Does Monetary Policy Affect Poverty and Inequality: Evidence from India

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Abstract

This paper studies the effect of an expansionary monetary policy shock on food prices, poverty and food consumption inequality in India over the period 1996 to 2013. I estimate Factor Augmented Vector Auto Regression (FAVAR) that includes disaggregated food prices and identify monetary policy shock using sign restrictions. In response to an expansionary monetary policy shock real food prices rise by 1% and mean real wages remain unchanged. Prices of food items which constitute a higher share of the poor people’s budget are more sensitive to a monetary policy shock. Food consumption of the poorest households fall by 3% in rural and 2.5% in urban India, thus aggravating poverty and hunger in the country. The results are robust across alternative measures of welfare i.e. food consumption inequality. Food consumption inequality rises by 3% in rural and 2% in urban India. I find evidence for a new channel, through which monetary policy affects poverty and inequality in India i.e. the food consumption channel. To the best of my knowledge, this is the first study to empirically investigate the impact of monetary policy on poverty and inequality in India. This may hold important policy implications for Indian policymakers as well as those in similar low income countries.

Keywords: Monetary Policy, Central Banking, Price level, Food Prices, Inflation, Inequality

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