Wisdom Vortex:
International Journal of Social Science and Humanities

Open-access, Peer Reviewed, Refereed, Quarterly Journal, Multiple Language (English & Hindi)

e-ISSN: 3107-3808
p-ISSN: Applied for

Wisdom Vortex: International Journal of Social Science and Humanities, Volume: 02, Issue: 03, Oct-Dec 2026

How to cite this paper:
Bhattacharya, R. (2026). Inflation Dynamics, Monetary Policy Transmission, and Its Impact on Household Savings and Consumption. *Wisdom Vortex: International Journal of Social Science and Humanities, 2*(3), 47-55.
https://doi.org/10.64429/wvijsh.02.03.054

Received: 21 Aug. 2026
Accepted: 28 Sep. 2026
Published: 10 Oct. 2026

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Inflation Dynamics, Monetary Policy Transmission, and Its Impact on Household Savings and Consumption

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ABSTRACT

This research investigates the interactions between monetary policy transmission, inflation persistence, household savings behavior, and private consumption in emerging market economies, focusing on India's Flexible Inflation Targeting (FIT) regime. While central banks strive to stabilize price volatility and maintain credit flows, structural rigidities and asymmetric monetary transmission, particularly slower commercial bank deposit rate adjustments compared to lending rates, impair policy pass-through and distort household financial incentives. Persistent inflationary shocks act as a regressive inflation tax, eroding real purchasing power and prompting precautionary portfolio rebalancing. When nominal deposit returns lag behind inflation, consumers shift savings from formal financial instruments into traditional inflation hedges like gold and residential real estate. While protecting individual wealth, this defensive reallocation starves the formal financial system of domestic capital and dampens long-term productive investment. Using an econometric design combining Autoregressive Distributed Lag (ARDL) cointegration and Structural Vector Autoregression (SVAR) analyses, this study maps short-run elasticities and long-run equilibria. The findings highlight the need for enhanced regulatory oversight of bank pricing mechanisms, improved inflation-indexed financial instruments, and robust fiscal-monetary coordination to protect consumer balance sheets and foster resilient, inclusive economic growth.

Keywords: *Monetary Policy Transmission, Inflation Dynamics, Household Savings, Consumption Expenditure, Asymmetric Pass-Through, Inflation Tax*

The architecture of modern macroeconomics places central bank governance at the epicenter of economic stability, particularly through the operationalization of explicit monetary frameworks that balance price

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stability with sustainable economic growth (Patra et al., 2021). In emerging market economies like India, the adoption of the Flexible Inflation Targeting (FIT) framework has provided the Reserve Bank of India (RBI) with a formal institutional anchor to manage aggregate price volatility while attempting to foster an enabling macroeconomic environment for capital formation and output expansion (Mohanty, 2023). However, maintaining this delicate equilibrium requires a granular understanding of how monetary policy instruments interact with real economic activity, price dynamics, and household balance sheets (Reserve Bank of India, 2021). Inflation dynamics are rarely restricted to monetary aggregates alone; rather, they are continuously shaped by a complex interplay of global supply chain disruptions, domestic structural rigidities, imported commodity price shocks, and shifting consumer inflation expectations (Goyal & Parab, 2020). Consequently, the primary operational challenge for central banks lies in deploying policy rate adjustments that neutralize inflationary pressures without inadvertently choking the credit flows essential for broader economic development (Ahmed et al., 2024). At the heart of the monetary transmission mechanism lies the intricate behavioral nexus linking central bank policy actions to commercial banking operations and, ultimately, to individual household decisions concerning borrowing, lending, savings portfolios, and consumption expenditure (Bernanke & Blinder, 1992). When a central bank adjusts its policy repo rate, the impulse is expected to ripple through the financial system via multiple interdependent channels, including the interest rate channel, the credit availability channel, and the asset price channel (Mishkin, 1996). Ideally, an increase in the policy rate raises the cost of capital for commercial banks, leading to higher retail lending rates that discourage leveraged consumption and speculative borrowing, while simultaneously raising deposit rates to incentivize household savings (Cucic & Gorea, 2026). Conversely, during phases of economic deceleration, monetary easing is designed to lower borrowing costs, stimulate credit off-take, and encourage private final consumption expenditure (Utari et al., 2020). Nevertheless, the effectiveness of this transmission depends heavily on how households perceive real interest rates, manage their liquidity buffers, and rebalance their asset portfolios between safe financial instruments, riskier market-linked securities, and traditional physical assets like gold and real estate (Basten et al., 2025). Despite the theoretical elegance of these transmission pathways, empirical realities reveal persistent structural frictions, significant time lags, and pronounced asymmetries that complicate the macroeconomic landscape (Borio & Zhu, 2012). Monetary transmission is rarely instantaneous or uniform across the economy. Commercial banks frequently exhibit sluggish adjustment speeds, transmitting policy rate hikes to retail borrowers rapidly while dragging their feet when passing rate cuts on to depositors a structural asymmetry that distorts household savings incentives (Drechsler et al., 2017; Böhnke et al., 2025). Furthermore, persistent inflationary shocks act as a regressive "inflation tax," eroding the purchasing power of disposable incomes and severely undermining the real returns on household financial savings (Albanesi, 2007). When inflation outpaces nominal deposit rates, households experience negative real returns, prompting a behavioral shift away from formal financial savings toward inflation-hedging physical assets, which consequently starves productive sectors of domestic capital (Mohan, 2019). It is precisely these frictions, transmission lags, and distortions in household saving-consumption patterns that necessitate a rigorous empirical investigation into the dynamic interactions between monetary policy, inflation persistence, and consumer behavior.

RESEARCH OBJECTIVES

The foundational blueprint of this empirical investigation is structured around a primary overarching goal supported by four distinct sub-objectives, designed to systematically unpack the complex feedback loops connecting central bank policy to household economic welfare (Patra et al., 2021).

Primary Objective

The primary objective of this study is to comprehensively investigate the dynamic transmission mechanism of monetary policy actions on aggregate inflation rates and to rigorously evaluate their consequential impact on household savings behavior and private consumption expenditure within the modern macroeconomic framework (Mohanty, 2023). By tracing how policy shocks ripple through financial intermediaries and influence real economic decisions, this research aims to provide a holistic assessment of macroeconomic policy efficacy at the household level (Reserve Bank of India, 2021). To fulfill this primary mandate, the study pursues four specific sub-objectives:

- First, the research seeks to analyze the core underlying drivers of inflation dynamics specifically distinguishing between cost-push supply shocks, demand-pull pressures, and imported global price volatilities operating under the contemporary Flexible Inflation Targeting regime (Goyal & Parab, 2020).
- Second, it aims to measure the speed, magnitude, and pass-through efficiency of central bank policy repo rate changes onto commercial bank retail lending rates and domestic term deposit rates, quantifying any structural asymmetries in the transmission process (Drechsler et al., 2017; Böhnke et al., 2025).
- Third, the study examines how fluctuating real interest rates and shifting consumer inflation expectations alter household portfolio choices, particularly regarding the substitution effect between formal financial savings and inflation-hedging physical assets such as gold and real estate (Basten et al., 2025; Mohan, 2019).
- Fourth, it evaluates the short-run and long-run elasticities of private final consumption expenditure in response to unanticipated monetary policy shocks and persistent price volatility, thereby illuminating consumer vulnerability to macroeconomic stabilization policies (Albanesi, 2007; Utari et al., 2020).

METHODOLOGICAL FRAMEWORK

The empirical investigation of monetary policy transmission, inflation dynamics, and their subsequent repercussions on household savings and consumption requires a rigorous, quantitative, and econometric research design (Gujarati & Porter, 2009). To capture both immediate adjustments and sustained structural shifts within the macro-economy, this study adopts a quantitative time-series research design utilizing secondary datasets spanning a robust historical horizon (Enders, 2014). This approach enables the systematic modeling of dynamic interdependencies between central bank policy levers and consumer financial behavior without experimental manipulation, relying instead on historical macroeconomic observations and econometric identification strategies (Stock & Watson, 2015). To ensure high econometric reliability and analytical precision, this study relies exclusively on secondary macroeconomic and financial datasets procured from globally and nationally accredited institutional repositories (Patra et al., 2021). Policy rates, monetary aggregates, Weighted Average Lending Rates (WALR), Weighted Average Domestic Term Deposit Rates (WADTDR), and headline/core Consumer Price Index (CPI) inflation metrics are sourced directly from the statistical publications and databases of the Reserve Bank of India (RBI) and the International Monetary Fund (IMF) International Financial Statistics (Reserve Bank of India, 2021; IMF, 2025). Furthermore, national accounts statistics pertaining to Private Final Consumption Expenditure (PFCE) and gross domestic product are drawn from national statistical office archives, while comprehensive household financial savings figures and consumer sentiment indicators are integrated using structured datasets from the Centre for Monitoring Indian Economy (CMIE) Consumer Pyramids Household Survey (CPHS) and household income-expenditure surveys (CMIE, 2025). The econometric models operationalized in this research are structured around three distinct categories of macroeconomic and financial variables, where the dependent outcome indicators representing household financial health include Household Net Financial Savings (HNFS) as a percentage of disposable income, the Gross Household

Savings ratio, and Private Final Consumption Expenditure (PFCE) (Mohan, 2019). The primary independent transmission and shock variables comprise the Central Bank Policy Repo Rate, commercial bank retail pricing metrics including the Weighted Average Lending Rate (WALR) and Weighted Average Domestic Term Deposit Rate (WADTDR), and both Headline and Core Consumer Price Index (CPI) inflation rates (Drechsler et al., 2017; Goyal & Parab, 2020). To mitigate omitted variable bias and isolate true monetary shocks, the specification incorporates macroeconomic controls such as real GDP growth, per capita disposable income growth, and quantitative consumer inflation expectations derived from central bank survey units (Basten et al., 2025; Utari et al., 2020). To rigorously examine the short-run dynamics and long-run equilibrium relationships, the study employs two primary advanced econometric frameworks. First, the Autoregressive Distributed Lag (ARDL) Bound Testing Approach developed by Pesaran et al. (2001) is deployed to evaluate the long-run cointegrating vectors and short-run error correction mechanisms linking monetary policy transmission, inflation persistence, and household savings-consumption patterns, chosen for its statistical flexibility which accommodates variables integrated of order zero or order one without requiring strict pre-testing for unit roots while accounting for optimal lag lengths to eliminate serial correlation. Second, a Vector Autoregression (VAR) and Structural VAR (SVAR) model is estimated following Sims (1980) and Blanchard and Watson (1986) to trace the propagation of unanticipated monetary shocks and inflationary spikes over time, where plausible economic identifying restrictions generate orthogonalized Impulse Response Functions (IRFs) and Variance Decomposition analyses to map out exact temporal trajectories, transmission lags, and magnitudes through which household savings ratios and consumption expenditures respond to policy rate innovations and price shocks (Bernanke & Blinder, 1992; Borio & Zhu, 2012).

THEORETICAL AND EMPIRICAL LITERATURE REVIEW

The theoretical and empirical exploration of monetary policy transmission and household economic behavior rests upon a robust foundation of macroeconomic literature that traces how central bank actions permeate the broader economy (Mishkin, 1996). Understanding this complex architecture requires examining both the structural mechanisms through which monetary impulses travel and the foundational consumer theories governing household savings and consumption decisions under uncertainty (Patra et al., 2021).

Transmission Channels

The transmission of monetary policy operates through several interrelated pathways that collectively bridge central bank policy rates and real economic activity (Bernanke & Blinder, 1992). The interest rate channel forms the traditional cornerstone of monetary economics, wherein a change in the central bank policy repo rate alters short-term interbank rates, subsequently driving commercial retail lending and deposit rates and thereby modifying the cost of capital for households and firms (Taylor, 1995). Complementing this is the credit channel, which bifurcates into the balance sheet channel and the bank lending channel; it emphasizes how monetary tightening impairs borrower net worth, collateral values, and bank liquidity, thereby restricting credit availability and dampening aggregate demand beyond what standard interest rate effects would predict (Gertler & Gilchrist, 1994). Furthermore, the asset price channel highlights the wealth and substitution effects triggered when monetary policy shifts asset valuations across equity, housing, and bond markets, altering consumer net worth and influencing private consumption expenditure (Mishkin, 2001). Finally, in an increasingly integrated global economy, the exchange rate channel operates through uncovered interest rate parity, where domestic rate adjustments influence capital flows, exchange rate movements, and import prices, thereby directly feeding into domestic inflation dynamics and external trade competitiveness (Obstfeld & Rogoff, 1995).

Savings Behavior Theories

At the microeconomic level, household decisions regarding savings and consumption in response to monetary shocks and price volatility are primarily grounded in classical economic paradigms (Deaton, 1992). Milton Friedman's Permanent Income Hypothesis (PIH) posits that individuals base their consumption choices not on current transitory income, but on their long-term expected permanent income (Friedman, 1957). Consequently, when temporary inflationary spikes or monetary shocks occur, households treat them as transitory deviations, smoothing their consumption paths by adjusting their savings buffers rather than altering their lifestyle standards (Flavin, 1981). This is further expanded by Franco Modigliani's Life-Cycle Hypothesis (LCH), which suggests that individuals accumulate savings during their peak earning years to finance consumption during retirement, thereby linking savings ratios directly to demographic structures, wealth accumulation, and real interest rate returns over a lifetime horizon (Modigliani & Brumberg, 1954). However, in environments characterized by persistent macroeconomic volatility and high inflation uncertainty, these standard models must account for precautionary savings behavior (Buffer-stock saving models), where households ramp up their liquid savings buffers to insure against future income uncertainty and eroding purchasing power, shifting their asset portfolios away from financial instruments toward inflation-hedging physical assets such as gold and real estate (Caballero, 1990; Carroll, 1997).

EXPECTED FINDINGS AND DISCUSSION

The empirical evaluation of monetary policy transmission, inflation dynamics, and household financial behavior yields critical insights into the structural frictions characterizing emerging macroeconomic environments (Patra et al., 2021). By synthesizing econometric modeling outputs with established consumer theory, the anticipated findings illuminate how monetary policy impulses are distorted before reaching household balance sheets, and how persistent price volatility fundamentally restructures consumer savings portfolios (Mohan, 2019). A central finding anticipated from the econometric estimation of commercial bank pricing behavior is the presence of pronounced upward and downward rigidities, commonly referred to as asymmetric pass-through in retail interest rates (Drechsler et al., 2017). Empirical models examining the dynamic adjustment speeds between the policy repo rate and commercial retail metrics specifically the Weighted Average Lending Rate (WALR) and the Weighted Average Domestic Term Deposit Rate (WADTDR) are expected to reveal that commercial banks transmit policy rate hikes to retail borrowers rapidly while dragging their feet when passing rate cuts on to depositors (Böhnke et al., 2025). During monetary tightening cycles, banks aggressively mark up lending rates to protect their net interest margins against rising funding costs and anticipated credit defaults, thereby squeezing household borrowers immediately (Cucic & Gorea, 2026). Conversely, during monetary easing cycles, deposit rates are adjusted downward sluggishly or remain sticky, allowing financial intermediaries to preserve profitability at the expense of household savers (Hofmann & Mizen, 2004). This structural asymmetry blunts the intended stimulative impact of central bank easing, distorts household savings incentives, and creates friction in the interest rate channel of monetary transmission (Mishkin, 1996). Concurrently, the empirical analysis is expected to demonstrate that persistent inflationary shocks act as a severe, regressive "inflation tax" that systematically erodes the real returns on fixed-income financial assets (Albanesi, 2007). When headline and core Consumer Price Index (CPI) inflation outpaces nominal bank deposit rates, households experience negative real interest rates, drastically diminishing the purchasing power of their accumulated financial wealth (Basten et al., 2025). Rather than accepting sustained wealth depletion in formal banking channels, households typically respond by engaging in portfolio rebalancing (Tobin, 1969). Under conditions of high inflation uncertainty and macroeconomic volatility, precautionary savings motives intensify, prompting a structural shift away from liquid financial instruments such as bank deposits, small savings schemes, and corporate bonds toward traditional inflation-hedging physical assets, primarily gold and residential real estate

(Caballero, 1990; Carroll, 1997). While physical assets offer historical protection against purchasing power erosion, this behavioral shift diverts household savings away from the formal financial system, ultimately reducing the pool of domestic capital available for productive investment and long-term economic growth (Mohan, 2019).

POLICY RECOMMENDATIONS

Drawing directly from these econometric insights and the structural rigidities identified in monetary transmission, central monetary authorities, banking regulators, and fiscal policy architects must implement a comprehensive suite of targeted policy interventions to enhance transmission efficiency, eliminate structural asymmetries, and protect vulnerable households from the corrosive effects of inflationary volatility (Mishkin, 1996; Patra et al., 2021).

- First, central banks and banking sector regulators should strengthen regulatory oversight and supervisory frameworks governing commercial bank pricing mechanisms to eliminate asymmetric pass-through. By enforcing greater transparency in internal benchmark-linked lending and deposit rates (such as the External Benchmark Lending Rate framework), regulators must ensure that monetary easing cycles are transmitted expeditiously to retail deposit rates, preventing commercial banks from protecting their net interest margins at the unfair expense of household savers (Drechsler et al., 2017; Hofmann & Mizen, 2004).
- Second, to mitigate the regressive impact of the inflation tax on financial savings, monetary authorities must maintain rigorous adherence to credible Flexible Inflation Targeting (FIT) frameworks, anchoring consumer inflation expectations firmly within low and stable target bands through proactive liquidity management and forward guidance (Mohanty, 2023; Goyal & Parab, 2020).
- Third, policymakers and capital market regulators should champion the aggressive expansion and retail accessibility of inflation-indexed financial savings instruments—such as inflation-indexed bonds and sovereign gold bonds—and foster the deepening of domestic financial markets. This will provide households with safe, liquid, and high-yielding financial alternatives that effectively compete against physical asset hoarding like gold and real estate, thereby channeling domestic savings back into productive capital formation (Tobin, 1969; Mohan, 2019).
- Fourth, to address the structural vulnerability of lower-income groups who lack diversified asset buffers, monetary authorities must collaborate closely with banking institutions to expand financial literacy and promote basic savings account inclusion, ensuring that marginalized populations gain access to formal interest-bearing financial conduits rather than relying on informal, high-risk credit or cash holdings (Demirguc-Kunt et al., 2018).
- Fifth, targeted fiscal and monetary policy coordination is essential to shield vulnerable households from extreme imported supply shocks and food price volatility. This requires deploying calibrated supply-side buffer management, targeted food subsidies, and direct cash transfer safety nets during inflationary spikes, preventing households from experiencing severe consumption-smoothing disruptions (Albanesi, 2007; Utari et al., 2020).
- Finally, central banks should incorporate household balance sheet health and debt-servicing burdens explicitly into their macroprudential surveillance models. By monitoring household leverage ratios and debt-at-risk across income quintiles alongside traditional corporate metrics, monetary policymakers can ensure that stabilization strategies foster not only aggregate price stability but also broad-based, financially resilient, and inclusive economic growth across all strata of society (Borio & Zhu, 2012; Bernanke & Blinder, 1992).

The policy recommendations detailed above establish a comprehensive, multi-dimensional roadmap designed to bridge the persistent gap between central bank monetary interventions

and real household welfare. By moving beyond traditional aggregate-level targeting, this framework explicitly addresses the structural frictions, transmission asymmetries, and distributional inequalities that emerge during economic stabilization cycles. At its core, the framework emphasizes that monetary policy efficacy is severely undermined when commercial banks exhibit asymmetric pass-through rates. By advocating for stringent regulatory oversight on internal benchmark pricing, the recommendations ensure that retail depositors are not unfairly penalized during easing phases, thereby restoring vital incentives for formal household savings. Furthermore, by reinforcing credible Flexible Inflation Targeting and expanding the availability of inflation-indexed financial instruments, the policy measures directly combat the regressive "inflation tax." This effectively curtails the unproductive hoarding of physical assets like gold and real estate, channeling domestic capital back into productive, growth-generating investments. Finally, the integration of macroprudential surveillance over household balance sheets, coupled with proactive fiscal-monetary coordination, ensures that lower-income and vulnerable populations are shielded from external supply shocks. Ultimately, this holistic synthesis guarantees that modern macroeconomic governance fosters not only price stability, but also long-term financial resilience and inclusive economic growth.

CONCLUSION

The intricate relationship connecting monetary policy actions, inflation dynamics, and household financial behavior forms the absolute cornerstone of macroeconomic stability and long-term economic development. Throughout this study, the primary focus has been directed toward understanding how central bank policy decisions ripple through the financial architecture and ultimately influence the daily economic reality of individuals and families. Traditional macroeconomic evaluations have frequently relied on aggregate output metrics, treating the broader economy as a monolithic entity while overlooking the nuanced distribution of monetary shocks across household balance sheets. By shifting the analytical lens toward consumer savings portfolios, private consumption expenditure, and the behavioral adjustments prompted by price volatility, this research provides a comprehensive evaluation of how monetary governance interacts with everyday economic life. The investigation underscores that monetary policy transmission is rarely an instantaneous or frictionless process. Commercial banking systems frequently exhibit structural rigidities and asymmetric pricing behaviors, transmitting rate hikes rapidly to borrowers while delaying relief to depositors. This operational friction distorts financial incentives and imposes unintended burdens on ordinary savers. Concurrently, persistent inflationary pressures function as an invisible and highly regressive tax, systematically eroding the purchasing power of accumulated wealth and forcing households to rethink their financial strategies. When nominal returns on safe financial instruments fall short of rising price levels, families naturally seek refuge in traditional physical assets like gold and real estate to safeguard their hard-earned savings. While this defensive portfolio rebalancing offers individual protection against inflation, it simultaneously deprives the formal financial system of vital domestic capital, slowing down productive investments that fuel national growth. Addressing these profound structural challenges requires a deliberate evolution in macroeconomic policy design. Central banks and financial regulators must look beyond headline inflation figures and interest rate targets to actively monitor the health, leverage, and savings patterns of the household sector. Strengthening regulatory oversight over commercial bank transmission mechanisms, expanding access to inflation-protected financial instruments, and fostering robust financial literacy are essential steps toward bridging the gap between monetary authority decisions and consumer welfare. Furthermore, proactive coordination between monetary policy levers and fiscal safety nets remains indispensable for shielding vulnerable populations from imported price shocks and global supply chain disruptions. Ultimately, true macroeconomic success cannot be measured by price stability alone. A resilient and thriving economy requires a harmonious balance where central bank governance not only tames inflation, but also protects household savings, fosters inclusive

financial participation, and lays a secure foundation for sustainable, equitable long-term growth across all segments of society.

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