Role of Monetary Policy Committee in Controlling Inflation

Establishing a Monetary Policy Committee (MPC) has been an agenda for the Central Government and Reserve Bank of India (RBI) for a long time. Successive committees headed by the Governors of RBI recommended formulation of a committee which can decide upon and give recommendations with respect to maintaining the price stability and inflation in the Indian economy. The MPC has been set up by insertion of Chapter IIIF in the RBI Act, 1934 in the year 2016. The present article is an attempt to assess the working of the MPC towards controlling inflation in India and the tools at its disposal for the same.

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INTRODUCTION

Prior to the establishment and setting up of the Monetary Policy Committee (**"MPC"**) by the Government of India (**"GoI"**), there existed a Technical Advisory Committee (**"TAC"**) on monetary policy which was reconstituted in January, 2007, first set up in July 2005. The said TAC had participation of authorities and specialists from varied fields of interest inter alia *"monetary economics, central banking, financial markets, and public finance".* The said TAC was organized only to provide advice to the Reserve Bank of India (**"RBI"**) on the issues of monetary policy. The Central Government established the MPC under Section 45ZB of Chapter IIIF of the Reserve Bank of India Act, 1934, to define and decide the policy interest rate vital to meet the inflation target, and its resolution is binding on the RBI. On June 27, 2016, the committee was constituted.[1]

The idea of forming an MPC is no novelty as it dates back to 2002. It was introduced and proposed by the Y. V. Reddy Committee in year 1998. After Y. V. Reddy Committee report in 1998, several successive committees proposed the idea of setting up a Committee for dealing with issues related to monetary policy and inflation in India.[2] Since then, it has attracted public attention and led to administered monetary policy issues on a committee-based decision-making system in India. Such committee based decision making was aimed to bring greater transparency and accountability. During the last few years, the Indian Monetary policy framework has evolved substantially as a reaction to shifting macroeconomic state of affairs and financial developments in India.

In year 2016, the parliament effected an amendment in the preamble of the RBI Act. This amendment contained provisions to include a monetary policy framework under RBI Act. By such insertion regarding monetary policy framework, the parliament empowered the Central Government as well as RBI to consider and determine the inflation targets in terms of the Consumer Price Index. By this amendment, a new chapter was inserted in the RBI Act indicating towards changes in the working framework of monetary policy.

The Monetary Policy Department (**"MPD"**) of the Apex bank supports the MPC in preparing the monetary policy. The process of deciding the repo rate involves taking the view of key pillars of the economy, and the RBI's analytical inputs. The main aim of monetary policy is to keep prices stable, manage inflation or unemployment, and keep currency exchange rates stable while achieving the goal of growth. The Board of MPC is constituted as follows:

1. The Governor of the RBI: Serves as the ex officio chairperson of the MPC.
2. Deputy Governor of the RBI: Serves as the ex officio member in charge of Monetary Policy,
3. One RBI officer to be nominated by the Central Board of RBI as an ex officio member of the Committee, and
4. Three members to be appointed by the Central Government.

TOOLS OF MONETARY POLICY FOR CONTROLLING INFLATION

MPC is an authority which controls inflation through multiple monetary policies in order to maintain the economic balance. Given below are the key tools used by the MPC to do so:

i. **Repo Rate:** The rate at which the RBI provides overnight liquidity to banks against the G-SECs and other approved securities under the Liquidity Adjustment Facility (**"LAF"**).[3] The Repo Rate is a tool used to limit and regulate the

1 *Monetary Policy Overview, Reserve Bank of India, available at: https://www.rbi.org.in/scripts/FS_Overview.aspx?fn=2752 (last visited on May 20th, 2022) .*

2 *See: The Tarapore Committee in 2006, the Percy Mistry Committee in 2007, the Raghuram Rajan Committee in 2009, and the Financial Sector Legislative Reforms Commission (FSLRC) and the Dr. Urjit R. Patel (URP) Committee in 2013.*

3 *Supra note 1.*

inflation in the economy. The RBI, in times of high inflation, hikes the Repo Rate in order to absorb the liquidity from the market and vice versa.[4]

ii. **Reverse Repo Rate –** It is a concept inverse of the Repo Rate. It indicates a rate at which the RBI provides a return on the money deposited by the banks with the RBI. In addition to Repo Rate, Reverse Repo Rate also assists in controlling the liquidity available in the market/economy.[5]

iii. **Liquidity Adjustment Facility ("LAF") –** The LAF is a policy mechanism of RBI which allows the banks and RBI to enter into contractual arrangements with respect to lending and borrowing of monies with a reciprocal future commitment of buying (Repos) or selling (Reverse Repos).[6] It is a tool that helps in maintaining liquidity demands and ensuring fundamental stability in the financial market.

iv. **Marginal Standing Facility ("MSF") -** MSF is a provision made by the RBI through which scheduled commercial banks can obtain liquidity overnight if inter-bank liquidity completely dries up.

v. **Bank Rate -** Published under Section 49 of the RBI Act, 1934, it is the rate at which the banks avail the facility of rediscounting of bills of exchange and/or other negotiable instruments. This rate is directly proportional to the rate of MSF.[7]

vi. **Cash Reserve Ratio ("CRR") –** It is the rate at which the banks have to maintain cash balance with RBI.[8] It needs to be maintained on an average daily basis and calculated on the sum of total time and demand liabilities of the respective banks. A raise in CRR necessarily implies lesser amount of liquid assets available with the bank which such bank can use to grant loans and vice versa. Hence, such a rate aids the RBI in maintaining the cash availability with the banks and regulates credit creation in the economy.[9]

vii. **Statutory Liquidity Ratio ("SLR") –** This rate depicts the amount which the banks have to maintain in form of government securities, bullion and liquid cash as a share of the sum of net time and demand liabilities of banks.[10] The SLR regulates credit growth and inflation in the Indian economy. An increase in SLR results into a decrease in the lending power of the banks and vice versa.

viii. **Open Market Operations ("OMO") -** OMO refers to transacting and dealing in G-SECs in the open market by the RBI. In open market operation, in order to target inflation, short-term interest rate securities in debt markets are earmarked and dealt.

ix. **Market Stabilisation Scheme ("MSS") -** MSS entails an intervention by the RBI in order to suck out the liquidity from the market by offering G-SECs. The scheme was used to withdraw excess liquidity created during the demonetisation in 2016.[11]

LEGAL FRAMEWORK OF MONETARY POLICY

Chapter III F of RBI Act, 1934 describes the framework of working of monetary policy:[12]

1. The provisions of this chapter of the RBI Act shall have an overriding effect on other provisions mentioned in the act.
2. It empowers the GoI to define the rate of inflation in the economy based upon the Consumer Price Index once every five years in consultation with the RBI.
3. MPC of the RBI is constituted by the GoI through a notification in the Official Gazette.
4. MPC has powers to define the Policy Rate necessary to attain the inflation target.
5. The resolution of MPC will be binding on the RBI.
6. On the recommendations of the Search-cum-Selection Committee, the MPC members will be appointed by the Central Government from among people of talent, integrity, and stature who have knowledge and expertise in economics, banking, finance, or monetary policy.
7. Members appointed by the GoI have a term of four years and are not eligible for reappointment. The Central Government may set the terms and conditions of employment and the Central Board may set the compensation and other benefits. A member of the MPC can resign before the end of his term by giving Central Government at least six weeks' written notice.
8. The Members appointed by Central Government may be removed from the office of the MPC, in cases of inadequate disclosure of any material conflict of interest, attendance of committee meetings, acquiring financial or other interest, acquired any other post, abused position of member. RBI shall give a fair opportunity of being heard in these matters.
9. The RBI must provide all information essential to accomplish the inflation objective to the members of the MPC. Further, a member can also request the RBI for other information, such as data, models, or analysis.
10. The RBI must hold at least four MPC meetings per year, with the meeting calendar being announced by the RBI at least one week before to the first meeting of the year. The meeting calendar can be amended only by an agreement of the MPC at a previous meeting, or if the governor believes an additional meeting or rescheduling is necessary due to administrative exigencies. *"The quorum for a meeting of the MPC is four members, at least one of whom is the Governor, and in the absence of the Governor, a deputy governor who is a member of the MPC. Each member of the MPC gets one vote, and in the event of an equality of votes, the Governor has a second or casting vote."*[13]

4 Available at: https://economictimes.indiatimes.com/definition/Repo-rate (last visited on May 20th, 2022)

5 Available at: https://economictimes.indiatimes.com/definition/reverse-repo-rate (last visited on May 20th, 2022)

6 Available at: https://www.investopedia.com/terms/l/liquidity_adjustment_facility.asp#:~:text=A%20liquidity%20adjustment%20facility%20(LAF,RBI%20through%20reverse%20repo%20agreements (last visited on May 21st, 2022)

7 Supra note 1.

8 Ibid.

9 Available at: https://www.business-standard.com/about/what-is-cash-reserve-ratio#collapse (last visited on May 21st, 2022)

10 Ibid.

11 Available at: https://prepp.in/news/e-492-market-stabilization-scheme-mss-indian-economy-notes (last visited on May 22nd, 2022)

12 Chapter IIIF of Reserve Bank Of India Act, 1934.

13 Section 45ZI of Reserve Bank of India Act, 1934.

11. The RBI must publish a document containing the steps it will take to implement the MPC's decisions, as well as the frequency with which it will do so: at the conclusion of each meeting; on the fourteenth day after each meeting; and every six months for the monetary policy report.

12 The Central Government makes rules for the purpose of carrying out the provisions of this Chapter.

FACTORS IMPACTING INFLATION

Some of the major indices, such as the Wholesale Price Index (**"WPI"**), Index of Industrial Production (**"IIP"**), Consumer Price Index (**"CPI"**), provide an accurate picture of the health of the economy.

1. Wholesale Price Index

The Wholesale Price Index is a method of computing the economy's average wholesale price movement. The Economic Advisor in the Ministry of Commerce and Industry and the Department of Industrial Policy and Promotion prepare and disseminate the WPI on a monthly basis. *"Primary Articles (22.62 %), Fuel & Power (13.15 %), and Manufactured Products (13.15 %) are the three primary components of WPI in India in the making of 64.23 % of weightage. Food inflation is also measured year on year in the WPI. WPI is a measure of headline inflation at the wholesale level. Inflationary pressure in the economy is indicated by a rise in WPI, and vice versa. The rate of increase in the WPI is used to gauge the economy's wholesale inflation."*[14] The WPI, which comprises of 697 commodities (services are excluded), is used to evaluate headline inflation in India (the most recent base year is 2011-12). It is calculated on a year-on-year basis, i.e. the rate of change in price levels in one month compared to the same month the previous year. It is also known as 'Point to point inflation'. The annual rate of inflation was reported at 15.08% (provisional) for the month of April, 2022 (over April, 2021) as compared to 10.74% in April, 2021. The index numbers and inflation rate for the last three months of all commodities and WPI components are given in table 1.1.

> The Monetary Policy Department ("MPD") of the Apex bank supports the MPC in preparing the monetary policy. The process of deciding the repo rate involves taking the view of key pillars of the economy, and the RBI's analytical inputs. The main aim of monetary policy is to keep prices stable, manage inflation or unemployment, and keep currency exchange rates stable while achieving the goal of growth.

Table 1.1

Index Numbers & Annual Rate of Inflation (Y-o-Y in %) **							
All Commodities / Major Groups	Weight (%)	Feb-22 (Final)		Mar-22 (Provisional)		Apr-22 (Provisional)	
		Index	Inflation	Index	Inflation	Index	Inflation
All Commodities	100.0	145.3	13.43	148.8	14.55	151.9	15.08
I Primary Articles	22.6	167.5	13.87	170.3	15.54	174.9	15.45
II Fuel & Power	13.2	138.3	30.84	146.9	34.52	151.0	38.66
III Manufactured Products	64.2	138.9	10.24	141.6	10.71	144.0	10.85
Food Index	24.4	166.7	8.67	167.3	8.71	172.9	8.88

***Annual rate of WPI inflation calculated over the corresponding month of the previous year*

Source: *https://eaindustry.nic.in/pdf_files/cmonthly.pdf*

2. Consumer Price Index

CPI monitors the variation in the general price level of goods and services purchased by households for consumption over time. CPI is determined using retail prices acquired from various markets and applied to consumers. The CPI basket comprises of services like housing, education, medical care, recreation, etc. Table 1.2 shows inflation rates on a point-to-point basis all over India, i.e. current month over previous month (April 2022 over April 2021) based on General Indices and CFPIs:

All India Inflation rates (%) based on CPI (General) and CFPI

Table 1.2

Indices	Apr. 2022 (Prov.)			Mar. 2022 (Final)			Apr. 2021		
	Rural	Urban	Combd	Rural	Urban	Combd	Rural	Urban	Combd
CPI (General)	8.38	7.09	7.79	7.66	6.12	6.95	3.75	4.71	4.23
CFPI	8.50	8.09	8.38	8.04	7.04	7.68	1.31	3.15	1.96

** Prov. – Provisional, Combd. - Combined

Source: *https://static.pib.gov.in/WriteReadData/specificdocs/documents/2022/may/doc202251255501.pdf*

*"According to the Households' Inflation Expectations Survey (**"HIES"**) for March 2022, households' median inflation the observation for the current period has remained unchanged at 9.7%, while expectations for the three months and one year ahead rose by 10 basis points each to 10.7% and 10.8%, respectively, as compared to the January 2022 round".*[15]

14 Office of the Economic Adviser Department of Industrial Policy & Promotion Ministry of Commerce & Industry Government of India, Manual on Wholesale Price Index (New Delhi).

15 Available at: https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/IESHMAR2022DA6B44E294484CDD9143913E6C7AA71C.PDF. (last visited on May 23rd, 2022)

3. Index of Industrial Production

The IIP is a representation of the rates of growth of various industry groups in the economy over a selective period of time/ duration. The Central Statistical Organisation (**"CSO"**) computes, determines and announces *"the IIP index"* on a month to month basis. IIP is a composite gauge that evaluates the rate of growth of industrial groups categorized as Broad sectors, that include Mining, Manufacturing, and Electricity, and use-based sectors, like Basic Goods, Capital Goods, and Intermediate Goods.

Index of Industrial Production - (2-Digit Level)

Table 1.3

Description	Weight	Index		Cumulative Index		Percentage growth#	
		Mar'21	Mar 22*	Apr-Mar*		Mar'22*	Apr-Mar*
				2020-21	2021-22		
Mining	14.3725	139	144.6	101	113.3	4	12.2
Manufacturing	77.6332	143.3	144.6	117.2	130.9	0.9	11.7
Electricity	7.9943	180	191	157.6	170.1	6.1	7.9
Index	100	145.6	148.3	118.1	131.5	1.9	11.3

* Figures for March 2022 are Quick Estimates.

#the growth rates over the corresponding period of previous year are to be interpreted considering the unusual circumstances on account of COVID 19 pandemic since March 2020.

Source:*https://mospi.gov.in/documents/213904/416359//IIP%20Mar'22%20Press%20Release1652356833134.pdf/81622e54-2d53-33d4-4cf8-680fb517e0b0*

RECENT TRENDS OF MONETARY POLICY COMMITTEE – EXCEPTIONAL EVENTS

1. Instances where RBI held off-cycle Monetary Policy Committee meetings

   In March 2022, the RBI held its 22nd meeting of the MPC. During this meeting, the MPC decided to diminish the policy repo rate under the LAF with immediate effect, reduce the reverse repo rate under the LAF, and maintain the accommodative attitude as long as it is required to restore growth and mitigate the impact of the coronavirus on the economy, due to the COVID-19 pandemic.

   Secondly, in May 2020, the MPC decided to lower the policy repo rate under the liquidity adjustment facility and the reverse repo rate under the LAF with immediate effect, maintaining the accommodative stance as long as it is necessary to revive growth and mitigate the impact of COVID-19 on the economy, all while maintaining inflation within the target range.

   The third instance occurred in May 2022, when the RBI decided to increase the policy repo rate under the liquidity adjustment facility and to remain accommodative while focusing on withdrawal of accommodation to ensure that inflation remains within the target going forward, while supporting growth, at its thirty-fifth meeting of the MPC.

2. **Brief of the last meeting held of Monetary Policy Committee**

   On May 2 and May 4, 2022, the MPC held an off-cycle meeting to consider the rising inflation-growth dynamics and their implications. The MPC went over the staff's macroeconomic assessment as well as alternative scenarios for significant risks to the outlook in great detail. MPC decided to raise the policy repo rate under the LAF by 40 basis points to 4.40 percent with immediate effect, based on an assessment of the current and emerging macroeconomic environment. Global economic disruptions, shortages, and rising costs caused by geopolitical tensions and sanctions have persisted, as have downside concerns, prompting the decision to raise the repo rate. The International Monetary Fund (**"IMF"**) cut its forecast for global output growth, while the World Trade Organization cut its forecast for world trade growth. In terms of the domestic economy, headline CPI inflation increased in March, owing to geopolitical spillovers, higher food inflation, and IMF projections of higher inflation in emerging markets, advanced countries, and developing economies.

   While economic activity is directing the counterflow of forces challenging the world with resilience based on the strength of underlying fundamentals and buffers, risks to the MPC's near-term inflation prediction are rapidly materialising, according to the MPC. In this context, the MPC expects inflation to continue high, necessitating robust and controlled efforts to stabilise inflation expectations and limit another consequence of rising commodity prices: higher unit costs as a result of government initiatives.

   The MPC voted unanimously to hike the policy repo rate and remain accommodative while working on removing accommodation to ensure that inflation remains within target while maintaining future growth.

> The Central Statistical Organisation (**"CSO"**) computes, determines and announces *"the IIP index"* on a month to month basis. IIP is a composite gauge that evaluates the rate of growth of industrial groups categorized as Broad sectors, that include Mining, Manufacturing, and Electricity, and use-based sectors, like Basic Goods, Capital Goods, and Intermediate Goods.

SUGGESTIONS & CONCLUSION

The WPI is primarily concerned with bulk purchases of goods and commodities, although the service sector has grown increasingly significant in today's economy. So it is necessary to have a comprehensive approach altogether.

Given the various components of the CPI, a CPI based on previous weights is likely to underestimate or overestimate inflation when our spending patterns change. For example, the amount of money spent on outdated transistors has decreased. If transistor prices rise, the old allocation will result in a larger inflation rate than what the consumers will see. As a result, in order to remain consistent with current consumption patterns, the weights used to calculate CPI must be changed in line with the current trends.

To avoid overdependence on a single indicator, a broader measure of inflation objective which includes the GDP deflator, wholesale price index, and CPI is needed. After considering the current global economic situation, the COVID-19 pandemic and inflationary pressures, a monthly meeting of the MPC is preferable, so that any choices or considerations made by the MPC at its meeting will be positively received by the economy and financial markets.

Thus, it can be concluded that the role of MPC in controlling inflation has proved itself to be vital to balance various aspects of the economy. CS