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

July 27, 2011

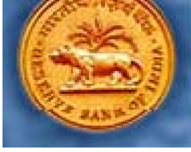
Moderator: Ladies and gentlemen good day and welcome to the Reserve Bank of India post policy conference call for researchers and analysts. As a reminder for the duration of this conference, all participant lines will be in the listen-only mode and there will be an opportunity for you to ask questions at the end of today's presentation. To ask a question, you may press * and 1 at any time during the conference call. Should you need assistance during the 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.

Alpana Killawala: Thank you Melissa and welcome to all of you on behalf of Reserve Bank of India. Dr. Subir Gokarn is chairing today's conference and I will hand it over straight to him, Dr. Gokarn.

Dr. Subir Gokarn: Thank you Alpana, thank you Melissa. Good afternoon to all of you and let me welcome you to this 7th I believe; in the sequence of post policy conference call. As I am sure all of you will agree this is very important part of our policy dissemination. We find it very useful as a way to clarify and nuance some of the things that we said in the policy and the actions that we took and we also appreciate hearing from you the kinds of issues that the statements and actions have raised in your mind. I would like to apologise on behalf of Governor Dr. Subbarao who had a meeting scheduled at short notice for which he had to travel and so he is unable to join us.

Let me begin by giving a very quick overview of what we did and why we did it and end with a reiteration of our guidance and then we can open it up for questions. As you all know by now, we raised the repo rate by 50 basis points which automatically raised the reverse repo rate by 50 basis points and the marginal standing facility rate, which is now the top end of the LAF corridor, by 50 basis points. So the repo rate stands at 8%, the reverse repo at 7 and the marginal standing facility at 9. Going by yesterday's responses, both in the markets and in the overall commentary, this move came as a surprise. Many people were expecting a hike, but the weight of expectation was on 25 basis points. So I think it bears some explanation as to why we chose to take a more aggressive stance. I think we have to go back to the May policy to place this decision in context. When we look back at the inflation trajectory over the last year and a bit going back by perhaps to the first quarter of 2010-11, there are two distinct phases and in fact this analysis has been very well documented in the macro and money developments where we looked at the changing drivers of inflation; in fact they have three phases there, but I will describe in terms of two.

Up to the end of 2010, the headline rate was certainly a problem. It was around 7-7.5 and what we measure as core, which is the non-food manufacturing component, had started to stabilise in the second half at around 5, came down little bit below that in a month, but otherwise around 5.1-5.2. This went on to about November or December and in that context, our approach was being validated - calibration as an approach - to dealing with what were clearly visible inflationary pressures, but at that point not very strong ones, and we had over



the period starting March 2010 done roughly 50 basis points and this was reinforced by the shift in the call rate from the bottom of the corridor to the top. That was around 150 basis points.

Now at the end of October, early November and from there, a new factor entered into the equation. We saw a very-very sharp increase in commodity prices. And this then translated into a very different and significantly higher trajectory for inflation starting early 2011. Now we took stock of this; a number of other factors that had to be taken into consideration - whether this was going to be persistent or not, what the budget position would be, what the fiscal position would be post budget and so on. And after having taken all of this into account, as we looked at the inflation trajectory, both in the early part of 2011 and going ahead, we felt that it was a new situation. The combination of commodity prices and persistently buoyant domestic demand was resulting in a much higher rate of inflation than had been the case in the previous year and that was really the motivation for our May action where we moved to 50 basis points hike from the previous cycle of 25. Now in our May statement, we indicated a trajectory of inflation which basically said that it would remain close to current level, which is around 9%, for some period of time and start to moderate towards the second half of the year as a result of, among other things, the cumulative actions of monetary policy. Commodity prices were seen as a risk then, not just in terms of where they were, but also the prospect of them rising further. So this was clearly an inflation risk that we had factored into our calculations in the May policy statement. Three months later, we have a somewhat different situation on commodity prices. There is of course a whole series of global developments, but I will not get into those for lack of time; but on commodity prices specifically, the pattern has changed somewhat. They are still high, but there is not that much expectation that they will continue to harden further and that in the sense gives us some relief looking ahead that the pressure that they will exert on domestic inflation will remain, but it is not likely to become worse.

The second factor that we have taken into consideration is the state of domestic demands. Now clearly interest rate hikes of over 400 basis points must start cutting into demand and we are certainly seeing signs of that in all of our discussions prior to the policy. The point that was repeatedly made, was that banks are having difficulty in passing on more credit particularly for new capital investment, consumer durables and real estate pointed to some difficulty. All of these interest rate-sensitive sectors suggested that rates had reached a point which was beginning to impact on demand. Now whether this in itself was enough for transition to quickly bring inflation rates down from the demand side was a judgment that we had to make. We did look very carefully at corporate numbers both the full set of results for Q4 and whatever early results we could get in time for the policy from Q1; and yes, there were clear signs of moderation on margins, with projects where pricing power was coming down. But it was not a very dramatic shift. So keeping the current rate of inflation in mind, keeping the fact that the trajectory was likely to remain at this level, 9 plus, for some period

of time, we felt that the best course of action of course was to continue with the May stance, which was to continue with the 50 basis point hike.

Now as we look ahead, how do we see this playing out? Clearly we expect growth to slow down somewhat as demand compresses. Last year's growth, as estimated today, was 8.5%. But there are some indications that this might be revised upwards. We have already started to see some discussion of this in the public discourse partly because the new industrial production series suggest that industrial growth was somewhat higher over the course of the year than previously thought. So actually moving from 8.5 plus to around 8 to us reflects a fairly significant deceleration or moderation in growth. That is the factor that will start to have an impact on inflation. The inflation number itself, as we said, will start to come down in around November-December. The cumulative impact of rate actions on demand will help to do this and commodity prices may further reinforce this if they start to soften in that period. But as I have said, we really do not have any control and at this point, it would be prudent to assume that they will remain in a somewhat hostile range going forward, but not perhaps getting any worse.

As a result of this, we see inflation starting to, as it starts trend down, to move to 7% by March end. Some people have indicated that it might be somewhat higher. I think what is important is not so much the number at March end which is for us, a projection, but rather that it is the beginning or it is a part of downward trajectory in inflation which of course if we extended into the following year will continue to take the number down and that is the broad scenario with which we are entering this. When do we decide when the time is right to review the stance and to change the stance? Essentially it is being driven as it said in the guidance by these two factors; what is happening to the commodity prices, what is happening to domestic demand. As both of these show signs of allowing inflation to start to trend down, clearly that would be the right time to review the stance. We think that this process, this high inflation trajectory will continue for the next few months and so as we watch it, clearly our stance remains at this point anti-inflationary, but we believe also that we have a clear set of indicators to look at as we review it.

So let me stop with these brief opening remarks, and we can open it up for Q&A now. I am joined of course by all the deputy governors: Dr. Chakrabarty, Mr. Sinha, and Mr. Khan, by Executive Directors – Deepak Mohanty, Mr. Gandhi and Mr. Mahapatra and the Head of the Monetary Policy Division, Dr. Janakraj.

Alpana Killawala: Yes, Melissa. We will go with the questions.

Moderator: Thank you. Ladies and gentlemen we will now begin with the question and answer session. Anyone who wishes to ask a question may press * and 1 on their touchtone telephone. If you wish to remove yourself from the question queue, you may press * and 2. Participants are

requested to use handsets while asking a question. The first question is from the line of Mahrukh Adajania from Standard Chartered. Please go ahead.

Mahrukh Adajania: Good afternoon. My question was on the priority sector guidelines for banks. The May credit policy did mention about revamp of these existing guidelines. So when can we expect clarification on those?

Dr. KC Chakrabarty: Now you see; we have said that a committee will be constituted, but pending that the existing guidelines continue, the committee is being appointed. It may be appointed in a week's time and the report is expected in four months' time.

Mahrukh Adajania: Okay, but there won't be any change till the committee is appointed?

Dr. K C Chakrabarty: Absolutely

Dr. Subir Gokarn: It is not going to end with the committee's appointment; it is going to end with its recommendations being accepted.

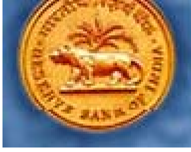
Mahrukh Adajania: Okay, thank you.

Moderator: Thank you. The next question is from the line of Kaushik Das from Deutsche Bank, Mumbai. Please go ahead.

Kaushik Das: Dr. Gokarn, you mentioned that the end March inflation projection that you gave, is more of a guidance rather than an end target and what is more important is the trajectory of inflation and when it will come down and that will probably decide, let you decide, the change in monetary policy stance. Regarding that, I was wondering, is it possible for RBI to give the average WPI inflation for a financial year rather than just giving an end March target? And also, given the fact that you look at non-food manufactured goods inflation so closely and that is the only proxy for core inflation. Is it at least possible to give an end March target for core inflation as well?

Dr. Subir Gokarn: Actually on the first question, you actually have it in the policy statement. We have not given explicitly, but we have given a monthly number on the fan chart. So you can actually compute it. That should not stop us from giving it and we will consider that. On the second, yes, I think that is work in progress. We do obviously forecast it internally, but we have to be careful that we are not subject to significant errors in which case the guidance itself becomes a little misleading, but implicit in our headline number which we have been traditionally giving projections on, is also a core that is consistent with the trajectory. We do not publish it, but it is clearly part of our internal analysis.

Kaushik Das: One more question which I had on the industrial production index and you have talked about it earlier and the Governor has also talked about it that it is kind of gives faulty indications at



times. So how important is the industrial production growth number as far as your policy decision is concerned as of today?

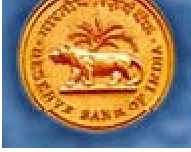
Dr. Subir Gokarn: It is one input out of several as I have said on other occasions, but perhaps not to this audience; that we have 3 sets of inputs into our decision. We have the data and the models and the forecasts that come from it. We have a series of surveys including surveys of companies. So this is an industrial outlook survey which we referred to in our MMD (Macro and Monetary Developments document) as well as the capacity utilisation survey, order book inventory in capacity utilisation and now a credit conditions survey which is a survey of bank officials and we have consultations with the whole range of stakeholders. So we try and triangulate these inputs and try and arrive at a picture which is consistent or an inference which is consistent with the largest number of indicators that we get information on. The IIP is an important one. We recognise that there are some limitations to it, but we do not reject it entirely, but we see it in the context of what we are hearing and what we are seeing from other indicators as well.

Kaushik Das: Thank you.

Moderator: Thank you. The next question is from the line of Shubhada Rao from YES Bank, Mumbai. Please go ahead.

Shubhada Rao: Thank you. Good afternoon everyone. I had actually two questions. The first question was regarding the core inflation trend of recent months. I think at these volatile times, the incremental data assumed larger significance and what we have seen is a clear trend from Q4 of FY11 to Q1 - either month on month de-seasonalised or adjusted. We have seen a sharp drop from one point for average in Q4 of FY11 to 0.4, month-over-month trend in core index and even if you look at it seasonally adjusted, from 1.2, it has come sharply lower at 0.1. So are we reading too much into this trend? And we did not see any comment on these latest core inflation month-over-month sequential patterns from Reserve Bank of India in the statement. So I would like to hear your thoughts on that one. The second was more an academic question perhaps that when we are looking at incipient signs of moderation, the quantum of hikes seen in last 3 months of 125 bps, does it then carry a potential risk of seeing growth going well below comfort levels? So it is essentially on the quantum, while rate hike was in store, but the large dose of hike and amidst the moderating cycle, does one see some risks in growth spiralling lower, faster than anticipated? So these are the two questions to the panel. Thank you.

Deepak Mohanty: Shubhada, I think it is very difficult really to derive substantive conclusion just looking at what happened in Q1 of 2011-12. As you know that one month of final data and two months of provisional data and in the past that we have seen substantial revision in the provisional data. So what is happening there that you can see in April, the non-food manufacturing the final data was 7 and the provisional itself has gone up to 7.2-7.3 and if really one compares



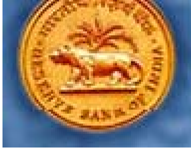
that with Q4 of 2010-11 where it gives an impression that the non-food manufacturing really picked at 8.5% at end March. So if you add them together an extent, obviously it will show you a pattern that is clear deceleration, but one is not too sure because it has to be taken with some caution. If you are doing any kind of time series exercise, the end point data also creates a problem. So it will give a kind of a false number there as you can see that momentum has come down. But if you see the provisional itself over the final this year in April, it is on the uptrend and let us hope that it moderates because our assumption is some moderation will take place, but what is the extent of moderation that we need to ascertain.

Dr. Subir Gokarn: The second question is important and as I have indicated in my opening remarks is that the fact that there were some signs of moderation very much in evidence in our discussions with stakeholders. So that did lead to the dilemma of whether we should go for a stronger hike versus the lower one. I think what really worked in favour of a stronger hike was essentially the robustness of several components of demand. Some of which have to do with the fact that there is low interest-sensitivity there. For example, the consumption is from all indications, quite buoyant. Of course there are components of it which are interest-sensitive and those seem to be showing some signs of moderation, but otherwise there are no great signs. Secondly there is, even with the ongoing fiscal consolidation process, still a very significant contribution to demand coming from public expenditure which, as we know is the result of the crisis response, is substantially higher today than it was before the crisis which had seen a steady improvement in the fiscal situation. So those two components are essentially quite robust. The fiscal situation may be adjusting, but it is still quite strong and given that we felt that the downside risk to growth from interest rate hikes would be fairly bounded whereas the upside risks to inflation, particularly a perception, that with a 9-9.5 number, the action was not being seen as adequate. Of course, people l expected 25, but that does not mean everybody thought that it was the right thing to do. They were predicting an action, not making a judgment on what was optimal. We thought that the stronger action was essentially consistent with the new stance that we had signalled in May. So there is of course a downside risk to growth. We have pointed out some of them in the document. We have indicated the range where we think that growth may go down to, but at the end of the day there is also, we think a very strong lower bound on that risk whereas the inflation risk does not unfortunately have an upward bound. It is unbounded in many ways and so we may have to play the balance of risks in favour of going little more aggressively against inflation.

Shubhada Rao: Thank you.

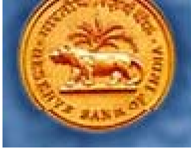
Moderator: Thank you. The next question is from the line of Srinivas Varadarajan from Credit Suisse, Singapore. Please go ahead.

Srinivas Varadarajan: I would like to thank the panel for taking my questions. I have two questions. The first one goes as follows. If one looks at the inflation expectations survey that you publish every quarter, I have some numbers on this the average one-year forward inflation over



expectations since September of 06 has been close to around 9% and since October of 09 will be actually shifted policy. And this shifted policy emphasises in this cycle, the average one-year forward expectation is being close to about 11.5% and the last published number for the period Jan to March one-year forward expectation is being 13%. The point that I try to make is that there seems to be, you alluded to this, that there are fiscal offsets to monetary policy action. The fiscal impulse of the large advance tax refunds, the NREGA indexation or the MSP and one is not of course taking into account an anticipated Food Security Act. The point is that all these policies are welcome from a welfare perspective. They have a side effect in terms of keeping structural inflation and inflation expectations high. Was this one of the reasons for you to actually keep your growth forecast at 8% and upping your year-end inflation forecast to 7% despite monetary policy action of 475 basis points in this cycle and also seems to be that expectations are not really sensitive to policy actions that have been taken so far and that is this kind of point towards basically a wage price spiral, a significant risk of that? That is the first question and the second question is, what is the real rate in India? If one takes, the SBI base rate of 9 quarter and one-year forward inflation expectations of 13%; then the real rate is still is about negative 375 basis points. How would you respond to this?

Dr. Subir Gokarn: I think on the first question, we have to put a lot of weight on the fact that this survey where the 4000 odd respondents to the inflation expectations surveyed cut across a range of socio-economic categories and there is a relatively high weight or high proportion of people for whom food is the largest single item of household expenditure by far. This is true of, daily-waged labourers, self-employed people in formal sector, kind of, and there is a relatively small proportion of people who are white-collar professionals we could say. So the recent experience with food does have an impact on inflation expectations. I think that is playing a significant role in how these expectations are moving. So we certainly pay a lot of attention to them in terms of directionality and which is why the point I mentioned about the movement from 11 something to 13 is important that it suggests that people are starting to see inflation rising, but not very much in terms of the actual number because that is really the weighted outcome of the sample composition and so I think we have to put some caveats on that. But the broader point about expectations and the possibility of this translating to wage demand, I think that is very relevant. If you have read the MMD, towards the end of the document, we have now introduced a discussion on wage dynamics and it is very significant because we obviously have very significant bargaining power in many labour market segments which is translating into, you heard this anecdotally, but it is now showing up in aggregate data as well, into very large wage increases. So the ability to index even in implicit contracts, so informal market transactions is quite high and so high expectations does or rising expectations do certainly enhance the risk of a spiral emerging. So if you recall one of the statements made on the macro money developments document is that we need to focus on dealing with this wage price dynamics. So it is an important issue and dealing with expectations even if they do not translate directly into household, let us keep in mind that wage is a two-sided contract whether the worker asking for a wage and there is an employer



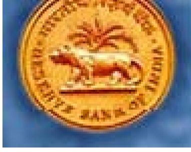
willing to give him one, both have to have similar expectations in terms of inflation for them to be able to agree on mutually acceptable inflation premium. So if the employers feeling the pinch as they have been talking about the possibility of moderation and so on, that premium may not be forthcoming. So there is a countervailing force on the other side of this. So even if monetary policy is not showing up in individual household expectations, it clearly has an impact on what a potential employer is willing to pay given his assessment of business prospects. So there is a transmission there.

In terms of the second question, I think I will refer back to the issue that or the response to the previous question which was that we do see not so much directly or explicitly what you said, but clearly that there is still a significant role that fiscal or public spending is playing on demand and that it is not terribly interest-sensitive. So as long as that continues, the adjustment is ongoing, the Ministry of Finance clearly has laid out a 3-year timeframe for fiscal consolidation, but even as this is ongoing, it is still playing a large role in demand and that keeps pressure on demand up regardless of what monetary policy actions are taken. So that, along with the few other such considerations where we feel the demand is quite robust for good reasons, for example, private consumption spending, that is also part of the reason why we decided to stay with the 8% and not take it down. These factors have also been taken into consideration in the May policy so we did not feel that there was adequate ground to sharply bring that growth forecast down. But again I emphasise that we've given a range, 8% is the mid point of that range. Deepak would like to add to this?

Deepak Mohanty: Just to supplement in terms of the inflation expectations survey, DG has clarified this again. This is the household survey. Too much cannot be read into as the time horizon increases to one year down the line. Mostly what happens is that these are more adaptive expectations and expectations formed by learning and unless people see that the ground level prices coming down, they do not change their expectation so much. And so going by that, I think a useful thing to see is the current inflation and three months down the line, so they are more accurate in terms of validation, and in the subsequent kind of data we see that once inflation comes down, the one-year inflation expectation also coming down. I think the best way to read this is that inflation expectations remain anchored, but they are quite relevant.

Srinivas Varadarajan: And what about the question on the real rate? If I take the SBI base rate of 9 quarter and again one-year forward inflation expectation of 13%, may be the 3-month forward is closer to about...

Dr. Subir Gokarn: Again, I think we have to make a distinction between the effective rate of inflation for a person who is borrowing at the base rate. What is relevant rate of inflation for a business person? Is it WPI as a whole, is that the core component of WPI, CPI… I think those are the defining…real in… by taking two numbers that do not necessarily link up, I think it is not appropriate. So if you take the WPI, then lending rates and deposit rates also are positive real at this point. Policy rate clearly is not, but the lending and deposit rates are broadly there.



Srinivas Varadarajan: Thank you.

Moderator: Thank you. The next question is from the line of Manvinder Singh from International Institution of Studies. Please go ahead.

Manvinder Singh: My question to the panel is that the rise in the policy rates had created an arbitrage opportunity through interest rate differential. So that will bring in the foreign inflow into the country. Now what I wanted to know one thing is that the rise in the inflows will on one hand lead to appreciation in exchange rate. First question is will RBI allow appreciation in exchange rate or secondly will they allow increase in foreign exchange reserves to move up. If RBI allows increased appreciation in exchange rate, so does RBI think that this will lead to lowering down of imported inflation?

Dr. Sabir Gokarn: On the first question, our policy position is that we do not intervene in the forex market with the objective of determining or setting the exchange rate. To the extent that we do intervene which we have not done a lot of for some time, it is essentially to react to very sharp volatility and not with a rate determination in mind. So the exchange rate is essentially market determined within the broad contours of some capital controls which are on debt flows. So if there is an inflow as a result of an interest rate arbitrage, but we are not seeing at this point a very large inflow, but if there is, then the default response would be to let the currency appreciate; let the market determine what the exchange rate would be. So in that case, there is no significant accumulation of reserves. If the rupee does appreciate, yes, obviously, everything else remaining the same, there is a positive impact on inflation to the extent that imports become cheaper and this is also contractionary, in the sense that because exports become less competitive, the aggregate demand goes down, so it helps to contain demand and therefore bring inflation down. But, it is really a matter of magnitude and what has happened over the last several months is that the rate has been fairly variable, because we have had capital inflows, but they have not been very much larger than the current account deficit. So there has not been very much change in the exchange rate overall. So as a hypothetical situation, yes, it would help to deal with appreciation, but reality is that even with a relatively open capital account at this point the rupee moves in two directions, it is not moving distinctly in one direction.

Manvinder Singh: Sir, my second question is that if RBI says that there is huge demand, aggregate demand is more than aggregate supply because of huge liquidity present in the economy do you not think instead of moving with 50 basis points rise in repo and reverse repo rate, would it not be good if something would have done on CRR front and repo and reverse repo would have been raised by 25 basis points only?

Dr. Subir Gokarn: Yeah, a very interesting point. I think we have to distinguish between the notion of liquidity that you are referring to and the broader sense that there is a sort of a large or buoyant demand in the economy. When we talk about liquidity, we are talking about the

resources available to the financial system on the basis of which they can expand credit. So typically, banks would need liquidity to support its CRR, Cash Reserve Ratio. Now, in that context, liquidity actually is in deficit and has been so consistently since the end of May 2010. Given that we do not see any significant benefit in using the CRR. Because what it will do, it will certainly tighten situation, but it could also disrupt the normal business activity of banks because availability and cost of liquidity become unpredictable. So, since we are in deficit already, the transmission from policy rates to actual lending rates is quite strong. If you saw yesterday soon after policy many banks announced at least I thought two or three banks have announced that their base rate will be hiked also by roughly the same 50 basis points. So transmission is quite strong and that is the impact that we seek to achieve.

Manvinder Singh: Thank you.

Moderator: Thank you. The next question is from the line of Devika Mendiratta from Credit Suisse, Singapore. Please go ahead.

Devika Mendiratta: Hi, good afternoon. Thank you so much for taking the question. My question relates to do with the charts that you had on real interest rates in the quarterly macro publication released the day before. I totally take your point that let us not look at a particular value of real interest rates right now, because which inflation rates should we use right now; but if we like you got a chart there which is showing banks lending rates in real terms and you have stated that using the WPI and what I found interesting was that starting 2000, the trend for that, is clearly been downwards. So real rates have actually fallen starting 2000 pretty much consecutively. So if someone would look at that, some might say that real rates seem to be low on a trend basis compared to historical trend, and hence stimulative. I was wondering what your thoughts were on this please? Thank you.

Deepak Mohanty Yeah, the various calculations that we have given there but you are absolutely right in terms of trend that one looks at that there has been a secular decline in the real interest rate. And if one really looks at suppose, we take the high growth phase of 2003-2008 by all calculations the real interest rate there could be in the range of around 5%, and obviously we are quite lower than that at this stage. Of course, one factor that one would have to take that more than a decade now the inflation rate also has remained very high for a couple of years now.

Dr. Subir Gokarn: I think it is important, Devika, to look at the structural changes and the financial changes that have taken place over this period of time. So I am not sure that the trend has an indication of whether the policy is stimulatory or contractionary is that revealing. I think it has to be seen over the course of the cycle. But over this period of time keep in mind that from 2000 onwards there have been very significant changes in the financial sector including I think the SLR being brought down - I don't remember when, but it moved from

38 to 35 - some of that change was… then the small savings rate was brought down from 12 to 8, that is a very substantial change. So we have had a series of deregulations in the market, which have also clearly impacted on that trend. So I think looking at the long-term does not necessarily give you an indication of the state of our policy. It has to be I think more appropriately seen over the cycle.

Devika Mendiratta: Right. Thanks.

Moderator: Thank you. The next question is from the line of Peckwee Yeo from RBS Singapore. Please go ahead.

Peckwee Yeo: Hi, good afternoon. Just a one quick question on where does RBI actually see estimate of trend growth or potential growth of the economy?

Dr. Subir Gokarn: We now use the word 'trend' and not 'potential' because there is a bit of semantic confusion in the public debate here. 'Potential' is seen as an aspirational number, so we prefer to use the word 'trend.' So our assessment which has been communicated in the MMD (Macro and Monetary Development document) which you may have had a chance to look at is around 8%.

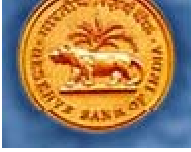
Peckwee Yeo: Right. This trend growth would be just for the fiscal year ending 2012, going beyond that, is there a particular trend growth that RBI is looking at where you see as somewhat non-inflationary?

Dr. Subir Gokarn: No, we are saying that business as usual, this is a trend which is essentially non-inflationary, that is , if we can sustain this for some period of time, not just for this year, but for some period of time without inflationary pressures becoming too acute. But, of course, to raise it requires a bunch of other investments and we have repeatedly referred to supply response concerns on food, on infrastructure. Now we are seeing pressure on wages. So there is a human capital and skill issue, number of constraints that need to be addressed to take the trend rate of growth higher, but in a business as usual scenario, clearly, just recent experience would suggest that if the growth rate is significantly higher than 8 for some period of time we start to see inflationary pressures becoming quite significant. So that is the sort of broad perhaps a reasonable benchmark to work with.

Peckwee Yeo: Thank you.

Moderator: Thank you. The next question is from the line of Shishir Shindekar from BYK College of Commerce, Nasik. Please go ahead.

Shishir Shindekar: Thank you. Good afternoon, sir. Thanks for organising this event regularly. I am Shishir Shindekar from Nasik.



Dr. Subir Gokarn: Hi, Shishir.

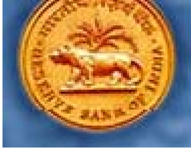
Shishir Shindekar: My question is what kind of correlation is observed between the repo rate and rate of inflation in WPI as well as M3 and real GDP during the last three years, specifically from 2009 and how much time is normally required for the transmission mechanism from change in monetary variables such as repo rate to the change in real economy? Thank you, sir.

Deepak Mohanty: You would see that transmission were quite strong in the money market because as soon as the rates change, you see the money market rates adjusting that pretty quickly. It is a little slower into the debt market and then it goes into credit market. And of late, we have seen that transmission to the credit market is also quite good with the base rate system coming in place, more or less corresponding increase es taking place in the lending rate. And research would suggest that these are all policy instrument and they impact the ultimate variables, growth and inflation, with a lag. So our assessment would suggest that something between a year to 18 months. So that is the kind of lags are there in terms of policy instruments. But as you know, this lags are variable and depends on the structure of the economy, how it moves.

Moderator: Thank you. The next question is from the line of Varda Pande from Birla Mutual Fund, Mumbai. Please go ahead.

Varda Pande: Hi, good afternoon. My question actually is to do with the timing of aggression to clamp down on inflation. The three triggers that were actually pointed out in the May 3 policy were the fuel price hike expected, MSP hike expected and persistence of non-food manufacturing inflation. Now, in terms of expectations, all these three counts scored very, very high even during May, by the 10th of June may be we were through with two of them. If we were to look at the non-food manufacturing inflation trajectory between February to May it was well over 7%. That one concern played out. Fuel price hike was expected by mid-June, it was done a little later, 24th, but the point being that all three triggers actually came through before the June 16 mid-quarter. So if really this kind of an aggression now which was shown yesterday could have been shown in the June policy, may be expectations could have come off. So, why was the guidance for March '12 number on inflation not opt in the June policy?

Dr. Subir Gokarn: Keep in mind that the six weekly cyclical is a much less intense process. That when we do the mid-quarter which we now have been doing for I think five quarters we started in the mid-quarter. We do not have the intensity of process that we do for quarterly and I describe this in previous response where we draw on both data, model, forecast, company numbers, company results, conversations, and surveys that does not come to us at a six-weekly frequency. So when we do a six-weekly review it is essentially based on data releases. The two data release that come after the quarterly policy, that is IIP numbers and



WPI numbers. But also we have the usual financial data, credit, deposits and so on. So, it is a little difficult, and this is of course a new process, is now getting entrenched to take what might have been a sort of risky action on the basis of relatively limited inputs. So although this does result in some difficulty, some challenges of communication, I think the choice in June was to say, look may be we think the momentum is still there and our stance continues, but let us not move as aggressively as we might on the basis of more comprehensive set of inputs which we got in the usual quarterly process. So it is really a question of how much new information, how much analysis we can do on that information and therefore the ability to be a little more confident in the appropriateness of our decision.

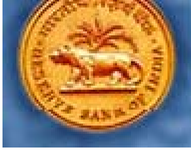
Varda Pande: And so, if I understand it is more a reaction to, let us say procedural quarterly data inflow instead of incrementally what we see on a daily basis?

Dr. Subir Gokarn: I am not sure I follow. What you are saying but that is what sounds right that is it is based on these two new sets, we have two months of data coming in by the mid-quarter and we are trying to see whether this reinforces our quarterly assessment or does it challenge us somewhat.

Varda Pande: Right, all right thank you very much.

Moderator: Thank you the next question is from the line of Parul Saini from RBS Securities, Singapore. Please go ahead.

Parul Saini: Good afternoon, thanks for taking my question. I have two questions actually. One is regarding some core manufacturing inflation and I do realise you mentioned earlier that the numbers for May and June were provisional, so we should not put much faith in the seasonally adjusted trend. It does show a significant deceleration versus a trend earlier in the calendar year. If you look going forward even if the seasonally adjusted trend was within the RBI's comfort zone of 4% to 5%, the year-over-year core manufacturing inflation number would stay pretty high even through December around 7%. And given that you have said that the tightening stance only comes off if core manufacturing inflation goes down significantly, it might be helpful for us to know, as to what matrix you would be looking at closely, would be at the year-over-year number because that will be impacted by base affect and could stay high even if the seasonally adjusted number is coming off. And you also talked about corporate pricing power regarding core manufacturing inflation, expectations and earlier results do suggest that there are a lot of margin compression coming in, so some thought as to what do you think is appropriate margin compression because some industrial companies have seen significant margin compression. So those two questions on the core manufacturing inflation; and the second question is your financial stability review points out that higher interest rates are the more significant risk to asset quality, at that even higher than the GDP slowdown. Given these rate hikes that have

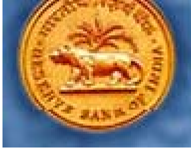


come through the system, do you think that you are significantly threatening asset quality and it will be good to get your views on that. Thanks.

Dr. Subir Gokarn: Well, on the first question, although we typically frame our policy statements on year-on-year number, in our process we certainly review the month-on-month and now quarter-on-quarter, the adjusted numbers as well to get a sense of momentum. As you would have discovered, if you would go back a few months, the significant upward revision in the final numbers from the provisional have actually resulted in a very significant change in the picture that one gets from this analysis. So one has to view that with some degree and if not that it is to be rejected, but it is something that we have to place in the overall dash board as one more input. But clearly if there is evidence of momentum dramatically changing, you as well as the previous questioner have raised issues about momentum and something we are keeping track of, but, to put it down to a number I think would be difficult and perhaps not even very appropriate, I think it is really a question of whether the pattern is consistent with what we are looking for. Now how is this number going to go down? I mean it is going to go down because pricing power has gone down? It is going to go down because overall demand has gone down? So do we see consistency between the corporate numbers, between the production numbers, and the price numbers? If we see a sort of everything or most things pointing roughly in the same direction, I think that gives us confidence that a trend is underway and we can base a decision on that. Again on margin compression I would say the same thing. Now we have made a statement in the policy that we do not see very significant, there we will certainly see compression, but it is not very significant, that suggest that this was early results, we had about 120-odd companies on the Friday before the policy so, we analysed those. We will, by perhaps the middle of August, have the full set and the analysis done, to review what the margin dynamics are, what the earnings dynamics are and that will be an input into both our mid-quarter and going forward we will get the early results of Q2 in our October statement. So it is an ongoing process and it is really the change, the break in the pattern that we (are) most keen to see - not really necessarily a numerical benchmark. Keep in mind this is not an established history here, these are all relatively new recent inputs coming into our policy making process.

Parul Saini: Second question on interest rate?

Dr. K C Chakrabarty: Yeah, you see asset quality definitely deteriorates with the rise in interest rates, but in the financial stability report, what we are indicating is (that it is) not that interest rate (are) to be brought down because the asset quality will otherwise deteriorate, we are only cautioning the banks that their risk management, their monitoring system of the credit quality has to be more vigorous so that because of increase in the interest rate, if there is a deterioration in asset quality, at least partly this risk can be mitigated. We are quite sure that there is enough gap in the risk management practices, in the monitoring of the credit quality, follow-up, recovery, So these efforts need to be accelerated. We cannot say that



because of the increase in the interest rate asset quality deteriorates and if the economy requires to control the inflation, you want to increase the interest rate, this should not be done. The purpose is different. Regarding financial stability this is more to warn the system that what are the risk and what the action should be taken.

Parul Saini: Sure, just to clarify, given that you have expressedly said that you will wait for core manufacturing inflation to come down sustainably, you would have a numeric number in mind. So looking for September and October, let us say the month-on-month manufacturing inflation does come down, the year-over-year numbers does stay high. But we do see a demand slowdown and also margin being compressed further. Should we take that as reasons enough that monetary policy stance will change?

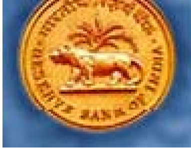
Dr. Subir Gokarn: Well, between now and then we have the September mid-quarter and we have an October quarterly, so clearly we are indicating that we will give you appropriate guidance in those statements.

Parul Saini: Thank you.

Moderator: Thank you. The next question is from the line of Pradeep Mamak from Citibank, Mumbai. Please go ahead.

Badri: Yeah. My name is Badri from Citibank. A couple of specific questions and specifically for the coming quarter policy. The first question is on growth guidance. I am not sure of what is the percentage of interest sensitive sectors to overall GDP but if services and exports continue to remain buoyant and your headline GDP is within your trend, then are you saying that you will be ignoring what's happening to interest sensitive sectors and continue with your anti-inflationary stance? Second question is on inflation, you talked about possible spike in food and fuel inflation in the coming months. Will your next policy stance precisely be guided by non-food manufacturing inflation only? And my third question is on fiscal. You talked quite a bit about fiscal issues. Have you considered specific impact of your monetary actions and sacrificing growth in the near-term on the immediate fiscal situation from the revenue side?

Dr. Subir Gokarn: Well, on the first question in relation to the composition of output. No, I think if whatever scenario you visualise for how that growth emerges, whatever composition of sectoral activity drives it, if there is a significant decline in broad category of sectors, one should somewhere fairly quickly see profits earnings coming down in that sector, of margins being compressed and also as a result of lower pricing power pricing coming down. So as we are tracking the components or the contributors to inflation we should pick this up in terms of the link between real activity and how it is translating to both corporate numbers and actual inflation numbers. So I do not think we are looking at these numbers in isolation. We are looking at them in terms of how they eventually reflect in terms of what



we are trying to do, which is to bring inflation down and what are going to be the drivers of that process. The second question was with respect to a spike in, I did not quite get the second question?

Badri: Yeah, I was talking about the food and fuel price inflation could possibly go up due to MSP and other reasons there, is the next policy guidance action going to be precisely based on NFM and not food and, fuel, etc.?

Dr. Subir Gokarn: Clearly, the linkage between these first round shocks and the transmission into the larger inflation process is going to drive our thinking. And sorry, the third one was –

Badri: On fiscal?

Dr. Subir Gokarn: Oh, yeah, very important. At this point if you look at the tax buoyancy issue clearly the base for indirect taxes is nominal GDP. So the actual mix of growth and inflation is not that important if you are getting to the overall budget estimate of 14%, then I don't think there would be much shortfall on the indirect taxes. On direct taxes we may see some compression because earnings are going down and that may have an impact, but there is also an ongoing process of tax administrative improvements, better monitoring, better collections and that may actually offset. So I do not think the growth in inflation numbers we have on the table although they are currently slightly different from the Finance Ministry, should have a direct bearing on this aspect. There may be other reasons for fiscal slippage some of which we highlighted in the statements, but on a revenue accrual basis, I do not think there is too much worry.

Badri: Thanks.

Moderator: Thank you. The next question is from the line of Soumyajit Niyogi from SBI. Please go ahead.

Soumyajit Niyogi: Yeah, good afternoon. This is Soumyajit Niyogi from SBI DFHI. Dr. Gokarn, I would like to ask you that in the last policy we have seen that the M3 growth has been reduced to 15.5% from 16%. Is it because of that in spite of having low money supply we have achieved deposit growth of 17.5%? So there is no more liquidity required. Or is it your anti-inflationary stance that you would like to continue with low money supply?

Deepak Mohanty: No, it is essentially because of the anti-inflationary stance because then you would have to have control over the liquidity and alongside that you would have seen also the credit projection also we have…

Soumyajit Niyogi: And second thing is that since yield curve has flattened significantly but that there is no sign of long-end curve has hardened significantly. So can we say that the borrowing would be mostly in the long end curve compared to short end? Because we have already

government announced that they will continue with cash management bills and obviously T-Bills will continue.

Dr. Subir Gokarn: Mr. Khan will address this question.

Mr. Khan: Cash management bills and short-term treasury bills are basically meant for short-term capital mismatches. So they are not meant for long-term requirements of the government. So far the long-term requirement is concerned we have a fairly well-distributed allocation of securities with short-term, medium-term and long-term. Taking advantage of flattening of the curve, our strategy has been to comparatively increase the size in the long-term. So that strategy continues.

Soumyajit Niyogi: Okay, thank you.

Alpana Killawala: Can we take last two questions, Mellissa?

Moderator: Sure. The next question is from the line of Manish Wadhawan from HSBC Mumbai. Please go ahead.

Manish Wadhawan: Good afternoon. I would like to seek your views on the trajectory of the monetary policy tightening. Basically, the whole idea here is, since 2009 when the monetary policy tightening happened, we started with a non-direct approach which was the SLR hike only and then we have seen 25 basis points hike over 2010 and at this point of time in 2011 when there was concern regarding some kind of a slowdown or there were talks of moderation of growth, we have gone ahead with the 50 basis points in June and again 50 basis points yesterday in the policy.

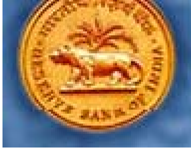
Dr. Subir Gokarn: The 50 basis points was in May.

Manish Wadhawan: In May. Yeah. And in between there was a 25 basis points.If you could throw some light, the same factors existed in 2010 when we talk of wage pressures or core inflation or commodities firming up. What could you suggest? What has gone through?

Dr. Subir Gokarn: I think you have to look at in three phases, right. Did you listen to my introductory remark?

Manish Wadhwa: Yeah, sure.

Dr. Subir Gokarn: I was talking about the different trajectory that inflation between 2010 and 2011. So that is an important part of this explanation. But we have to go back one step to look at the exit from the prices also. If you are looking at where we started this particular cycle of tightening from, remember, that we did not start from a normal situation, we started from a very, very sort of desperate situation driven by the crisis. The effective call rate was 3.25%



when we started this process. So in 2010, there were two processes running in parallel essentially. There was a correction process or normalisation process, and there was also a bit of tightening which was reflecting the inflationary forces that we were seeing emerging in the economy during that year. Now, to begin with, I would refer you to the discussion in the MMD on this. The first phase of this inflationary process was driven by food. So at that point, obviously, the view was that food prices are not going to be amenable to monetary policy. But we need to deal with the expectation issue. So we can justify tightening at that point. There was normalisation and tightening going on at the same time. It started to look at phase two which is roughly July 2010 to November-December 2010. Inflation actually started moderating. Headline came out and so did core and what was contributing mainly was non-food primary products were contributing there. So that was that. One phase which sort of ended by end-2010. Now, in early 2011, the new shock, commodity prices as a shock factor in 2010, they were rising but they were not so significant. Today, commodity prices even after some softening in the last few weeks are still about 30% higher than they were a year ago. So that was a completely different inflation trajectory emerging in the early part of 2011 and that is what we have been responding to with the more aggressive actions now. So I do not think one should see this as logically a continuous cycle. There have been two distinct breaks in the cycle; one is the normalisation and two is the more recent shock in terms of the global commodity price factor.

Manish Wadhawan: Appreciate it. Thank you very much.

Moderator: Thank you. The last question is from the line of Shubra Mittal from Kotak Mahindra, Mumbai. Please go ahead.

Shubra Mittal: Good afternoon. My question really is that we have been talking right now with the assumption of a normal monsoon. I was just wondering that in case monsoon were to fail then it would have implications for both growth and inflation with upside risk to inflation materialising and downside risk to growth also materialising simultaneously. In that situation, what possibly could be the stance of the RBI?

Dr. Subir Gokarn: For the moment, since we do find from analysis that rainfall in July is really the critical monsoon risk. And July has been 99% so far over the country, and we have a production weighted index, food production weighted index, which is looking at a 104 or so. So, slightly above normal. So the risk has significantly actually abated now. There is some risk in August. But if July were to be a failure then your question would have gained a lot of significance. But we have some comfort from the July numbers and if August becomes inadequate, yes some crops will be affected and we will obviously have to take that into consideration. But for the moment, the monsoon risk is somewhat less significant. I would say significantly less, significant than it was when we went to our May cycle because we had no idea of how the temporal distribution of rainfall would be. But the July performance has been very reassuring, it is more or less nationwide and with this food

grain production weighted index we do not see very serious stresses emerging on food. There are structural issues which we have been talking about impacting food prices, but the added burden of a bad monsoon is unlikely to be part of the story now.

Shubra Mittal: Thank you.

Dr. Subir Gokarn: We are going to bring this to a close now. Thank you all for participating. We appreciate the questions that were asked and we hope that people who did not get a chance to ask questions benefitted from listening to both, the questions and the responses. Our next conference would be post the October policy, although that is a Diwali day, immediately after policy, so we may have to tweak schedule a little bit, but we look forward to being in touch with you again at that point through this format and certainly in other ways in another event. Thank you very much for listening and all the best.

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