Does forward looking Taylor rule forecast Indian data well?

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Abstract

Forward looking Taylor rule bodes well for many inflation targeting economies. This paper looks at forecast accuracy and predictive efficiency of a forward looking Taylor rule for India especially after its adoption of flexible inflation targeting in 2015. Our analysis shows that a forward looking Taylor rule fits well for India, especially when augmented using an external benchmark like the exchange rate or the US monetary policy. Using generalized method of moments (GMM) technique a la Clarida et al (1998), we analyze the forecasting efficiency of the Taylor rule using three interest rates namely, weighted average call money rate (WACMR), 91-day treasury bills rate and 364-day treasury bills rate. The 364-day treasury bills rate provides the best estimate of Taylor rule. It is the only interest rate that is significantly influenced by the output gap. Reserve Bank of India (RBI) follows a forward looking Taylor rule during normal times. It deviates from the rule during crises as it did for Asian and global financial crises.

Keywords: Monetary policy, Monetary policy reaction function, Taylor Rule
JEL Classification: E31, E52, E58

1. Introduction

Since the seminal publication by Kydland and Prescott (1977), the debate on rule-based vs. discretionary monetary policy has held a significant importance in monetary policy debates. Taylor (1993), a strong supporter of rule based policy provided a simple interest rate rule which is shown to be followed by many central banks directly or indirectly. In a series of seminal papers, Clarida, Gali and Gertler (1998, 1999, 2000), CGG henceforth, developed rules for optimal monetary policy.

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