RBI's Working Paper on "Monetary Policy Transparency and Anchoring of Inflation Expectations in India"- A summary

The adoption of Flexible Inflation Targeting (FIT) in India was a regime shift in the Central Bank's policy making. As much as the containment of inflation assumed importance, an equally important objective has been to anchor inflation expectations of the economic stake holders. This has been implicit in the framing of the inflation targeting frame work. If inflation expectations are well anchored, then any surprise variations in the usual economic conditions do not change the inflation expectations to a great extent. The crucial part of the Central Bank's monetary policy is to control not only inflation but also to keep the inflation expectations stable and impervious, as far as possible, to the major economic currents.

In maintaining the realized inflation at a stable level and the inflation expectations anchored within bounds, the Central Bank has to maintain monetary policy transparency. Transparency is a qualitative attribute and not easily quantifiable due to the inherent subjectivity associated with it. The Reserve Bank of India (RBI) has recently published a Working Paper[1] titled "Monetary Policy and anchoring of inflation expectations in India", co-authored by G.P. Samanta, Adviser and Shweta Kumari, Assistant Adviser, Reserve Bank of India. This paper constructs an index of monetary policy transparency for India and examines the role of transparency in anchoring inflation expectations. The authors' empirical results show that the degree of policy transparency has indeed increased substantially since the adoption of FIT in 2016. The results are based on data acquired through text mining techniques, which state the impact the degree of the monetary policy transparency has on anchoring inflation expectations.

The authors suggest that to build the required credibility, central banks across the world maintain a high degree of transparency by keeping the markets and the public informed and updated about the actions taken by the central bank to achieve the stated goals. Greater transparency may improve the effectiveness of monetary policy in several possible ways. First, it makes central banks more accountable, thereby creating a potential scope for enhanced credibility. Second, transparent and credible policy actions can influence market expectations to stabilize/align their movements with stated policy targets. Further, in situations when a central bank needs to take unconventional policy actions, proper explanation of the rationale for such actions combined with credibility earned beforehand can help the market and other stakeholders to understand the situation and avoid any hasty reaction.

[1] Working Paper Series - These papers present research in progress of the staff members of RBI and the views expressed in these papers are those of authors and not that of RBI.

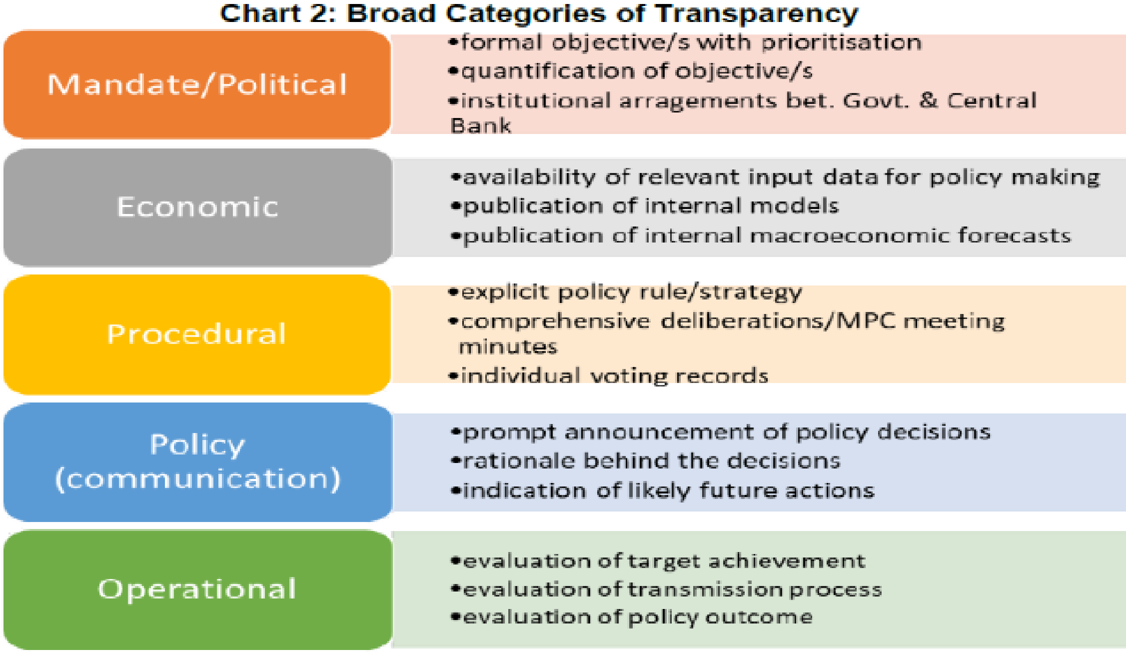
In India, central bank communication, especially related to the monetary policy receives extensive coverage, in print media, social networks and TV channels. RBI's policy decisions and communications on the outlook for the near future are widely sought after, along with the rationale behind such decisions and deliberations. Against this background the authors attempt to:

1. Quantify the monetary policy transparency in India;
2. Understand how the transparency levels evolve; and
3. Examine if transparency facilitated the anchoring of inflation expectations.

The authors achieve this by constructing an index which measures the monetary policy transparency In India. The study constructs a monthly index of transparency (instead of annual estimates) using big data techniques, especially text mining techniques to help in reading of policy statements and other relevant documents instead of complete manual reading. The authors consider inflation forecasts as obtained in the Survey of Professional Forecasters (SPF) and inflation expectations as obtained in the Inflation Expectations Survey of Households (IESH) conducted by RBI in this study.

The authors adopt the analytical framework of Eijffinger and Geraats (2006) for the construction of a monetary policy transparency index for India. The choice of using this framework is primarily driven by the theoretical background, descriptive questions and clarity of scoring mechanism for various questions. The broad categories of transparency are depicted below in a chart as given in the study and sourced from Eijffinger and Geraats (2006).

Chart 2: Broad Categories of Transparency



Source: Eijffinger and Geraats (2006).

To construct the Transparency Index (TRP Index) the authors use the information released by the RBI as contained in the Monetary Policy Statements, Monetary Policy Reports (MPR), Minutes of Monetary Policy Committee (MPC) meetings, erstwhile Macroeconomic and Monetary Developments (MMD) Reports and Minutes of Meeting of Technical Advisory Committee on Monetary Policy (TACMP), together with a few other reference documents. The period for the study is from October 2009 to February 2019. The basic premise of transparency being the release of information to the public, only publicly available documents have been considered in the study - approximately 100 documents, all sourced from RBI website. Since the notion of transparency is subjective and accurate measurement is elusive, the authors estimate a few variants of the TRP Index. These variants are constructed by altering the scores of the relatively more subjective items and re-estimating the index.

Chart 3: Monetary Policy Transparency Index

Source: Authors' calculations.

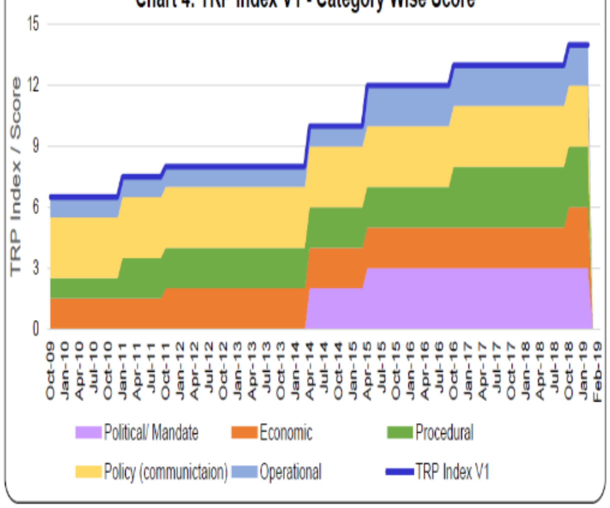
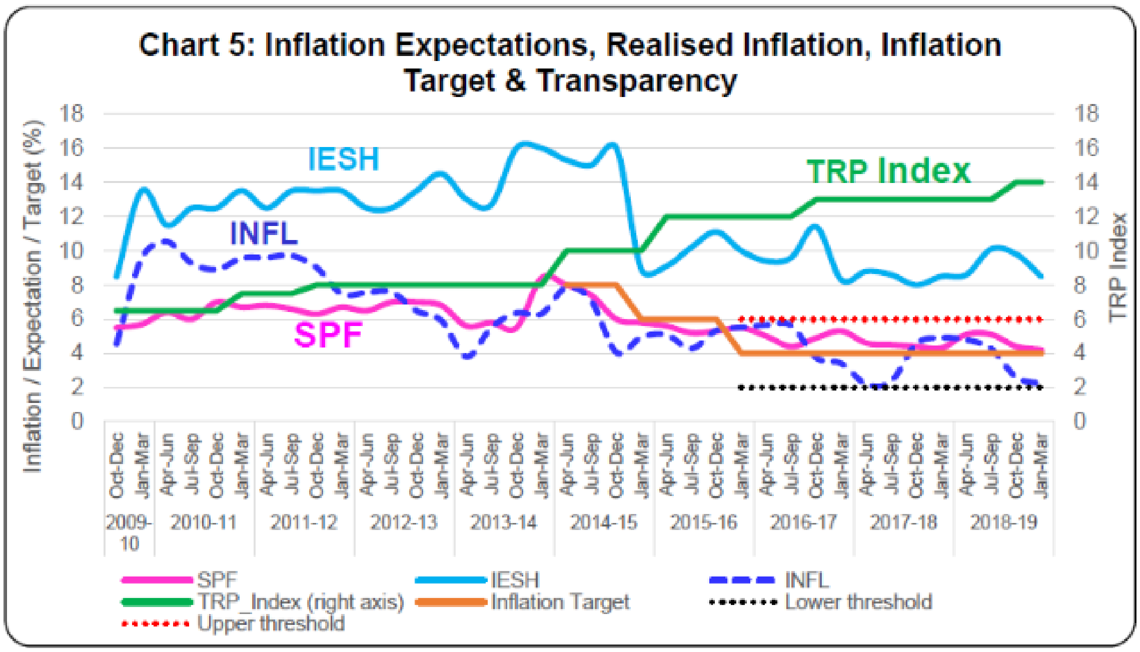


Chart 4: TRP Index V1 - Category Wise Score

Source: Authors' calculations.

The authors note that transparency has increased considerably during the period from a score of 6.5 to 13-14. Notably, transparency has increased significantly in almost all aspects. The score of RBI's monetary policy transparency in the three categories, viz. economic, procedural and policy transparency is good. A full score of three for policy transparency for the entire period under study establishes that RBI has been making efforts for higher transparency even before the adoption of FIT (political mandate aspect). Further, releasing of TACMP minutes was also an additional step towards increasing transparency (procedural aspect), even before there was any formal MPC with voting rights. Publishing the results of monetary policy surveys (economic aspect), as well as providing detailed assessment and outlook for medium-term together with internal macroeconomic forecasts, have been significant steps towards transparency.

After the construction of the Transparency Index, the authors attempt to examine how well the inflation expectations are being anchored in India from time to time, particularly during the period when the degree of transparency remained reasonably stable around a high level. The authors define the three forms of expectation anchoring, viz., weak-form, semi-strong-form, and strong-form. In weak-form, the information set is just realized inflation, and one may examine if expectation adjusts/responds to realized inflation. The semi-strong form examines whether expectations are influenced by realized inflation as well as other information that are publicly available at the time of forecasting exercise. Finally, the strong-form models are concerned with whether the forecasters incorporate any privately available information on top of those covered under weak-or-semi-strong forms.



Source: RBI and Authors' Calculations.

The authors conclude that as India moved towards an inflation targeting regime, the degree of transparency enhanced greatly. Based on the timing and magnitude of changes in the Transparency Index, the authors identify that the study period consists of three distinct transparency/policy regimes: transition, pre-transition and post-transition periods. These transition phases broadly coincide with the periods of RBI's adoption of self-imposed disinflationary glide path since 2014 and implementation of flexible inflation targeting in 2016. Empirical analysis on weak-form suggests that the participants of SPF could anchor their inflation expectations slightly above the central value of inflation target post-adoption of the FIT framework by the RBI and policy transparency index improved substantially. The Households inflation expectations also remained anchored during the same period as their inflation expectations were not so easily affected by realized inflation, though households had anchored their inflation expectations above the upper band of the inflation target. The authors also mention the interesting case of the transition phase when the transparency of the Central Bank improved substantially on a few occasions, both the realized and expected inflation declined in tandem resulting in a case of no anchoring of inflation expectations.

The authors have attempted to quantify an essentially qualitative attribute like the degree of transparency of the Central Bank in this context the Reserve Bank of India. The present study focuses more on the weak form of inflation expectations anchoring and the authors suggest a few directions where the study can be focused on semi strong or strong form of inflation expectations anchoring, or other forms of inflation expectations anchoring like ideally anchored, consistently anchored. Further research can be extended to analyzing the potential benefits of inflation expectations anchoring and the consequences of transparency on lags and magnitude of policy transmission.

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CIN: U67110MH2006PLC165306
A/B1- 801, A Wing, 8th floor, Marathon Innova, Marathon Next Gen Compound,
Off. Ganpatrao Kadam Marg, Lower Parel (w), Mumbai 400013.

Dealing Room: (022) 66202217-20 ● Settlements: (022)66202262-64, Fax (022) 66202288
Delhi Office: (011) 47676555-57 ● Kolkata Office: (033) 40611435-36 ● Bengaluru Office: (080) 42183166/1021Please mail your feedback to stcipd@stcipd.com ● Website: http://www.stcipd.com