



RBI Communications and Monetary Policy: A review of recent measures

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In the second quarter review for FY 2010-11, RBI Governor gave a forward guidance on future policy action. The markets were surprised by this move from RBI. There were mixed reviews from market participants on the need to have this statement in Indian context.

This paper reviews the global central banking practices in central bank communications and tracks recent developments in RBI communication policies. It notes how RBI's communication has become more transparent in recent monetary policies and the recent forward guidance is part of the same process.

Background

Not very long ago, central banking and central bankers were seen as mysterious entities. They were considered important but how central bank conducted monetary policy was not clear even to best economists. Central bankers spoke rarely and whenever they did, it was not understood by again the best economists. There is a very popularly quoted story of Alan Greenspan, former Federal Reserve's FOMC chief. When a senator said that he understood the chairman's comment, Greenspan famously replied: "If you understood what I said, I must have misspoke."

Transparency in central banking communications has gone through significant changes since these famous Greenspan quotes. Some economists even convey that if Greenspan (who retired just 4 years ago) is asked to review central banking communications now, he would think it is a different era all together.

In this new era, Central Bankers have changed their approach completely. The focus now is to be as transparent as possible in their communications strategy. The monetary policy operations remain complex but central bankers take great efforts to explain their actions to the public.

Economics of Transparent Communications

Transparency reduces information asymmetry between the central bank and financial sector intermediaries. Central banks have a comparative advantage because of their institutional design. They not only analyse and monitor trends in economy and financial



but also have access to data which private sector may or may not have. They have huge research departments which look at data in both microscopic and macroscopic manner. Thus, they are in a better position to understand the ongoing trends in an economy. By sharing this information with the financial markets and public, the central banks help reduce this asymmetry. In economics parlance, increased transparency leads to two effects:

- Information effect: As central banks disclose information, they lower the information asymmetry and help the public/financial markets make better decisions. This is the direct impact of increased transparency.
- Incentive effect: This is the indirect impact of increased transparency. As people/financial markets get more information, their incentive structure could change. For example, a new macroeconomic report from the central bank could highlight that inflation trends are expected to be higher. This could lead people to redo their expectations and change their asset portfolio, budgets etc.

Increased transparency has following benefits:

- It improves the predictability of monetary policy actions and outcomes
- It enhances credibility and makes long term inflation expectations more
- The enhancement in credibility induces reputation building of the central bank

Transparency also poses difficulties for central banks. Once, it moves ahead on the path for increased transparency, the question that comes to mind is how much transparency is enough? When should it stop? Then there is always the case of markets interpreting the communication differently from the central bank's intentions and in some cases there can be misjudgment as well (discussed later).

Tools to Increase Transparency in Communications

Central banks mainly communicate with financial market participants. Lately the central banks are focusing on communicating with the general public as well. In recent years, central banks have initiated number of new tools to increase transparency in communications.

These tools can be divided into two broad headings – Monetary Policy Communications and General Communications. In Monetary Policy Communications category, we include all those tools which central banks use to explain the monetary policy actions. Some tools have come up especially because of the 2007 crisis. General Communications includes tools for other aspects of central banking except monetary policy.

- **Statements/ Press conferences after the monetary policy:** Most central banks release statements after the monetary policy explaining briefly the basis of policy actions. These statements are put up on the website immediately after the meeting. Some central banks like ECB release the statement in multiple languages taking care of the



several languages spoken in European Monetary Union. These statements are worded very carefully as market participants parse each word very carefully.

More detailed analysis follows either in the form of minutes (explained below) or is included in the original statement (as in the case of RBI). Some central banks like ECB use the press conference to explain their actions. The President and Vice President of ECB participate in the press conference after the meeting to answer questions and answers from the press.

- ***Minutes of the Monetary Policy Committee:*** This has come out as one of the portent communication tool. Quite a few central banks have started releasing minutes of the monetary policy meeting. These minutes are released at different intervals. Federal Reserve releases minutes after three weeks, Bank of England after two weeks etc. The minutes document the discussions amidst members in the meeting and the background for making the decision. Each central bank has its own way of presenting minutes.
 - FOMC minutes are very detailed. The outlook is presented by both Fed Staff and FOMC members to arrive at a conclusion.
 - Bank of England minutes are neatly structured and less detailed.
 - Minutes of Sweden's central bank MPC highlights views of each member and shows how each member differs in his/her outlook.
- ***Economic Forecasts:*** Central Banks also release their forecasts of economic variables. This helps market participants compare their forecasts with the central bank and possibly change their expectations as well.
- ***Future Policy Guidance:*** Most central banks give forward guidance these days but it is mostly a qualitative statement. This is most carefully read part of the policy statement as it indicates future trajectory.

This has been used especially in the current crisis. As interest rates touched zero, communications was seen as a useful tool to guide market expectations. Quite a few central banks expressed that they would keep interest rates at current low levels till economy recovers. Here also central banks followed different strategies. Fed said it would keep interest rates low for an extended period of time. Bank of Canada said it would maintain its policy rate at 0.25% and added a conditional commitment that it will hold rates till end of the second quarter of 2010. This conditional commitment was removed in April 2010 monetary policy meeting and it raised rates in June 2010 Hence unlike Fed, Bank of Canada was more specific about the time-period till which it will keep the rates low. Bank of Canada has called this as conditional commitment strategy.

Ben Bernanke et al in a research paper said central bank communications play a critical role in zero interest rate regime (Monetary Policy Alternatives at the Zero Bound: An Empirical Assessment, 2004).



- ***Policy interest rate forecast:*** Few central banks like New Zealand, Norway and Sweden have taken a step further and provide a quantitative analysis of the future interest rate outlook. This has generated controversy amidst economists with some saying this confuses market participants in case there are shocks and central banks move the policy rate differently from the expectations.
- ***Internet chatting to explain monetary policy actions:*** This has emerged as another useful tool to explain the policy actions to a wider set of audience. In this the central bank Governor/senior official answers questions posed by the audience via an internet chatting session. This was started by Sweden's central bank in July 2009. Sweden's central bank has further expanded the horizon and has put the videos of press conferences & analysts' meetings together with other films on the bank's operations on Youtube, a website which shares videos.
- ***Mandatory testimonies before Parliament/Congress:*** Federal Reserve Chairman presents semi-annual testimonies to the US Congress in months of February and July. This is mandatory as per Humphrey-Hawkins Act of 1978.
- ***Countryside tours to explain monetary policy actions:*** Bank of England (BoE) took exceptional measures to prevent fallouts from the 2007 crisis. BoE officials undertook a country wide tour to explain its quantitative easing program to the public.
- ***College tours to explain monetary policy actions:*** This has been a common practice as central bankers visit college campuses and education departments to explain about monetary policy to students. Recently, New York Fed President William Dudley explained Federal Reserve's monetary policy in this crisis in several US universities (University at Buffalo, University of Rochester, Cornell University etc.).

General Communications

- ***Speeches:*** Apart from explaining monetary policy, Central bankers give speeches in various forums on variety of economic topics. This helps the audience understand critical issues in areas of economics. Some of the speeches also become hallmarks and set future agenda for research and discussion. Like Ben Bernanke's speech on global imbalances in 2005 generated tremendous interest amidst researchers and policymakers. Likewise his speeches on deflation and Japan in early 2000s are referred to understand the tools Federal Reserve can deploy to avoid the emerging Japan like situation in US currently.
- ***Developing simplified writing:*** This is a measure which helps overall improve transparency. Central banks these days take a lot of interest in simplifying their writing style. The various research reports central banks write, emphasis is on simplifying the content. One can clearly see how the strategy has evolved by comparing older content from central banks. Sweden's central bank even won the



Language Council's Plain Swedish Crystal award. It was awarded for making its reports comprehensible to members of the general public who are interested in reading them. This is a great compliment for a central bank!

Impact of increased transparency

The next set of agenda is to understand whether transparency has influenced market behavior and interest rates in particular. The studies have been limited so far. A leading study by Alan Blinder et al (Central Bank Communication and Monetary Policy: A survey of Theory and Evidence, May 2008) reviews limited studies which have estimated the impact of central bank communications on market expectations. It shows that central bank communications like outlook for the economy and monetary policy have a substantial impact on financial markets. Official statements, reports, and minutes appear to have the clearest and most consistent empirical effects on financial markets. The evidence on the impact of speeches is more mixed.

Christine Fay and Toni Gravelle study the transparency in communications experiences in Bank of Canada (Has the Inclusion of Forward-Looking Statements in Monetary Policy Communications Made the Bank of Canada More Transparent? November 2010). The authors find evidence that press releases, and, to a lesser extent, speeches by Governing Council members, significantly affect near-term interest rate expectations. This indicates that central bank communication conveys important information to market participants. However, the authors' results show that press releases and speeches do not significantly impact market rates over the more recent period. This is the time when forward-looking statements have been used on a regular basis. They find that forward-looking statements have made the Bank's decisions on the policy rate more predictable, but not necessarily more transparent.

The 2007 crisis led to forward guidance by number of central banks on future policy actions (explained above). There have been few initial researches evaluating these communication strategies. Puneet Chehal and Bharat Trehan of San Francisco Fed find that Bank of Canada's (BoC) conditional commitment strategy was effective but so was Federal Reserve's strategy of keeping low rates for unspecified period of time (Talking about Tomorrow's Monetary Policy Today, November 2009). Hence, BoC's strategy was not very different from Federal Reserve's strategy in terms of market impact.

An alternative view emerges from another paper by BoC's economist Zhongfang He (Evaluating the Effect of the Bank of Canada's Conditional Commitment Policy). The research shows that the BoC's conditional commitment has likely produced a persistent effect in lowering Canadian interest rates relative to what their historical relationship with inflation and unemployment rates would imply. However, this finding is not statistically strong and is subject to caveats such as model instability and the dependence of the results on the choice of inflation variable. It is going to be an exciting area of research in future.



RBI and Communications

Recently, RBI has taken number of steps in increasing the transparency in its communications process. Going by the recent developments at RBI, it seems the current RBI Governor Dr. D. Subbarao has taken a special interest in this objective. In an interview with CentralBanking.com (July 2, 2009), the Governor said improving communications at RBI was one of the three things he would like to do in his term. He said “We need to improve communication at both technical and non technical levels”.

Some insights into the increased openness in communication at RBI under the current Governor were obtained from the recent interview of the outgoing Deputy Governor Ms. Usha Thorat. Ms. Throat in an interview with Mint (a financial daily) said on certain matters, the current Governor is emphatic for example, in RBI’s communications. He also wants that RBI should not be seen as an enigma by people and should be accessible in every way.

The above discussion points to the importance RBI is attaching to improving transparency in its communication process. Let us look at the various tools RBI is using to improve its communication process with both financial markets and public.

Monetary Policy Communications

- ***Governor’s Statement after the monetary policy:*** RBI releases a Governor’s statement after the monetary policy. In its first quarter review of monetary policy FY 2009-10, the Governor’s statement was shortened and was simplified for an easier reading. This was welcomed by all market participants. Earlier Governor’s monetary policy statements included most of the analysis in macroeconomic and monetary developments report released previous day. Now the Governor’s statement simply said that “*the Policy Review should be read and understood together with the detailed review in Macroeconomic and Monetary Developments released yesterday by the Reserve Bank.*”

The policy statement also includes fan charts showing probabilities for most likely trajectory of both inflation and GDP growth. So far, RBI gives projections for the current fiscal year. In April 2010 policy, Governor also indicated that RBI would give longer-term forecasts as well in upcoming reviews

- ***Teleconference with Press:*** In the past, RBI Governors interacted with the business press after the meeting but it was limited mostly to Mumbai based media. Now RBI conducts teleconference so that regional media can participate as well from their locations. The telephone numbers are placed on RBI’s website well before the conference which is highly convenient. RBI also publishes a Press Statement from the Governor which is a more concise summary of the overall policy statement.



- **Teleconference with Researchers/Analysts:** This is another novel initiative started by RBI. From the third quarter review of monetary policy review for 2009-10 (held on January 29, 2010), RBI has started organizing a teleconference with financial market researchers/analysts. The conference is attended by the senior staff of RBI and questions are answered with respect to the current policy and actions taken. This has generated a lot of interest amidst researchers as it is an opportunity to interaction with senior RBI officials and also helps understand the policy better. RBI also publishes the transcripts of both the teleconferences which serves as a useful document for future research purposes.
- **Increase in monetary policy reviews:** Earlier, RBI's policy was a quarterly event. However, with increased global uncertainty and RBI taking actions before monetary policy (in March-2010 and July-2010), RBI has decided to hold four mid-term reviews in addition to the four policy meetings. The reviews will be held in March, June, September and December respectively. This has led to reduction in uncertainty over pre-policy actions.
- **Forward Guidance Statement:** This is the latest tool deployed by RBI. In its September-2010 review RBI added a statement on its future policy actions:

The Reserve Bank believes that the tightening that has been carried out over this period has taken the monetary situation close to normal. Consequently, the role of normalisation as a motivation for further actions is likely to be less important. Current and expected macroeconomic conditions will be the more important considerations going forward.

In October 2010 policy, RBI further made a forward guidance statement:

Based purely on current growth and inflation trends, the Reserve Bank believes that the likelihood of further rate actions in the immediate future is relatively low. However, in an uncertain world, we need to be prepared to respond appropriately to shocks that may emanate from either the global or domestic environment.

Both these statements generated frenzy amidst market participants and media as RBI had started giving a clear guidance to its future market actions. In September it said policy rates are close to normal and future action will depend on the macroeconomic conditions going forward. In October, it said based on current economic trends, probability of rate actions in future is low. However if economic situation is different from the expected scenario, RBI can take actions.

Some market participants have interpreted the forward guidance statement as confusing and unwanted given the volatile economic situation. However, this may not necessarily be a right interpretation. As we show above, this was part of the



overall transparency process RBI has been undertaking in the tenure of current RBI Governor.

Infact, it is in uncertain times that market participants need guidance from the central bank on its actions. RBI has been increasing rates since March-2010 and there was a need to wait and let the transmission work. Monetary policy works with a lag and in Indian condition the lag is higher given the inefficient financial system. We have seen transmission process has actually slowed even more since the crisis started in 2008. First as RBI cut rates sharply banks did not cut rates as sharply. And when RBI started to raise rates, banks have been reluctant to raise their lending and deposit rates again hindering the transmission. Inflation remains high but is again a structural issue as supply has not kept pace with rising demand. The core inflation which is impacted more by RBI actions has seen some moderation recently. Hence, RBI said in its guidance that given the situation and rates back to normal there is a low probability of increases in policy rate.

Other Policy Communications

- ***Financial Inclusion and Literacy:*** Financial Inclusion and literacy have always been at the centre of RBI's functions. In order to make improve the state of financial inclusion a number of initiatives have been taken.
 - It has released comic books in several languages to explain key concepts of finance to general public.
 - RBI officials are doing a "financial outreach" programme, under which it will take stock of the financial condition of 200-odd villages in about eight months — a first-of-its-kind initiative from the central bank.
 - In another initiative, RBI has tied up with Karnataka Government and has developed syllabus on financial literacy for classes V, VII, VIII and IX. This revised syllabus would apply from academic year 2010-11.
- ***Others:*** There is an overall improvement in the way RBI has been presenting its several reports and information with the public. This is in line with the global trends highlighted above.

Concluding Thoughts

The above analysis tracks the recent initiatives taken by central banks to improve transparency in their communication process. The paper also explores the recent changes done by RBI to improve its communication process and finds the changes are in line with global central banking. The process is continuous and we are likely to see more additions to RBI's communication tool-kit in future. Just like other central banks, RBI may also consider in future, releasing minutes of its monetary policy meetings and also provide quantitative assessment of its forward guidance. All this augurs well for Indian central bank watchers and market participants.



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