

“A Study on the Transmissions in Indian Monetary Policy”

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Abstract

The Reserve Bank's ability to adjust the way its monetary policy settings affect inflation and economic activity is known as monetary policy transmission. The time and size of the economic impact are both subject to great unpredictability due to the complexity of this process. Transmission, to put it simply, happens when modifications to monetary policy have an impact on the economy's interest rates. Interest rate changes affect both inflation and economic activity. These two phases are described in this explanation along with some of the main ways that monetary policy has an impact on the Australian economy.

Keywords: Reserve Bank of India, Monetary Policy Rates, Repo Rate, Inflation, Economic activity.

Introduction

Monetary policy transmission is the method by which the central bank's policy action is carried out in order to accomplish the twin ultimate goals of inflation and growth. Customers must benefit from lower loan rates, for instance, if the RBI lowers its policy rates. The truth is that clients were not informed about monetary policy during the internal benchmark era.

A deliberate, long-term impact on the economy is required for monetary policy to be successful.

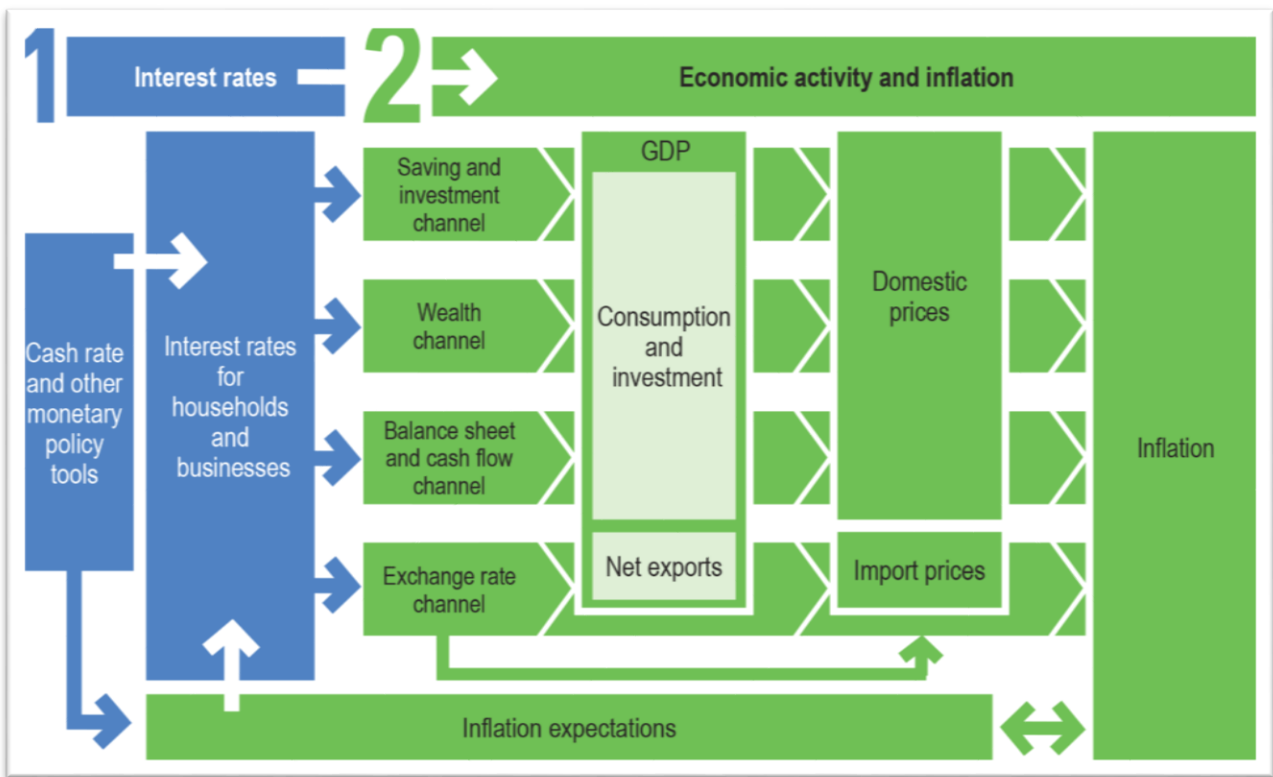
A priori economic theory and some empirical evidence have both acknowledged that the three primary ways that monetary policy influences these final aims are through production, employment, and inflation. Prices or quantities on the financial market can be roughly categorised as monetary transmission mechanisms. The relative importance of each channel varies from economy to economy depending on a variety of factors including underlying structural characteristics, financial market development, available monetary policy

instruments, fiscal stance, and degree of openness. Despite the fact that these channels are not mutually exclusive.

Changes in the Reserve Bank's monetary policy settings, also known as monetary policy transmission, have an effect on inflation and economic growth. Given the complexity of the process, it is difficult to predict when and how much it will affect the economy. To put it simply, the transmission can be divided into two sections.

1. Changes in monetary policy have an impact on interest rates in the economy.
2. Changes in interest rates have an impact on inflation and economic expansion.

This explanation details these two periods as well as some of the most important ways that monetary policy affects the Indian economy.



Source: Reserve Bank of Australia, Education.

Stages of Monetary Policy transmission

The initial stage of transmission is focused on how adjustments to the settings of these tools impact the economy's interest rates. The market interest rate for overnight loans made between financial institutions is known as the "cash rate," and it significantly affects other interest rates, including those for personal and corporate

deposits and loans. The longer-term interest rates in the economy are primarily impacted by the Reserve Bank's other monetary policy instruments.

The economy's interest rates are guided by monetary policy, but it is not the sole determinant. Interest rates can also be influenced by other elements, including the state of the financial markets, shifts in the level of

competition, and the risk involved with different forms of loans. The disparity between the cash rate and other interest rates consequently varies over time.

The transmission of short-term policy in India is significantly impacted by the repo rate. The repo rate is used to calculate the economy's interest rate (of the banking system). The financial health of the banking sector today determines how much a change in the repo rate can influence a corresponding adjustment in interest rates by banks. In this sense, India's banking system plays a crucial role in the dissemination of monetary policy. The two steps that make up the policy transmission mechanism are as follows: Key rates in the financial markets are transmitted from the policy rate. transmission through financial markets to end goals like output, employment, and inflation.

The impact of monetary policy changes on inflation and economic activity is the subject of the second stage of transmission. Consider how reduced interest rates for consumers and businesses impact the whole economy and inflation to illustrate this. (Demand and inflation respond inversely to rising interest rates.)

Aggregate Demand: Reduced interest rates encourage spending, which boosts the overall demand. However, it can take some time for the supply of products and services to adjust because it might need more personnel, resources, and infrastructure to generate them. As a result, prices first experience upward pressure since total demand initially outweighs total supply. As a result of firms raising their prices more swiftly in response to rising demand, inflation increases.

There is a lag between changes in monetary policy and their influence on economic activity and inflation because it takes time for people

and companies to alter their behaviour. One to two years are thought to be necessary for monetary policy to have its greatest impact. However, because of varying economic conditions and changes in the economy's structure throughout time, these estimates are rife with uncertainty. Because of this, monetary policy's overall impacts and the amount of time it takes to have an impact on the economy are subject to change.

Inflation projection: How well monetary policy is conveyed is influenced by inflation expectations. Employees might want higher wage increases, for instance, to keep up with inflation, if they expect growing inflation. The quicker pay growth would cause inflation to soar. The central bank can aid in stabilising inflation expectations by setting an inflation target. Now that the economy is less uncertain, people and businesses should be more confidence when it comes to saving and investing.

Literature Review

Mishra and Montiel (2012) examine the data regarding the efficiency of currency transmission in developing nations. They draw the conclusion that monetary transmission appears to be inadequate in developing nations despite methodological problems inherent in the literature. According to **Mishra et al. (2014)**, there are significant regional differences in how bank lending rates react to monetary policy shocks, with weaker transmission in developing nations. In-depth analysis of Indian monetary policy is provided by **Mohan (2008)**, who also looks at reforms, the evolution of the framework, and tools for managing liquidity. A vector autoregression (VAR) model is used by **Sengupta (2014)** to look into the various routes of monetary transmission in India between 1993 and 2012. She finds that the Liquidity

Adjustment Facility (LAF establishment)'s in 2000 caused a structural break in transmission, with the bank lending channel continuing to be significant but the interest rate and asset price channels growing stronger as a result. Using a VAR model, **Singh (2011)** calculates the policy rate pass-through to various short- and long-term market interest rates from March 2001 to June 2012. Under deficit liquidity conditions, he discovers strong contemporaneous pass-through as well as large lag effects. This method has the issue of not clearly expressing the speed of transmission, which is a factor that policymakers must take into account when deciding on the policy rate, even though it assesses the impact of changes in the policy rate on other interest rates. **Mohanty (2012)** focuses on the interest rate channel, researching changes in policy rates all the way to how they affect output and inflation. He discovers that policy rate increases have a moderating impact on inflation with a latency of three quarters and a negative impact on production growth with a lag of two quarters after being estimated in a quarterly structural VAR model (eight to ten quarters). **Bhaumik et al. (2011)** investigates how bank ownership affected banks' responses to monetary policy between 2000 and 2007. The authors estimate the change in loans in response to changes in PLR at the bank level using the average prime lending rate (PLR) of large banks as a proxy for the monetary policy rate. They find that during tight money periods, banks reduce loan supply in reaction to rises in PLR, and they argue that during tight money periods, the bank lending channel of monetary policy is likely to be more effective than during easy money years. However, because the authors use the prime lending rate of banks as an indicator of monetary policy, they implicitly assume that changes in monetary policy are fully and quickly passed through to bank lending rates. As a result, they overlook the possibility of a price

response to monetary policy and instead concentrate on a quantity response.

Channels of Monetary Policy Transmission

Saving and Investment Channel

Economic activity is impacted by monetary policy because it alters the incentives for saving and investing. This channel frequently has an impact on corporate investment, housing investment, and consumer expenditure. 1) Lower interest rates on bank deposits lessen the incentive for households to save. However, households are more motivated to spend their money on products and services. 2) Lower loan interest rates may encourage households to borrow more money because repayments will be lower. Lower interest rates on loans hence increase demand for assets like real estate. 3) Lower interest rates could lead to an increase in company investment (on capital goods like new equipment or buildings). This is as a result of falling borrowing costs and rising demand for the products and services they offer. This makes it more likely that these initiatives will provide returns greater than the cost of borrowing, which supports moving forward with them. Businesses that borrow money to finance projects will be more directly impacted by this than those that rely on owner cash.

Cash Flow Channel

Interest rates are influenced by monetary policy, which in turn impacts how much cash is available for households and businesses to spend on goods and services. For people without access to financial resources, this is a crucial avenue (for example, those who have already borrowed up to the maximum that banks will provide). Because loan interest payments are reduced when lending rates are lowered, households and businesses have more money to spend on products and services. For households

with variable-rate mortgages, for instance, a decline in interest rates reduces repayments, increasing their available income. Additionally, if interest rates decline, consumers and businesses receive less from deposits, which can lead them to reduce their expenditure. Despite the fact that these two impacts work in opposition to one another, a decrease in interest rates is anticipated to increase spending in the Indian economy through this route (with the first effect larger than the second).

Exchange Rate Channel

The exchange rate can significantly affect both economic activity and inflation in a small open economy like Australia. In sectors that are focused on exports or that compete with those that are imported, it is typically of more importance.

If the Reserve Bank lowers the cash rate, it signals a drop in Indian interest rates relative to those elsewhere in the globe (all else being equal). Lower interest rates lower investor returns on Indian assets (relative to other countries). Investors move their money to foreign assets as a result of lower returns, which decrease demand for Indian assets (as well as Indian Rupees) (and currencies). Foreign goods and services are often more expensive than those made in Australia when interest rates are lower (relative to the rest of the globe) and the currency rate is lower. Exports and domestic activity rise as a result of this. Because import prices increase when converted into Indian Rupees, a lower exchange rate also raises inflation.

Asset Prices and Wealth Channel

Wealth and asset values affect a person's borrowing capacity and economic spending. Consumption and investment are typically impacted by the wealth and asset price channels. Lower interest rates boost the demand

for assets, which upholds asset values (including those for houses and stocks). One explanation is that future income has a higher current discounted value when interest rates are low. The equity (collateral) of an asset that banks can lend against increases as asset prices grow. This might make it simpler for people and companies to borrow money. People's wealth increases as asset prices rise. This could result in more consumption and housing investment since households typically spend a share of their wealth gains. The expectations channel is undoubtedly driven by the monetary authority's legitimacy.

Mechanism of Monetary Policy in India

The method by which a central bank's monetary policy signals such as the repo rate are transmitted to firms and people via the financial sector is known as the monetary transmission mechanism (MTM) or monetary transmission.

The repo rate is the RBI's most potent monetary policy signal, among many others. The overall interest rate in the economy changes along with changes in the repo rate. A decline in the repo rate affects the interest rates on bank loans, which promotes consumption and investment among businesses and households. Both consumption and investment are typically financed through bank loans. The repo rate channel is frequently referred to as the interest rate channel of monetary transmission since the repo rate causes changes in market interest rates.

Repo rate ↓ → Interest rate ↓ → Consumption,
Investment ↑ → Output ↑ → Growth ↑

The interest rate is the primary means by which monetary policy is transmitted. Similar channels include those for credit, asset prices, confidence, and so forth. The fact that central banks now routinely communicate in the form of guidelines intended to have specific consequences on the financial market is an intriguing recent

development. Transmission of monetary policy in India

The transmission of policy in the Indian setting is significantly impacted by the repo rate. The anchor rate used to calculate the interest rate for the economy is the repo rate (of the banking system). Now, the financial health of the banking system determines how much a change in the repo rate can influence a matching adjustment in interest rates by banks. In this sense, the banking system plays a crucial role in the dissemination of monetary policy in India.

Significance of Monetary Policy Transmission:

Monetary policy transmission has an impact on economic growth, prices, and other aspects of the economy. Bank lending rates and bond yields will rise as central banks raise the official interest rate. Central banks can influence the cost of borrowing for businesses and consumers by changing the official interest rate. Changes in the official interest rate affect the discount rates used to compute the present value of cash flows, which are used to estimate the value of securities. In the event that official interest rates were lowered, economic agents would anticipate higher lending as a consequence of reduced borrowing costs or rising asset prices as a result of lower discount rates and predictions of stronger growth. Changes in the official interest rate have an impact on exchange rates. All other things being equal, investing in a country becomes more desirable when its interest rates rise.

Challenges of Monetary Policy Transmission in India:

Inflexible Funding Cost: Banks in India borrow money from the market primarily through the issuing of debentures and commercial papers, while customer deposits make up the great

majority of their borrowings. The majority of these deposits are contracted at fixed rates; hence the cost of funds is often set. In addition, interest rates on small deposits remained high when measured against bank rates. Bank deposits have decreased as a result. Due to a lack of funds, banks have been unable to lend at reduced deposit rates. Banks won't be able to send monetary policy signals at the necessary speed and magnitude until and unless this problem is remedied.

Policy Rates are not linked to the market: Since the repo rate is controlled by the Monetary Policy Committee, it cannot be regarded as a rate set by the market. Regardless of the cost of lending money, banks must peg their lending rates to the repo rate.

High Level of Non-Performance Assets (NPA): The accumulation of significant NPAs has hurt bank profitability. Banks maintain the weighted average lending rate substantially higher than the marginal lending rate as a result.

Conclusion

Over the time, especially after the adoption of the external benchmark system, the Reserve Bank's attempts to enhance transmission to bank deposit and lending rates have begun to show results. The external benchmark system has encouraged banks to adjust their term and savings deposit rates, thereby broadening the scope of transmission across sectors that are not even linked to the external benchmark, as lending rates are frequently adjusted in line with the benchmark rates to protect their net interest margins. However, there are still a number of transmission barriers that must be removed right away.

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