Financial Frictions and Monetary Policy Transmission in India

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Date: 24.08.2018, Venue: C21 @ 2.30PM

Abstract

One of the well-documented stylized facts on Indian macro economy is the weak and incomplete transmission of monetary policy. In view of the empirical evidence from literature (Kletzer, 2012; Mishra et al. 2016), the paper examines whether the frictions of the bank-led credit market can explain such low pass-through of monetary transmission mechanism. It addresses the research question using a New Keynesian business cycle model (Gerali et al., 2010, Anand et al., 2014) with Indian-economy-specific features of liquidity-constrained population, competitive labour market and statutory requirements of the bank. It incorporates a variety of real and nominal shocks to the prototype economy in order to replicate the business cycle properties and quantify the variance decomposition of shocks. Combining the methods of calibration and estimation, the baseline parameterisation is configured and validated with second order moments of the data. The model explains the comovements of interest rates, incomplete pass-through and adjustment mechanism of the real, nominal and financial variables for a positive interest rate shock. Further, it identifies the critical role of liquidity-constrained and collateral-constrained households, and interest rate rigidity in the transmission process.

Speaker Profile:

Shesadri Banerjee is an applied macroeconomist, presently working as an Assistant Professor at Madras Institute of Development Studies (MIDS), Chennai. Previously, he has worked as a Research Consultant at Centre for Training and Research in Public Finance and Policy (CTRPFP) unit of Centre for Studies in Social Sciences, Calcutta (CSSSC) and held the research position as an Associate Fellow in the division of Macroeconomics and Economic Policy at National Council of Applied Economic Research (NCAER). He has been specializing in Dynamic Stochastic General Equilibrium (DSGE) modeling. His research includes various issues related to inflation dynamics, business cycles, and fiscal and monetary policies in advanced and developing countries. He is leading a Development Research Group (DRG) Study for the Reserve Bank of India on financial shocks to the banking sector and business cycle outcomes in India. He taught courses on Advanced Macroeconomics and International Finance at the University of Durham, Newcastle University Business School, and Reserve Bank Staff College (Chennai). He received his Ph.D. in Economics from University of Durham, UK.

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