

Divisia Aggregates and Monetary Policy in India

Abstract

The aim of this paper is to develop a suitable monetary policy framework for the Indian economy. We break the analysis into three different parts. The first part deals with the choice of monetary policy instrument. Here we evaluate three different hypotheses, namely: 1) Money has more information content as opposed to interest rates 2) Divisia monetary aggregates are superior to Simple sum and 3) Broad money is better than narrow money. In the second part of the study, we build a medium size New Keynesian DSGE model that accurately captures the peculiar features of the Indian economy. The third part of the study aims to evaluate various monetary policy rules in the context of the Indian economy. The current version of the study works through the first part. Initial results suggest that money does indeed have more information content as compared to interest rates and that Divisia aggregates are superior to their simple sum counterparts. The evidence is a bit ambiguous regarding the comparative performance of broad and narrow money.