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How effective are monetary policy signals in India?☆

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Abstract

The signalling mechanism of monetary policy is of vital importance as it conveys the central bank's assessment of the economy and its future outlook. In the Indian context, changes in the policy environment since the later half of the 1990s have brought about shifts in the operating procedure of monetary policy. As a result, beside the traditional instruments, new indirect instruments have emerged as tools of monetary policy signalling. Against this backdrop, we examine the efficacy and robustness of alternative monetary policy instruments in transmitting policy signals and its impact on financial market behaviour. Employing a SVAR model, we ascertain whether the gradual emphasis on indirect instruments have facilitated the task of conveying the monetary policy stance and also provide evidence of asymmetric response of financial markets to monetary policy shocks.
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1. Introduction

Central banks emphasise on transparency of communication with the public in order to enhance the effectiveness of monetary policy. In this regard, the signalling of policy stance is of vital importance as it conveys the intent of the monetary authority and its future outlook on macro fundamentals. While the signalling mechanisms in developed countries are quite robust,

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they tend to be weak in the case of emerging market economies, particularly in the wake of market segmentation and absence of a well-defined transmission mechanism. In the Indian context, the changes in the framework and operating procedure of monetary policy since the later half of the 1990s has necessitated broadening the array of policy instruments for communicating shifts in monetary policy stance, whereby greater reliance is on price rather than quantity adjustments.

Against this backdrop, the paper examines whether the shift in emphasis towards the price channel *vis-à-vis* the quantity channel is borne out by empirical evidence on Indian financial market data. In particular, we try to ascertain the relative efficacy and robustness of alternative monetary policy instruments in communicating policy signals and influencing financial market behaviour. More specifically, this paper has two objectives. First, to discuss briefly the empirical literature on the pass-through effect of policy signals on financial market behaviour. Second, in view of the above, to empirically analyse the impact of changes in policy instruments on various segments of the Indian financial market through a Structural Vector Auto Regression (SVAR) model and draw policy perspectives.

While most studies have analysed the dynamic interaction between monetary policy and financial markets in developed countries (e.g. Faust & Rogers, 2003; Roley & Sellon, 1995), the present paper is different in three ways. First, we examine the case of an emerging economy, *viz.* India, where the transmission mechanism exhibit dynamics that are significantly different from more mature markets. Second, we study the impact of all monetary policy instruments, which are actively used by the central bank, on different segments of the financial market.[1] Third, we impose identifying conditions from theory and observed market behaviour instead of estimating an atheoretic model and discuss in detail the policy implications of the results obtained from the empirical exercise.

The rest of the paper proceeds as follows. Section II briefly reviews the empirical literature on the pass-through effects of monetary policy announcements on financial markets. Section III provides a brief discussion of the changes in operating procedure in India brought about by changes in the policy environment. Section IV provides an empirical analysis of the signalling impact of monetary policy in India along with its policy implications. Section V concludes by summarising the key findings.

2. Brief review of literature

Monetary policy works through financial markets, the latter being the core of the transmission mechanism in conveying policy signals. Since financial markets are typically characterised by asymmetric information, signalling is an effective mechanism of bridging the asymmetry and conveying the central banks policy stance to the market.[2] It is important that the policy signals are clear and credible as this may even obviate the need for active stabilisation policy (Christensen, 1999). In this regard, the central bank's interest rate decisions, communicated by changes in the key policy rate, play a signalling role: the policy rate is public information and an indicator of the central bank's views on the state of the economy (Amato, Morris, & Shin, 2002).[3]

[1] Excluding the credit market, which is constrained by several structural rigidities including directed lending.

[2] The seminal work on market signalling as a mechanism to circumvent the problem of asymmetric information was in the context of the job market by Spence (1973). An early application in the context of monetary policy is Barro and Gordon (1983) and Vickers (1986).

[3] For a theoretical exposition on the signalling role of monetary policy actions, see Morris and Shin (2002).

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