

Abstract

Monetary transmission refers to a process through which changes in the policy instrument(s) get translated into the ultimate objectives of inflation and growth passing through some intermediate process. Literature on monetary transmission in India is still in a nascent stage, which makes our study relevant. In this thesis, we have examined three issues: (i) development and extent of integration in the domestic financial market in India, (ii) evidence of interest rate channel of monetary transmission, and (iii) the impact of liquidity on the interest rate channel of monetary transmission.

We first test for cointegration in the financial market, and then estimate a quarterly Structural Vector Auto Regression (SVAR) model for the 16 year period from 1999-2000:Q₁ to 2014-15:Q₄ in three variables: (i) policy rate, (ii) GDP growth rate and (iii) headline inflation rate broadly in a New Keynesian framework. Empirical results showed a single cointegrating equation between short-term interest rate, yield on government security and bank lending rate suggesting the first stage of interest rate channel of monetary transmission from the policy rate to the broader financial markets.

Our SVAR model showed that changes in policy rate has a negative relationship with growth and inflation. It first impacts GDP growth with a lag of two quarters, which persists till the 7th quarter. Once growth is impacted inflation gets impacted from the 3rd quarter and persists till the 8th quarter. Thus, the full impact of monetary policy action on growth and inflation persists for two years. At its peak, a one-percentage point increase in policy rate shaves off ½ percentage point each from growth and inflation. Further, liquidity deficit strengthens monetary transmission. At a shorter lag length, policy rate has a relatively stronger impact on output than on inflation. While we observed a trade-off between growth and inflation in the short-run, in the long run lower inflation has a positive impact on growth. In the Indian context, our findings validate the conventional belief in monetary economics that price stability fosters sustainable growth.

The findings of this research provide robust evidence that interest rate channel of monetary transmission is effective, lending support to the current framework of monetary policy in India, which relies on interest rate (repo rate) as the principal instrument of monetary policy.