Monetary policy framework

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Source: *The Hindu*

Manifest pedagogy: The monetary policy framework needs to adapt to changing circumstances and hence there is a critical need to review the framework from time to time. The co-existence of higher than expected inflation coupled with slowing growth has called for this change.

In news: RBI governor has recommended for the review of Monetary policy framework

Placing it in syllabus: Monetary policy

Static dimensions:

- Current framework
- Urjit Patel committee

Current dimensions: Need for changes

Content:

Current framework:

- The **monetary policy framework aims to** set the policy repo rate as per the assessment of the present and developing macroeconomic situation.
- The agenda also aims at modulating liquidity conditions to adjust the money market rates at/around the repo rates.
- The **RBI Act of 1934, was amended in May 2016,** to provide a legal basis for the execution of the flexible inflation targeting agenda.
- The edited RBI Act provides for the **inflation target to be set by the Indian Government**, after discussing with the Reserve Bank, **once every five years.**

- It provides for setting up a **Monetary Policy Committee (MPC)** by the Central Government which determines the policy interest rate required to achieve the inflation target.
- Consumer Price Index (**CPI) of 4% inflation is the target set** for the period **from 5 August 2016 to 31 March 2021,** with the **higher tolerance limit of 6% and the lower tolerance limit of 2%.**

Urjit Patel committee:

The **Expert Committee to revise and strengthen the Monetary Policy Framework,** headed by RBI Deputy Governor Urjit R Patel was appointed in 2014 by the RBI.

Recommendations:

- RBI should adopt the **new Consumer Price Index (CPI)** for anchoring the monetary policy.
- **Inflation target** should be set at **4% with a band of +/- 2% around it.**
- Monetary policy decision making should be vested in a **Monetary Policy Committee (MPC)** that should be headed by the Governor.
- The schemes of Dependence on Market Stabilisation Scheme (MSS) and Cash Management Bills (CMBs) may be discontinued.
- The **government debt and cash management** must be taken over by the government's Debt Management Office.
- All **fixed income financial products** should be treated on par with the bank deposits for the purposes of taxation and TDS.
- **Detachment of Open Market Operations (OMOs) from the fiscal operations** and instead linked solely to the liquidity management. **OMOs should not be used for managing yields on government securities.**

Need for changes:

The Monetary Policy Framework and the MPC have been in action for over three years now. The **term of the MPC’s external members**, who were appointed in 2016, **comes to an end in September 2020.**

As the **members can’t be reappointed for a second term.** Given that both the mandate and the members soon complete their term, it’s time to review the functioning of the framework.

As the RBI had set up the Urjit Patel Committee that recommended inflation targeting, the Monetary Policy Framework and MPC, **it is fair that the review should come from the RBI**.

It is necessary that **financial stability be made the central bank’s mandate**. As the external sector, which is an important angle of stability is falling outside the purview of the MPC, the new revised framework would include this sector.

Criticism:

- Though the CPI is getting outsized importance as an indicator, the 4 percent anchor has proved less useful.
- According to analysts, the fiscal deficit has gone overboard, despite the CPI anchor.

The review should not judge the inflation targeting framework and the MPC as an institution too hastily. The framework may be enriched by adding multiple indicators like asset inflation, real effective exchange rate, credit off take, current account deficit, fiscal deficit, money supply etc…