

The Interest Rate Channel of Monetary Transmission Mechanism in India: An Empirical Study

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With the deregulation of interest rates in India, it is expected that the traditional channel of monetary transmission mechanism, which is the interest rates channel, will be revitalized. The present study examines the monetary policy transmission through the interest rates by analyzing the interest rates pass through within the spectrum of interest rates. In the process the pass through of the policy signal among select short term rates and long term rates was carried out, using Ordinary Least Square (OLS) approach. The results reveal that the transmission of a monetary policy signal is incomplete. It can be concluded that while some transmission of the monetary policy signal takes place in the short run, the policy impulses get lost in the long run.

I Introduction

Monetary policy is a powerful tool, but it has unwarranted consequences. To be successful in conducting monetary policy, the concerned authorities need to have a precise assessment of the effects and the timing of the required policies. This necessitates a sound understanding of the mechanism with which monetary policy affects the economy. Monetary transmission mechanism is a description of the means of how changes in monetary policy - a change in central bank interest rates or in money supply - transmit into the domestic economic activity and domestic inflation. While the literature on monetary transmission mechanism throws light on a number of channels, the interest rate channel has emerged as the traditional channel. As the determination of interest rates is dependent on the demand for and supply of money, monetary policy influences the structure of interest rates through its impact on money supply. The rate of interest, in turn, influences the volume of investments

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