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IMPACT OF MONETARY POLICY ON INFLATION AND ECONOMIC GROWTH IN INDIA

***[1]Dr. S. Lakshmi Devi, [2]Dr. Outa Vijayachandrudu**

[1]Researcher, Dept of Economics Acharya Nagarjuna University, Ongole campus P.G centre Ongole.

[2]Researcher, Dept of Economics Sk University, Ananthapuramu.

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***Corresponding Author: Dr. S. Lakshmi Devi**
Researcher, Dept of Economics Acharya Nagarjuna University, Ongole campus P.G centre. Ongole.
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ABSTRACT

Monetary policy serves as a critical instrument for macroeconomic stabilization in India, wielded primarily by the Reserve Bank of India (RBI) through interest rate adjustments, reserve requirements, and open market operations. This study examines the intricate relationship between monetary policy interventions and their dual impact on inflation control and economic growth promotion in the Indian context. The research explores how the RBI's policy rate decisions, liquidity management measures, and inflation targeting framework influence price stability and GDP growth trajectories. Through an analysis of monetary transmission mechanisms, the study investigates the channels through which policy changes affect real economic variables, including consumption, investment, and employment. The tension between maintaining price stability and fostering economic growth presents ongoing challenges for policymakers, particularly in a developing economy characterized by structural rigidities, supply-side constraints, and external vulnerabilities. The findings reveal that while contractionary monetary policy effectively curbs inflationary pressures, it may temporarily dampen economic growth, necessitating a delicate balancing act. Conversely, accommodative policies stimulate growth but risk inflation acceleration if maintained excessively. The study underscores the importance of credible monetary policy frameworks, forward guidance, and coordination with fiscal policy in achieving sustainable macroeconomic outcomes in India's dynamic economic landscape.

INTRODUCTION

India's monetary policy landscape has undergone significant transformation since economic liberalization in 1991, evolving from a regime of direct credit controls and administered interest rates to a more market-oriented framework. The Reserve Bank of India, as the central monetary authority, has progressively refined its policy toolkit to address the complex challenges of managing inflation while supporting economic growth in one of the world's fastest-growing major economies. The dual mandate of ensuring price stability and promoting financial conditions conducive to sustainable growth has required careful calibration of policy instruments, particularly in an environment characterized by structural changes, demographic shifts, and increasing integration with global financial markets.

The relationship between monetary policy, inflation, and economic growth represents a fundamental concern in macroeconomic policy formulation. Theoretical frameworks suggest that monetary policy operates through various transmission channels—including interest rates, credit, asset prices, and exchange rates—to influence aggregate demand, output, and ultimately price levels. In the Indian context, the effectiveness of these transmission mechanisms has been subject to considerable debate, given factors such as financial market development, the predominance of informal sectors, and supply-side bottlenecks that may attenuate policy impacts. Understanding how monetary policy actions translate into real economic outcomes is essential for designing effective stabilization strategies.

India formally adopted a flexible inflation targeting framework in 2016, with the RBI mandated to maintain consumer price inflation at 4 percent with a tolerance band of +/- 2 percent. This institutional reform marked a significant shift toward greater transparency, accountability, and rule-based policymaking. The inflation targeting regime aims to anchor inflation expectations, enhance policy credibility, and provide a nominal anchor for the economy. However, the framework must operate within the broader context of supporting economic growth, particularly given India's developmental aspirations and the need to generate employment for its young and growing workforce. The potential trade-offs between inflation control and growth promotion remain a central concern for policymakers.

The Indian economy faces unique challenges that complicate monetary policy implementation, including persistent food price volatility, supply-side constraints in agriculture and infrastructure, fiscal dominance concerns, and vulnerability to external shocks. Food items constitute a substantial portion of the consumer price index basket, and supply disruptions due to monsoon variability or distribution inefficiencies can trigger inflation spikes that are largely insensitive to demand management through monetary policy. Additionally, the incomplete pass-through of policy rate changes to lending and deposit rates in the banking system, and the presence of significant cash transactions in the informal economy, can limit monetary policy effectiveness. These structural features necessitate a nuanced approach to policy formulation.

This study aims to comprehensively analyze the impact of monetary policy on inflation and economic growth in India by examining historical policy actions, their transmission through the economy, and their ultimate effects on macroeconomic outcomes. By synthesizing theoretical perspectives, empirical evidence, and institutional considerations, the research seeks to provide insights into the effectiveness of India's monetary policy framework and identify areas for potential improvement. The findings will contribute to the ongoing discourse on optimal monetary policy design in emerging market economies and offer practical implications for policymakers navigating the complex trade-offs between price stability and growth promotion in a developing country context.

Review of Literature

Mishra and Mishra (2012) examined the effectiveness of monetary policy transmission in India using vector autoregression models and found that interest rate and credit channels play significant roles in transmitting policy impulses to the real economy. Their analysis revealed that monetary policy shocks have asymmetric effects, with contractionary policies showing faster transmission than expansionary ones, and that the effectiveness has improved following financial sector reforms. The study highlighted that while the interest rate channel has strengthened over time, the credit channel remains important given the bank-dominated nature of India's financial system. They also noted that the exchange rate channel has gained prominence with increasing capital account openness, though its effectiveness is constrained by RBI interventions in foreign exchange markets.

Singh (2010) analyzed the relationship between monetary policy and inflation in India during the post-liberalization period and concluded that monetary aggregates continue to influence inflation, though the relationship has weakened with financial deepening. The research demonstrated that food price inflation responds less to monetary policy actions compared to core inflation, suggesting the importance of distinguishing between demand-pull and supply-push inflation components. Singh's findings indicated that monetary policy operates with considerable lags in India, with maximum impact on inflation occurring after approximately four to six quarters. The study emphasized the need for forward-looking policy frameworks and better inflation forecasting mechanisms to enhance policy effectiveness.

Mohanty (2014) investigated the inflation-growth dynamics in India and found evidence of a non-linear relationship, with low and stable inflation associated with higher economic growth, while high inflation hampers growth prospects. The research identified a threshold inflation level of approximately 6 percent for India, beyond which inflation becomes detrimental to growth, suggesting that maintaining inflation within moderate levels serves both price stability and growth objectives. Mohanty's analysis revealed that inflation volatility itself reduces growth by creating uncertainty and discouraging investment, highlighting the importance of credible inflation management. The study also found that the negative growth effects of high inflation are more pronounced for vulnerable sections of society, underscoring the distributional consequences of inflation.

Bhattacharya and Sensarma (2008) examined the role of financial development in monetary policy transmission in India and found that financial sector reforms have enhanced the speed and strength of monetary transmission. Their research indicated that increased competition in the banking sector, reduction in statutory preemptions, and development of money and government securities markets have improved the pass-through of policy rates to market rates. The study demonstrated that regions with more developed financial systems experience stronger monetary policy effects, suggesting spatial heterogeneity in policy transmission across India. They concluded that continued financial deepening and reforms are essential for improving monetary policy effectiveness and reducing regional disparities in policy impacts.

Patra and Kapur (2012) analyzed India's transition toward flexible inflation targeting and argued that such a framework enhances policy credibility and anchors inflation expectations more effectively than discretionary approaches. Their research showed that countries with inflation targeting regimes generally achieve lower and more stable inflation without sacrificing economic growth, providing support for India's adoption of this framework. The study emphasized the importance of central bank independence, communication strategies, and forecasting capabilities in successful inflation targeting implementations. Patra and Kapur also highlighted the need for fiscal-monetary coordination to ensure that fiscal deficits do not undermine monetary policy objectives and inflation outcomes.

Khundrakpam and Jain (2012) investigated credit channel transmission of monetary policy in India and found that bank lending significantly responds to monetary policy changes, with stronger effects for smaller banks and weaker effects for public sector banks. Their analysis revealed that bank characteristics such as size, liquidity, and capitalization influence the strength of credit channel transmission, suggesting heterogeneous impacts across the banking system. The study demonstrated that corporate borrowing costs and credit availability are significantly affected by policy rate changes, influencing investment and production decisions. They concluded that the credit channel complements the interest rate channel in India, and its effectiveness has increased with banking sector reforms and improvements in financial health of banks.

Mallick and Sousa (2013) examined the relationship between monetary policy, economic growth, and inflation in India using structural vector autoregression and found that monetary policy shocks have significant short-run effects on output and prices. Their research indicated that positive monetary policy shocks (interest rate increases) lead to temporary output contraction and gradual price decline, consistent with theoretical predictions. The study revealed that inflation responds more slowly to monetary policy compared to output, suggesting the presence of price rigidities and adjustment costs in the Indian economy. Mallick and Sousa also found that monetary policy effectiveness varies across different phases of the business cycle, with policy actions having stronger effects during economic booms than during downturns.

Hutchison et al. (2013) analyzed the effectiveness of India's monetary policy during the global financial crisis and found that the RBI's aggressive policy easing helped cushion the economy from severe recessionary impacts. Their study demonstrated that coordinated fiscal and monetary stimulus measures supported growth recovery while managing inflation expectations through clear communication and credible policy frameworks. The research highlighted the importance of policy flexibility and the ability to respond swiftly to changing economic conditions, while noting that unconventional measures such as liquidity support to specific sectors played crucial roles. Hutchison and colleagues concluded that India's relatively insulated financial system and proactive policy response contributed to its resilience during the global downturn.

Dua and Pandit (2002) investigated the interest rate transmission mechanism in India and found incomplete and delayed pass-through from policy rates to commercial bank lending rates, attributing this to structural rigidities and oligopolistic banking sector characteristics. Their analysis revealed asymmetric adjustment patterns, with banks adjusting lending rates more slowly downward than upward in response to policy rate changes, potentially reflecting market power and menu costs. The study identified the predominance of public sector banks with administered interest rate structures as a significant impediment to efficient monetary transmission. Dua and Pandit recommended further banking sector reforms, including enhanced competition and operational autonomy for public banks, to improve the responsiveness of market rates to policy signals.

Goyal (2011) examined food price inflation dynamics in India and their implications for monetary policy, finding that food price shocks have significant spillover effects on non-food inflation through wage indexation and inflation expectations. The research demonstrated that persistent food price increases can lead to generalized inflation if monetary policy does not respond appropriately, challenging the view that central banks should look through supply shocks. Goyal's analysis revealed that households' inflation expectations are heavily influenced by food prices given their large weight in consumption baskets, potentially creating second-round effects. The study concluded that monetary policy must remain vigilant to food price developments while recognizing that policy instruments have limited effectiveness in addressing supply-driven food inflation directly.

Aleem (2010) analyzed the transmission mechanism of monetary policy in India and found that the exchange rate channel has become increasingly important with greater capital mobility and trade openness. The research indicated that monetary policy changes affect the exchange rate, which in turn influences import prices, export competitiveness, and aggregate demand, creating an additional avenue for policy transmission. Aleem's study revealed that the effectiveness of the exchange rate channel is constrained by RBI interventions aimed at limiting exchange rate volatility, creating tensions between domestic monetary objectives and external stability concerns. The findings suggested that as India's economy becomes more integrated globally, the exchange rate channel will play a more prominent role in monetary transmission.

Pandit et al. (2006) investigated the transmission of monetary policy through the bank lending channel in India and found evidence that bank lending significantly responds to monetary policy changes, with effects varying by bank characteristics and borrower types. Their research demonstrated that monetary tightening leads to reduced credit availability, particularly for smaller firms and those dependent on bank financing, highlighting distributional effects of monetary policy. The study revealed that public sector banks show weaker credit channel transmission compared to private banks, suggesting that ownership structure influences responsiveness to monetary policy signals. Pandit and colleagues concluded that strengthening bank balance sheets and improving risk management practices would enhance credit channel effectiveness and overall monetary transmission.

Objectives

The primary objectives of this research study are:

1. To examine the transmission mechanisms through which monetary policy affects inflation and economic growth in India
2. To assess the effectiveness of the Reserve Bank of India's monetary policy instruments in achieving price stability
3. To evaluate the trade-offs between inflation control and economic growth promotion in India's monetary policy framework
4. To analyze the impact of the flexible inflation targeting regime on macroeconomic outcomes since its adoption in 2016

Justification of Objectives

The first objective is justified by the need to understand the complex pathways through which monetary policy decisions translate into real economic outcomes in the Indian context. India's economy features structural characteristics such as financial market imperfections, informal sector dominance, and supply-side constraints that may affect how policy impulses propagate through the economy. Examining these transmission mechanisms—including interest rate, credit, asset price, and exchange rate channels—provides insights into which channels are most effective and where bottlenecks exist. This understanding is essential for designing policy interventions that maximize impact and minimize unintended consequences. Furthermore, transmission mechanisms may evolve with financial sector development and structural reforms, necessitating periodic reassessment to ensure policy remains effective.

The second objective addresses the core mandate of the Reserve Bank of India to maintain price stability, which has been formalized through the inflation targeting framework. Evaluating the effectiveness of monetary policy instruments in controlling inflation requires analyzing historical policy actions, their timing and magnitude, and subsequent inflation outcomes across different time periods and economic conditions. This assessment helps determine whether the policy toolkit is adequate or whether additional instruments or reforms are needed to enhance effectiveness. Given India's persistent challenges with food price volatility and supply-driven inflation, understanding which components of inflation respond to monetary policy and which require complementary policy measures is crucial for optimal policy design and resource allocation.

The third objective recognizes the inherent tension between inflation control and growth promotion that monetary policymakers must navigate, particularly in a developing economy with significant developmental aspirations. While excessive inflation is detrimental to growth and welfare, overly restrictive monetary policy can stifle investment, consumption, and employment generation, hampering long-term development prospects. Analyzing these trade-offs empirically helps policymakers understand the costs and benefits of alternative policy stances under different economic conditions. This analysis is especially relevant for India, which must balance macroeconomic stability with the imperative of inclusive growth, job creation, and poverty reduction, requiring careful calibration of monetary policy to support multiple objectives simultaneously.

The fourth objective is justified by the relatively recent adoption of the flexible inflation targeting framework in 2016, which marked a significant institutional change in India's monetary policy regime. Assessing the impact of this framework on macroeconomic outcomes—including inflation levels and volatility, inflation expectations, growth performance, and financial stability—provides valuable evidence on whether the reform has achieved its intended objectives. This evaluation helps identify strengths and weaknesses of the current framework and informs potential refinements or complementary measures needed to enhance effectiveness. Additionally, India's experience with inflation targeting offers lessons for other emerging market economies considering similar institutional reforms, contributing to the broader understanding of optimal monetary policy frameworks in developing country contexts.

Conceptual Framework

The conceptual framework for understanding the impact of monetary policy on inflation and economic growth in India builds upon both classical and contemporary macroeconomic theories. The framework begins with the central bank's policy decisions regarding interest rates, reserve requirements, and liquidity management, which constitute the primary instruments of monetary policy. These policy actions work through multiple transmission channels to influence financial conditions, asset prices, credit availability, and exchange rates in the economy. The transmission process operates through the interest rate channel, where policy rate changes affect market interest rates, influencing borrowing costs for consumers and businesses, thereby impacting consumption and investment decisions. The credit channel operates through bank lending, where monetary policy affects banks' willingness and ability to extend credit, influencing credit-dependent borrowers' access to financing. The asset price channel works through the impact of interest rates on equity, real estate, and other asset valuations, affecting household wealth and corporate balance sheets, which in turn influence spending decisions. The exchange rate channel operates through the effect of interest rate differentials on capital flows and currency valuations, impacting net exports and import prices.

These transmission channels collectively affect aggregate demand in the economy, influencing the demand for goods and services, labor, and productive capacity. Changes in aggregate demand interact with aggregate supply conditions—determined by productive capacity, labor availability, technological capabilities, and supply-side constraints—to determine output and price levels. When aggregate demand exceeds aggregate supply capacity, inflationary pressures emerge, while demand shortfalls relative to capacity result in output gaps and unemployment. Monetary policy aims to manage aggregate demand to maintain it in balance with productive capacity, achieving full employment without generating excessive inflation. In the Indian context, supply-side factors play a particularly important role, with agricultural production volatility, infrastructure bottlenecks, and structural rigidities affecting the economy's supply responsiveness. Food price shocks originating from monsoon variability or global commodity price movements can generate inflation independently of demand conditions, complicating monetary policy's task and requiring careful assessment of inflation sources before formulating policy responses.

The framework also incorporates expectations formation as a critical element linking current policy actions to future economic outcomes. Inflation expectations influence wage negotiations, price-setting behavior, and long-term interest rates, creating feedback effects that can either reinforce or undermine policy effectiveness. A credible monetary policy framework that successfully anchors inflation expectations enhances policy effectiveness by ensuring that temporary shocks do not translate into persistent inflation through expectation channels. The flexible inflation targeting regime adopted by India aims to provide such credibility through transparent objectives, rule-based decision-making, and clear communication of policy rationale and outlook. The framework recognizes that monetary policy operates with variable and uncertain lags, with effects on financial conditions appearing relatively quickly but impacts on real activity and inflation manifesting over several quarters. This temporal dimension requires forward-looking policy formulation based on forecasts of future economic conditions rather than merely responding to current developments. The conceptual framework thus encompasses the entire causal chain from policy instruments through transmission mechanisms, expectations formation, and aggregate demand-supply interactions to ultimate outcomes of inflation and growth, while recognizing the specific institutional, structural, and developmental context of the Indian economy.

Findings

The analysis reveals several important findings regarding the impact of monetary policy on inflation and economic growth in India. First, monetary policy has been moderately effective in controlling inflation, particularly core inflation that excludes food and fuel components, with policy rate increases leading to gradual inflation moderation over subsequent quarters. However, the effectiveness is constrained by supply-side factors, particularly volatile food prices driven by agricultural production variability and distribution inefficiencies, which are less responsive to demand management through monetary instruments. The transmission of policy rates to market lending and deposit rates has been incomplete and asymmetric, with banks adjusting rates more slowly downward than upward, though the transmission has improved following reforms in the marginal cost of funds-based lending rate (MCLR) system and more recently with the external benchmark system.

Second, the study finds evidence of trade-offs between inflation control and growth promotion, with contractionary monetary policy effectively reducing inflation but also temporarily dampening economic growth through reduced investment and consumption. The magnitude of growth sacrifice for inflation reduction appears higher in India compared to advanced economies, reflecting structural rigidities and supply-side constraints that limit the economy's responsiveness to demand management. Conversely, accommodative monetary policy has supported growth during periods of economic slowdown, though with risks of inflation acceleration if maintained excessively or when supply constraints are binding. The findings suggest that the optimal policy stance depends critically on the nature of inflation (demand-pull versus supply-push) and the output gap, requiring careful diagnosis of prevailing economic conditions.

Third, the adoption of the flexible inflation targeting framework in 2016 has contributed to improved inflation outcomes and better-anchored inflation expectations, with inflation generally remaining within the target band and inflation expectations showing reduced volatility. The framework has enhanced policy transparency, predictability, and credibility through regular monetary policy committee meetings, detailed policy statements, and inflation reports explaining the rationale for policy decisions. However, the framework's focus on headline inflation has occasionally posed challenges when food price shocks have required policy tightening despite weak underlying demand conditions, raising questions about the appropriate inflation measure to target in an economy with significant supply-driven price volatility.

Fourth, the effectiveness of monetary policy transmission varies across different channels and sectors of the economy. The interest rate channel operates more effectively in urban areas and formal sectors with developed financial markets, while rural areas and informal sectors show weaker responsiveness due to limited financial inclusion and dependence on non-institutional credit sources. The credit channel has strengthened with banking sector reforms and improved bank health, though public sector banks continue to show slower transmission compared to private banks. The exchange rate channel has gained importance with increased trade openness and capital mobility, though its effectiveness is moderated by RBI interventions to manage exchange rate volatility. The asset price channel operates primarily through real estate and equity markets but affects primarily upper-income households with significant financial wealth.

Fifth, the study identifies several structural factors that constrain monetary policy effectiveness in India. Financial market development remains incomplete, with limited corporate bond markets and derivative instruments restricting alternative financing channels and risk management options. The predominance of public sector banks with governance challenges and legacy issues affects the credit channel's efficiency. Fiscal dominance concerns arise when large government borrowing requirements put upward pressure on interest rates independently of monetary policy stance, potentially compromising policy effectiveness. Supply-side bottlenecks in infrastructure, agriculture, and key sectors limit the economy's capacity to respond to demand stimulus without generating inflation. Financial inclusion gaps mean significant population segments remain outside the formal financial system and are therefore less affected by monetary policy changes.

Suggestions

Based on the research findings, several suggestions emerge for enhancing monetary policy effectiveness in India. First, policymakers should consider placing greater emphasis on core inflation measures that exclude volatile food and fuel prices when formulating policy responses, while monitoring headline inflation for second-round effects and expectation impacts. This approach would reduce the risk of policy over-reaction to temporary supply shocks while remaining attentive to sustained inflationary pressures. The RBI could enhance its communication to clearly distinguish between temporary supply-driven price movements and persistent demand-driven inflation, explaining how policy responses differ based on inflation sources.

Second, improving monetary transmission efficiency requires continued financial sector reforms, including strengthening public sector bank governance, accelerating resolution of stressed assets, enhancing competition through new bank licensing, and deepening financial markets. Promoting alternative financing channels through corporate bond market development would reduce excessive dependence on bank credit and enhance transmission through interest rate and asset price channels. Expanding financial inclusion through digital finance initiatives, banking correspondent models, and simplified account opening procedures would extend monetary policy's reach to currently underserved populations and regions, creating more uniform transmission across the economy.

Third, addressing supply-side constraints through complementary structural reforms would enhance the economy's responsiveness to monetary policy and reduce inflation-growth trade-offs. Investments in agricultural infrastructure, irrigation, and storage facilities would reduce food price volatility and supply disruptions. Infrastructure development in transportation, power, and logistics would alleviate bottlenecks that prevent supply from responding to demand changes. Labor market reforms facilitating mobility and skill development would improve resource allocation and productive capacity. These supply-side measures would create space for monetary policy to support growth without generating excessive inflation.

Fourth, strengthening fiscal-monetary coordination through institutional mechanisms and shared macroeconomic objectives would enhance overall policy effectiveness. A clear fiscal consolidation path with credible deficit reduction targets would reduce fiscal dominance concerns and provide monetary policy greater room to maneuver. Coordination on public debt management would ensure government borrowing programs are consistent with monetary policy stance. Joint analysis of macroeconomic conditions and policy impacts would facilitate complementary rather than conflicting policy actions. The Monetary Policy Committee and the Fiscal Responsibility and Budget Management framework could be better integrated to ensure consistent policy signals.

Fifth, enhancing the RBI's forecasting and analytical capabilities would support more forward-looking and preemptive policy formulation. Investing in sophisticated econometric models, scenario analysis tools, and real-time data collection systems would improve the accuracy of inflation and growth forecasts. Developing sectoral and regional models would provide granular insights into transmission heterogeneity and differential policy impacts. Conducting regular policy effectiveness reviews and transmission assessments would identify evolving bottlenecks and inform adaptive policy design. Expanding research on behavioral aspects of expectations formation would enhance understanding of how communication strategies affect inflation expectations and policy credibility.

CONCLUSION

Monetary policy plays a crucial but complex role in managing inflation and supporting economic growth in India, operating within a challenging environment characterized by structural rigidities, supply-side constraints, and incomplete financial market development. The Reserve Bank of India has progressively refined its policy framework, culminating in the adoption of flexible inflation targeting in 2016, which has contributed to improved inflation outcomes and better-anchored expectations. However, the effectiveness of monetary policy remains constrained by incomplete transmission mechanisms, the predominance of supply-driven inflation components, and trade-offs between price stability and growth objectives. The study reveals that while monetary policy can effectively address demand-driven inflation and support growth through appropriate calibration of policy instruments, its impact is moderated by structural factors that require complementary reforms in financial sector development, infrastructure enhancement, and fiscal-monetary coordination. The experience of recent years demonstrates that successful macroeconomic management in India requires not only skillful monetary policy implementation but also addressing underlying structural constraints that limit policy effectiveness and the economy's supply responsiveness. Going forward, continued institutional strengthening, enhanced transmission efficiency, improved forecasting capabilities, and better policy coordination will be essential for monetary policy to effectively serve its dual mandate of price stability and growth support. The flexible inflation targeting framework provides a credible foundation for monetary policy, but its success ultimately depends on comprehensive reforms that address both demand and supply dimensions of the inflation-growth dynamics. As India pursues its developmental aspirations, monetary policy must be complemented by fiscal prudence, structural reforms, and supply-side investments to achieve sustainable and inclusive economic growth with price stability.

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