Recommendations of expert committee for Monetary Policy Framework

The monetary policy committee report released on January 21st, 2014 recommended landmark changes in the monetary policy framework of India. It marked significant departure from the extant multiple indicator approach that came into existence in 1998 and assigned importance to both quality variables and rate variables in monetary policy decisions. The committee enunciated the following recommendations in the monetary policy framework of India:

**Choice of combined CPI as the nominal anchor**

The committee recommended the adoption of inflation as the explicit nominal anchor in the monetary policy framework. The rationale for the adoption of flexible inflation targeting approach is the persistence of elevated levels of inflation in India despite weak growth scenario. This is primarily due to deeply entrenched inflationary expectations that have impacted inflation dynamics with detrimental impact on growth. An important aspect of inflation targeting approach is the fact that it presumes accordance to the transparency and communication which is important to guide the decisions of economic agents and thereby has a desired aspect on inflation dynamics.

The Combined CPI inflation has been identified as the nominal inflation anchor based on analysis that Combined CPI inflation is more appropriate to anchor inflationary expectations. The RBI analysis also included the study that shocks to food and fuel have more persistent impact on households’ expectations as compared to non food inflation and therefore core CPI may not be representative of inflation dynamics. While conceding that data on Combined CPI inflation is not sufficient, RBI analysis showed that CPI IW inflation has demonstrated significant correlation with the Combined CPI series and thus can be used to generate long term series for analysis. Moreover, the committee added that the significance of output gap relative to inflation expectations has been declining and this explains the current scenario in Indian economy.

The numerical target for Combined CPI inflation is set at 4% with a band of +/-2% around it. The plan envisaged to adopt this target in two years involves bringing down the CPI level to 8% in next 12 months and subsequently to 6% by the end of 2 years. The transition to the proposed 4% target is contingent upon seasonal swings, government’s commitment to fiscal consolidation roadmap, gradual phase out of administered price mechanism, pace of economic growth and global growth scenario.

Although flexible inflation targeting approach would necessitate clear communication, its ability to anchor inflationary expectations hinges on the demonstration of credibility on part of the central bank. Inflation targeting approach discounts the first round impact of some supply shocks; the commitment of the central bank depends on the timely response to risks emanating from second round effects and inflation expectations. Thus the proposed
framework by nature would emphasize greater transparency, communication, credibility and accountability.

Formation of Monetary Policy Committee (MPC)

The report recommended the institution of MPC with voting rights to its members for monetary policy decision making process. The committee would constitute five members including Governor of RBI, Deputy Governor and Executive Director in charge of monetary policy and two external members.

In line with the practices of majority inflation targeting countries, the MPC will be held accountable for the failure to achieve the nominal anchor which is defined as the inability to achieve the inflation target of 4% (+/- 2%) for three successive quarters. Greater accountability in inflation targeting approach requires more robustness in forecasts and predictions of various macroeconomic variables and thus the report argued the need to supplant the existing skills, technology, management information system and its reorganization.

Operating framework of Monetary policy

The operating framework involves the identification of operating target that is aimed at using policy instruments and setting up the intermediate target that is more closely related to the final goal variables. The current operating framework involves the use of Repo rate as a policy instrument to steer weighted average call rate which is the operating target. LAF corridor is directed at liquidity management to ensure the alignment of operating rate to the policy rate. The report outlines that simple rule in terms of real policy rate and nominal anchor would be conducive to the conditions of Indian economy. The report recommends the phased modification of the operating framework in conduct of monetary policy.

**Phase I:** In this phase, the traditional operating framework will remain intact with weighted average call rate continuing to be the operating target and overnight LAF repo rate as the single policy rate. Based on its assessment, RBI will provide liquidity through overnight repos and term repos at variable rate. However, there will be limit on quantum of liquidity made available under overnight LAF. The rationale behind this is that access to unlimited funds under overnight LAF precludes the development of term repo market which is essential to the effective monetary transmission process across spectrum of interest rates.

**Phase II:** This phase would involve a shift to Target Policy rate for short end of the money market as the policy rate and 14 Day Term Repo rate as the operational target. Liquidity management under this phase would be done using term repos at variable rate and there will be complete phase out of standing facility.

In order to support this, the committee recommends the introduction of new instruments like standing deposit facility rate for absorption of surplus liquidity, term repos of long tenor and phasing out of MSS bonds and CMBs.
Addressing impediments in monetary policy transmission process

The monetary transmission process works through various channels encompassing interest rate channel, credit channel, asset prices channel and exchange rate channel. The monetary policy rate needs to be transmitted through all these channels so as to affect the final goal variable. While this transmission is effective for advanced economies, emerging markets have less developed financial markets that impedes this process in their economies. To strengthen this interest rate channel which is more effective for Indian economy, the report recommended the need to subsequently reduce the SLR requirements of banks, removal of administered rates on small savings, tax treatment of fixed financial products in accordance with bank deposits and revisit on the need of subventions for certain sectors of economy. Another factor highlighted in the report that acts as an impediment in the transmission process is the presence of large informal sector which has higher borrowing cost.

Monetary policy transmission takes place via bank lending rates that ultimately impacts the consumption and investment behavior of economic agents. The report recommended that there is a need to establish external benchmark that can be used for pricing of financial products due to the fact that in absence of appropriate pricing of assets and liabilities in the banking system, the pass through from policy rate to banks interest rate is incomplete. The report also recommended that liquidity operations should concur with the monetary policy stance, i.e. anti-inflationary stance should be accompanied by tight liquidity conditions and vice versa.

The report also recommends that OMO should be used as liquidity management tool rather than managing government yields. This is because OMO operations results in creation of reserve money through indirect monetization of fiscal deficit that is not intended to be the mandate of RBI.

Conduct of monetary policy in globalised environment

The committee was of the view that the conduct of monetary policy has become more challenging in this globalised environment since the domestic economy has become more susceptible to the ebbs and flows of capital. Since 2003, Indian economy has witnessed various episodes of capital flows that warranted use of appropriate tools to manage such volatility.

Against this backdrop, the committee recommended that flexible setting of monetary policy by RBI in the short run is warranted by using various instruments at its disposal to manage capital volatility while maintaining flexibility in exchange rate determination. The report also recommended that to manage unanticipated inflows, RBI should create a sterilization reserve out of existing portfolio of government securities along with standing deposit facility that will empower it with unlimited sterilization. Similarly, the recommendations also included the strategy to build up buffer of foreign exchange reserves so as to effectively deal with the
external shocks. The committee also proposed the efficiency of using conventional policy measures to enable clarity in terms of communication.

**Outlook**

The proposed monetary policy framework espoused the adoption of flexible inflation targeting approach that is in line with the practices of several advanced nations. This approach is significant development over the extant framework given the current evolving scenario where inflation rose to peak levels despite weak growth scenario. This framework involves more clarity in communication and greater accountability on part of Central bank since it outlines the explicit targets that the Central bank is striving to achieve in the long run concomitant with the sustainable growth.

An important aspect is the choice of Combined CPI inflation as the nominal anchor. This is particularly important since it is this inflation metric that that is faced at the retail level and has an impact on their decision making. What is critical is the numerical target that the committee has proposed at 4% (+/-2%), the sanctity of this number will be understood with the inflation trajectory that will play out in future.

The report also stated the impediments that need to be addressed so as to effect the smooth transmission of monetary policy decision. But it may be a slightly long term phenomenon dependent upon the pace of development in money market and financial markets. An important recommendation that is important for country like India which had large current account deficit is creation of sterilization reserve and maintaining buffer of foreign exchange reserves to manage unanticipated flows to maintain stability on external front.

The report is certainly an important step directed at strengthening monetary policy framework and achieving greater clarity in RBI’s communication on policy decisions. The monetary policy review that is scheduled for 28 January, 2014 may provide RBI governor Dr. Raghuram Rajan’s take on this framework and how far these recommendations are under consideration towards changing monetary policy framework.