Chapter VI

Recommendations

The recommendations of the Committee are set out in this Chapter.

The Choice of Nominal Anchor

(1) Inflation should be the nominal anchor for the monetary policy framework. This nominal anchor should be set by the Reserve Bank as its predominant objective of monetary policy in its policy statements. The nominal anchor should be communicated without ambiguity, so as to ensure a monetary policy regime shift away from the current approach to one that is centered around the nominal anchor. Subject to the establishment and achievement of the nominal anchor, monetary policy conduct should be consistent with a sustainable growth trajectory and financial stability *(Para No: II.25).*

The Choice of Inflation Metric

(2) The RBI should adopt the new CPI (combined) as the measure of the nominal anchor for policy communication. The nominal anchor should be defined in terms of headline CPI inflation, which closely reflects the cost of living and influences inflation expectations relative to other available metrics *(Para No: II.36).*

Numerical Target and Precision

(3) The nominal anchor or the target for inflation should be set at 4 per cent with a band of +/- 2 per cent around it (a) in view of the vulnerability of the Indian economy to supply/external shocks and the relatively large weight of food in the CPI; and (b) the need to avoid a deflation bias in the conduct of monetary policy. This target should be set in the frame of a two-year horizon that is consistent with the need to balance the output costs of disinflation against the speed of entrenchment of credibility in policy commitment *(Para No: II.42).*

Time Horizon for Attaining Price Stability

(4) In view of the elevated level of current CPI inflation and hardened inflation expectations, supply constraints and weak output performance, the transition path to the target zone should be graduated to bringing down inflation from the current level of 10 per cent to 8 per cent over a period not exceeding the next 12 months and to 6 per cent over a period not exceeding the next 24 month period before formally adopting the recommended target of 4 per cent inflation with a band of +/- 2 per cent. The Committee is also of the view that this transition path should be clearly communicated to the public *(Para No: II.43).*

(5) Since food and fuel account for more than 57 per cent of the CPI on which the direct influence of monetary policy is limited, the commitment to the nominal anchor would need to be demonstrated by timely monetary policy response to risks from second round effects and inflation expectations in response to shocks to food and fuel *(Para No: II.44).*

Institutional Requirements

(6) Consistent with the Fiscal Responsibility and Budget Management (Amendment) Rules, 2013, the Central Government needs to ensure that its fiscal deficit as a ratio to GDP is brought down to 3.0 per cent by 2016-17 *(Para No: II.47).*

(7) Administered setting of prices, wages and interest rates are significant impediments to monetary policy transmission and achievement of the price stability objective, requiring a commitment from the Government towards their elimination *(Para No: II.48).*

Organisational Structure for Monetary Policy Decisions

(8) Monetary policy decision-making should be vested in a monetary policy committee (MPC) *(Para No: III.22).*

Monetary Policy Committee: Composition & Tasks

(9) The Governor of the RBI will be the Chairman of the MPC, the Deputy Governor in charge of monetary policy will be the Vice Chairman and the Executive Director in charge of monetary policy will be a member. Two other members will be external, to be decided by the Chairman and Vice Chairman on the basis of demonstrated expertise and experience in monetary economics, macroeconomics, central banking, financial markets, public finance and related areas *(Para No: III.23).*

(10) External members will be full time with access to information/analysis generated within the Reserve Bank and cannot hold any office of profit, or undertake any activity that is seen as amounting to conflict of interest with the working of the MPC. The term of office of the MPC will ordinarily be three years, without prospect of renewal *(Para No: III.24).*

(11) Each member of the MPC will have one vote with the outcome determined by majority voting, which has to be exercised without abstaining. Minutes of the proceedings of the MPC will be released with a lag of two weeks from the date of the meeting *(Para No: III.25).*

(12) In view of the frequency of data availability and the process of revisions in provisional data, the MPC will ordinarily meet once every two months, although it should retain the discretion to meet and recommend policy decisions outside the policy review cycle *(Para No: III.26).*

(13) The RBI will also place a bi-annual inflation report in the public domain, drawing on the experience gained with the publication of the document on Macroeconomic and Monetary Developments. The Inflation Report will essentially review the analysis presented to the MPC to inform its deliberations *(Para No: III.27).*

(14) The Chairman, or in his absence the Vice Chairman, shall exercise a casting vote in situations arising on account of unforeseen exigencies necessitating the absence of a member for the MPC meeting in which voting is equally divided *(Para No: III.28).*

Accountability of MPC

(15) The MPC will be accountable for failure to establish and achieve the nominal anchor. Failure is defined as the inability to achieve the inflation target of 4 per cent (+/- 2 per cent) for three successive quarters. Such failure will require the MPC to issue a public statement, signed by each member, stating the reason(s) for failure, remedial actions proposed and the likely period of time over which inflation will return to the centre of the inflation target zone *(Para No: III.29).*

(16) With the establishment of the MPC, there would be a need to upgrade and expand analytical inputs into the decision making process through pre-policy briefs for MPC members, structured presentations on key macroeconomic variables and forecasts, simulations of suites of macroeconometric models as described in Chapter II, forward looking surveys and a dedicated secretariat. This will require restructuring and scaling-up of the monetary policy department (MPD) in terms of skills, technology and management information systems, and its reorganization *(Para No: III.30).*

The Operating Framework of Monetary Policy

(17) As an overarching prerequisite, the operating framework has to subserve stance and objectives of monetary policy. Accordingly, it must be redesigned around the central premise of a policy rule. While

several variants are available in the literature and in country practice, the Committee is of the view that a simple rule defined in terms of a real policy rate (that is easily communicated and understood), is suitable to Indian conditions and is consistent with the nominal anchor recommended in Chapter II. When inflation is above the nominal anchor, the real policy rate is expected, on average, to be positive. The MPC could decide the extent to which it is positive, with due consideration to the state of the output gap (actual output growth relative to trend/potential) and to financial stability *(Para No: III.59).*

(18) A phased refinement of the operating framework is necessary to make it consistent with the conduct of monetary policy geared towards the establishment and achievement of the nominal anchor *(Para No: III.60).*

Phase-I

(19) In the first or transitional phase, the weighted average call rate will remain the operating target, and the overnight LAF repo rate will continue as the single policy rate. The reverse repo rate and the MSF rate will be calibrated off the repo rate with a spread of (+/-) 100 basis points, setting the corridor around the repo rate. The repo rate will be decided by the MPC through voting. The MPC may change the spread, which however should be as infrequent as possible to avoid policy induced uncertainty for markets *(Para No: III.61).*

Liquidity Management

(20) Provision of liquidity by the RBI at the overnight repo rate will, however, be restricted to a specified ratio of bank-wise net demand and time liabilities (NDTL), that is consistent with the objective of price stability. As the 14-day term repo rate stabilizes, central bank liquidity should be increasingly provided at the 14-day term repo rate and through the introduction of 28-day, 56-day and 84-day variable rate auctioned term repos by further calibrating the availability of liquidity at the overnight repo rate as necessary *(Para No: III.62).*

(21) The objective should be to develop a spectrum of term repos of varying maturities with the 14-day term repo as the anchor. As the term yield curve develops, it will provide external benchmarks for pricing various types of financial products, particularly bank deposits, thereby enabling more efficient transmission of policy impulses across markets *(Para No: III.63).*

(22) During this phase, the RBI should fine-tune and sharpen its liquidity assessment with a view to be in a position to set out its own assessment of banks' reserves. This will warrant a juxtaposition of top-down approaches that estimate banks' reserves demand consistent with macroeconomic and financial conditions appropriate for establishing the nominal anchor, and bottom-up approaches that aggregate bank-wise assessments of liquidity needs submitted by banks themselves to the RBI on a daily basis. As these liquidity assessments become robust, they should be announced for market participants prior to the commencement of market operations every day and could be subjected to review and revision during the day for fine-tuning them with monetary and liquidity conditions. It is envisaged that the RBI will expand capabilities to conduct liquidity operations on an intra-day basis if needed, including by scaling up trading on the NDS-OM platform *(Para No: III.64).*

(23) Consistent with the repo rate set by the MPC, the RBI will manage liquidity and meet the demand for liquidity of the banking system using a mix of term repos, overnight repos, outright operations and the MSF *(Para No: III.65).*

Phase-II

(24) As term repos for managing liquidity in the transition phase gain acceptance, the "policy rate" voted on by the MPC will be a target rate for the short end of the money market, to be achieved through

active liquidity management. The 14-day term repo rate is superior to the overnight policy rate since it allows market participants to hold central bank liquidity for a relatively longer period, thereby enabling them to on lend/repo term money in the inter-bank market and develop market segments and yields for term transactions. More importantly, term repos can wean away market participants from the passive dependence on the RBI for cash/treasury management. Overnight repos under the LAF have effectively converted the discretionary liquidity facility into a standing facility that could be accessed as the first resort, and precludes the development of markets that price and hedge risk. Improved transmission of monetary policy thus becomes the prime objective for setting the 14-day term repo rate as the operating target *(Para No: III.66).*

(25) Based on its assessment of liquidity, the RBI will announce the quantity of liquidity to be supplied through variable rate auctions for the 14-day term repos alongside relatively fixed amounts of liquidity provided through longer-term repos *(Para No: III.67).*

(26) The RBI will aim at keeping 14-day term repo auction cut-off rates at or close to the target policy rate by supplementing its main policy operation (14-day term repos) with (i) two-way outright open market operations through both auctions and trading on the NDS-OM platform; (ii) fine tuning operations involving overnight repos/reverse repos (with a fine spread between the repo and reverse repo rate) and (iii) discretionary changes in the CRR that calibrate bank reserves to shifts in the policy stance *(Para No: III.68).*

(27) The MSF rate should be set in a manner that makes it a truly penal rate to be accessed only under exceptional circumstances *(Para No: III.69).*

(28) An accurate assessment of borrowed and non-borrowed reserves and forward looking projections of liquidity demand would assume critical importance in the framework. So far, the government's cash balances have been the prime volatile autonomous driver of liquidity, making accurate liquidity projections a difficult task. Therefore, continuing with reforms in the Government securities market, which envisage that the debt management function should be with the Government, the cash management function should concomitantly also be with the Government *(Para No: III.70).*

New Instruments

(29) To support the operating framework, the Committee recommends that some new instruments be added to the toolkit of monetary policy. Firstly, to provide a floor for the new operating framework for absorption of surplus liquidity from the system but without the need for providing collateral in exchange, a (low) remunerated standing deposit facility may be introduced, with the discretion to set the interest rate without reference to the policy target rate. The introduction of the standing deposit facility (analogous to the marginal standing facility for lending purposes) will require amendment to the RBI Act for which the transitional phase may be utilised. The standing deposit facility will also be used for sterilization operations, as set out in Chapter 5, with the advantage that it will not require the provision of collateral for absorption – which had turned out to be a binding constraint on the reverse repo facility in the face of surges in capital flows during 2005-08 *(Para No: III.71).*

(30) Secondly, term repos of longer tenor may also be conducted since term repo market segments could help in establishing market based benchmarks for a variety of money market instruments and shorter-term deposits/loans *(Para No: III.72).*

(31) Thirdly, dependence on market stabilisation scheme (MSS) and cash management bills (CMBs) may be phased out, consistent with Government debt and cash management being taken over by the Government's Debt Management Office (DMO) *(Para No: III.73).*

(32) Fourthly, all sector specific refinance should be phased out *(Para No: III.74).*

Addressing Impediments to Transmission of Monetary Policy

Statutory Liquidity Ratio

(33) Consistent with the time path of fiscal consolidation mentioned in Chapter 2, SLR should be reduced to a level in consonance with the requirements of liquidity coverage ratio (LCR) prescribed under the Basel III framework. *[Para No: IV.22 (a)].*

(34) Government should eschew suasion and directives to banks on interest rates that run counter to monetary policy actions [*Para No: IV.22 (b)].*

Small Savings Schemes

(35) More frequent intra-year resets of interest rates on small saving instruments, with built-in automaticity linked to benchmark G-sec yields, need to be brought in. Also, the benchmark should be based on the average of the previous six months or even shorter intervals so as to better capture changes in interest rate cycles within a year [*Para No: IV.22 (c)].*

Taxation

(36) All fixed income financial products should be treated on par with bank deposits for the purposes of taxation and TDS. Furthermore, the tax treatment of FMPs and bank deposits should also be harmonized [*Para No: IV.22 (d)].*

Subventions

(37) With a sharp rise in the ratio of agricultural credit to agricultural GDP, the need for subventions on interest rate for lending to certain sectors would need to be re-visited [*Para No: IV.22 (e)].*

Financial Markets Pricing Benchmarks

(38) Unless the cost of banks' liabilities moves in line with the policy rates as do interest rates in money market and debt market segments, it will be difficult to persuade banks to price their loans in response to policy rate changes. Hence, it is necessary to develop a culture of establishing external benchmarks for setting interest rates out of which financial products can be priced. Ideally, these benchmarks should emerge from market practices. The Reserve Bank could explore whether it can play a more active supportive role in its emergence *(Para No: IV.28).*

(39) The RBI's liquidity management operations should strive to ensure consistency with the stance of monetary policy. Accordingly, an increase in the policy rate to convey an anti-inflation policy stance should be accompanied by tightening of liquidity conditions through liquidity management operations, whereas an easing of the policy stance should be associated with accommodative liquidity conditions *(Para No: IV.29).*

(40) There should be close coordination between the settings of monetary policy and macro-prudential policies, since variations in macro-prudential instruments such as capital buffers, provisions, loan-to-value ratios and the like alter the cost structures and lendable resources of banks, thereby impacting monetary transmission *(Para No: IV.30).*

Open Market Operations (OMOs)

(41) OMOs have to be detached from fiscal operations and instead linked solely to liquidity management. OMOs should not be used for managing yields on government securities (*Para No: IV.35).*

Conduct of Monetary Policy in a Globalised Environment

Managing Surges in Capital Inflows/ Sudden Outflows

(42) In view of the cross country and Indian experience with global spillovers driving episodes of large and volatile capital inflows as well as outflows, a flexible setting of monetary policy by the RBI in the short-run is warranted. This presages readiness to use a range of instruments at its command, allowing

flexibility in the determination of the exchange rate while managing volatility through capital flow management (CFM) and macro-prudential measures (including sector specific reserve requirements) *(Para No: V.25).*

(43) With regard to inflows that are excessive in relation to external financing requirements and the need for sterilized intervention: (a) the RBI should build a sterilization reserve out of its existing and evolving portfolio of GoI securities across the range of maturities, but accentuated towards a 'strike capability' to rapidly intervene at the short end; and (b) the RBI should introduce a remunerated standing deposit facility, as recommended in Chapter-III, which will effectively empower it with unlimited sterilization capability *(Para No: V.26).*

(44) As a buffer against outflows, the RBI's strategy should be to build an adequate level of foreign exchange reserves, adequacy being determined not only in terms of its existing metrics but also in terms of intervention requirements set by past experience with external shocks and a detailed assessment of tail events that materialised in the country experiences. As a second line of defence, swap arrangements, including with regional financing initiatives, should be actively pursued. While retaining the flexibility to undertake unconventional monetary policy measures as demonstrated in response to announcement effects of QE taper but with clarity in communication and better co-ordination, the Committee recommends that the RBI should respond primarily through conventional policy measures so as to ensure common set of shared expectations between the markets and the RBI, and to avoid the risk of 'falling behind the curve' subsequently when the exceptional measures are unwound *(Para No: V.27).*

(45) In addition to the above, the RBI should engage proactively in the development of vibrant financial market segments, including those that are missing in the spectrum, with regulatory initiatives that create depth and instruments, so that risks are priced, hedged, and managed onshore *(Para No: V.28).*