

Monetary Policy Accommodation and Banking Risk: An Indian Perspective

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Abstract

In the aftermath of the global financial crisis of 2007, numerous research studies have been undertaken to analyze *inter alia* the severity of its impact, and to examine the role of various factors leading to the crisis. Many such studies exposed weaknesses of the then prevailing banking regulatory framework, and narrow focus of the monetary policy. It was observed that extensive financial engineering and regulatory arbitrage led to underestimating actual systemic risk in the banking sector. Several studies flagged monetary accommodation for a protracted period in the US and many other advanced economies exacerbating banking risk, as the low-interest rate environment moderated the risk perception on the one hand, as also led to search for high returns in risky lending, on the other. In this backdrop, the present study attempted to assess if similar monetary policy accommodation during 2002-11 in India could have any role in increasing banking risk in India, which was reflected in the incidence of high bank NPAs since early 2010s. To examine this issue, we have used a dynamic panel data analysis based on data of 41 commercial banks for the period 2004-05 to 2019-20. In the econometric model, the variation in bank risk was explained by using standard macroeconomic and bank-specific variables, and the monetary policy stance was added to the list as an additional explanatory variable. The estimated results revealed that although the coefficient of monetary policy stance was negative suggesting monetary policy accommodation having potential to raising banking risk in India, but the coefficient was not statistically significant. Thus, the present study could not find evidence of monetary policy accommodation impacting banking risk in India. This may be due to effective coordination of monetary policy and banking regulatory policies, undertaken by the RBI. Important policy implication in the above context is to continue and consolidate judicious use of appropriate banking regulatory instruments in synchronization with the accommodative monetary policy, so that the adverse consequences of the latter to raise banking risk can be suitably neutralized.

JEL Classification and Key Words: E52, E58, G21, G28; Monetary Policy, Central Banking, Banks, Banking Regulation

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The authors are thankful to Prof. Yoshino N. for his helpful comments during presentation of the paper in the Virtual Conference on International Macroeconomics and Finance held on March 27, 2021 in honour of Prof. B. Kamaiah. The authors are also thankful to the anonymous referee(s) for valuable suggestions.