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RBI study on Role of Bank lending channel in Transmission of Monetary Policy

The Reserve Bank of India has today published a study titled "Transmission of Monetary Policy and the Bank Lending Channel: Analysis and Evidence for India" co-authored by Prof. B.L.Pandit of Delhi School of Economics along with three internal team members under the aegis of the Development Research Group (DRG). The study attempts to characterise the process of monetary policy transmission in India and crystalise the role of bank lending channel, employing both published and unpublished data broadly covering the period 1993-94 to 2002-03. Development Research Group (DRG) is constituted in the Reserve Bank's Department of Economic Analysis and Policy undertakes quick and effective policy-oriented research backed by strong analytical and empirical basis on subjects of current interests. The study was undertaken in the context that the understanding of the process of transmission of monetary policy is a critical input for its designing and implementation. In a country like India, the economic structure is undergoing crucial transformation through changes in both intersectoral primacy and intersectoral linkages. The processes of economic liberalisation and prudential regulation of the financial sector are underway. The financial sector is changing in terms of its competitiveness, depth and spread. As a result, macroeconomic environment and financial structure are both changing. Consequently, channels of monetary policy transmission are evolving continuously.

The results of the study can broadly be summarised as follows: First, the analysis suggests that there is not much difference between Cash Reserve Ratio (CRR) and Bank Rate as alternate policy instruments. However, on the basis of plausibility of relationships as given by the impulse response functions, CRR seems to perform relatively better *vis-à-vis* the Bank Rate. Second, the results support the existence of a bank lending channel in India. And finally, the lending behaviour of big and small banks differs in response to a policy shock. In particular, small banks are more acutely affected by contractionary monetary policy shocks as compared to big banks.

The results have important implications for policy. First, the existence of a bank lending channel in the Indian context would imply that the central bank, while formulating the monetary policy, is likely to encounter independent shifts in the loan supply. These changes in bank loan supply would also induce changes in bank portfolios. Second, evidence seems to point to the fact that large banks with a wider resource base can more successfully insulate their loan supply from contractionary policy shocks *vis-à-vis* small banks. This would imply that bank mergers and other moves towards consolidation in the banking sector, which are likely to lead to creation of bigger banks, have implications for the efficacy of the monetary policy. Third, despite the gradual scaling down of CRR and the Bank Rate, quantitative instruments like the CRR continue to be important along with the price instruments like Bank Rate. This is primarily so in a medium-term framework, adopted in the present study. Finally, prudential regulations have an important role to play in influencing lending decisions of banks. In particular, the institution of capital adequacy ratios has made banks more concerned with the risk-return profile of loans, since additional lending warrants augmenting of capital-base in order to adhere to the regulatory capital standards.

This study is available on the Bank's website (www.rbi.org.in) under publications.

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