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Evidence of Interest Rate Channel of Monetary Policy Transmission in India

How interest rate actions and liquidity operations of the central banks impact desired objectives of monetary policy in terms of inflation and growth depends on the underlying monetary transmission. During last two decades, substantial research efforts have been devoted to understanding the monetary transmission mechanism, especially in developed nations. In the absence of any unique mechanism, several theories have been postulated and multiple channels are observed in the literature. However, such exploration has been limited in emerging economies. In this context, [this paper](#) provides empirical evidence of interest rate channel of monetary policy in India.

With the development of domestic financial markets and gradual deregulation of interest rates, monetary policy operating procedure in India in the recent years has evolved towards greater reliance on interest rates to signal the stance of monetary policy. This process is buttressed by significant evidence that policy rate changes transmit through the term structure of interest rates, though the intensity of transmission varies across financial markets. Following a quarterly structural vector auto-regression (SVAR) model, this paper finds evidence that policy rate increases have a negative effect on output growth with a lag of two quarters and a moderating impact on inflation with a lag of three quarters. The overall impact persists through 8-10 quarters. These results are found to be robust across alternative specifications with different measures of output, inflation and liquidity. Moreover, significant unidirectional causality was found from policy interest rate to output, inflation and various measures of liquidity except broad money (M_3), underlining the importance of interest rate as a potent monetary policy tool.

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