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Website : www.rbi.org.in

इ-मेल email: helpdoc@rbi.org.in

संचार विभाग, केंद्रीय कार्यालय, एस.बी.एस.मार्ग, मुंबई-400001

DEPARTMENT OF COMMUNICATION, Central Office, S.B.S.Marg, Mumbai-400001

फोन/Phone: 022- 22610835 फैक्स/Fax: 91 22 22660358

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DRG Study No. 44:

Role of Financial Frictions in Monetary Policy Transmission in India

The Reserve Bank of India today released on its website the DRG Study titled, "[Role of Financial Frictions in Monetary Policy Transmission in India](#)". The study is co-authored by Dr. Shesadri Banerjee, Dr. Harendra Behera, Shri Sanjib Bordoloi and Shri Rakesh Kumar.

The study developed a New Keynesian Dynamic Stochastic General Equilibrium (NK-DSGE) model with an imperfectly competitive banking sector and examined the role of various financial frictions in monetary policy transmission in India.

Main findings of the study:

- The study finds a weak transmission of monetary policy shocks. Interest rates in the economy increase following a positive policy rate shock, albeit at a lesser pace and squeeze the demand for credit. This leads to contractionary effects emanating from both the demand side of the economy, *via* reduction of consumption and investment demand, and from the supply side, *via* replacement cost of physical capital. This two-pronged contraction leads to a sharp decline in the demand for factors of production, in particular the labour, which drives down the aggregate output and inflation. A negative policy rate shock leads to lower interest rates which, in turn, exert expansionary effects in the economy.
- Monetary policy transmission improves if friction in the financial system diminishes, particularly with greater financial inclusion in terms of depositors' base and easing of the collateral constraints of the households. Easier norms for collaterals are likely to enable households to increase their borrowings which, in turn, may improve the transmission.
- The simulation experiments suggest that the standard form of Taylor rule with forecast-based inflation and output gap turns out to be the optimal rule to stabilise inflation and output. In fact, adjusting the policy interest rate to smooth out the credit cycle and/or asset price cycle exacerbates volatility of inflation and output. Overall, it emerges that targeting financial stability through monetary policy may not be appropriate for the purpose of economic stabilisation.

**: Development Research Group (DRG) has been constituted in Reserve Bank of India in its Department of Economic and Policy Research to undertake quick and effective policy-oriented research backed by strong analytical and empirical basis, on subjects of current interest. The DRG studies are the outcome of collaborative efforts between experts from outside Reserve Bank of India and the pool of research talent within the Bank. These studies are released for wider circulation with a view to generating constructive discussion among the professional economists and policy makers. DRG Studies are published in RBI web site only and no printed copies will be made available.*