Monetary Policy in India: is something amiss?

Riccardo Cristadoro and Giovanni Veronese

Discussant: Abhishek Gupta
National Institute of Public Finance and Policy (NIPFP)

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A brief explanation of this paper

- Focuses on recent performance of RBI in conducting monetary policy
- Documents the unhinging of inflationary expectations since 2008
- Methodology:
  - Survey data on inflation expectations
  - Taylor rules
  - Term structre of interest rates
- Conclusion: RBI lacks a clear objective function for monetary policy and this hurts RBI's credibility and policy effectiveness

Survey data on Inflation Expectations

- Graph correlation between Consensus Forecasts(CF)' inflation expectations at short and long horizon and current inflation
  - Positive correlation for India indicates weak credibility for RBI policies
- Graphs are a bit confusing.
  - In figure 1, authors state they are using April CF, but infact they are plotting both April and October CF.
- Similar correlation graphs for India would be informative for SPF forecasts and household survey of inflation expectations

Taylor Rule

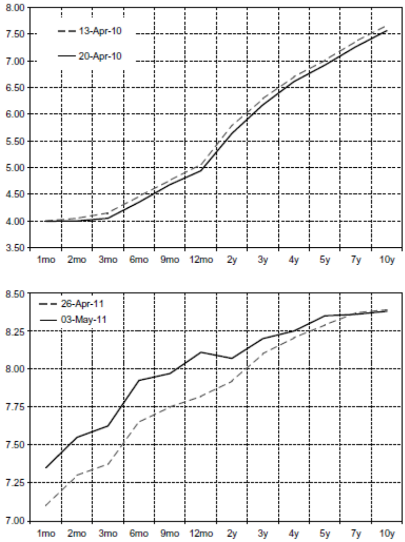
- Estimate recursive Taylor Rule coefficients for India
  - Taylor principle not satisfied
  - Coefficient on inflation although insignificant, has been increasing since 2009

Term Structure of Interest Rates

- Ellingsen and Soderstrom(2001) build a theoretical model that predicts:
  - When Central Banks act unexpectedly to private information about macroeconomic shocks, then all rates move in the same direction, long rates move less than short.
  - When Central Bank acts unexpectedly and agents perceive that as a shift in the reation function, the short and long rates move in opposite directions.
- Assumption: Central Banks objective function is known and stable

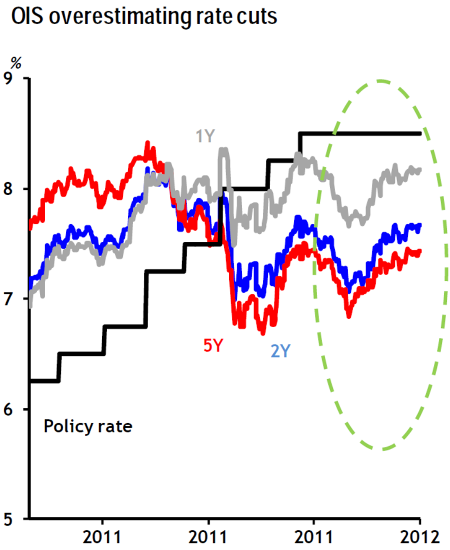
Term Structure of Interest Rates

- Graph the OIS yield curve before and after the policy move by the RBI. Focus on two episodes:
  - Gradual tightening: 25 bps increase in April 2010
  - Cold turkey: 50 bps increase in May 2011
- The gradual tightening was anticipated and hardly led to any change in the yield curve
- The unanticipated tightening of 50 bps led the market to update its views of the central bank's preference parameters



OIS yield curve.
Top panel: 25 bps gradual increase in repo rate in line with market expectations.
Bottom panel: An unexpected 50 bps increase.

Why do the authors take the yield curve a week prior to the event?



OIS interest rates and policy rate.
Maybe RBI changed its reaction function sometime in mid-2011
Due to lack of RBI credibility, market unable to process this
Gradually, market is internalizing this

Change in RBI's reaction function?

- Statement issued by a market analyst at Nomura on March 15, 2012:

  "...the RBIs tolerance for slower growth has risen. This is consistent with the governors statement that the non-inflationary rate of growth has now fallen to 7.0% (23 February 2012)... the RBIs reaction function has changed. In our view, the weight accorded to growth has fallen relative to inflation..."

Another Paper?

- Some questions that this paper motivated:
  - How does the market perceive the surprizes in policy moves?
  - Has there been a structural change in the RBI's reaction function?
  - How long does it take for the market to perceive changes in RBI's reaction function given the uncertainty surrounding RBI's policy design.

Is the RBI paying attention?

- Maybe...
- March 2011 report of the working group on operating procedure of monetary policy recommended:
  - Move to a single policy rate (repo-rate) to signal the stance of monetary policy
  - Repo-rate should operate within a corridor set by the Bank rate (upper bound) and the reverse-repo rate (lower bound)
  - The operating objective should be to contain the weighted average call money market rate around the repo rate within the corridor
  - Persistent liquidity excesses and shortfalls to be managed through outright OMO, CRR and MSS
- Most of these recommendations and few others are already operational

Is the RBI serious about containing inflation?

- Maybe not...
  - Issues with RBI communication.

Communication

- On 3rd May 2011, after an unexpected 50 bps rate hike RBI Governor had said:

  "... the conduct of monetary policy will continue to condition and contain perceptions of inflation in the range of 4.0-4.5 per cent"

- On 9th May 2011, the RBI Governor said:

  "Monetary Policy, as is well known, is an ineffective instrument for reining in inflation emanating from supply pressures. It is unrealistic, under these circumstances, to expect the Reserve Bank to deliver on an inflation target in the short-term...we have a problem about which inflation index to target."

Thank you