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Monetary Policy Transmission Faster When Monetary System is in Deficit Mode

The Reserve Bank of India today placed on its website a Working Paper titled "Financial Development and Monetary Policy Transmission across Financial Markets: What Do Daily Data tell for India?" under the RBI Working Paper Series. The paper has been authored by Dr. Partha Ray and Shri Edwin Prabu.

Developed and integrated financial markets are pre-requisites for effective and credible transmission of monetary policy impulses. The more integrated financial markets are, in all likelihood the more would be the strength of monetary transmission across financial markets. It is in this context that this study looks into the extent of market integration and its implication for monetary policy taking the daily data for the period from January 2005 until November 2012.

In specific terms, the paper analyses two distinct but inter-related issues: (a) the extent of integration among different segments of financial markets; and (b) impact of monetary policy on financial markets. The markets considered are: (i) money market (comprising the call money, the collateralised borrowing and lending obligation (CBLO) and the market repo markets); (ii) bond market (comprising Government securities and corporate bonds markets); (iii) forex market (proxied by exchange rate); and (iv) stock market (viz., NSE Nifty).

Using a structural vector autoregression (SVAR) model and imposing identifying restrictions from behavioral patterns of the Indian financial markets, the study finds that the impact of monetary policy on the financial markets differs considerably across four periods classified based on the liquidity position in the system. The transmission of monetary policy works well in the call money rate, as it is impacted immediately with robustness. As regards other financial market variables, except for the stock market, the study could find evidence of transmission from the monetary policy shocks.

Within the sample period of 2005-12, the study finds a distinct pattern of impact of monetary policy on financial markets depending on the stance of the monetary policy (i.e., whether it is expansionary or contractionary). The following results are highlighted in particular:

- First, the transmission was swift and persistent for the period June 2010 to November 2012, when the liquidity was in deficit mode and the monetary policy was tightened.

- Second, the transmission was also exhibited in the period January 2005 to November 2006, when the liquidity was in surplus mode but monetary policy was tightened due to inflationary pressures.

- Third, transmission was not on the expected lines for December 2006 to November 2008 period and December 2008 to May 2010 period, perhaps on account of measures initiated during global financial crisis.

The evidence thus indicates that monetary policy transmission to financial markets in India is asymmetrical – it is faster and persistent when the monetary system is in deficit mode, than when it is in expansionary phase.

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 the Reserve Bank and are disseminated to elicit comments and further debate. The views expressed in these papers are those of authors and not those 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.

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Director

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