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Monetary Policy Transmission in India : A Peep Inside the Black Box

The Reserve Bank of India today placed on its website a Working Paper titled "Monetary Policy Transmission in India : A Peep Inside the Black Box". The Working Paper has been written by Shri Jeevan Kumar Khundrakpam and Shri Rajeev Jain.

Monetary policy transmission is a process through which monetary policy decisions affect the economy in general and the price level in particular. It is a complex process, wherein the transmission of policy actions to market interest rates and further to real sector may proceed through several channels. Therefore, monetary policy transmission mechanism is still considered to be a "*black box*". In this context, this paper, using SVAR models on quarterly data for 1996-97:1 to 2011-12:1, examines the relative importance of various transmission channels of monetary policy to output growth and inflation in India.

The paper finds that external exogenous factors prolong the impact of monetary policy transmission on GDP growth and inflation in India, while removing the problem of '*price puzzle*'. Among the various channels of transmission, interest rate channel, credit channel and asset prices channel are found to be important, while exchange rate channel is weak. A positive shock to policy rate leads to slowdown in credit growth with a lag of two quarters and subsequently impacts GDP growth and inflation negatively. The same monetary policy shock has a negative impact on asset prices from the third quarter onwards and, in turn, has a pronounced negative impact on GDP growth and inflation. Exchange rate channel is found to have an insignificant impact on GDP growth, but has non-negligible impact on inflation. Interest rate channel is found to account for about half of the total impact of monetary shocks on GDP growth and about one-third of the total impact on inflation, indicating that interest rate channel is the most important channel for monetary policy transmission in India.

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.

Alpana Killawala
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