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Monetary Policy in India: The Road Ahead

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Abstract

The recent years in the Indian Economy especially the period 2008 onwards has witnessed stubborn inflation as measured by both WPI and the CPI Index. The WPI inflation averaged at 9.56 percent in 2010-11 whereas the CPI showed a higher level of 10.45 percent during the same period. A combination of Monetary Policy Measures like the Repo, Reverse Repo, CRR, SLR, Ways and Means Advances, the Liquidity Adjustment Fund, popularly known as the 'Multi Indicator approach' was adopted to curtail inflation, which met with only limited success. The major causes for this very persistent rise in prices have been attributed to the excessively high level of food inflation which was at an uncomfortable high of 11.10 percent (2010-2011) and fuel inflation which was at 12.28 percent in the same period. This, combined with supply bottlenecks and a rise in the rural wages on account of MNREGA Scheme further aggravated the inflationary tendencies in the economy. Continuous adhoc measures and RBI interventions were witnessed to harness the prices throughout the said period. The Monetary Policy in the recent years had to focus very intensely on maintaining a fine tune not only to curtail inflation but also to fulfill the mainstay objective of our Monetary policy i.e. maintaining 'Growth with Price Stability'. It is against this background that the RBI focused on' Inflation Targeting' and the establishment of the Monetary Policy Committee (MPC) on the recommendations of the Dr. Urjit Patel Committee, mainly to broaden the stance of the monetary policy and tackle the problem of inflation within well- defined macro parameters. This paper attempts to review and analyze the main approach and limitations of the Monetary Policy in the recent years in India with a special emphasis on the above mentioned recent changes proposed in the approach of the RBI as well as the Government with reference to tackling the problem of inflation in India. Though there is a caution against whether this kind of move would endanger the autonomy of the RBI, it is now accepted that working of RBI and Government on issues of both Monetary and Fiscal policy (a long standing necessity) will get a formal framework through establishment of the Monetary Policy Committee. This no doubt, would be a tight ropewalk but in the right direction.

Key Words: *Inflation, Growth, Monetary Policy, Multi indicator approach, WPI, CPI, Food and Fuel Inflation ,Monetary Policy Committee, Macro Fundamentals, Inflation Targeting, Dr. Urjit Patel Committee Report*

INTRODUCTION: APPROACH AND OBJECTIVES

The recent years in the Indian Economy especially the period 2008 onwards has witnessed stubborn inflation as measured by both WPI and the CPI Index. The WPI inflation averaged at 9.56 percent in 2010-11 whereas the CPI showed a higher level of 10.45 percent during the same period. A combination of Monetary Policy Measures like the Repo, Reverse Repo, CRR, SLR, Ways and Means Advances, the Liquidity Adjustment Fund and so on which is popularly known as the 'Multi Indicator approach' was adopted to curtail inflation, which met with only limited success. Temporary relief in the inflation was seen, but for very short periods during this decade.

The major causes for this very persistent rise in prices have been attributed to the excessively high level of food inflation which was at an uncomfortable high of 11.10 percent (2010-2011) and fuel inflation which was at 12.28 percent in

the same period. Together, these 2 groups of commodities have a weightage of 52.63 in the CPI. These factors combined with supply bottlenecks and a rise in the rural wages on account of MNREGA Scheme further aggravated the inflationary tendencies in the economy. Continuous adhoc measures and RBI interventions were witnessed to harness the prices throughout the said period and the Monetary Policy in the recent years had to focus very intensely on maintaining a fine tune not only to curtail inflation but also to fulfill the mainstay objective of our Monetary policy i.e. maintaining 'Growth with Price Stability'.

It is against this background that the RBI focused on' Inflation Targeting' and the establishment of the Monetary Policy Committee (MPC) on the recommendations of the Dr.UrjitPatel Committee. This paper attempts to review and analyze the main approach andlimitations in the efficacy of the Monetary Policy in the recent years in India with a special emphasis on the recent changes proposed in the approach of the RBI as well as the Government with reference to tackling the problem of inflation in India. It gives a brief on the main recommendations of the Dr. Urjit PatilCommittee , the Monetary Policy Committee and the concept of Inflation Targeting which are the main stays of the future monetary policy approach in India.

METHODOLOGY

This paper relies on secondary data and attempts a brief review of the monetary policy in India in the recent past and as it stands today with the establishment of the Monetary PolicyCommittee.

The Paper is divided into the followingmain sections:

I) Trends in recent and current inflation in India (2008-2015)
II) Background of the Recent Monetary Policy in India
III) Monetary policy in India: The Road Ahead.(*Inflation Targeting, Monetary Policy Committee-Frame Work and Recommendations*)

I) Trends in recent and current inflation in India (2008-2015).

This section tracesthe trends in overall Inflation in the economy for the period 2008-09 to 2014-15.

Table 1shows the movements in Inflation during the period **2008-09 to2012-13** by the WPI and CPI indicators which reveals that the overall inflation by WPI for the period 2008-09 to 2012-13 has been in the range of 7.55 and 9.56 percent .Measured by the CPI in all categories, it is in the range of 8.18 to 13.91 percent for the same period.

Table 1
Annual Inflation as Per Different Price Indices (%)

Price Index	2008-09	2009-10	2010-11	2011-12	2012-13
WPI	8.4	3.80	9.56	8.94	7.55*
CPI-IW**	9.1	12.37	10.45	8.39	10*
CPI-AL***	10.2	13.91	10	8.18	9.17*
CPI-RL****	10.2	13.76	10.1	8.35	9.41*

Source: Economic survey GOI (2012-2013)

The very high and persistent inflation of the period 2008-13 has been attributed dominantly to very high food inflation range of 7.4 to 13.49 percent during this period. Fuel prices also

showed an upward trend andtogether these two groups of commodities have a weightage of 52.63 in the CPI, thusaggravating the inflationary situation.

In the later years,more controlled levels of Inflation is witnessed at 6% in 2013-14 measured by WPI and 9.7% by CPI for the same period(**Table 2**). For April-December 2014-15 the price situation is further encouraging at 3.41% (WPI) and 6.2%(CPI).

Table- 2
Key Indicators: Price Movements (Percentage)

Indicator	2011 - 2012	2012 - 2013	2013 - 2014	2014-2015(April -Dec)
Inflation WPI (Average)	8.9	7.4	6.0	3.4
Inflation CPI (Average)	8.4	10.4	9.7	6.2

Source: Economic survey GOI (2014-2015) - Volume – II

The economy has also witnessed a gradual decline in food and fuel prices in the period 20130-14 to 2014-15 which has contributed to taming inflation in India in the current times. Food inflation in the 2nd quarter of 2014-15 stood at 4.5% and fuel at3.4%(provisional).

II. Background of theRecent Monetary Policy in India

It is against the background of slowly easing prices witnessed from 2012-13 onwards that optimism started building up in the monetary and thereby economic spheres. Tapering -off of prices have mainly been attributed toa decline infood prices, wages, fuel prices..Inflation expectations are also expected to remain in a benign rangeBoth the global food and fuel prices are predicted to remain stable and infact is estimated to decline.The CPI which was at 6.2% in 2014-15 is likely to decline further to 5 -5.5% creating further expectations that inflation would taper and monetary policy easing will be possible in future.

Monetary Policy Responses:

Till January 2015 RBI kept Policy rates unchanged and it was only with some indication of easing of inflation thatthe monetary stance changed by cutting repo rates by 25 basis points in January 2015,RBI also worked simultaneously on all other monetary instruments and also cut SLR by 50% basis points from 22 to 21.5 %.It also adopted the new CPI-Combined(CPI-C) as nominal anchor for policy communication from April, 2014 ,thus creating a balance in liquidity conditions in the recent times.

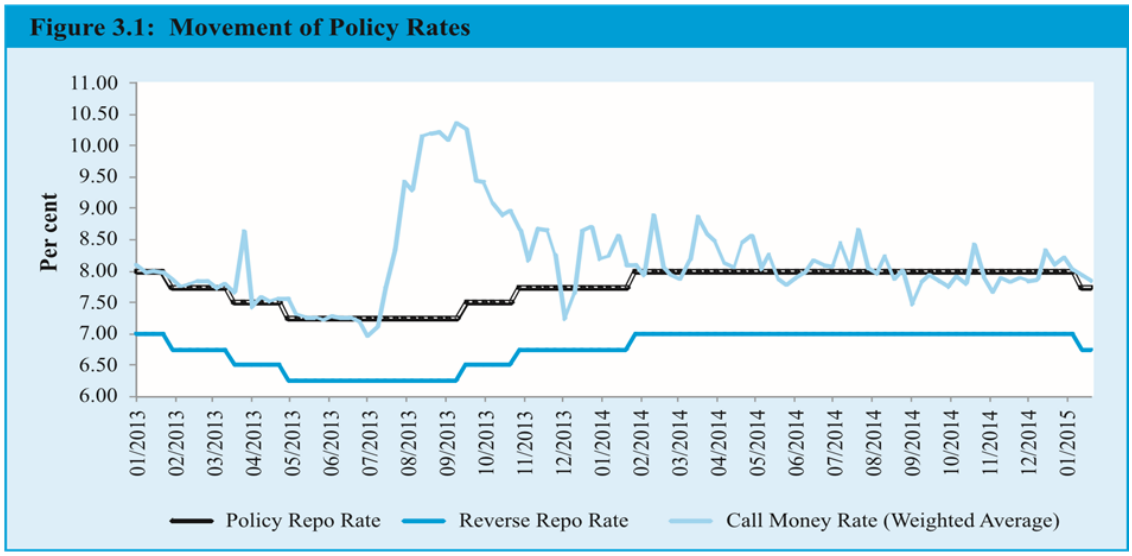
Table-3
Traces the major Revision in Policy rates in recent times

Table 3 Revision in Policy Rates					
Effective date	**Bank rate/ MSF rate***	**Repo rate (per cent)**	**Reverse repo rate (percent)**	**CRR (per cent - of NDTL)**	**SLR (per cent of NDTL)**

19-03-2013	8.50	7.50	6.50	4.00 $		
03-05-2013	8.25	7.25	6.25			
15-07-2013	10.25					
20-09-2013	9.50	7.50	6.50			
07-10-2013	9.00					
29-10-2013	8.75	7.75	6.75			
28-01-2014				9.00	8.00	7.00
14-06-2014	22.50					
09-08-2014	22.00					
15-01-2015	8.75	7.75	6.75			
7-02-2015	21.50					

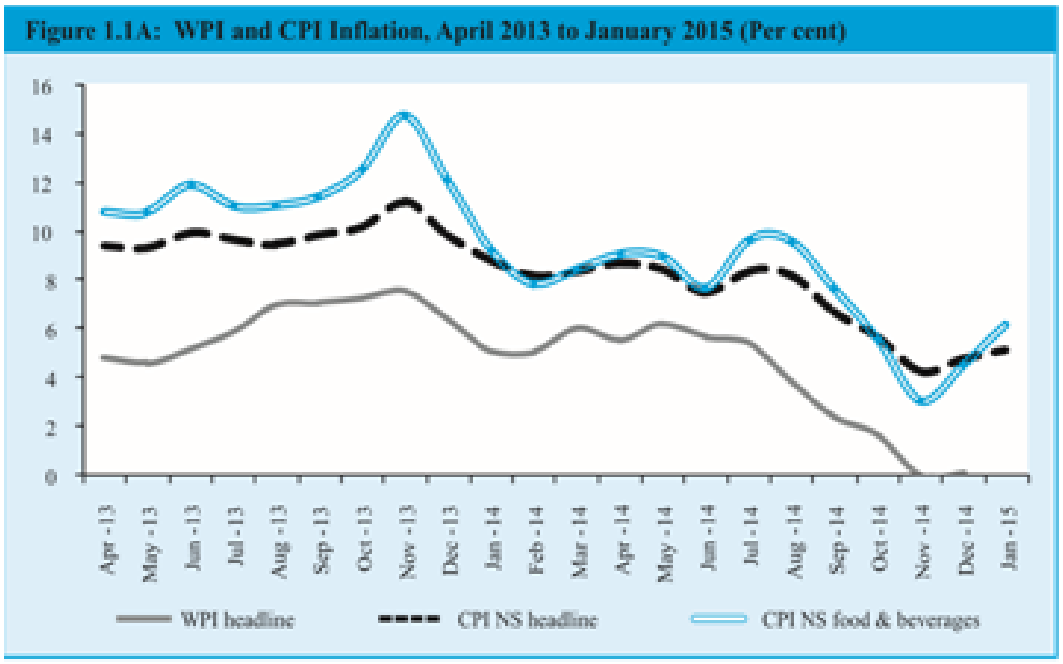
Source: Economic Survey GOI (2014-2015) - Volume – II

Figure 3.1
Depicts the movement of monetary policy rates in recent years



Source **: RBI**

The monetary policy responses and other factors mentioned led to tapering of the WPI and CPI rates towards 2013-15 indicated in Fig 1.1.A given below.



Source: Economic survey GOI (2014-2015) - Volume – II

The above positives coupled with greater fiscaldiscipline in the economy further paved the way for a higher growth rate in the coming years.The gross fiscal deficit declined from 5.7% of GDP in 2011-12 to 4.1% in 2014-15 and further slated at 3.9% in the recent Union budget of 2015.

These dynamic changes are being reflected in the current trends of positivegrowth rates in the economy summarized below in Table 4.

Table 4
Growth in GVA at Constant (2011-12) Basic Prices (per cent)

Category	2012-13	2013-14	2014-15
GVA at basic prices	4.9	6.6	7.5
GDP (at market prices)	5.1	6.9	7.4

Source: Based on the CSO's Press Notes dated 30 January 2015 and 9 February 2015,Economic Survey 2014-15 Vol- II

A number of studies have analyzed inflation and monetary policy responses in the recent years .The lagged or slow responses of monetary policy instruments to inflation during the period 2008-09 onwards also came in for criticism at various forums. Arecent study by Pankaj Kumar & Naveen Srinivasan(2015) focuses on the role of the monetary policy in the period post 2008 and especially in the stubborn period of inflation post (2010-11) and has analyzed the gap between actual and potential output growth in the period between 1999 – 2013 in terms of the supply and demand shocks. It observed that the monetary responses during period under question could not

have a deep impact on curtailing inflation and balancing the demand-supply factors in the economyand also comments on the inappropriate responses of the Monetary policy during the said periodA recent study (S. MahendraDev, Vijay LaxmiPandey&AndaleebRehman 2015) on food inflation also do attribute among other major causes the working or rather gaps in the coordination of the monetary &fiscal policy during this crucial decade to be a cause of the inflation.

III. Monetary policy in India: The road Ahead.

(*Inflation Targeting,Monetary Policy Committee: Frame work and Recommendations)*

Currently the Indian economy stands at a juncture where the macro and monetary fundamentals are looking stable The current rates and movements of monetary policy instruments are also in tune with macro parameters .(Rajan 2015). With domestic positives in terms ofa taperingprice situation, industrial growth, investment and infrastructural developments, narrowing current account deficits and pockets of well performing service sector, economic growth is expected to receive a boost. The areas of caution still being the slightly uncomfortable food inflation and unpredicted domestic and global shocks.

In this somewhat stable macro environment the RBI also has begun to ease its liquidity conditions creating further optimism in the economy.

It is against the background that this section attempts to very briefly look at two recent developments which have unanimously been accepted by the Central Bank and the Central Government viz. the policy of 'Inflation Targeting'and the establishment of Monetary Policy Committee.

This newmonetary policy framework has set two major goals.

1. With the agreement on Monetary Policy Framework between the Government and the Reserve Bank of India dated February 20, 2015, the Reserve Bank has formally adopted a Flexible Inflation Targeting (FIT) or *InfaltionTargeting* frameworkto gradually control inflation in the economy by setting an inflation target of 6% for 2016 measured by CPI combined and moving to an inflation target of 4 percent +/- 2percent for the financial year 2016-17 and in future.Inflation targeting is the monetary policy strategy used by the Central Banks to keep inflation within a certain range and focuses on a target inflation rate.
2. Establishment of a Monetary Policy Committee (MPC) as announced in the Union Budget 2015 on the recommendations of the Dr. Urjit Patel Committee Report.

These developments aim at broadening the stance of monetary policy and also tackling the problem of Inflation within well-defined macroparameters.

The Urjit Patel Committee calls for a further strengthening of monetary policy framework to provide a more long term approach not only to the problem of spiraling inflation but also to ensure that inflation vsgrowth contradictions are minimized

Monetary Policy Committee : Frame work and Recommendations

The key recommendations of theTheUrjit Patel CommitteeCommittee are:

(i) The Headline Consumer Price Index (CPI) should be the nominal anchor for monetary policy and the Reserve Bank of India (RBI) should make this the predominant objective.

ii)The nominal anchor for inflation should be set for a two-year horizon at 4 per cent with a band of plus or minus 2 per cent. Since the present CPI inflation is 10 per cent the Committee recommends a 'glide path' of 8 per cent for January 2015 and 6 per cent for January 2016.

(iii) The Central Government needs to reduce the fiscal deficit to 3.0 per cent of GDP by 2016-17and also reduce impediments to monetary transmission mechanism like administered prices, wages and so on.

iv) The Monetary Policy Committee (MPC) comprising the Governor, the Deputy Governor and Executive Director in charge of monetary policy and two external full-time members would

be entrusted the task of monetary policy decisions .

v)The decisions of the MPC will be by voting. Members will be accountable for failure to attain the target—failure being defined as inability to attain the target for three successive quarters.

vi)The Repo Rate would be the single policy rate

(vii)A standing deposit facility at the RBI to be created to sterilize excess liquidity.

(vii) Creation of an independent Debt Management Office, (DMO

(viii) All sector specific refinance should be phased out as committed to the Asian Development Bank in 1992.

Concluding Observations

The basis and the logic of the Monetary Policy Review Committee and adapting Inflation Targeting in India is an issue currently under wide discussion and analysis.

Inflation Targeting , though seemingly, a very appropriate move involves coordination of a number of parameters and also a well-defined framework for being successfully implemented which includes – which index to adopt, the band of the inflation rate target, the forecasting methods and the interrelations with other macro fundamentals and so on.

Though there is a caution against whether this kind of move would endanger the autonomy of the RBI, it is now accepted that working of RBI and Government on issues of both Monetary and Fiscal policy (a long standing necessity) will get a formal framework through establishment of theMonetary Policy Committee. The Debt Management Office coupled with the Financial Sector Legislative Reforms Commissions would provide a more stable platform for economic growth. All this, reiterating the fact that Fiscal consolidation lies at the heart of effectiveness of Monetary Policy This no doubt, would be a tight ropewalk but in the right direction.

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