ABSTRACT

In this thesis dissertation, which consists of five essays, we examine the role of liquidity in monetary policy transmission to bank lending in India. In the first essay, we examine the effect of a change in bank deposits on banks' lending and investment behaviour. To identify the change in deposits, we study a positive liquidity shock i.e., currency demonetization in India in November 2016. We exploit the demonetization effect on different types of banks' deposits (savings bank deposits and demand deposits) to find that the increase in deposits had a negative effect on bank lending. However, banks' balances with the central bank went up with an increase in deposits induced by demonetization. When we analyse the one year lagged effect of deposits on bank lending, we find a positive impact suggesting a long run increase in lending due to demonetization. Finally, we investigate the implications for monetary policy transmission and find that the increase in deposits due to a liquidity shock weakened the monetary policy transmission to bank lending in the long-run. In the second essay, we examine the role of bank liquidity in monetary policy transmission in India. We analyse annual data for Indian banks during 2005-2020 employing the dynamic threshold panel regression method. We first show in a benchmark estimation (without a threshold) that there is a negative impact of monetary policy tightening on bank lending. With liquid assets of banks as the threshold variable, we find that in a low liquidity regime, bank lending declines with monetary policy tightening, while in a high liquidity regime, bank lending does not respond. We also find different portfolio reallocation behaviour by banks in high versus low liquidity regimes in response to monetary policy changes. Our results suggest that for effective transmission of monetary policy, any abundant liquidity with banks must be neutralized by the monetary authority.

In the third essay, we study the factors responsible for prevalence of excess liquidity in the banks in India. We apply standard panel regressions for the analysis. We find numerous factors responsible for the prevalence of excess liquidity in Indian banks which either impact positively or negatively such as required reserves, exchange rate and call rate. For instance, we find that the response of excess liquidity and call money rate to required reserves is negative while the exchange rate and government securities held by banks have a positive effect on excess liquidity. In the fourth essay, we examine the effect of monetary policy on liquidity creation by banks in India. We also study the role of bank characteristics in the transmission of monetary policy to liquidity creation. We find a negative impact of monetary policy on total as well as only on-balance sheet liquidity creation. We also find that capital, size, and profit of banks support the monetary policy transmission to liquidity creation. Finally, ownership structure of banks seems to matter only for the response in on-balance sheet liquidity creation but not for total liquidity creation.

Finally, in the fifth essay, we investigate the role of interbank liquidity in monetary policy transmission in India. We employ standard and dynamic panel regression methods to analyze data for 40 commercial banks during the period 1999-2018. We find a significant role of interbank liquidity in easing the negative impact of monetary policy tightening on bank lending. We also find a heterogeneous role of interbank liquidity in monetary policy transmission across public sector and private sector banks. The policy implication for the monetary authority in India is that managing net liquidity positions of banks is necessary to realize the desired effects of monetary policy.