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WEEKLY CURRENT AFFAIRS

MONETARY POLICY FRAMEWORK OF INDIA

Monetary Policy is an integral arm of public policy. It is concerned with measures taken to regulate the supply of money, the cost and availability of credit in the economy. It also deals with the distribution of credit.

- In developed countries, the monetary policy has been used for overcoming depression and inflation as an anti-cyclical policy.
- In developing countries, it play significant role in promoting economic growth.

Goals/ Objectives, Targets and Instruments of Monetary Policy

- Goals: Price stability, Full employment, exchange rate stability or economic growth.
- Targets: Variables such as supply of money, bank credit, interest rate which are sought to be changed through the instruments of monetary policy so as to attain objectives.
- Instruments: Variations in bank rates, other interest rates, open market operations, selective credit controls, variation in reserve requirements or changes in supply of money.

UNDERSTANDING ATTAINMENT OF OBJECTIVES

Price stability: It means reasonable rate of Inflation.In the Monetary Policy framework adopted in 2015 for the period 2016-2020, 4% inflation target with +/- 2% band has been adopted.

Economic growth: Monetary policy promotes economic growth by ensuring adequate availability of credit and lower cost of credit. Easy availability of credit at low interest rate stimulates investment and thus accelerates economic growth.

Trade-off between Growth and Inflation

- In the short-run there exists a trade-off between growth and Inflation.
- For higher economic growth, the policy of easy money i.e. large expansion in money supply and lower interest rates is followed. However, easy monetary policy leads to increase in aggregate demand which the current aggregate supply is unable to meetand hence there is an increase in prices (Aggregate Demand > Aggregate Supply).

Resolving trade-off

- Expert Committee on monetary policy suggested target of 4% as "acceptable rise in price". The easy monetary policy should be so regulated that the rate of inflation does not exceed 4% p.a.
- Present Inflation Targeting Framework has adopted inflation target of 4% with +/- 2% band.

Exchange rate stability

- In an open economy, changes in capital flows and changes in demand for & supply of foreign exchange cause large fluctuations in foreign exchange rate of domestic currency.
- **To prevent large deprecation and large appreciation of domestic currency, central bank follows tight and easy monetary policy respectively or it can sell foreign currency(increase its supply) and purchase foreign currency respectively.**

Another Trade- off:

- In an open economy with floating exchange rate, objective of higher economic growth may also come in conflict with objective of exchange rate.
- For example: To prevent deprecation, tight monetary policy will be followed however this policy may hamper growth

Economic Survey 2020-21: Solving Impossible Trinity

1. Robust capital flows, particularly FDI and FPI drove foreign exchange reserves of India to an all-time high of US$ 586.1 billion as on January 8, 2021, covering about 18 months of imports.
2. This forex entailed a concomitant release of domestic liquidity which aided large-scale government borrowing without entailing any implications for monetary policy as long as inflation was benign.
3. However, with the headline inflation ruling above the policy band of 4+/-2%, RBI has to confront the classic conundrum of Mundell-Flemingtrilemma or impossible trinity – maintain an open capital account, stable exchange rate, and still conduct independent monetary policy.
4. Faced with a large Balance of payment surplus, RBI faced with two options: absorb the surplus and accumulate more forex reserves or let the ₹` appreciate.
5. With inflation largely attributed to supply-side disruptions and expected to stabilize, RBI chose to intervene in the forex market, **accumulate reserves, prevented one-sided appreciation of ₹`** and supplemented expansionary monetary policy.
6. However, the sustenance of high level of headline inflation has led to the requirement of RBI to maintain a fine balance between tightening of monetary policy to control inflation on the one hand and stimulate growth on the other hand.

INSTRUMENTS OF MONETARY POLICY

Central Bank controls credit to achieve its objectives. There are broadly two types of instruments of monetary Policy to control credit.

- Quantitative tools: Seek to change the total quantity of credit in general. These include changing bank rate and repo rate, conducting open market operations and changing cash reserve ratio.
- Qualitative Tools: Changing the volume of a specific type of credit.

MONETARY POLICY FRAMEWORK IN INDIA

Mid-1980s till 1997–98: M3

- Monetary targeting framework was on lines of recommendations by **Chakravarty Committee (1985).**
- **Annual growth in broad money (M3) was used as an intermediate target** of monetary policy to achieve final objectives. The reason for adopting M3 as target was the stability of money demand function
- Monetary management was concerned with working out M3 growth that is consistent with projected GDP growth and a tolerable level of inflation.
- However, it was not regarded as a rigid number for the year, rather was subjected to 'feedback rule', thus had an element of flexibility. Feedback were taken from the developments in the real sector. For example, if the real GDP growth was expected to be higher, M3 projection was revised upwards.

Changing the approach:

- In general, money demand functions for India have exhibited relatively high degree of stability, but such stability cannot be taken for granted as financial sector develops and financial innovations take place.
- The third working group on money supply gave a hint of weakening stability in money demand in recent years and indicated that while money supply would continue for some time to be a major indicator as well as an instrument of policy, the rate of interest could emerge as a critical variable in policy-making.
- Thus in 1998, other approach for financial reforms was adopted.

Late 1990s: Multiple Indicators Approach

- There was a shift to multiple indicators approach in the late 1990s. Reason: Increasing market orientation of financial system and greater capital inflows —> instability to the money demand function.
- Under Multiple Indicators Approach: Interest rates in different markets along with movements in currency, credit, fiscal position, trade, capital flows, inflation rate, exchange rate, refinancing and transactions in foreign exchange – available on a high frequency basis – are juxtaposed with output data for drawing policy perspectives.
- The approach evolved and was augmented by forward looking indicators.
- Augmented multiple indicators approach: The forward looking indicators are drawn from the Reserve Bank's industrial outlook survey, capacity utilization survey, professional forecasters' survey and inflation expectations survey. The assessment from these indicators and models feed into the projection of growth and inflation.

> - In general market players (foreign institutional investors, commercial banks, development finance institutions and major non-bank financial intermediaries),favoured the 'multiple indicators' approach to a single intermediate target.
> - Domestic liquidity conditions are seen by market players to be a more important factor than mere money supply.
> - Liquidity is influenced by open market and repo operations which are conducted with an eye to stabilising the market rates of interest in a way that the yield curve will be smooth and in accordance with the market expectations. The operations, however, impact market expectations, depending on the size, timing, and maturity period of security.

OPERATING PROCEDURE

- It refers to **day to day management of monetary conditions consistent with the overall stance** of monetary policy.
- Choice of operating target is crucial as is at the beginning of the monetary transmission process. It could be bank reserves, base money or a benchmark interest rate.

Prior to 1991 (Pre-reform era)

1. Bank reserves is natural choice as an operating target, when M3 is targeted, as was till 1997 and CRR principal operating instrument.
2. Besides CRR, pre-reform period prior to 1991, given the command and control nature of the economy, RBI resort to direct instruments like interest rate regulations and selective credit control.
3. The administered interest rate regime kept the yield rate of the government securities artificially low. The demand for them was created through periodic hikes in SLR for banks. The task before RBI to develop financial markets to prepare ground for indirect operations.

1992–93 Landmark

1. Market borrowing programme of the government was put through the **auction process.**
2. **Phased deregulation of lending rates** in the credit market. RBI brought down SLR to statutory minimum of 25% by October 1997, CRR brought down from 15% to 9.5% by November 1997.
3. **Automatic monetization of deficits phased out** in April 1997.
4. All these measures resulted in decline in pre-emption of resources from the banking system from a peak of 63% in 1992 to 35% by 1997.

Narsimham Committee (1998)

- It noted that money market continued to remain lopsided and volatile and the RBI also had no effective presence in the market.
- Need to transform the call money market into a pure inter-bank market and RBI operations to be market based.
- Thus following these recommendations, Reserve Bank introduced the liquidity adjustment facility (**LAF) in June 2000** to manage market liquidity on a daily basis and also to transmit interest rate signals to the market.
- Under the LAF, the Reserve Bank's policy reverse repo and repo rates set the corridor for overnight market interest rates. Thus, Open Market Operations including LAF emerged as the dominant instrument of monetary policy, though CRR continued to be used as an additional instrument of policy.

2016 NEW FRAMEWORK UNDER THE RBI AMENDED ACT

- India switched to an inflation target-based monetary policy framework in 2015, with the 4% starting from 2016-17.

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- Flexible Inflation Targeting: Under this framework primary objective of MP is to achieve an inflation rate of 4%, while keeping in mind the objective of growth.
- Many developed countries had adopted an inflation rate focus as an anchor for policy formulation for interest rates rather than past fixations with metrics like the currency exchange rate or controlling money supply growth.
- Emerging economies have also been gradually adopting this approach.

Features of FIT:

1. Inflation rate is defined as year-on-year changes in the Consumer Price Index (CPI) that iscompiled and released every month by National Statistical Office under the Ministry of Statistical and Programme Implementation. It is an all-India Index and combines both rural and urban prices.
2. To accommodate the fact that Indian economy is subject to supply shocks such as vagaries of monsoon or international crude oil prices changes over which national authority have no control, a tolerance band of +/- 2% has been prescribed to the inflation target.
3. The target and tolerance limits are specified by the government–providing an example of Fiscal-Monetary coordination.
4. The target is expected to be achieved over a period of time, thus adding to flexibility of policy. The central bank has the visibility and the time to smoothly alter and adjust its policies in order to attain the targeted inflation levels over the medium term, rather than seek to achieve it every month.
5. Clear rules of accountability have been laid down. If there is deviation from the tolerance limit for three consecutive quarters, then RBI has to write to Government explaining reasons for deviation, action to be taken to for correction and time taken to achieve the target.
6. The decision is taken by a 6-member committee, unlike the previous individualistic framework in which RBI governor was the sole decision maker.

Composition of Monetary Policy Committee

- The 6 member Monetary Policy Committee (MPC) constituted by the Central Government as per the Section 45ZB of the amended RBI Act, 1934. The composition of the MPC as on April 2019 is as follows;
- Internal members: Governor of RBI is the Chairperson, Deputy Governor in charge of Monetary Policy and a officer of RBI nominated by Central Board are appointed as ex officio internal members.
- External Members: Other three members are selected by the government in terms of criteria relevant to the conduct of monetary policy and species in the RBI act.
- Each member has a single vote, with Chairman having a casting vote in case of a tie.

INFLATION TARGET FOR 2021-26

- On the last day of the financial year 2020-21, the Finance Ministry announced that the inflation target for the five years between April 2021 and March 2026 will remain unchanged at 4%, with an upper tolerance level of 6% and a lower tolerance level of 2%.
- This is the retail inflation target that will drive the country's monetary policy framework and influence its decision to raise, hold or lower interest rates.

Background of the decision

- Volatile food prices and rising oil prices had already driven India's consumer price index (CPI) based inflation past the 6% tolerance threshold several times in 2020 and that core inflation trends were rising again.
- While inflation headwinds remain, there was some speculation that the Central government, whose topmost priority now is to revive growth in the COVID19 pandemic battered economy, may ease up on the inflation target by a percentage point or two. This would have given the Reserve Bank of India (RBI) more room to cut interest rates even if inflation was a tad higher.

RBI's position

- The RBI had, inrecent months, sought a continuance of the 4% target with the flexible tolerance limits of 2%.
- It argued that the 6% upper limit is consistent with global experience in countries that have a large share of food items in their consumer price inflation indices.

- Accepting inflation levels beyond 6% would hurt the country's growth prospects.

Consumers' concern:

- Suppose the inflation target were to be raised to 5% with a 2% tolerance band above and below it.
- For consumers, that would have meant that the central bank's monetary policy and the government's fiscal stance may not have necessarily reacted to arrest inflation pressures even if retail price rise trends would shoot past 6%**.**
- For instance, the central bank has been perhaps the only major national institution to have made a pitch for both the Centre and the States to cut the high taxes they levy on fuels that have led to pump prices for petrol crossing ₹100 a litre in some districts. As high oil prices spur retail inflation higher, the central bank is unhappy as its own credibility comes under a cloud if the target is breached.
- If the upper threshold for the inflation target were raised to 7%, the central bank may not have felt the need to seek tax cuts (yet). Thus, the inflation target makes the central bank a perennial champion for consumers visàvis fiscal policies that, directly or indirectly, drive retail prices up.

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