Issues in Monetary Policy Transmission in India

Abstract

When Central Banks take monetary policy actions, those set in motion a series of consequences that start with an influence on the financial markets, work through changes in spending, production and employment and end with an effect on the price level or more specifically the rate of inflation. This chain of developments is known as the *transmission mechanism.* The literature on monetary policy transmission identifies the following channels, viz. traditional interest rate channel, other asset prices channel and the credit channel. In the traditional interest rate channel, money and bonds are the only two perfectly mutually substitutable financial assets and monetary policy has effects on the economy by changing the money supply and interest rates. Credit channel emphasizes asymmetric information in the financial markets and considers a third asset "bank loans" besides money and bonds. These different channels of monetary policy transmission are not mutually exclusive and the economy's overall response will incorporate the impact of various channels.

This dissertation looks at some specific aspects of monetary policy transmission to examine its effectiveness in the Indian context.

In the first part of the study, we test the empirical validity of credit channel in India in the context of mid nineties episode of monetary shock by analyzing firm level financing data of a particular industry.

In the second part, we look into the issues for rigidities in the interest rate channel of monetary policy transmission. The first issue we discuss is the administered rates on small-scale savings. Linking these rates to market determined rates will impart smooth transmission of monetary impulses, but there are a whole lot of issues that need to be taken care of before such mechanical benchmarking procedure is adopted. We discuss these issues in the second part.

In the third part, we look at the issue of high non-performing assets (NPAs) in the banking system and how it hinders the smooth transmission of interest rates to the financial markets. In

the context of the Securitisation Act recently promulgated in India to recover NPAs, we survey the approaches taken by developing countries and discuss what needs to be done to make the Securitisation Act more effective.

The final part concludes.