

A New Era in Indian Monetary Policy: Monetary Policy Committee

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Abstract: *An article on the formation of Monetary Policy Committee by the Reserve Bank of India for deciding upon the Interest rate decisions. The Monetary Policy committee will strive to bring the inflation rate under control.*

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A new era in Indian monetary policy has begun. On 4th October, 2016 the first interest rate decision taken by the monetary policy committee (MPC) was unanimous. All six members voted for a reduction in the benchmark repo rate by 25 basis points.

The government has decided to bring the provisions of amended RBI Act regarding constitution of MPC into force on June 27, 2016 so that statutory basis of MPC is made effective," according to a finance ministry statement. "The rules governing the procedure for selection of members of Monetary Policy Committee and terms and conditions of their appointment and factors constituting failure to meet inflation target under the MPC framework have also been notified on June 27, 2016."

Composition

The six-member Committee — tasked with bringing "value and transparency to monetary policy decisions" — will comprise three members from RBI, including the Governor, who will be the ex-officio chairperson, a Deputy Governor and one officer of the central bank.

The other three members will be appointed by the Centre on the recommendations of a search-cum-selection committee to be headed by the Cabinet Secretary.

"These three members of MPC will be experts in the field of economics or banking or finance or monetary policy and will be appointed for a period of four years and shall not be eligible for re-appointment," according to the statement.

The Committee is to meet four times a year and make public its decisions following each meeting.

For the first time, a monetary policy committee (MPC), and not just the Reserve Bank of India governor, is taking a call on policy rate.

The Members from the Central Bank are Governor (Urjit Patel), deputy governor in charge of monetary policy (R Gandhi) and an RBI-nominated executive (Michael Patra, RBI executive director). The other three members are nominated by the government. Currently, the three external members are well esteemed academicians — Chetan Ghate, Pami Dua and Ravindra H Dholakia. These external members will hold office for four years.

The Mpc Improves Transparency and brings a collective approach to the inflation problem. According to the mandate, the MPC will have to release the minutes of the meetings 14 days after the meet, which are expected to reveal how a member voted and why.

Why is it important?

Until recently, India's central bank used to take its monetary policy decisions based on the multiple indicator approach. Its rate decisions were expected to take into account inflation, growth, employment, banking stability and the need for a stable exchange rate.

As you can see, this is a tall order. Thus, RBI (with the Governor as the focal point) would be subject to hectic lobbying ahead of each policy review and trenchant criticism after it. The Government would clamor for lower rates while consumers bemoaned high inflation. Bank chiefs would want rate cuts, but pensioners would want high rates. RBI ended up juggling all these objectives and focusing on different indicators at different points in time.

To resolve this, RBI set up an Expert Committee under Urjit Patel to revise the monetary policy framework, and it came up with its report in January 2014. It suggested that RBI abandon the 'multiple indicator' approach and make inflation targeting the primary objective of its monetary policy. It also mooted having an MPC so that these decisions could be made through majority vote. Having both Government and RBI members on the MPC was suggested for accountability. The Government would have to keep its deficit under check and RBI would owe an explanation for runaway inflation.

What happened on 4th October, 2016?

It's been a day of firsts at the Reserve Bank of India (RBI).

Not only was today (Oct. 04) the new RBI governor Urjit Patel's first monetary policy review, it was also the first time that a newly-appointed committee decided the interest rate trajectory.

After meeting over the last two days, the recently-formed monetary policy committee (MPC) decided to cut the repo rate—the rate at which the RBI lends to commercial banks—by 25 basis points to 6.25%. A lower repo rate reduces the overall cost of borrowing in the country and boosts investment, thereby strengthening economic growth.

The repo rate is now the lowest in six years, Reuters reported.

The policy review is keenly watched by investors for ascertaining whether Patel and the MPC will continue former governor Raghuram Rajan's policy stance on inflation and interest rates. Rajan was rather vocal about the importance of reining in inflation and using interest rates as one way to do that.

With all six members of the MPC voting in favour of the policy decision, the committee seems to have taken into account the drop in retail inflation over the last few months.

"The momentum of growth is expected to quicken with a normal monsoon raising agricultural growth and rural demand, as well as by the stimulus to the urban consumption spending from the pay commission's award," the RBI statement said. "The accommodative stance of monetary policy and comfortable liquidity conditions should support a revival of credit to the productive sectors."

The rationale for a rate cut was pretty strong: inflation has stabilized, and good rainfall means food prices may fall further given the likelihood of ample supply. The economy is still recovering at a slow pace and rate cut could spur private borrowing and spending. Even India's finance minister Arun Jaitley was batting for a rate cut. In September, Jaitley had said that the RBI and the MPC should consider the fall in inflation and act accordingly.

The Sensex index—India's benchmark—rose 0.5% as soon as the policy statement was released at 2:30pm. The index closed 0.32% higher than its previous closing level.

The MPC—appointed by the government on Sept. 23—includes three non-RBI members: Pami Dua, director of the Delhi School of Economics; Chetan Ghate, a professor at the Indian Statistical Institute; and Ravindra Dholakia, a professor at the Indian Institute of Management, Ahmedabad. The other three members are Patel, R Gandhi, an RBI deputy governor, and Michael Patra, an executive director at the central bank. Patel can give the deciding vote, in case of a tie among the members.

How it concerns the general public?

What happens to interest rates in the country matters to you as a saver, investor, consumer and borrower. High rates can help savers earn more on debt options. Loan-takers may prefer lower rates. The MPC will ensure that decisions on interest rates are made through debate by a panel of experts. The many-heads-are-better-than-one approach may also help ensure that the decision isn't easily influenced by bias or lobbying.

India's shift to an MPC, driven by a clear inflation-targeting framework, if it succeeds, may also ensure that consumers and investors can look forward to lower inflation rates over the long-term. The public disclosure of MPC deliberations will also tell you why its members batted for higher or lower rates.

The future

Will it be independent enough to resist the pressures from the government and from business? Will it have a firm resolve to fight inflation? Will it stick to the 'glide path' towards the 4% inflation target laid down by the previous governor? Will it stick to the rule of thumb that the real policy rate should be 1.5-2 percentage points higher than the yield on the one-year Treasury bill? Will it be able to communicate effectively?

But there can hardly be differing views about the information content of the MPC statement and the minutes of the meeting. Stating the reasons for policy stances is of course a must, but we also need to get information about what committee members think about the trajectory of GDP growth, about inflation, about interest rates and about a host of other policy matters. The more numbers the MPC puts out the better for transparency and accountability.

And finally, committee members must make it a point to communicate effectively, not just at the MPC, but also in their interaction with the public between meetings. More communication in an inter-meeting period helps markets to better anticipate monetary policy decisions.

For all these reasons, the RBI meet this time will usher in a new chapter in monetary policy in the country. It is up to the MPC to write it well.