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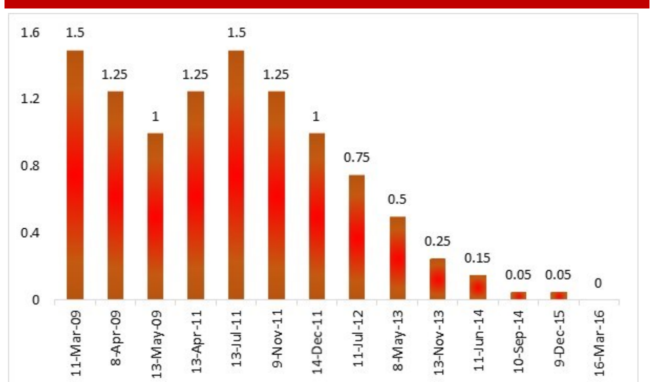
DOES MOVING AWAY FROM 25 BPS CHANGES SIGNIFY RBI INTENT TO USE COMMUNICATION AS A POLICY IN ITSELF?

RBI Governor has recently stirred a debate on whether the time is now apt to challenge the conventional wisdom of a rate change in multiples of 25 bps. Instead, the size of the rate change could be calibrated in small or larger magnitudes to indicate policy stance. We believe such thinking signifies the RBI intent to use communication as a policy in itself rather than being the policy statement being the vehicle for communication. **These are akin to second generation policy signals that Fed provides to the market now.**
Interestingly, drawing from the US experience during the crisis, such second generation policy signals reduce disconnect with markets. For example, the Fed had realized that its repeated announcement of keeping rates low '***for an extended period' during financial crisis'*** led markets to reach a certain inference on what ***'extended period'*** could mean. In this context, it was argued that Fed could modify the language of the statement to communicate to investors that it anticipates keeping the target Federal Funds rate low for a longer period than was currently priced in the markets. This, it was believed, would have eased financial conditions as was desired at that time. In the same vein, RBI could use the rate change in non multiples of 25 bps as a first step towards providing second generation signals to market of future policy stance. The next step could be replacing say "for an extended period" with precise date. However, the problem of rate cuts of smaller magnitude could be of policy transmission and clarity in communicating with markets unless properly decoded. For example, can we also not think of a rate hike / cut of even more than 50 bps? Alternatively, can we then have a table of rate changes mapped to policy stance just as rating agencies do? There are all questions that need to be answered!
China has been experimenting with rate changes that are not in multiples of 25 bps, but it was abandoned in Oct'10 (Only on 2 occasions, after 2010 the rate change was not in multiple of 25 bps!) The ECB has also changed rates in lower multiples of 25 bps though Fed rate changes are in multiples of 25 bps. The advantages of a 25 bps construct as believed is the simplicity of connecting with market!

OUT OF BOX THINKING: WHY BABY STEPS

- RBI Governor has recently raised a point of discussion by saying that if the unit of 25 bps is not sacrosanct and just a convention, monetary policy can be well served by calibrating the size of the policy rate to the dynamics. Basically, Governor is indicating whether a 10 bps reduction of rate can communicate the intent of the regulator, why should there be a need for wasting 15 basis point of rate action. Interestingly *SBI Research in its 27 March 2014 research report titled " Rate hike of smaller magnitude?" had indicated the fact that rate change may be of smaller magnitude also.*
- The intent of the Governor looks quite positive but seems to be futuristic as well. However, in a scenario, where a rate cut of 25 bps or sometimes even a 50 bps of audacious rate cut is not able to initiate a transmission of rate cut, how an indicative rate cut of 10 or 15 bps will work?
- Further, if we look at some of the advanced economies, ECB does changes rates by non multiples of 25 bps. However, Fed has been making the changes in round number of 25 bps or more in every move. The advantages of a 25 bps policy changes or in multiples thereof is the clarity in communication with markets. Rate changes of odd magnitude could be difficult to connect with markets unless properly decoded.
- For example, can we not think of a rate hike / cut of even more than 50 bps? Alternatively, can we have a table of rate changes mapped to policy stance just as rating agencies do? These are all questions that need to be answered!

Graph 1: ECB Rate(%)



Source: SBI Research

Hypothetical Rating Scale Mapped to Stance

Rate Cut of	Stance
15 bps	Least Accommodative
25 bps	Moderately Accommodative
35 bps	Accommodative
45 bps	More Accommodative
55 bps	Most Accommodative

Source: SBI Research

- Looking at China's Central Bank, for the 34 times since May'96 that it either cut or raised its benchmark lending rate, it is only from Oct'10 that it has started using the 25 bps figure for moving its rate. Before that 27 bps was the number of choice. Also China has not hesitated from choosing unconventional numbers like 18 bps, 54 bps, 144 bps etc. It all depends on the magnitude that will do the trick.

Bank of China Benchmark Lending Rate Movement	
bps Change	Number of times
90	1
144	1
72	1
99	1
54	3
27	10
18	3
108	1
25	11
31	1
40	1

Source: SBI Research

COMMUNICATION IS THE KEY

- If we look at central banks across the world, monetary policy communications can be grouped into 4 categories.
- ***First,*** indirect signals, such as a balance-of-risk statement or a risk scenario showing how much inflation would deviate from the target, if policy rates were kept unchanged.
- ***Second***, direct qualitative / first generation signals—for example, the policy 'bias' statement used by the Fed for a short period in the late 1990s. This type of guidance can also include phrases indicating that policy accommodation "can be maintained for a considerable period" or "can be removed at a pace that is likely to be measured." The ECB use of such code words as "strong vigilance" also belongs in this category.
- ***Third***, direct quantitative signals, such as the explicit numerical projections for the policy rate published by the central banks of New Zealand, Sweden, Norway, Iceland and the Czech Republic.
- ***Fourth***, the BoC's calendar-based (time-contingent or date -based) "second generation signals" of extraordinary guidance. Such guidance provides exact information to the markets and the public about how the date of exit may change in response to new economic information.
- Interestingly, In August 2011, the Fed emulated the BoC approach. It enhanced its guidance, which until then had stated that the federal funds rate (FFR) would likely stay at exceptionally low levels for "some time" or "for an extended period," by replacing the latter with "at least through mid-2013." Simultaneously, to make its objectives clearer, in January 2012, the FMOC released a Statement on Longer-Run Goals and Monetary Policy Strategy.

COMMUNICATION SHOULD BE POLICY ITSELF FOR RBI

- In the Indian context, the RBI typically provides first generation signals in its policy statement.
- We believe the RBI may think of providing "**second generation signals**" in its policy statement. This will reduce the disconnect with market expectations in the subsequent press conference with researchers and analysts.
- Sometimes, communication, instead of being a vehicle for policy, can be the policy itself. Drawing yet again from the US experience during the crisis, the Fed realized that its repeated announcement of keeping rates low 'for an extended period' led markets to reach a certain inference on what 'extended period' could mean. In this context, some policy analysts argued that a step that the Fed could consider was to modify the language of the statement to communicate to investors that it anticipates keeping the target Federal Funds rate low for a longer period than was currently priced in the markets. This, it was believed, would have eased financial conditions as was desired.
- **In the same vein, RBI could use the rate change in non multiples of 25 bps as a first step towards providing second generation signals to market of future policy stance. The next step could be replacing the "for an extended period" with precise date. However, the problem of rate cuts of smaller magnitude could be of transmission.**
- **We also expect that let the Governor always speak**. Too many voices may create a cacophony (Blinder, 2008).

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