प्रेस प्रकाशनी PRESS RELEASE

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October 31, 2012

RBI Occasional papers Vol. 32 No. 2 : Monsoon 2011

The Reserve Bank of India, today released the Monsoon 2011 issue of its Occasional Papers. Occasional Papers, a research journal of the Reserve Bank, contains contributions of its staff and reflects the views of the authors. This issue is woven around some important themes which have been at the forefront of policy discussions. The issue contains following articles, special notes and book reviews.

How Asymmetric is the monetary policy transmission to financial markets in India?

The paper titled "*How Asymmetric is the monetary policy transmission to financial markets in India?"* authored by Bhupal Singh examines a key question regarding the existence of asymmetries in the transmission of monetary policy to financial market. The author discusses as to how the same magnitude of policy rate change causes varied impact on financial asset prices during different phases of policy cycle, varied liquidity conditions and across the spectrum of maturity. Using a sample period of 2001:M3 to 2012:M6, the author estimates responses of various financial asset prices to policy shocks in a dynamic framework using a vector autoregression (VAR) model. The empirical estimates suggest that short end of the financial market exhibits a significant and contemporaneous (instantaneous) pass-through in between 40 to 75 basis points in response to a percentage point change in the monetary policy rates. The magnitude of contemporaneous as well as lagged pass-through, however, differs significantly depending on the state of liquidity conditions in financial markets as also the cycle of monetary policy. Significant asymmetry is observed in the transmission of policy rate changes between the surplus and deficit liquidity conditions, particularly at short end of financial markets, suggesting that maintaining suitable liquidity environment is critical to yielding improved pass-through. There is also considerable asymmetry found in the transmission of monetary policy to financial markets depending on the tightening or easing cycles of monetary policy, which suggests the criticality of attaining a threshold level for the policy rates under each cycle to have desired pass-through impact on spectrum of financial markets.

Industry Effects of Monetary Transmission Mechanism in India: An Empirical Analysis of Use-based Industries

The paper titled "*Industry Effects of Monetary Transmission Mechanism in India: An Empirical Analysis of Use-based Industries*" by Sarat Dhal evaluates the industry effects of monetary policy on disaggregated monetary transmission mechanism. The study uses vector auto regression model and monthly data from 1993 to 2011 pertaining to output growth of five use-based industries, call money rate and WPI inflation rate for evaluating the transmission mechanism. The empirical analysis shows that following a tight money policy shock, the output growth could be affected more for consumer durables and capital goods than basic, intermediate and consumer non-durable goods. The cumulative moderation in output growth following a tight policy could span over 2 to 5 years for capital goods, consumer durables and basic goods. Intermediate and consumer non-durable goods could show a relatively moderate transient response and transmission lag could be evident only for the consumer non-durables.

Estimating Value at Risk using Filtered Historical Simulation in the Indian Capital Market

In a paper titled "*Estimating Value at Risk using Filtered Historical Simulation in the Indian capital market*", Indrajit Roy estimates Value at Risk (VaR) of the daily return of Indian capital market (SENSEX/NIFTY) using Filtered Historical Simulation (FHS). Covering the period January 2003 to December 2009, the author uses GARCH framework to model the volatility clustering on returns and examines the usefulness of considering lag values of return (on S&P 500, INR-EURO INR-USD exchange rate, gold price) as proxies of global financial condition in the specification of the mean equation. The VaR is estimated based on two approaches. In the first approach, the mean equation of daily return in Indian capital market is captured by its own lag and daily return of S&P-500, INR-EURO, INR-USD exchange rate and gold price; while volatility is modeled by GARCH model and finally the VaR is estimated through FHS. In the second approach, the mean equation is being captured by ARMA model, while volatility is modeled by GARCH model and finally the VaR is estimated through FHS. It is observed that VaR estimated using GARCH with suitable mean specification outperforms VaR estimated based on ARMA-GARCH method.

Special Notes

In a note on "*Regional Inequality in Foreign Direct Investment Flows to India: The Problem and the Prospects*", Atri Mukherjee examines the major determinants affecting regional distribution of FDI flows in India. Based on the panel data analysis, covering period 2000-01 to 2010-11, the author reveals that market size, agglomeration effects and size of manufacturing and services base in a state have significant positive impact on FDI flows. The impact of taxation and cost of labour is negative. While the impact of quality of labour is ambiguous, infrastructure, however, has significant positive influence on FDI flows. With the presence of a strong agglomeration effect, it is essential to have a conscious and coordinated effort at the national and the state government level to make the laggard states more attractive to FDI flows.

Another note titled "*Financial Inclusion - IT as enabler*" by Sanjeev Kumar Gupta emphasises that technology can play an important role in reducing operating cost of providing banking services, particularly in the rural and unbanked areas. There are technologies that could drive the growth in financial inclusion. The note outlines major steps which have been taken so far by the Reserve Bank and Government of India to enable financial inclusion for weaker sections of Indian society. The efforts made by the Reserve Bank in this direction so far, role of Information and Communications Technology with focus on Mobile Banking and finally the Unique Identification (UID) number are discussed in detail in the note. The author argues that the enrolment to UID and UID enabled bank account will be a game changer in the entire process of financial inclusion plan.

Book Reviews

N. C. Pradhan reviews a book titled "*The New Gold Standard: Rediscovering the Power of Gold to Protect and Grow Wealth*" by Paul Nathan and published by John Wiley & Sons, New Jersey, USA.

The author of the book believes that under a revived new gold standard, there is no need for a central bank of last resort. As long as the market is free to operate under the rules of the gold standard, the conditions that lead to the kind of excessive leverage we have in today's world, could never happen. It is argued in the book that the gold standard cannot prevent monetary or economic crises but it prevents the kind of debt and leverage levels we see in today's world. The author argues that a country, prepared to go on a gold standard, would have to carry out many reforms. For instance, the US federal government may have to stop inflating, balance its budget, and abandon welfare programs which are somewhat politically difficult. The book also provides guidance on how a gold standard can strengthen the dollar, reduce debt, and help stabilise the economy, offering practical strategies for investing in gold.

Avdhesh Kumar Shukla reviews a book titled "Borderless Economics: Chinese Sea Turtles, Indian Fridges and the New Fruits of Global Capitalism, authored by Robert Guest and published by Palgrave Macmillan, New York.

The book provides new insights on the multidimensional impacts of migration on global economy. The book suggests that the economic impact of migration is direct and very effective, unlike foreign aid, which is marred with unwarranted leakages and wastages. According to the author, countries particularly, China and India have benefited immensely due to their overseas Diaspora. India is the largest recipient of remittance income, and about three fourth of foreign direct investment in China is made by the Chinese Diaspora. But according to the book, benefits of Diaspora is not limited to the economic benefits only but is spread to political and cultural aspects also. As regards the issue of brain drain, the book concludes that rather than doing harm to emerging economies, brain drain has helped countries to reduce global poverty. As regards the impact on advanced economies, the book provides an example of the US economy and highlights that migration will lead to increase in working age population and will save it from problem of high dependency of old age population unlike China.

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Press Release : 2012-2013/728