybe, whether it is the fiscal, whether it is global, whether it is policy uncertainty, whatever they maybe. So, when we look at the role of interest rates and stimulating growth, I think this also emerges from the experience of the high growth phase that there is a complementarity between interest rate policies or interest rate impacts and the impact of other policy action. So that complementarity is really what we are addressing. That when circumstances create something of opening, if you will, or an opportunity for investment pick up, whatever the circumstances maybe, that is the point at which interest rates start to have a significant impact on growth and that is the kind of scenario that we are visualizing.

Samiran Chakraborty: If I can just add on to this, if in a hypothetical scenario where those complementary policies are not taken and growth keeps on slipping down, will there be a role for monetary policy to stimulate growth?

Dr. Subir Gokarn: It comes back to the Governor's response to Shubhada's question which is we are watching the dynamics, the basic policy approach we follow- give some way to the inflation gap and some way to the output gap. And obviously, if growth were to fall below a certain threshold that may put enough pressure on the rule or exert enough weight on the rule to justify an interest rate action. But, the overall impact in terms of investment clearly I think it is quite obvious now that interest rates in and of themselves will not offset and not neutralize the investment dampening effects of many other things that are going on both globally and domestically.

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

Rajeev Malik: I have two questions really to better my own understanding of exactly the stance and the approach the RBI is taking. On the first one, if I understand correctly, RBI does not want to cut interest rates because inflation is a concern, but it is okay with increasing lendable funds with the banks by an SLR cut. And assuming that this is not so much about medium-term dynamics even though these banks are actually flocking to GSecs much more than they need to and loan growth is actually tracking RBI's target. Is there any inconsistency in this kind of a framework? Implicitly there is almost a suggestion that somehow lending to productive sectors of the economy at a time when inflation is a concern should not be an issue, it is almost

indicative that lending to the sectors does not add to inflationary pressures. That is the first one. Second one I will come back after this please.

Dr. D. Subbarao: I will answer this question, Rajeev, and then I will pass on to Subir and Deepak if they want to add. We want funds to go to the productive sectors to generate the supply response to spur investment which has now declined for sometime as you know. So, as we said several times we are trying to manage the difficult balance between growth and inflation. Even though as you said the credit growth is tracking our projected rate we wanted to shift the banks portfolio in favor of private investment, we hope and believe that the SLR cut that we effected yesterday will encourage that shift and ensure flow of credit, especially through the small and medium industries which have not been able to get credit from the banks. The big corporates are able to generate credit from alternate sources but the medium, small and micro industries are particularly squeezed.

Dr. Subir Gokarn: I think we also have to look at it in terms of liquidity impact which is that when we look at the normality of credit flows the liquidity backdrop is very important and we have found and that has been the basis of our definition of a comfort zone that when liquidity is particularly tight even normal flows of credit, whatever the macroeconomic circumstances maybe, tend to get disrupted. So, this SLR cut does not immediately infuse any liquidity into the system. It depends on what banks will do to leverage of it. But, given the always present risk of liquidity shortages of higher than or beyond the comfort zone that this creates a cushion that banks have to manage it and that is also in a way contributing to undisturbed and non-disruptive environment for credit flows.

Rajeev Malik: My second question goes back to in a way the very first question that was asked by Srini about OMOs and whether or not these are kind of like a backdoor monetization of the fiscal deficit. Now, while RBI's official response has always been, that the main motivation is liquidity management rather than direct targeting of government bond yields, but surely that liquidity pressure is far more pronounced because of fiscal laxity. And if RBI indirectly is only dealing with liquidity which in a way is driven by that fiscal laxity ultimately it does come back that RBI is playing a far more supportive role as far as the whole financing is concerned. Would you agree with that or not?

Dr. Subir Gokarn: No, we would not, because it comes back to the potential disruption that this liquidity situation can create for close to the private sectors to and so, yes, maybe one way of putting pressure on government with respect to managing its finances to let yields rise as high as possible with liquidity being as tight as possible, so that is one side of it, but when we look at the likely impact of the scenario on flows of credit to the private sector it can be disruptive and that has really been the whole rationale for our concept of a comfort zone. So, it maybe a price to pay that it appears that they are accommodating an untenable fiscal policy but the motivation

remains as we officially say and I think we unofficially also say that that the motivation is exclusively liquidity management.

Rajeev Malik: But RBI would not deny that there is a certain indirect perhaps or inadvertent support as far as financing of the fiscal laxity is concerned?

Deepak Mohanty: The one thing currently the way you see because it is happening within the given monetary projection because as you see the liquidity and the money supply numbers are not well beyond that. Because once the budget is given then we put out, we have to meet the government borrowing requirements so that is given because spillover and all that is a different thing. And given that we see that there is no crowding out and how much of credit should be provided to the corporate sector and the productive sectors. So, what is happening now on the liquidity side it is within the monetary projection. So there is no undue accommodation to the government sector in that.

Moderator: Thank you. The next question is from Arvind Chari from Quantum Mutual Fund. Please go ahead.

Arvind Chari: My question is on the trade-off on fiscal reforms. Given the current context if there is a fuel price hike, it seems that it will be far more inflationary in terms of headline and also in terms of the second order impact of diesel price increase and in the current monsoon scenario, higher input cost for farmers also. In that sense as policymaker is there any short-term trade-off for fiscal reform or fiscal reform always takes as that there should not be any trade-off between the short-term and long-term in terms of what the government needs to do about fiscal.

Dr. D. Subbarao: In all policymaking we have to draw the balance between the short-term and the long-term. Indeed, that is the debate that is at the heart of the debate both in Europe and the US. In our own country, of course, we believe that the fiscal burden of the subsidies is unsustainable and some of these are getting to be structural in nature. You are right that if the correction takes place in the administered prices it will be inflationary, we have factored some of that into our estimate, not the full correction, but you must also recognize that if the correction does not take place fiscal deficit will continue to be there and that will exert pressure on inflation. So, there will be inflationary pressure one way or the other. So the choice is between whether you want fiscal deficit through a correction of administered prices or through continuing high fiscal deficit. If you correct the administered prices we will also get the benefit of efficiency that comes from prices so we believe that correction is necessary especially given the fiscal pressures there are at the moment.

Arvind Chari: On the SLR cut, is it just one more commitment by the RBI to live up to that 1% NDTL? Because we are telling the banks that even if you hold lesser SLR than what you hold,

currently they are holding about 6% excess to the 23% even if they go to about 4% excess SLR the commitments that RBI in honoring the 1% NDTL is that much more stronger now.

Dr. D. Subbarao: Well, our commitment to holding within that plus/minus 1% NDTL has been for all along. You want to interpret this recent action as to making the commitment even stronger, please go ahead and do so.

Moderator: Thank you. The next question is from Kumara Raja from Barclays. Please go ahead.

Kumara Raja: I just have one question which is again related to the SLR cut. SLR cut obviously gives banks the ability to access lendable resources at an 8% cost, but the fact that banks already have an excess SLR, right now means that banks are not willing to access that facility to extend this in the form of credit. So, how do we think that this SLR cut will actually help in moving lendable resources into credit? And as a follow-up, does this also imply, the fact that banks are reluctant to use this for credit growth, means that our banks actually looking for incremental liquidity at a lower cost than the incremental liquidity coming at an 8% cost.

Dr. Subir Gokarn: I think the basis of the SLR action is really the experience we have had with banks managing liquidity when it was extremely tight. We are now in a comfortable liquidity situation so it is not an automatic pass-through from a reduced SLR to lending but we have had several months of this in the last year and a half that when liquidity is very tight many banks are reaching the limit, in fact, we had many banks drawing from the MSF also at times which was basically indicative of very high pressure. But what we heard from banks during the time was that if they were heavily dependent on the LAF, then their ability to make any kind of long-term commitment on the credit side was constrained. So essentially borrowing overnight to lend slightly longer. And that disrupted and imposed some constraints on their normal pattern of credit allocation. So, what we have done here is to create a cushion, create an excess capacity, an additional capacity for banks to be able to rely on should liquidity pressures reemerge and there is likelihood that that might happen. So, if they are comfortable with that extra cushion then it gives them back much more confidence in terms of maintaining their longer-term commitments and I think that is the stabilizing impact that an SLR action is going to have even if it does not immediately have an implication for enhance lending by banks. So the creation of cushion sort of following on from what we did with an MSF this is another step at a direction in terms of trying to create liquidity conditions that are predictable, that are something that the banking system can rely on.

Kumara Raja: You have mentioned that the impact of a bad monsoon is probably higher on inflation than on growth. But what do you think will be the impact of the bad monsoon in terms of the second round effects given that the confidence in the economy is already lower. So, in terms of consumption, do you think the bad monsoon will have a higher second round impact and therefore impacting growth much more?

Dr. Subir Gokarn: That is a complicated question. I think the key difference between earlier scenarios and I would actually go back to 2002 when the NHDP program was just getting underway, we had a very bad monsoon in 2002 if you recall, and the NHDP actually provided a kind of willy-nilly a safety net because it was creating lots of jobs in large tracks of rural economy. And now that that safety net has been institutionalized, the fact that a monsoon failure will actually create larger demand for the national rural employment guarantee scheme. At least that protects incomes and consumption to some degree, although it may mean a larger fiscal commitment. So, it is not an ambiguous impact in terms of one or the other. The safety net is important, it will help to protect consumption to some degree, it may push up costs because of wage pressures, some crops prices will go up, so farmers who are able to get a successful crop out will actually have higher income, so it is a many, many channels through which it will work.

Kumara Raja: So just add to that, because as you said the government is also constrained in terms of providing further fiscal support if the monsoon has to fail. Does that not mean that this burden actually falls a lot more on the monetary policy?

Dr. Subir Gokarn: Burden of what?

Kumara Raja: Burden of supporting growth, if growth actually is much lower because of bad monsoon.

Dr. Subir Gokarn: It goes back to what we have been talking about in terms of a policy rule which is something that gives some weight to the inflation gap and some weight to the output gap. So, obviously, slower growth will mean the output gap will be larger and it will have a larger bearing on the policy decision, but we cannot, in that scenario just abandon the inflation situation entirely.

Alpana Killawala: That would be the last question I am afraid. Governor, over to you if there is any specific remarks?

Dr. D. Subbarao: Not much by way of any substantive remarks but I want to thank all of you, all those who asked questions and all those who actually tuned in, I want to say that you people keep us on our toes and this teleconference with all of you helps us in improving our communication and dissemination. Thank you very much.

Dr. Subir Gokarn: Thank you.

Alpana Killawala: Thank you, Marina.

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