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Monetary Policy Committee

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Why is in news?

The six-member Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI), which will meet from October 4 to 6, is **expected to keep the repo rate unchanged at 6.5 per cent** for the fourth consecutive time, as consumer price index (CPI) based inflation continues to remain sticky. The central bank is also likely to maintain its 'withdrawal of accommodation' stance in the policy, economists believe.

Why is RBI likely to maintain status quo?

The six-member rate-setting panel will meet **against a backdrop of growing domestic as well as external economic challenges**.

These **domestic challenges encompass** growing risks to consumption demand amid soaring food inflation, an uneven monsoon adversely affecting kharif crops, higher interest rates and rising global crude oil prices, a Care Ratings report said.

The **frequent incidences of recurring food price** shocks pose a risk to anchoring of inflation expectations, which has been underway since September 2022.

International crude oil prices have averaged nearly $89 per barrel, sitting above $85 per barrel factored into RBI estimates (April 2023 policy briefing). In fact, since September 8, prices have hovered above $90 per barrel.

The recent spike in crude oil prices and global bond yields shall keep MPC vigilant on inflation-growth dynamics. The MPC is expected to maintain status quo on rates and stance at the upcoming October meeting.

Monetary Policy:

Monetary policy refers to the measures taken by the central bank (the RBI) to **regulate the supply of money and credit in the economy.**

Primary objectives:

Price stability: To maintain stable prices and control inflation within a target range.

Growth: To promote sustainable economic growth while maintaining price stability.

Financial stability: To maintain the stability of the financial system and prevent financial crises.

Types of monetary policy:

Expansionary Monetary Policy: This is used to stimulate economic growth by increasing the money supply and lowering interest rates. The aim is to encourage borrowing and investment, which in turn leads to increased spending and economic activity.

Contractionary Monetary Policy: This is used by central banks to slow down economic growth and control inflation by decreasing the money supply and raising interest rates. The aim is to reduce borrowing and investment, which in turn leads to decreased spending and economic activity.

Monetary Policy Committee:

Under **Section 45ZB of the amended (in 2016) RBI Act, 1934**, the central government is empowered to constitute a six-member Monetary Policy Committee (MPC).

The Monetary Policy Committee (MPC) is a **body of six members** that **decides the key policy interest rate** and the **monetary policy stance of the Reserve Bank of India** (RBI).

The **policy interest rate, also known as the repo rate**, is the rate at which the RBI lends money to commercial banks for short-term purposes.

The monetary policy stance is the direction in which the MPC intends to move the policy rate in the near future.

Background:

The MPC was **set up in 2016** as a result of an **agreement between the RBI and the Government of India** to ensure transparency and accountability in the conduct of monetary policy.

The agreement, also known as the **Monetary Policy Framework Agreement**, was signed in 2015 and came into effect in 2016.

The agreement specified the objectives, targets, and instruments of monetary policy, as well as the composition, functions, and procedures of the MPC.

Composition:

The MPC has **three members from the RBI**, including the Governor, who acts as the chairperson, and two other officials nominated by the RBI.

The **other three members are external experts** appointed by the Government based on their knowledge and experience in economics, banking, finance, or monetary policy.

The external members have a term of **four years and are not eligible for reappointment**.

The MPC members have one vote each and in case of a tie, the Governor has a casting vote.

Working Structure:

The MPC **meets at least four times a year and more often if necessary**. The meetings are usually held two weeks before the end of each quarter and last for two days.

The MPC **reviews the macroeconomic and financial developments and projections** and decides on the policy rate and stance by majority vote.

The MPC publishes its decisions and rationale after each meeting in a resolution statement, along with a summary of its deliberations and individual votes.

Various Instruments of Monetary Policy:

Monetary policy instruments are of two types namely **qualitative instruments and quantitative instruments**.

Quantitative instruments include Open Market Operations, Bank Rate, Repo Rate, Reverse Repo Rate, Cash Reserve Ratio, Statutory Liquidity Ratio, Marginal standing facility and Liquidity Adjustment Facility (LAF).

Qualitative Instruments refer to direct action, change in the margin money and moral suasion.

Liquidity Adjustment Facility (LAF):

The LAF consists of **overnight as well as term repo auctions**.

It is a tool used by the Reserve Bank of India (RBI) to **regulate short-term liquidity in the banking system**.

It consists of two parts: repo and reverse repo.

Repo Rate:

The interest rate at which the **Reserve Bank provides overnight liquidity to banks** against the collateral of government and other approved securities under the liquidity adjustment facility (LAF).

Reverse Repo Rate:

The interest rate at which the **Reserve Bank absorbs liquidity on an overnight basis, from banks** against the collateral of eligible government securities under the LAF.

Marginal Standing Facility (MSF):

It is a facility **offered by the RBI to banks** to borrow money overnight **in case of emergency or unexpected shortfalls**.

This **provides a safety valve against unanticipated liquidity shocks** to the banking system.

The interest rate on MSF is **typically higher than the repo rate** and is fixed by the RBI.

Banks can borrow up to a certain limit based on the amount of government securities they hold as collateral.

MSF is intended to be a **measure of last resort**, as it is more expensive than the LAF.

Corridor:

The MSF rate and reverse repo rate determine the corridor for the daily movement in the weighted average call money rate.

Bank Rate:

It is the rate at which the **RBI is ready to buy or rediscount bills of exchange or other commercial papers**. The Bank Rate is **published under Section 49 of the RBI Act, 1934**.

This rate has been aligned to the MSF rate and, therefore, changes automatically as and when the MSF rate changes alongside policy repo rate changes.

Cash Reserve Ratio (CRR):

The average daily balance that a **bank is required to maintain with the Reserve Bank as a share of such per cent of its Net demand and time liabilities** (NDTL) that the Reserve Bank may notify from time to time in the Gazette of India.

Statutory Liquidity Ratio (SLR):

The share of NDTL that a bank is required to **maintain in safe and liquid assets**, such as unencumbered government securities, cash and gold.

Changes in SLR often influence the availability of resources in the banking system for lending to the private sector.

Open Market Operations (OMOs):

These include both, **outright purchase and sale of government securities**, for injection and absorption of durable liquidity, respectively.

Market Stabilisation Scheme (MSS):

This instrument for monetary management was introduced in 2004.

Surplus liquidity of a more enduring nature arising from large capital inflows is absorbed through sale of short-dated government securities and treasury bills.

The cash so mobilised is held in a separate government account with the RBI.

Conclusion:

The MPC has played a crucial role in maintaining macroeconomic stability in India since its inception. It has also demonstrated its flexibility and responsiveness in dealing with unprecedented challenges posed by the COVID-19 pandemic. The MPC will continue to strive for achieving its mandate of price stability while supporting growth in a dynamic and evolving economy.