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The Quest for Optimal Monetary Policy Rules for India

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Abstract

In the backdrop of adoption of inflation targeting framework, this paper computes optimal monetary policy rules for India conditional upon a small model of the economy covering the period 2000-2014. Weights to policy rules are developed by minimizing alterative inter-temporal loss functions defined over the variance of inflation, output and policy instrument from their respective targets. An optimal policy rule with the ratio of weight on output gap to inflation gap higher than in the standard Taylor rule and a flexible inflation targeting framework turns out to be welfare maximising for India. Lower interest rate smoothing or quicker monetary policy responses than estimated from the past data may be warranted to increase society's welfare. While a policy rate in the range of 6.25-6.70 appears to be best suited under the macroeconomic situation prevailing during 2015-16, rates lower than 6.25 per cent would lie outside the policy efficiency frontier.

JEL Classification: E47, E52, E58

Keywords: Aggregate demand; Aggregate supply; Monetary policy; Optimal policy rule

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