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वेबसाइट : www.rbi.org.in/hindi

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ई-मेल email: helpdoc@rbi.org.in
संचार विभाग, केंद्रीय कार्यालय, एस.बी.एस.मार्ग, मुंबई-400001

DEPARTMENT OF COMMUNICATION, Central Office, S.B.S.Marg, Mumbai-400001

फोन/Phone: 91 22 2266 0502 फैक्स/Fax: 91 22 22660358

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Estimating Impacts of Monetary Policy on Aggregate Demand in India

The Reserve Bank today placed on its website a Working Paper titled "[Estimating Impacts of Monetary Policy on Aggregate Demand in India](#)" under the RBI Working Paper Series. The paper has been authored by Shri Jeevan Kumar Khundrakpam.

There seems to be a general consensus that monetary policy affects real economy at least in the short run. The manner and channels through which monetary policy influences output and prices is, however, still an open and unsettled issue. Given the near unanimity on its short-run impact on the real economy, it is important to understand which sectors of the economy feel its impact the most. Another important aspect in this context is whether or not the impact is uniformly felt across all components of aggregate demand. For instance, macroeconomic implications of reduction in aggregate demand due to slowdown in investment following monetary tightening would be different than those due to the reduction on account of slowdown in consumption demand.

The paper has made an attempt to estimate the effect of monetary policy (change in interest rate) on various components of aggregate demand, namely, private consumption, government consumption, investment, exports and imports in India. This is done using a structural VAR model on quarterly data from 2000Q1 to 2011Q1.

The findings of the paper indicate that –

- An interest rate hike has a significant negative impact on the growth of aggregate demand. However, the maximum impact is borne by growth in investment demand and in imports.
- Impact on private consumption growth and exports growth is relatively far more subdued, while there is hardly any cumulative impact on growth of government consumption.
- Interest rate accounts for a significant percentage of the fluctuation in the growth of all the components of aggregate demand, except government consumption, while exchange rate has very little impact.
- In addition, interest rate channel completely dominates exchange rate channel in monetary transmission, though the latter channel has non-negligible impact on investment and imports.

Note: The Reserve Bank of India introduced the RBI Working Papers series in March 2011. These papers present research in progress of the staff members of RBI and are disseminated to elicit comments and further debate. The views expressed in these papers are those of authors and not that of the Reserve Bank of India. Comments and observations may kindly be forwarded to authors. Citation and use of such papers should take into account its provisional character.