

# Monetary Policy Committee as an Important Tool of RBI

<sup>1</sup>Dr. Sameer S Manek & <sup>2</sup>Dr. Navin R. Shah

<sup>1</sup>SDR Bapu Home Science Mahila College and Late M.J.Kundaliya English Medium Mahila Commerce and BBA College, Rajkot Gujarat (India)

<sup>2</sup>Department Of Economics, Saurashtra University, Rajkot, Gujarat (India)

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### \*Corresponding Author

Email: maneksameer[at]yahoo.in

## ABSTRACT

Success or failure of the economy is based on two important policy frameworks for a country like monetary policy and fiscal policy. Monetary policy is maintained by RBI while fiscal policy is maintained by Government of India. Monetary policy plays very important role for the stability of the monetary base of the economy as whole. There are various purposes of monetary policy for which it actually functions like price stability, employment generation, increasing production, economic growth and development etc. Traditionally monetary policy was meant to maintain price stability only but with the growing economic development other objectives were set for the monetary policy. But recently since 2014, government and RBI had determined the sole purpose of monetary policy that is price stability in the economy as a whole. For this purpose monetary policy committee is constituted for the effective functioning of RBI's monetary policy and keep price stability at a desired level of the economic need.

## 1. Introduction

The Reserve Bank of India Act, 1934 was amended on June 27, 2016, for giving a statutory backing to the Monetary Policy Framework Agreement and for setting up a Monetary Policy Committee (MPC). The Monetary Policy Framework Agreement is an agreement reached between the Government of India and Reserve Bank of India on the maximum tolerable inflation rate that the RBI should target to achieve price stability. The amended RBI Act (2016) provides for a statutory basis for the implementation of the 'flexible inflation targeting framework'. It is very important for the economy that the monetary policy and fiscal policy work with the mutual understanding of each other though the authority to design both the policies are different so that the economic goal and targets can be reached at the expected level. For this only purpose MPC was constituted.

## 2. Objectives

1. MPC will provide diversity of views as the RBI's and Government's members will work together.
2. With the constitution of MPC the economy will gain the specialized experience for the implementation of monetary policy.
3. MPC will provide independence of opinion.
4. MPC will also provide representativeness.
5. MPC will also provide accountability.

## 3. Research Methodology

The research paper is an attempt of exploratory research, based on the secondary data sourced from journals, magazines, articles and media reports.

## 4. Concept of Monetary Policy Committee

The main focus of the Monetary Policy Committee is to control price rise in the economy as a whole. An important landmark in India's monetary history is the constitution of an empowered six-member Monetary Policy Committee in

September, 2016 consisting of the RBI Governor (Chairperson), the RBI Deputy Governor in charge of monetary policy, one official nominated by the RBI Board and the remaining three central government nominees representing the Government of India who are persons of ability, integrity and standing, having knowledge and experience in the field of Economics or banking or finance or monetary policy.

The expert committee under Urjit Patel to revise the monetary policy framework, in its report in January, 2014 suggested that RBI abandon the 'multiple indicator' approach and make inflation targeting the primary objective of its monetary policy. The inflation target is to be set by the government of India, in consultation with the RBI, once in every five years. Accordingly,

- The Central Government has notified 4 percent Consumer Price Index inflation as the target for the period from August 5, 2016 to March 31, 2021 with the upper tolerance limit of 6 percent and the lower tolerance limit of 2 percent.
- The RBI is mandated to publish a Monetary Policy Report every six months, explaining the sources of inflation and the forecasts of inflation for the coming period of six to eighteen months.
- The following factors are notified by the central government as constituting a failure to achieve the inflation target;
  - (a) The average inflation is more than the upper tolerance level of the inflation target for any three consecutive quarters; or
  - (b) The average inflation is less than the lower tolerance level for any three consecutive quarters.

The choice of CPI was made because it closely reflects cost of living and has larger influence on inflation expectations compared to other anchors. Thus monetary policy committee is focusing on the inflation targets and tried their level best to keep the inflationary pressure under check so that the

economic growth and development can be witnessed effectively and transparently.

## 5. Functioning of Monetary Policy Committee

The MPC shall determine the policy rate required to achieve the inflation target. Accordingly, fixing of the benchmark policy interest rate is made through debate and majority vote by this panel of experts. With the introduction of the Monetary Policy Committee, the RBI will follow a system which is more consultative and participative similar to the one followed by many of the central banks in the world.

The Reserve Bank's Monetary Policy Department (MPD) assists the MPC in formulating the monetary policy. These views of key stakeholders in the economy and analytical work of the Reserve Bank contribute to the process for arriving at the decision on the policy repo rate. There are various tools that the MPC has to consider while determining the monetary policy for the economy and the respective changes in the same from time to time. The functioning of the MPC with the various quantitative tools are as follows;

1. **Cash Reserve Ratio (CRR):** Cash Reserve Ratio is the fraction of the total net demand and time liabilities of a scheduled commercial bank in India which it should maintain as cash deposits with the Reserve Bank. The Reserve Bank does not pay any interest on the CRR balances maintained by the scheduled commercial bank with effect from the fortnight beginning March 31, 2007; however, failure of a bank to meet its required reserve requirements would attract penalty in the form of penal interest charged by the RBI.
2. **Statutory Liquidity Ratio (SLR):** Statutory Liquidity Ratio is a wise measure. As per the Banking Regulation Act 1949, all scheduled commercial banks in India are required to maintain a stipulated percentage of their total Demand and Time liabilities in one of the following forms;
  - (a) Cash
  - (b) Gold,
  - (c) Investments in un-encumbered instruments
3. **Liquidity Adjustment Facility (LAF):** Reserve Bank of India provides liquidity to commercial banks when commercial banks face shortage of liquidity under LAF window. This facility is provided by the Central Bank through its discount window. The scheduled commercial banks can borrow from the discount window against the collateral of securities like commercial bills, government securities, treasury bills, or other eligible papers. The introduction of LAF is an important landmark since it triggered a rapid transformation in the monetary policy operating environment in India. As a key element in the operating framework of the RBI, its objectives are to assist banks to adjust their day to day mismatches in liquidity.
4. **Repo Rate:** Repurchase Options or in short 'Repo', is defined as 'an instrument for borrowing funds by selling securities with an agreement to repurchase the securities on a mutually agreed future date at an

agreed price which includes interest for the funds borrowed. In other words, repo is a money market instrument, which enables collateralized short term borrowing and lending through sale/purchase operations in debt instruments.

5. **Reverse Repo Rate:** 'Reverse Repo' is defined as an instrument for lending funds by purchasing securities with an agreement to resell the securities on a mutually agreed future date at an agreed price which includes interest for the funds lent. Reverse repo operation takes place when RBI borrows money from banks by giving them securities. The securities transacted here can be either government securities or corporate securities or any other securities which the RBI permits for transaction.
6. **Marginal Standing Facility (MSF):** Marginal Standing Facility announced by the Reserve Bank of India in its Monetary Policy, 2011-12 refers to the facility under which scheduled commercial banks can borrow additional amount of overnight money from the central bank over and above what is available to them through the LAF window by dipping into their Statutory Liquidity Ratio portfolio up to a limit at a penal rate of interest. Banks can borrow through MSF on all working days except Saturdays, between 7.00 pm and 7.30 pm, in Mumbai. The minimum amount which can be accessed through MSF is Rs. 1 crore and more will be available in multiples of Rs. 1 crore.
7. **Bank Rate:** Bank Rate has been defined as 'the standard rate at which the Reserve Bank is prepared to buy or re-discount bills of exchange or other commercial paper eligible for purchase under the Act'. The bank rate once used to be the policy rate in India but discounting/rediscounting of bills of exchange by the Reserve Bank has been discontinued on introduction of Liquidity Adjustment Facility. As a result, the bank rate has become dormant as an instrument of monetary management.
8. **Open Market Operation:** OMO is a general term used for market operations conducted by the Reserve Bank of India by way of sale/purchase of Government securities to/from the market with an objective to adjust the rupee liquidity conditions in the market on a durable basis. When the RBI feels there is excess liquidity in the market, it resorts to sale of securities thereby sucking out the rupee liquidity and vice-versa.

Thus, for the effective functioning of the Monetary Policy Committee, the above instruments play very important role and the determination of the above instruments and changes in the same considering the requirements of the economy is the important function being performed by Monetary Policy Committee.

## 6. Conclusion

With the introduction of the Monetary Policy Committee there is found much transparency in the functioning of the monetary policy. The main goal of the committee is to focus on the price stability in the economy as a whole and keep the inflationary or deflationary pressure under check from time to time so that the stability can be maintained expectedly. It is

assumed that the economic development, production, employment, GDP growth rate etc are the concerns which are directly connected with the inflationary conditions of the

economy as a whole and if it will be dealt with properly by the monetary policy the overall situation of the economy can be stabilized expectedly.

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