Challenges of Effective Monetary Policy in Emerging Economies

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Monetary policymaking in emerging economies have their own particular challenges. The compulsions of unique institutional details as well as the thinness of financial markets in the backdrop of increasing global integration often tends to render the monetary transmission mechanism unstable. This paper firstfleshes out a number of these confounding institutional and legacy issues in the context of India. We then illustrate the consequences of these frictions for the monetary transmission mechanism with two features of the policy environment in India: statutory liquidity ratio requirements imposed on banks and chronic fiscal deficits. We show that these frictions can completely invert the monetary transmission mechanism: when the constraint binds, under some stylized conditions, a reduction in the policy rate can end up raising lending spreads and thereby cause a contraction instead of an expansion in the economy.

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