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RESERVE BANK OF INDIA

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The Reserve Bank of India today placed Working Paper titled "Credit Channel of Monetary Transmission in India - How Effective and Long is the Lag?" by Jeevan Kumar Khundrakpam. The effectiveness of a monetary policy in the achievement of its objectives of growth with price stability depends on how the policy signals are transmitted through the financial system and the economy. When interest rate is the main instrument of signaling policy stance, transmission through the commercial interest rate is one of the main channels. In this channel, change in policy interest rate, by affecting the deposits and lending rates of financial institutions, alters the spending and investment decisions of households and businesses, and consequently, inflation and growth.

With the adoption of Liquidity Adjustment Facility (LAF) framework as the operating procedure, interest rate has become the main signaling instrument of monetary policy in India. Thus, this paper examines the credit channel of monetary policy transmission through change in policy interest rate during the post-LAF period of 2001:3 to 2011:3. Drawing on the literature, two reduced form equations, one representing nominal bank credit and the other real bank credit, are estimated. The estimates are carried out after transforming the variables to stationary form and following an approach similar to Hendry's general-to-specific method. Stability, structural break and various diagnostic tests, besides the estimations of rolling regressions, are performed to confirmed robustness of the results.

The paper finds that, besides the positive influence of economic activity on bank credit, policy induced expansion or contraction in deposit or money supply makes banks to adjust their credit portfolio correspondingly. Importantly, the credit channel of monetary transmission is found to be significant and robust. Specifically, the transmission of policy rate to nominal or real bank credit growth takes about seven months. This transmission lags was found to be robust across all sub-sample periods considered. Over the full sample period, 100 basis points increase in policy rate, *ceteris paribus*, led to decline in the annualised growth in nominal and real bank credit by 2.78 and 2.17 percentage points, respectively. However, according to the author, the impact of policy interest rate on bank credit declined after the global financial crisis.

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