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RESERVE BANK OF INDIA

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**RBI Working Paper Series 9 / 2012****Impact of monetary policy actions on inflation is modest and subject to lags**

The Reserve Bank of India today placed on its website a Working Paper No. 9 / 2012 titled "[Monetary Transmission Mechanism in India: A Quarterly Model](#)". The Working Paper has been written by Shri Muneesh Kapur and Shri Harendra Behera.

The paper "Monetary Transmission Mechanism in India: A Quarterly Model" examines the impact of monetary policy actions on growth and inflation. Given the volatility emanating from the agricultural sector, the paper models both overall growth and overall inflation as well as non-agricultural growth and non-food manufactured products inflation, i.e., components stripped of the influence from the agricultural sector and which are more amenable to monetary actions. The paper also estimates the impact of oil prices, real exchange rate and fiscal variables on growth and of exchange rate and minimum support prices on inflation.

Model simulations show that a one-quarter 100 basis points (bps) increase in the nominal effective policy rate leads to a peak reduction of 40 bps in non-agricultural growth (with a lag of 2 quarters) and of 25 bps on non-food manufactured products inflation (with a lag of 5 quarters). The results are sensitive to alternative measures of real interest rate. The estimates of interest rate on growth and inflation presented in the paper are average coefficients and the actual impact of monetary policy actions on growth and inflation would, inter alia, depend upon the stage of the business cycle and liquidity conditions.

Overall, the results indicate that the interest rate channel is effective in the Indian context and the magnitude of the impact on growth and inflation is comparable to that in major advanced and emerging economies. However, the evidence for both India and other countries suggests that the impact of monetary policy actions on inflation is modest and subject to lags. Despite the monetary tightening by the Reserve Bank of India during 2010 and 2011, inflation remained high and this could be attributed to the structural component of food inflation as well as the surge in international commodity prices beginning the second half of 2010 and continuing into the first half of 2011.

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 please be forwarded to authors. Citation and use of such papers should take into account its provisional character.

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