


A Policy Rate Channel Testing of Monetary Policy Transmission Mechanism


Firdous Ahmad Malik, National Institute of Public Finance and Policy, India*

 <https://orcid.org/0000-0002-7815-0143>

Deepanjali Das, Lucknow University, India

Laeq Razzak Janjua, Vistula University, Warsaw, Poland

Hebatallah Adam, O.P. Jindal Global University, India

 <https://orcid.org/0000-0002-3038-7037>

ABSTRACT

Against the backdrop of invariant financial and economic reforms, there are presumptive changes in the confines and speed with which target variables respond to Reserve Bank of India (RBI) policy signals. The result of transmission lags from monetary policy to the real sector is unmistakable. The empirical approach used in this study is a natural progression from the VAR model videlicet, co-integration, and error correction techniques used to overcome the problem of spurious regression associated with non-stationary time-series data. After a shock induces disequilibrium, the speed and degree of adjustment return to a balanced state but with some time lag. The results indicate that in the two-step verification model, it takes approximately 2.851 months for WACMR to fully respond to a change in policy rates, whereas in the second step, it takes approximately 10.33 months for base rates to reach their complete pass-through following changes in call money market and deposit rates.

KEYWORDS

Cointegration, Monetary Policy Transmission Mechanism, Structural Breaks, Weighted Average Call Money Rates

1. INTRODUCTION

The central bank, together with fiscal authorities, affects real economy growth through the monetary policy transmission mechanism (Taylor 1995), which describes the process through which monetary policy decisions effect economic growth and inflation. Monetary policy decisions affect asset values and the economy via the monetary transmission mechanism (Aksoy & Basso, 2014). The Patel Committee Report to the Reserve Bank of India (RBI) detailed a roadmap toward a more robust monetary policy framework, building on the foundation laid in the mid-1990s. The success of monetary policy is measured by how quickly and significantly it fulfils its goals. However, there is debate about the policy's impact mechanism.

By establishing the policy rate and establishing the terms under which borrowed and unborrowed reserves are made available to the banking system, the Reserve Bank of India (RBI) exerts a hegemonic influence over the operating procedure. It is this provision that forces a bank to resort to the money market in order to satisfy its short-term funding needs. That is why money markets are pegged to

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*Corresponding Author

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policy rates: they provide stability. When funds are tight, banks can borrow money daily at overnight rates or issue certificates of deposit; whatever method provides the lowest interest rate is chosen. Because of this kind of discretionary arbitrage by banks, the money market is highly dependent on the direction of the Reserve Bank of India's (RBI) policies toward policy target variables (Kuttner, 2001). To measure the magnitude of monetary shocks, these market instruments attempt to predict the path of future monetary policy. In order to put a number on policy shocks, it is necessary to use a proxy for policy expectations, such as the weighted average of call money rates. Considering the foregoing, it is crucial to study the impact of bank capital on the transmission of monetary policy in India. Recent research suggests that the state of the banking industry and the actions of its participants impact the growth and inflationary outcomes of monetary policy (Gambacorta and Shin 2018; Markovic 2006; Van den Heuvel 2002; Muduli, S., and Behera, H.) (2021). Several authors have presented convincing explanations for the magnitude, timeliness, and distributional effects of policy on an economy via bank credit lending channels: Bernanke and Blinder (1992), Kayshap and Stein (1995), deBondt (1999), Favero et al. (1999), and Kishan and Opiela (2000). They show how bank loans facilitate the spread of monetary policy. The United States' unstable banking sector and the role of banks as a possible source of friction in the transmission mechanism of monetary policy were again highlighted during the 2007–2010 financial crisis.

The following is the organisation of the paper: Section 2 is a review of the literature, Section 3 is a data source and empirical analysis with discussion, Section 4 is the conclusion, and Section 5 is the practical implications and recommended policies.

2. LITERATURE REVIEW

Over the last decade, the Indian money market has grown significantly in terms of depth, variety of instruments, and efficiency. It serves as a mechanism for balancing demand and supply of short-term funds, and this process enables central banks to influence both the quantum and cost of liquidity in the financial system, consistent with the monetary policy stance as a whole (Fabris, 2018). The evolution of the money market over time and the relative stability of the call money market have enabled the Reserve Bank to shift away from quantity-based instruments and toward price-based instruments since 1998, as part of its multiple indicator approach. Thus, the overnight call rate, which had been implicitly used as an operating target since the establishment of the liquidity adjustment facility (LAF) in 2000, became explicit in May 2011 with the adoption of a new operating procedure.

The Indian financial system is bank-centric, with banks accounting for a disproportionately large share of total financial assets and interacting closely with other financial system components. As espoused in textbooks and on a more general level, banks are perceived to play a minor role in the transmission of monetary policy. However, the works of Bernanke, Blinder, Wilcox, Stein, and others have generated considerable interest in the literature and debate over the importance of the credit channel in the transmission mechanism of monetary policy. Thus, financial constraints on banks impair their ability to neutralise hostile innovation on deposits with optional financing elements, creating supply side effects in the credit market and encouraging economic insecurity.

Cecchetti (1994, 1999) asserts that two distinct systems dominate the performance of the monetary policy transmission mechanism: the monetary approach¹ and another credit-oriented technique² Atique and Malik (2012). Numerous economists have been identified in the literature who have concentrated on the operation of monetary transmission onto financial factors and the relationship between the financial and real sectors. Sukmama, Kassim (2008) and Tobias, Hyun (2010) examined monetary policy impulses while taking into account the banking sector's unique intermediary role. The study adopted similar concepts to Cecchetti (1994, p:22) regarding the distinctive characteristics of geographical areas that vary by country, such as the degree of health of the banking system and the depth of financial markets, Auclert, Dobbie, and Goldsmith-Pinkham (2019)

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