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The New Monetary Policy Index : Case Study of the RBI's Monetary Policy

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Abstract

This study attempts to design monetary policy index to capture the stance as well as tools used by the RBI at various points in time in the backdrop of it operating frameworks. The New Monetary Policy Index (NMPI) is primarily based on methodology used by Samantaraya (2009), using both qualitative data as well as quantitative data. Qualitative data is collected through various circulars issued by the RBI from time to time and quantitative data is collected from the RBI's Handbook of Statistics on Indian economy. The choice of monetary policy tools to be included in the index and the weights assigned to the index variables are selected through Principal Component Analysis. To examine the alignment of the NMPI with the actual monetary policy stance, sharp contractions in the index are corroborated with actual data published by the RBI for the periods and compared with inflation, industrial output and bank credit at the time. This gives us positive results for the index designed.

I. Introduction

THE CENTRAL BANK has three main tools of monetary control. They are (a) changing the discount rate (the rate the central bank charges on its loans to banks and other financial institutions), (b) changing reserve ratios (percentage of commercial banks' total deposits liabilities required to be kept in cash with the Central Bank and in liquid assets kept with themselves) and (c) conducting open market operations (buying and selling government bonds to banks and public). Each tool works by changing the excess reserves in the banking system (McConnell and Brue, 2005). When the Central bank takes monetary policy actions, it sets in motion a series of actions in financial markets, which, in turn, lead to changes in spending, production and

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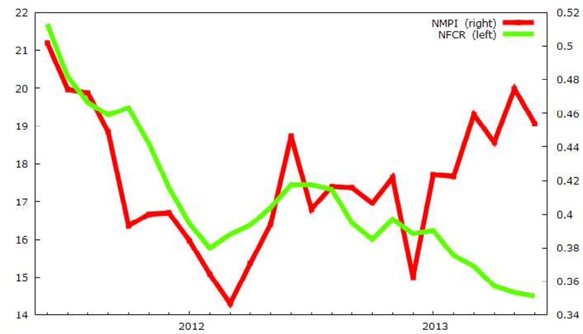

Figure 9
NFCR and NMPI-2011-2013

V. Conclusion

There has been a distinct change in the way the RBI has implemented the monetary policy after 1998 when market-determined instruments were adopted. This paper has developed a monetary policy index (NMPI) across the period 1975 to 2016 which seamlessly overcomes the challenge of changing monetary policy tools over the length of period. The index includes the narrative index as developed by Bhattacharya and Ray (2007), money supply and CRR / the call money rate. The index has adopted the index methodology adopted by Samantaraya (2009). The alignment of the NMPI to the actual monetary policy stance has been examined by identifying the sharp contractions in the index and corroborating them with the RBI annual reports for the periods and juxtaposing with inflation, industrial output and bank credit disbursement. The NMPI appears to represent monetary policy stance across period.

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