Monetary Transmission Mechanism and the Role of Transmission Channels

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ABSTRACT

Purpose: The study seeks to discuss the transmission mechanism of monetary policy, the role and functioning of various transmission channels and factors affecting the transmission process. Additionally, the paper attempts to study the transmission of monetary policy signals in India following the introduction of EBLR system.

Design/Methodology/Approach: The paper discusses transmission mechanism, the key transmission channels and their effects on different sectors and different variables based on the available literature. In addition, the paper discusses the monetary transmission in India, under the EBLR regime, by analysing the secondary data collected from the RBI reports.

Findings: Monetary transmission process and key channels of transmission are discussed in detail. While interest channel affects output growth and prices through its impact on investment and consumer expenditure, credit channel does so by affecting balance sheet of the banks and net worth of firms. Monetary signals are transmitted to asset market affecting investment and growth through asset price channel while exchange rate channel influences output and prices via effects on net exports and import prices. In India interest rate channel is proved to be the most effective channel of transmission. Monetary transmission has improved following the adoption of the EBLR system.

Originality/Value: With changing financial structure, macro-economic conditions, increasing liberalization and economic integration, monetary transmission mechanism is constantly evolving across countries. In this context, the paper would be useful to study the operation and relative importance of different transmission channels in the ever-changing financial landscape. Additionally, the paper would provide insights into the transmission process under the EBLR regime in India.

Paper Type: Theme Based Paper

KEYWORDS: Transmission Mechanism | Transmission Channels | Monetary Policy | Repo Rate | Policy Signals | EBLR

Introduction

Central banks undertake monetary policy with the prime objective of ensuring price stability while maintaining sustained growth. The efficacy of the policy action however, rests on an efficient transmission mechanism through which the changes in policy rates or monetary aggregates are transmitted to different segments of the economy, ultimately affecting prices and growth. Policy signals are transmitted through different channels, impacting several variables and sectors at varied speed and intensity. By affecting different nominal variables like asset prices, interest rate, exchange rate, credit flow and money supply, monetary policy influences aggregate demand, prices and output.

In India interest rate channel has been the pre-dominant channel of transmission where banks play the critical role of transmitting the monetary policy signals to the overall economy through adjustments in their lending and deposit rates. In order to improve the pace and extent of transmission, the RBI has made several attempts at refining the process of setting interest rates by banks. The External Benchmark-based Lending Rate (EBLR) method is the latest attempt in that endeavour, operational since October, 2019. All the systems prior to the adoption of EBLR, were internal benchmark-based and hence the rate setting by banks were arbitrary, non-transparent and non-standardised, resulting in slower transmission. EBLR regime seeks to address that issue with external benchmarking and quicker reset period of bank lending rates.

Literature Review

There has been extensive research on understanding monetary transmission mechanism, the channels of transmission and factors affecting monetary transmission. **Mishkin (1995)** provides a detailed and comprehensive analysis of key channels of monetary transmission, operation of those channels and their effects on different variables and sectors of the economy. **Ireland (2006)** presents a detailed review of the transmission channels and the theories surrounding the functioning of transmission mechanism. **Petursson (2001)** in his paper describes the process and lags in transmission by studying the monetary policy action of the Central Bank of Iceland. His study concludes that monetary policy changes are first transmitted to domestic demand roughly after half a year and peak after a year. The effects on inflation takes place after a year and peak after one and half years of interest rate hike. His study suggests no long run effect on real economy. **Mwamkonko (2023)** studied the effectiveness of monetary transmission in Tanzania and found expected inflation and exchange rates to be the predominant channels of transmission. To improve efficacy of other channels, his study suggests a concerted effort at increasing the financial inclusion in the country.

Acharya (2017) discusses the transmission mechanism in India and elaborates on the slow, incomplete and asymmetric transmission mainly driven by the interest rate rigidity on the part of the banks. For faster and better transmission, the author suggests introduction and wider use of external benchmarking in the rate setting by the banks. **Dua (2020)** presents a comprehensive review of the monetary policy framework and its evolution in India since 1980s while also analysing the process of transmission, its challenges in the form of rigidities and lags. **Ojha (2021)** while assessing the recent performance and challenges to monetary transmission, highlights the importance of financial inclusion in promoting better transmission. **Kashyap et al. (2023)** assert that overall transmission has improved under the EBLR system in India.

Channels of Monetary Transmission and Factors Affecting Transmission

(1) Interest Rate Channel

The channel finds its roots in the traditional Keynesian theory. As per this theory, an expansion in money supply, with short-run rigidity in wages and prices, would lead to reduction in real interest rate(r), thereby boosting investment(I) by firms. Increased investment leads to increased aggregate demand, employment and output(Y). Further, through a combination of rational expectations and sticky prices, the fall in short term interest rate will lead to a fall in long term real interest rate. This induces housing and inventory investment, consumer durable expenditure and business fixed investment, all of which boost aggregate demand and output (Mishkin, 1995). The transmission process of interest rate channel is presented below.

$$\Uparrow M \longrightarrow \Downarrow r \longrightarrow \Uparrow I \longrightarrow \Uparrow Y$$

The effective and efficient functioning of interest rate channel rests on how fast and by how much the policy rates are passed on to bank and other market rates. This pass-through depends on factors like the overall financial structure, regulatory framework, competition among financial intermediaries, access to alternative sources of finance and transparent monetary policy operations etc. (Sellon, 2002).

(2) Credit Channel

This channel takes into account the asymmetric information between lenders and borrowers while assessing the impact of monetary policy action (Mishkin, 1995). The channel operates through two different sub-channels, namely the balance-sheet channel and bank-lending channel.

Bank-lending channel: As per this channel, banks are the most suitable intermediaries when it comes to dealing with borrowers like small firms, where information asymmetry is more pronounced. A monetary expansion, by increasing the amount of bank reserves, enhances the lending capacity of banks. Bank lending in general and to the small borrowers in particular, go up, which positively affect the aggregate spending. The working of the channel is given below

$$\uparrow M \longrightarrow \uparrow \text{Reserves of the banks} \longrightarrow \text{Bank Credit} \uparrow \longrightarrow \uparrow \longrightarrow I \uparrow Y$$

The balance-sheet channel: It works via changes in net worth of the firms, following monetary policy action. A fall in interest rate due to expansion in money supply, leads to increase in equity prices of firms, while at the same time increasing their cash flow by reducing their debt obligations. This results in an increase in net worth of the firms and thus their borrowing capacity, which boosts investment and growth. The increased net worth also helps in reducing the risk premium on funds raised externally by firms.

$$\uparrow M \longrightarrow \downarrow r \longrightarrow \uparrow \text{Equity Price \& Cash flow} \longrightarrow \uparrow \text{Net-worth} \longrightarrow \uparrow \text{lending} \longrightarrow \uparrow I \longrightarrow \uparrow Y$$

Credit channel also affects the balance-sheet of consumer households. Expansion in money supply by increasing the cash flow of the households, leads to increased demand for consumer durables. Additionally due to interest rate reduction, prices of stocks held by the households go up. This results in rise in the value of their financial wealth, leading to increased expenditure on consumer durables and housing.

Effective operation of credit channel depends on the strength of country's banking sector. The financial condition of banks determines the cost and availability of bank loans. Banks, plagued with bad loans and mounting non-performing assets (NPAs), with low capital/asset ratio, generally tend to ignore the monetary policy impulses. Additionally, the existence of asymmetric information between banks and the borrowers, along with limited enforcement of contracts can adversely affect the financial position of banking system, thereby making it difficult for banks to swiftly and effectively respond to the changes in policy rates.

(3) Asset Price Channel

This channel affects aggregate demand and output via effects on asset price like stocks and bond prices. The mechanism is based on Modigliani's Life cycle theory of consumption and q-theory of investment by Tobin, where q represents the ratio of market value of firms to the replacement cost of capital. When central bank expands the supply of money, the demand for stocks increases, increasing the price of stocks or equity. This leads to increased market valuation of firms (q) compared to replacement cost which positively affects their investment and thus output.

Schematically,

$$\uparrow M \longrightarrow \uparrow \text{Equity Price} \longrightarrow \uparrow q \longrightarrow \uparrow I \longrightarrow \uparrow Y$$

The life cycle theory of consumer behaviour by Modigliani is based on the premise that people tend to smooth their level of consumption throughout their lifetime which in turn is dependent on their lifetime wealth. Stocks form an important part of their lifetime financial wealth, and when stock prices increase following expansion in money supply, consumers experience rise in the value of their financial wealth and hence increase in lifetime income/wealth. Increased lifetime wealth results in increased consumption (C), aggregate demand and output.

$$\uparrow M \longrightarrow \uparrow \text{stock Price} \longrightarrow \uparrow \text{Lifetime wealth} \longrightarrow \uparrow C \longrightarrow \uparrow Y$$

The efficient functioning of asset price channel depends on how developed, diversified and important the markets for bonds, stocks and real estates are. More developed such markets are, the greater and faster would be the transmission of policy signals. Further, the composition of financial portfolio of households and corporates also affects the degree of transmission through asset price channel. The more diverse the financial portfolios are, the stronger will be the effect on asset prices.

(4) Exchange Rate Channel

Through this channel, monetary transmission takes place via changes in net exports (NX). Expansion in money supply results in fall in domestic rate of interest (r), which makes domestic financial assets less attractive, leading to depreciation of domestic currency. Depreciation makes exports cheaper and imports dearer which results in rise in net exports (NX), AD and output.

$$\uparrow M \longrightarrow \downarrow r \longrightarrow \text{exchange rate depreciation} \longrightarrow \uparrow NX \longrightarrow \uparrow Y$$

Further, depreciation also affects domestic prices. Depreciation, by increasing NX, stimulates AD which leads to increase in prices. Depending on the degree of pass-through, depreciation also increases domestic prices through increased import prices.

The prominent factors affecting this channel are the degree of flexibility of the exchange rate regime, extent of capital market liberalization and the ease of substitutability between foreign and domestic assets.

The following figure presents the summary of the entire process of monetary transmission.

Figure 1- Transmission Mechanism of Monetary Policy
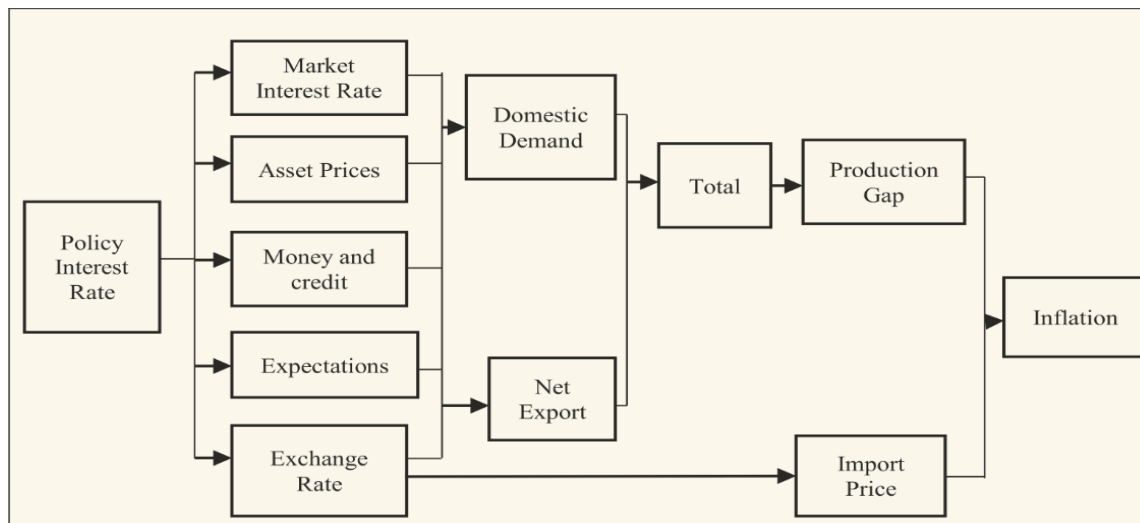
Source: Okur et al., 2019

Monetary Transmission in India -Recent Developments

The evolution and transformation of Monetary policy framework in India has been in line with the changing macro-economic conditions and financial developments. Accordingly, the operational framework in terms of targeting mechanism and monetary instruments has undergone substantial changes (Dua, 2020). The monetary policy framework currently adopted in India is called Flexible Inflation Targeting Framework (FITF). The prime goal of this framework is ensuring price stability while being mindful of the importance of economic growth. Under this framework, a flexible inflation target is set for a period of five years. Inflation target is currently set at 4 percent with a flexibility of +/-2 percent. The policy rates are set by the monetary Policy Committee while keeping in mind the specified inflation target and the evolving macro-economic situations. The rates then are transmitted to several other rates in the money market like bank interest rates, inter-bank lending rates, stock prices, government and corporate bond yields, finally culminating in its impact on growth and inflation (Acharya, 2017)

In India interest rate channel has been the most dominant channel of transmission. Indian financial sector continues to be dominated by banks, even though the share of alternative sources of finance such as NBFCs, bond and equity markets has been growing steadily. It is therefore the banking sector that plays the predominant role of conveying the policy signals to the real economy through changes in its lending and deposit rates.

Monetary Transmission under EBLR Regime

The EBLR system was introduced to address the problem of incomplete, uneven and sluggish transmission resulting from the earlier method of interest rate setting based on internal benchmark. Under this system, the floating lending rates are linked to an external benchmark such as, Certificate of Deposits rates, T-bill rates, repo rates etc. which are outside the control of banks along with the shorter reset period (at least once in three months) for lending rate by banks. The process is more transparent and standardized across banks which helps the borrowers to compare the loan offers from various banks simply by comparing the spreads over benchmark (Acharya, 2017). Further, since market rates move parallel to central bank's policy rates, external benchmark would be more suited to transmit the monetary signals.

Starting from October, 2019, the RBI has instructed all scheduled commercial banks (except RRBs) to tie their fresh loans under floating rates to an external benchmark such as RBIs policy repo rate or three or six-month T-bill yield of GoI, or any such benchmark issued by FBIL.

The transmission to lending rates saw a significant improvement during the accommodative phase (February 2019-March, 2022), coinciding with the introduction of EBLR regime. Against a repo rate cut (cumulative) of 250 basis points (2.5 percent), the Weighted Average Lending Rate (WALR) for outstanding and new loans fell by 150 and 232 basis points respectively. The substantial transmission however happened after the adoption of EBLR system. In case of deposits, the condition of excess liquidity along with subdued credit demand, helped the banking sector passing on

the repo rate cuts to term deposits rates. Consequently, the weighted average domestic term deposit rates (WADTDR) on outstanding and new deposits fell by 188 and 259 bps respectively (table:1). During the tightening phase (May, 2022-Feb, 2024), when repo rate in total was hiked by 250 basis points (2.5 percent), the banks raised their benchmark rates (tied to repo rates) by the equal magnitude. The transmission to 1-year MCLR (Marginal cost of Fund Based Lending Rates) however, was relatively weak (167 basis points). In contrast during the pre-EBLR phase (February, 2019- September, 2019), following the cumulative rate cut by 110 basis points, the WALR on fresh loans was reduced by 43 basis points, while on outstanding loans it actually saw an increase by 2 basis points. For deposits, the median TDR on fresh deposits fell by 9 basis points and WADTDR on outstanding deposits fell by 7 basis points (RBI, 2021)

Table-1: Pass-through of Policy Rate to Bank Deposit and Lending Rates (percent)

| Phase | Repo Rate (percent) | Deposit Rates | | Lending Rates | | | |
		WADTDR (fresh deposits)	WADTDR (outstanding deposits)	EBLR	MCLR (1-Year median)	WALR (Fresh Rupee Loans)	WALR (Outstanding Rupee Loans)
February 2019-March, 2022	- 2.5	-2.59	-1.88	-2.5	-1.55	-2.32	-1.5
May 2022 - February, 2024	2.5 %	2.41	1.83	2.5*	1.67*	1.85	1.11

*: EBLR data is for 32 domestic banks.

*: Data on EBLR and MCLR relate to March 2024

Source: RBI, Monetary Policy Report, , April, 2024

At bank group level, during May 2022-February, 2024, passthrough to both deposit and lending rates for public sector banks were higher than the private banks, barring outstanding loan category. Transmission was highest for foreign banks reflecting the increasing share of EBLR-linked loans on their lending side and low-cost shorter duration deposits on the liability side, which accelerates the process of interest rate adjustment. (Fig:2)

Figure-2: Transmission Across Banks (May 2022- February, 2024)

Chart IV.9: Transmission across Bank-groups (May 2022 to February 2024)
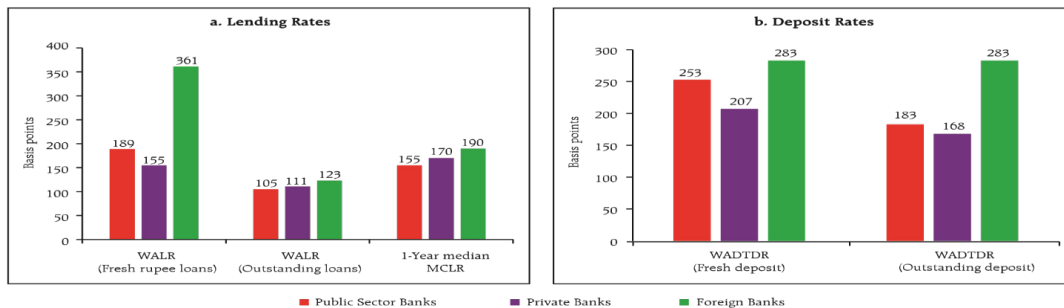
Source: RBI Bulletin, April, 2024

The WALR on fixed and outstanding loans increased to major sectors during May, 2022 – February, 2024 (Fig: 3), even though the transmission had been uneven.

Figure-3: Sector wise Transmission to WALRs of Domestic Banks (May 22-February 24)

Chart IV.29: Sector-wise Transmission to WALRs of Domestic Banks (May 2022 to February 2024)
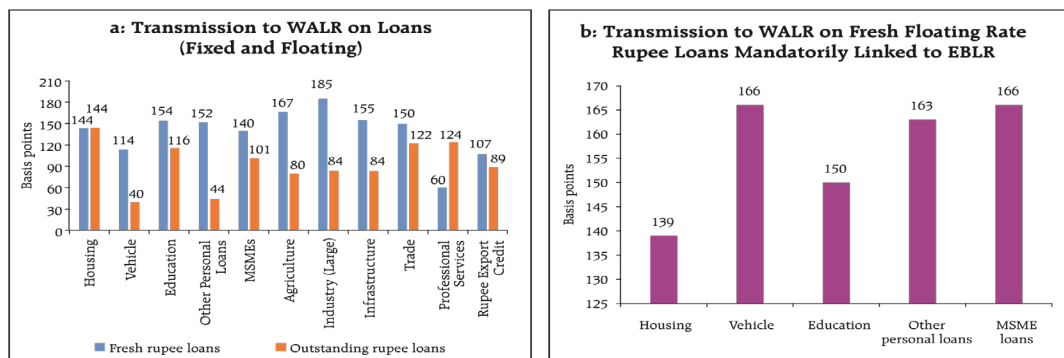
Source: RBI, Monetary Policy Report, April, 2024

With the adoption of the EBLR regime, the floating rate loans segment is now dominated by EBLR-linked loans. The proportion of EBLR loans in total loans (outstanding) has been continuously increasing and stood at 56.2% by the end of December, 2023, up from a mere 9.1% in March, 2020. Consequently, the share of MCLR-linked loans has fallen from 78.3% in March, 2020 to 39.4% in December, 2023. The rising share of loans tied to EBLR, along with a quicker reset period and rise in MCLR, helped in the passthrough to WALR on outstanding loans during May, 2022-February, 2024 (RBI Monetary Policy Report, April, 2024)

The transmission of changes in repo rates to bank interest rates has improved under the EBLR system (Kashyap et. al, 2023). However, there are still significant impediments to a faster and complete transmission. Loans linked to MCLR still form a significant proportion of the overall lending portfolio. Transmission mechanism is beset with lags. Balance sheet of the banks still remains stressed and hence needs to be strengthened with adequate capitalization and substantial reduction in NPAs.

Conclusion

An effective monetary transmission mechanism is an essential pre-requisite for successful pursuit of monetary policy objectives. The policy signals are transmitted to the real economy through various monetary channels. While Interest rate channel affects overall spending and output by impacting investment and consumer expenditure, credit channel affects the lending and borrowing capacity of banks and firms respectively. Asset channel influences demand and output through changes in asset prices, while exchange rate channel does so though changes in net exports (NX). The effective functioning of all these channels however depends on a robust and well-developed financial system, consisting of a sound banking sector, well developed equity, credit and bond markets and a flexible exchange rate regime with liberalized capital account.

In India, the interest channel has been the pre-dominant channel of transmission with banking sector playing the critical role of transmitting monetary policy signals to various sectors through the interest rate adjustments. Overall transmission has improved under the EBLR regime. Both lending and borrowing rates have moved in line with changes in policy rates and the same have been transmitted to the major sectors of the economy. Increasing proportion of loans are getting linked to EBLR, promoting faster transmission. However, we need to effectively address the problem of slow and incomplete transmission for the successful pursuit of monetary policy objectives. Balance-sheet and asset quality of banks need to be improved further with further reduction in NPAs and increasing capitalization. For a faster and complete monetary transmission in our growing economy, all the channels of transmission need to function effectively, which ultimately depends on a well-developed, well-integrated and resilient financial system.

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Annexure 16.2.4

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Reviewers Memorandum

Reviewer's Comment 1: The paper provides a comprehensive exploration of the monetary transmission mechanism and its various channels, with a special focus on the Indian context under the EBLR regime. The integration of theoretical underpinnings with empirical insights enhances the paper's academic value. Additionally, the clear articulation of key transmission channels (interest rate, credit, asset price, and exchange rate) and their unique contributions demonstrates a robust understanding of the subject.

Reviewer's Comment 2: The study is well-researched, drawing on a diverse range of academic and empirical sources to support its claims. The discussion on the evolution of monetary transmission in India is particularly noteworthy, especially in highlighting the challenges of earlier internal benchmark systems. The paper's empirical analysis relies heavily on secondary data from RBI reports without detailing the methodology used to derive specific findings. A deeper explanation of the dataset's limitations and a discussion of the potential biases in interpreting RBI's aggregated data would enhance the credibility of the conclusions.

Reviewer's Comment 3: The paper is well-written and generally clear, with a logical flow and relevant figures and tables supporting the narrative. However, certain sections, such as the "Exchange Rate Channel," are overly descriptive and lack analytical depth. Including real-world case studies or practical examples would help elucidate the application of theoretical concepts. Additionally, the paper could benefit from a stronger conclusion summarizing actionable recommendations for policymakers.

Editorial Excerpt

The article has 8% of plagiarism which is the accepted percentage as per the norms and standards of the journal for publication. As per the editorial board's observations and blind reviewers' remarks the paper had some minor revisions which were communicated on a timely basis to the authors (Sucharita), and accordingly, all the corrections had been incorporated as and when directed and required to do so. The comments related to this manuscript are noticeably related to the theme "**Monetary Transmission Mechanism and the Role of Transmission Channels**" both subject-wise and research-wise. The manuscript offers a valuable contribution to understanding the monetary transmission mechanism and its implications in India, particularly under the EBLR regime. While the narrative is comprehensive, the paper's accessibility for a broader audience can be improved by reducing technical jargon in certain sections. Moreover, a critical review of the limitations of the EBLR system and its potential implications for future monetary policy reforms would provide greater balance and depth. After comprehensive reviews and the editorial board's remarks, the manuscript has been categorized and decided to publish under the "**Theme Based Paper**" category.

Acknowledgement

The acknowledgment section is an essential part of all academic research papers. It provides appropriate recognition to all contributors for their hard work and effort taken while writing a paper. The data presented and analyzed in this paper by (Sucharita) were collected first handily and wherever it has been taken the proper acknowledgment and endorsement depicts. The authors are highly indebted to others who facilitated accomplishing the research. Last but not least, endorse all reviewers and editors of GJEIS in publishing in the present issue.

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