The Effect of Foreign Shocks on the Indian Economy\*

Aeimit Lakdawala † Sanjay R. Singh ‡

**Abstract**

The Indian economy has been increasingly exposed to external shocks with growing financial and trade integration. We examine the effects of four key international shocks: shocks to US monetary policy, oil supply, global economic policy uncertainty, and geopolitical risk. Using the external instruments strategy with local projections (LP­IVs) and structural vector auto regressions (SVAR­IVs) methods, we document the dynamic causal effects of these shocks on the Indian economy. We find significant effects of these foreign shocks on both macroeconomic and financial variables. Combined, these shocks explain about 15% to 35% of the variation in inflation, output, and financial variables at two to four-year horizons. However, the magnitude of effects on output are lower relative to both world output and output of peer developing countries. While the oil shock behaves like a traditional supply shock, the US monetary policy and economic policy uncertainty shocks look more like domestic demand shocks. We discuss the implications for stabilization policy.

Keywords: foreign shocks, Indian economy, external instruments

JEL Classifications: F4, E5, C3

\*We are grateful to Barry Bosworth, Ken Kletzer, Mihir Desai, Pami Dua, Karthik Muralidharan, Shekhar Shah, Rajeswari Sengupta, Abhijit Banerjee, Montek Singh Ahluwalia, Rakesh Mohan, Anne Krueger, Nirvirkar Singh and Rajnish Mehra for useful comments and suggestions.

†Corresponding author: Department of Economics, Wake Forest University (lakdawa@wfu.edu).

‡Department of Economics, University of California, Davis ([sjrsingh@ucdavis.edu](mailto:sjrsingh@ucdavis.edu)).

In recent years, increases in financial and trade linkages to the rest of the world has exposed India to global economic spillovers. This has worked through a variety of channels, including reliance on imported oil, exposure of financial markets to capital flows driven by global financial cycle and fluctuations in the exchange rate. These and other channels have contributed to the inclusion of India in the “fragile five” during the recent “taper tantrums”' episode.[[1]](#footnote-1)

While there has been much work studying the transmission of foreign shocks to emerging economies, there has been surprisingly little research that specifically answers these questions for the Indian macroeconomy. In this paper, we document the impact of foreign shocks on Indian macroeconomy. Our contribution is along two main dimensions. First, we focus on estimating dynamic causal effects of international shocks using the recently developed method of identification through external instruments. Second, we consider a comprehensive set of external shocks that are likely to have been important for driving economic fluctuations in India.

A key challenge in estimating dynamic causal relationships boils down to finding random variation in the treatment of interest. To tackle this issue, we rely on the recent progress made in the empirical macroeconomics literature in identifying exogenous macroeconomic shocks using a variety of new methodological innovations, see Ramey (2016) for an excellent recent survey. We incorporate these measures of identified exogenous shocks in a structural framework using both the local projections and structural vector autoregression frameworks. Within these frameworks we follow the recent modeling innovation of the external instruments approach, where the methodology involves using information outside (or external to) the core model to achieve the restrictions required for estimating causal relationships, see the work of Stock & Watson (2002), Mertens & Ravn (2013), Ramey & Zubairy (2018), and Jordà*,* Singh & Taylor (2020). Stock & Watson (2018) provide a survey of this literature focusing on the two main techniques of LP-IV (local projections instrument variables) and SVAR-IV (structural vector autoregression instrumental variable). Based on the relevance for the Indian economy, our focus is on a core set of shocks which include U.S. monetary policy, oil supply, commodity prices, uncertainty, and geopolitical risk.

As documented by Miranda-Agrippino & Rey (2018), there is a global financial cycle that is important for driving international flows and that the source of this cycle is the US Federal Reserve. Additionally, new work by Lakdawala (2018) shows that the spillover effects of US monetary policy to Indian financial markets has increased since the early 2000s. We incorporate US monetary shocks into our analysis by using high frequency changes in futures rates around the policy announcements of the Federal Open Market Committee (FOMC). The futures rates incorporate market expectations and thus any change in these futures rates in a narrow window around the FOMC announcement are likely due to unexpected changes in the monetary policy announcement. This approach has been used widely in the recent literature studying US monetary policy, see Gertler & Karadi (2015) for example.

According to the International Energy Agency, as of 2018, India was the third largest importer of crude oil. Hence, another important source of foreign shocks for the Indian economy is the fluctuations in the global price of oil. Since India accounts for a large share of total world oil consumption, changes in India's demand for oil are likely to be an important driver of the global price of oil, making causal identification of oil price shocks problematic. However, India's contribution to world oil production is less than 1% and thus supply disruptions in India are unlikely to be a contributor to changes in the global price of oil. Thus, we use an exogenous measure of oil supply shocks to identify the causal effect of disruptions in the global oil market to the Indian economy. While there is a long literature on separating oil demand from oil supply shocks, see for example Kilian (2009), we use the recently developed measure of oil supply shocks in Baumeister & Hamilton (2019). They use a Bayesian approach to rigorously incorporate prior information about supply and demand elasticities to identify oil supply shocks.

Our final two measures of baseline foreign shocks involve uncertainty. In a recent speech, Bank of England Governor Mark Carney (Carney, 2016) outlined an “uncertainty trinity” composed of economic, policy and geopolitical uncertainty as being important factors for economic activity. Recent work has also highlighted the importance of uncertainty and risk aversion for international asset prices and capital flows, see for example the work of Rey (2015) and Bruno & Shin (2015). There is also evidence for the substantial effects of US uncertainty on emerging economies, see Bhattarai, Chatterjee & Park (2017). For recent work exploring the impact of US uncertainty on the Indian economy see Ghosh, Sahu & Chattopadhyay (2017). We proxy uncertainty with two measures that are constructed from newspaper analyses by counting the relative frequency of certain key terms. The first measure proxies for global economic policy uncertainty, constructed by Baker et al. (2016), and the second measure is a proxy for geopolitical risk, constructed by Caldara & Iacoviello (2018).

Our main empirical analysis builds on the recent work of Mishra, Montiel & Sengupta (2016), who identify monetary policy shocks in India in a SVAR setting.[[2]](#footnote-2) Specifically, we use the index of industrial production as a proxy for output and the consumer price index to measure inflation. In addition to these macro variables we consider a variety of financial market variables. For our measure of interest rates, we use the ten-year Indian government bond rate. While there are a variety of short-term rates that could have better helped assess the response of the Reserve Bank of India to foreign shocks, we found data availability and non-variation over time to be an issue for several of these measures. Our qualitative results do not change if short-term repo rate is used instead of ten-year government bond rate. Moreover, since we want to focus on aggregate economic effect of foreign shocks, we concluded that a longer interest rate was the appropriate choice. We use the nominal exchange rate of Indian rupee with US dollar as our baseline measure of exchange rates. We found that using real and nominal effective exchange rates, that are constructed with a broader set of countries, gave similar results. Finally, we also include an indicator for the aggregate stock market index and total foreign reserves (excluding gold) measured in US dollars. We believe that the total foreign reserves and the ten-year government bond rate indirectly capture the policy stance of RBI, which uses various tools in its conduct of monetary policy.

Reassuringly, we find similar results using either the local projection or structural vector autoregression estimation strategy. Here are the key findings. US monetary, economic policy uncertainty and oil supply shocks have substantial disruptive effects on both economic activity and financial markets in India. But the geopolitical risk shock does not have a major discernible effect. Overall, US monetary policy and economic policy uncertainty have effects similar to a domestic demand shock while the oil shock has effects similar to a supply shock. From a stabilization policy perspective, this means that there is a tradeoff involved in responding to oil shocks but not US monetary or economic policy uncertainty shocks.

For the monetary policy shock, our results corroborate Rajan (2015)’s findings that US monetary policy indeed has important financial spillovers to the Indian economy. In response to a contractionary monetary policy shock to US policy rates, the Indian rupee depreciates, domestic stock market index and total foreign reserves held by the government decline. While financial market response is striking, the effect on inflation and output is relatively smaller. The real effects are consistent with the global spillovers of US monetary policy. The peak drop of India's monthly industrial production is -0.3%. To benchmark these effects, the peak drop in world industrial production is -0.4% and in BRICS industrial production is -0.3%.

Second, surprise increases in policy uncertainty measured with global economic policy uncertainty index of Baker et al. (2016) negatively affects real activity as well as financial market indicators. Industrial production exhibits a persistent drop which peaks at -0.3% at 16 quarters and becomes statistically indistinguishable from zero subsequently. Stock market index, government bond rate, and total reserves also decline significantly while rupee depreciates.

Third, geopolitical risk shocks lead to a delayed appreciation of the rupee, increase in total foreign reserves held by the government and expansion in stock market. The effect of this geopolitical risk shock is muted on prices and output. One way to understand these results is a flight to safety story: when the global geopolitical risk goes up, Indian economy becomes an attractive destination.

Finally, oil supply shocks act as textbook adverse supply shocks. After an adverse supply shock, there is a simultaneous drop in output and an increase in prices. Moreover, the effect is persistent. Relative to the BRICS benchmark we find that Indian output is more adversely affected by oil supply shocks. The shock also causes a general worsening of financial conditions with a reduction in total reserves, depreciation of the rupee and a fall in stock prices.

Overall, the exposure of Indian output to these shocks is lower relative to an index of advanced economies but comparable to an index of BRICS economies. To better understand how India performs among peer developing countries, we compare the response of Indian output individually to that of China, Russia, Brazil and South Africa. We find that, with the exception of China, Indian economy reacts less to these foreign shocks relative to these counterpart countries. This suggests that in facing an adverse international shock, the Indian economy is more resilient than other developing countries. But on the flip side, since the estimated model’s effects are symmetric, it implies that the Indian economy may also miss out from the positive effects of beneficial international shocks.

With the growing integration of India into the world economy, one might expect that the responsiveness of the Indian economy to international shocks has changed over time. To test this, we estimate the impulse responses for India by splitting our sample into two halves (pre and post December 2005). But for most of the variables (including output) we do not find statistically significant differences in the responses. What explains this phenomenon? A comprehensive analysis of this question would investigate any structural changes in the Indian economy and the response of policymakers. While this exercise lies outside the scope of this paper, our results provide some suggestive evidence on the role that monetary policymakers might have played.

Central banks can respond to international shocks primarily by changing their policy interest rates or intervening in exchange rate markets, at least in terms of conventional policy tools. A common pattern that also emerges in the analysis is the modest response of the 10-year government bond rate to these adverse global shocks. This has potentially important implications from a policy stabilization perspective. For example, policymakers may consider easing of interest rates in response to adverse international shocks. For the oil supply shock, the central bank faces a clear trade-off as output falls, but prices rise. Thus, if the central bank is worried more about higher inflation then it may want to refrain from lowering rates and accept the downturn in economic activity. But the US monetary policy and uncertainty shocks have effects that look like domestic demand shocks. In this case there is no longer a tradeoff and optimal monetary policy from conventional models dictates that the central bank lower rates.

In light of this, we think there are two different ways to interpret our results of relative non-responsiveness of the 10-year interest rate. First it is possible that the Reserve Bank is not responding strongly with interest rate changes to the international shocks, either because they fail to identify the shocks in a timely manner or if they perceive the tradeoff as too costly. Alternatively, the Reserve Bank is indeed responding to these shocks by changing interest rates but that the transmission mechanism of monetary policy in India is weak and thus there are no substantial effects on the long rate.

But the Reserve Bank of India has also intervened in the exchange rate market in response of international events. Our results from the split-sample estimation show that in response to adverse monetary and oil shocks, the Indian rupee depreciates less in the more recent sample. One potential factor could be the actions (or anticipated actions) of the Reserve Bank of India becoming stronger in the last decade or so. Our results highlight that disentangling these different channels is important to understand the role of monetary policy in overall stabilization policy.

Finally, we consider what each shock implies about the contribution to the forecast error variance of the core Indian macro variables. Overall, we find that the oil supply shock is the most important shock for explaining variations in industrial production. Specifically, oil shocks appear to create the most disruption in output around a year or two after impact. For inflation we find that the two uncertainty shocks and the oil supply shocks are important contributors to its variation. For the US monetary policy shock, we find more modest effects on both financial market variables and output and prices. Overall, when we sum up the contribution of the four main shocks that we consider, we find that just these four shocks can explain from 15% up to 35% of the variation in the Indian financial and macro variables at two to four-year horizons. We discuss some caveats to this analysis and recommend viewing these numbers as un upper bound. Nevertheless, the overall picture that emerges is that these four shocks combined account for a significant source of international fluctuations that are important for the Indian economy.

Our objective is to bring a new set of facts to the macro-policy debate in India. Understanding the quantitative response of the Indian economy to past international shocks is an important first step in preparing the policy response to future shocks. Moreover, our hope is that the econometric tools we have used can then be readily applied by researchers in policy institutions to broaden our understanding of the Indian macro economy. Finally, the new facts that we document can guide economic modelers in building structural economic models relevant for the Indian economy.

**2. Methodology**

To estimate dynamic causal effects, we will consider a structural framework that relies on both the local projections (LP) framework and vector autoregression framework (SVAR). For both these approaches we will either directly incorporate exogenous measures of shocks or use the instrumental variables framework.

The first strategy is to use a structural vector autoregression framework. Consider the structural VAR where is an vector of macroeconomic variables and and are parameter matrices

The components of the error terms are assumed to be uncorrelated with each other and interpreted as structural shocks. Pre-multiply by to get the reduced form VAR

where

and Also note that . This reduced form VAR can be estimated in a straightforward manner. However, identification of the impulse responses to the structural shocks requires an estimate of the matrix This requires further identifying restrictions. If the structural shock of interest is directly observable then we will order it first in the vector and use a Cholesky ordering to identify the structural impulse responses. If we do not directly observe the structural shock but have an instrument for it () then we will use the external instruments procedure developed by Stock & Watson (2002) and Mertens & Ravn (2013). In the external instruments methodology, the key requirements are to find instruments that are i) correlated with the shocks of interest, and ii) uncorrelated with the other structural shocks. Denote the structural policy shocks as and the structural non-policy shocks as . The reduced-form residuals from the corresponding policy and non-policy equations are denoted and respectively. For a given set of instruments , these two conditions can be formally stated as

With these conditions it can be shown in a straightforward manner how to identify the structural impulse responses, see for example Mertens & Ravn (2013).

Jordà (2005) introduced the local projections method for directly estimating impulse responses without relying on assumption that the vector auto regression (VAR) is correctly specified. In an analogy with forecasting, this method involves forecasting future values of a variable using a horizon specific regression rather than iterating one-period ahead on the estimated model. Estimating impulse responses using VAR is analogous to iterated forecasting while local projections method is analogous to direct forecasting. With a correctly specified VAR and standard assumptions on invertibility, Stock & Watson (2018) and with some generality Plagborg-Møller & Wolf (2019) prove that the impulse responses estimated using structural VARs and local projections are identical. However, in small samples, it is possible to reach different conclusions using the two different methods, thus we explore both of them in this paper.

For incorporating instruments variables into the *local projections* framework, we will follow the recent literature (Jordà Singh & Taylor 2020, Ramey & Zubairy 2018). This strategy is appropriate if the direct shocks are measured with error or if they capture only part of the shock. we treat the measured macroeconomic shocks as proxy for the true shocks . Here we describe the estimation strategy with local projections instrumental variables technique, and relegate the discussion of SVAR-IV to the appendix. In the first-stage, we instrument a policy indicator (for example the federal funds rate) with the relevant proxy. In the second stage, we run a sequence of predictive regressions of the dependent variable on the instrumented policy indicator for different prediction horizons. The estimated sequence of regression coefficients of the instrumented policy indicator are then the impulse responses.

More specifically, we estimate the following second-stage LP specification for horizons :

is the predicted policy instrument from the first-stage regression using instruments for the measured macroeconomic shocks . The set includes lags of dependent variable, the policy indicator, the policy instrument, and the current and lagged conditioning variables that identify exogenous fluctuations in the instrument and improve precision of standard errors (see Stock & Watson, 2018). The dynamic coefficients of interest are, therefore, the estimates of for . We compute standard errors based on heteroskedasticity and autocorrelation robust covariance matrix (Newey-West) estimators. We report one standard deviation confidence bands in our estimated impulse responses.

**3. Data**

***3.1 Indian Macro Data***

We consider the impact of external shocks on industrial production, consumer price index, holdings of foreign reserves, exchange rates, ten-year government bond rate and stock prices. We use the data for nominal exchange rate of INR with respect to US Dollar, stock price index (measured in constant USD), and total foreign reserves from the Global Economic Monitor database of the World Bank, and the International Financial Statistics of the IMF. We use Index of Industrial Production (seasonally adjusted) from the OECD database, and obtain non-seasonally-adjusted consumer price index from St Louis Fed's database.

Historically, Indian monetary policy has been conducted using multiple instruments: price-based and quantity-based. Starting from 3rd April, 2001 the RBI used the repo-rate as the price-based instrument. for the preceding years, we follow the BIS in using the bank rate as the price-based policy instrument. Quantity based instruments such as the Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) have also been used regularly. Nonetheless, we measure the overall stance of monetary policy using the price-based instruments.[[3]](#footnote-3) In the main text, we only report the impulse responses for ten-year government bond rate. Data for this series is available for the longest duration and exhibits considerable time-variation relative to short-term interest rate set by the RBI, as shown in FIGURE 1. Moreover, the RBI uses variety of instruments in its conduct of monetary policy. Market driven variation in the ten-year bond yields would proxy for variation in other instruments used by the central bank. Impulse responses for other policy indicator variables are available on request.

FIGURE 1: Interest rates: Repo and 10-year G-Sec

INSERT FIGURE 1 HERE

*Notes:* This figure compares the evolution of repo rate with interest rate on the ten-year bonds issued by the government of India. The sources for data series are described in the text. Sample: February 1996 - December 2018. See text for details.

We also looked at the responses of nominal and real effective exchange rates. The results are similar to the USD/INR nominal exchange rate. The data for these series came from the Global Economic Monitor database of the World Bank, and the International Financial Statistics of the IMF.

Next, we provide the details for our four baseline shock measures that we use in the analysis.

***3.2 U.S. Monetary Policy Shocks***

For measuring exogenous changes in the stance of US monetary policy we follow the external instruments (proxy-SVAR) strategy developed in Mertens & Ravn (2013) and Stock & Watson (2002). This methodology involves finding instruments that are correlated with the structural shock of interest (US monetary policy shock here) but uncorrelated with the other structural shocks. We follow the work of Gertler & Karadi (2015) and use changes in futures contracts in a narrow window around FOMC announcements as instruments to identify a structural US monetary policy shock within a standard SVAR. We use both federal funds futures and Eurodollar futures contracts. Specifically, we use the current month's and next month's fed funds futures contracts and the 2, 3 and 4 quarter ahead Eurodollar futures contracts. Following Nakamura & Steinsson (2018) we take the first principal component of the change in these contracts in a thirty-minute window around the FOMC announcement. Recent work in the literature has highlighted a potential issue with this approach by finding counterintuitive effects of monetary policy shocks based on information effects, see for example Nakamura & Steinsson (2018) and Lakdawala (forthcoming). To overcome this problem, we undertake two steps. First, we cleanse the instrument from information effects using real GDP forecasts from market-based measure of survey forecasts (*Blue Chip*). Specifically, we regress the instrument on four lags of itself, the *Blue Chip* real GDP forecast for the previous quarter, current quarter, next quarter, two quarters ahead and three quarters ahead. Second, we use this instrument to estimate the SVAR model of Gertler & Karadi (2015) and then use the estimated structural shocks from this SVAR as our baseline measure of monetary policy shocks. This approach ensures that the information contained in the survey forecasts and in the SVAR considers any predictability and information effects. Specifically, the SVAR model that we use for the US includes monthly data on industrial production, CPI price index, the excess bond premium of Gilchrist & Zakrajek (2012) and the 1-year Treasury rate as the monetary policy tool. The estimated monetary policy shock is plotted in the top left panel of FIGURE 2.

FIGURE 2: Foreign Shocks

INSERT FIGURE 2 HERE

*Notes:* This figure plots the four main shock measures. The sources for data series are described in the text. Sample: February 1994 - December 2017. See text for details. *Authors’ own calculations*.

***3.3 Economic Policy Uncertainty Shocks***

We will use the measure of Baker et al. (2016) of economic policy uncertainty (EPU). This measure is constructed by analyzing newspaper coverage and measuring the relative frequency of words that capture “… a trio of terms pertaining to the economy (E), policy (P) and uncertainty (U).” We use the Global EPU variable that captures economic policy uncertainty for 20 major economies. This measure is plotted in the top right panel of FIGURE 2. To identify the dynamic causal effects of changes in economic policy uncertainty Baker et al. (2016) use a SVAR with a Cholesky identification strategy by ordering the EPU index first. Recent work by Carriero et al. (2015) has pointed out that this approach can lead to attenuation bias due to measurement error. They advocate using a SVAR approach with external instruments. This approach has also been used recently by Caballero & Kamber (2019). Specifically, we construct a dummy indicator that takes the value one when the EPU index exceeds 1.65 times the unconditional standard deviation of the HP filtered data. The indicator is also plotted in the top right panel of FIGURE 2 (y-axis shown on the right side). This dummy indicator is used as an instrument for the structural shock to the EPU index in both the SVAR and LP frameworks.

***3.4 Geopolitical Risk Shocks***

We will use the geopolitical risk measure of Caldara & Iacoviello (2018). They use a methodology that is similar to Baker et al. (2016) and involves counting the frequency of newspaper articles related to geopolitical risk. They define geopolitical risk as “... risk associated with wars, terrorist acts, and tensions between states that affect the normal and peaceful course of international relations.” This measure (GPR) reflects both the risk of these adverse events occurring together with the actual realization of these events. Again, to identify the causal effects of geopolitical risk shocks, Caldara & Iacoviello (2018) use a SVAR identified with Cholesky ordering. Since the same caveat about measurement error and attenuation bias applies, we follow same approach as above to construct a dummy variable. Both the GPR index (y-axis shown on left) and the dummy indicator (y-axis shown on the right) are plotted on the bottom left panel of FIGURE 2

***3.5 Oil Shocks***

Given India's reliance on imported oil, a potentially important source of shocks to the Indian economy involves changes in the price of crude oil. Of course, oil prices dynamics are driven by shocks to both oil supply and oil demand. Since India is the third largest consumer of oil (after U.S. and China), oil demand shocks can be expected to be driven in part by changes to India's economic conditions. On the other hand, India contributes to less than one percent of total world oil production and thus oil supply disruptions originating in India are unlikely to move the global price of oil. Thus, to study the causal effect of changes in oil prices we rely on an exogenous measure of oil supply shocks. Specifically, we use the newly developed measure of oil supply shocks by Baumeister & Hamilton (2019). They use a structural vector autoregression framework to disentangle oil supply shocks from oil demand shocks. While the existing literature has made some strong assumptions about relevant elasticities, their Bayesian framework allows them to incorporate uncertainty about these elasticities in a transparent manner. The estimated oil shock is plotted in the bottom right panel of FIGURE 2.

**4. Results**

***4.1 Benchmark: World and BRICS Industrial Production***

We first document the responses of both world and BRICS countries industrial production to the external shocks. We believe this is useful for at least two reasons. First, these responses will be helpful to understand the nature of the foreign shock, for example whether it is contractionary and expansionary or the persistence of the effects of the shock. Second, it will help place a benchmark on the quantitative magnitudes we should have in mind when we go to the India specific macro and financial variables.

FIGURE 3: Response to one standard deviation shock: WIIP

INSERT FIGURE 3 HERE IN FOUR PANELS

|  |  |
| --- | --- |
| A: Monetary Policy Shock  INSERT FIGURE3TOPLEFT\_MP.PNG | B: Economic Policy Uncertainty Shock  INSERT FIGURE 3TOPRIGHT\_EPU.PNG |
| C: Geopolitical Risk Shock  INSERT FIGURE3BOTTOMLEFT\_GPR.PNG | D: Oil Supply Shock  INSERT FIGURE 3BOTTOMRIGHT\_OIL.PNG |

*Notes:* SVAR estimated response of world industrial production (OECD + BRICS) region to a one standard deviation shock. Shaded areas represent one standard deviation confidence intervals. Standard errors are bootstrapped as in Gertler & Karadi (2015). WIIP is an extended version of the OECD’s index of monthly industrial production in the OECD and six major other countries developed by Baumeister & Hamilton (2019). The sources for shocks are described in the text. Sample: February 1997 - December 2017. See text for details. *Authors’ own calculations*.

Our sample uses monthly data from January 1994 to December 2017. For the economic policy uncertainty shock, the sample starts in February 1997. FIGURE 3 plots the impulse responses of world industrial production to our four measures of shocks, namely, shocks to US monetary policy, economic policy uncertainty, geopolitical risk and global oil supply shocks. This measure of industrial production includes all OECD countries plus the six major non-member economies (Brazil, China, India, Indonesia, Russia and South Africa). As mentioned above the impulse responses are computed using a combination of putting our shocks directly in the SVAR or LP framework and using them as instruments in the SVARIV or LPIV framework. Specifically, for the monetary policy and oil supply shock we use these measures of exogenous shocks directly. For the responses to economic policy uncertainty and geopolitical risk shocks, we use the dummy indicators described above as instruments. FIGURE 3 displays the responses to a one standard deviation shock from a bivariate SVAR framework which include log of the industrial production index and the relevant shock. The impulse responses from the LP framework are similar and are put in the appendix. The blue dotted lines represent one standard deviation confidence bands, where the standard errors are computed using a bootstrap algorithm.

The top left panel shows the response to a contractionary US monetary policy shock, or an unexpected increase in short-term interest rate by the Federal Reserve. The response of world industrial production displays an inverse hump-shaped response with a trough of about –0.4% at the 1-year mark. The effects of the shock have faded by the 2-year horizon. These results are consistent with the hypothesis of global financial cycle (Miranda-Agrippino & Rey 2018) which find substantial global effects of US monetary policy. The top right panel shows the response to an increase in economic policy uncertainty. World industrial production falls on impact and the peak fall of 0.4% is reached around 6 months, the response stays around this level for about a year before reverting back. The bottom left panel shows a one standard deviation increase in geopolitical risk. The effects of this shock are also contractionary but somewhat smaller with a peak effect of –0.15%. Finally, the bottom right panel shows the response to an adverse supply shock in the oil market. As expected, we see a contractionary effect on world industrial production with a peak fall of about 0.3 %. In addition to having quantitatively meaningful effects, for all the four shocks the peak effect roughly around the one-year mark is also statistically significant as indicated by the confidence intervals.

FIGURE 4: Response to one standard deviation shock: BRICS IIP

INSERT FIGURE 4 HERE IN FOUR PANELS

|  |  |
| --- | --- |
| A: Monetary Policy Shock  INSERT FIGURE4TOPLEFT\_MP.PNG | B: Economic Policy Uncertainty Shock  INSERT FIGURE 4TOPRIGHT\_EPU.PNG |
| C: Geopolitical Risk Shock  INSERT FIGURE4BOTTOMLEFT\_GPR.PNG | D: Oil Supply Shock  INSERT FIGURE 4BOTTOMRIGHT\_OIL.PNG |

*Notes:* SVAR estimated response of monthly seasonally adjusted industrial production in the four BRICS region to a one standard deviation shock. Shaded areas represent one standard deviation confidence intervals. Standard errors are bootstrapped as in Gertler & Karadi (2015). The BRICS industrial production data is from World Bank Global Economic Monitor. Sample: February 1997 - December 2017. The sources for shocks are described in the text. *Authors’ own calculations*.

FIGURE 4 plots the impulse responses of industrial production for BRICS countries (Brazil, Russia, India, China and South Africa). The broad pattern of responses for these countries is similar to that of world industrial production qualitatively. Quantitatively, the responses are slightly smaller. For both the US monetary policy shock and economic policy uncertainty shock, the peak fall is around –0.25% (relative to roughly ­­–0.4% for world index). We do see a notable difference in response to the geopolitical risk shock. After this shock, BRICS industrial production actually rises slightly on impact before falling. However, the magnitude of the fall is quite small and is statistically insignificant. Thus, while geopolitical risk shocks had a clear adverse effect on OECD countries, there appears not to be much of an effect on BRICS countries. Finally, the response to oil supply shocks is quite similar to the world industrial production case.

In summary, we have established that adverse increases in our four shock measures have substantial and statistically significant on world industrial production and a somewhat smaller effect on industrial production in the BRICS countries. This establishes a simple benchmark for comparing the response of Indian economic activity, which we undertake next.

***4.2 Impulse responses for India economy***

In this section we present the impulse responses for the Indian macroeconomic and financial market variables. We have done the estimation using both the SVAR and LP frameworks outlined above. The results are consistent with both methods, so we relegate the LP estimation results to the appendix. From an econometric perspective, SVARs and local projections should give similar results as long as certain conditions about the sufficiency of the information set are met. Overall, we find similar results using both approaches which is reassuring. For the rest of this section we present results using the SVAR framework and the local projection results are presented in the appendix.

We estimate the impulse response functions for six Indian macro and financial variables available at monthly frequency: industrial production, consumer price index, nominal exchange rate USD/INR, yields on ten-year government bonds, stock market index and USD value of total foreign reserves (minus gold) as a measure of international liquidity (coded as RAXG\_USD in IMF/IFS). Following the recent trend in the empirical macroeconomics literature (see for example Gertler & Karadi (2015), we run the SVAR in log levels. Specifically, we put the 10-year bond rate in levels (percentage points) and for all the other variables we take the log of the variable and then multiply by 100. We also check the robustness of our results using a “gaps” specification. In this case we de-trend the seasonally-adjusted industrial production using HP filter with monthly frequency smoothing parameter of 14400. Further, we take the year-over-year percent change in the CPI price index to calculate the inflation. rate. This specification is similar to the one used recently by Mishra et al. (2016). We find that the results are similar using this approach and thus do not report these impulse responses in the main draft.

The SVAR is estimated with twelve lags. All figures are presented as responses to a one standard deviation “adverse” shock. This means that based on the responses shown for world and BRICS industrial production these shocks are expected to lower economic activity, for example an increase in U.S. interest rates or an increase in the global price of oil. One standard deviation confidence interval constructed using a bootstrap algorithm are reported on all the impulse response figures.

***4.2.1 Monetary policy shocks***

FIGURE 5 presents the impulse response to a contractionary monetary policy shock. On impact, the rupee depreciates and reserves and the stock market fall as has been documented in the literature, see for example Lakdawala (2018). These variables take about a year to a year and a half to recover from this shock. Overall, these effects are statistically significant and sizeable for reserves and the stock market with a peak fall of around 1.5% and 0.75% respectively. The response of prices, output and the government bond rate are not significant on impact but all three variables display a fall around the 6 months to 1-year mark. The peak fall in Indian industrial production is around 0.3%, which is quite similar to the fall in the BRICS industrial production displayed above and slightly smaller than the peak fall in world industrial production. However, Indian industrial production does not display the inertial and persistent response and has almost recovered around the 15-month mark.

FIGURE 5: SVAR response to monetary policy shock

INSERT FIGURE 5 HERE

*Notes:* SVAR estimated response of monthly industrial production, consumer price index, USD/INR nominal exchange rate, ten-year government bond rate, stock market index, and total reserves (excluding gold) outstanding to a one standard deviation identified US monetary policy shock. Shaded areas represent one standard deviation confidence intervals. Standard errors are bootstrapped as in Gertler & Karadi (2015). The sources for data series are described in the text. Sample: February 1994 - December 2017. See text for details. *Authors’ own calculations*.

These results are consistent with the story of the global financial cycle. Monetary policy shocks originating in the U.S. are prorogated throughout the world through the global financial cycle. However, we should note that relative to the size of the effect on the stock market and Dollar reserves, the effect on prices and. Thus, Indian economic activity is to some extent shielded from the global financial cycle.

***4.2.2 Economic Policy Uncertainty Shocks***

The impulse responses to a one standard deviation shock that increases the economic policy uncertainty are shown in FIGURE 6. Industrial production has a sustained fall for over two years of around 0.2%. The size of this effect for Indian industrial production is very similar to the size of the fall in BRICS industrial production. This shock has larger on the financial markets that are persistent as well. The rupee depreciates and Dollar reserves and stock market falls. Quantitatively, the stock market index falls more than 1% on impact and the peak effect is more than 2% after a couple of months. Reserves fall by a quarter percent on impact but gradually fall to trough at 0.75% and staying lower for over a year. The rupee depreciates on impact and returns back around the six-month mark. The government bond rate heads slightly lower around the six-month mark before recovering. Thus, an increase in global economic policy uncertainty is clearly detrimental to the Indian economy both immediately on impact and in the medium term.

FIGURE 6: SVAR response to economic policy uncertainty shock

INSERT FIGURE 6 HERE

*Notes:* SVAR estimated response of monthly industrial production, consumer price index, USD/INR nominal exchange rate, ten-year government bond rate, stock market index, and total reserves (excluding gold) outstanding to a one standard deviation identified shock to global economic policy uncertainty. Shaded areas represent one standard deviation confidence intervals. Standard errors are bootstrapped as in Gertler & Karadi (2015). The sources for data series are described in the text. Sample: February 1997 - December 2017. See text for details. *Authors’ own calculations*.

***4.2.3 Geopolitical Risk Shocks***

FIGURE 7 presents the impulse responses to a one standard deviation increase in the geopolitical risk shock. With this shock the SVAR results do not show a clear discernible pattern. The responses of both industrial production and consumer price index is quantitatively small and statistically insignificant. Thus, the response of Indian industrial production is consistent with the response of BRICS industrial production seen above: neither appear to be substantially affected by the geopolitical risk shock. Even for the financial market variables, we notice that the responses are mostly near zero and insignificant. The one exception is the stock market which falls on impact. Overall for the financial variables, if anything, this adverse shock represents some beneficial effects with an increase in the dollar reserves and a delayed rise in the stock market. Thus, in contrast to the other shocks, while the geopolitical risk shock does have a significant effect on OECD countries, for India as with the BRICS countries in general

FIGURE 7: SVAR response to geopolitical risk shock

INSERT FIGURE 7 HERE

*Notes:* SVAR estimated response of monthly industrial production, consumer price index, USD/INR nominal exchange rate, ten-year government bond rate, stock market index, and total reserves (excluding gold) outstanding to a one standard deviation identified shock to geopolitical risk measure. Shaded areas represent one standard deviation confidence intervals. Standard errors are bootstrapped as in Gertler & Karadi (2015). The sources for data series are described in the text. Sample: February 1997 - December 2017. See text for details. *Authors’ own calculations*.

***4.2.4 Oil Supply Shocks***

FIGURE 8 shows the impulse response to the oil supply shock. Industrial production falls on impact by 0.3%. Relative to world and BRICS industrial production, this contemporaneous response of Indian industrial production is larger. Moreover, this response stays negative and significant even at the two-year mark. Thus, from the four shocks we have considered the oil shock has the largest and persistent effects on Indian economic activity. Consistent with expectations, the oil supply shock responses look like a textbook “supply-shock.” Output goes down while at the same time prices go up. The consumer price index rises on impact and is still higher at the two-level horizon. The rupee depreciates on impact and the peak effect is almost half a percent. This is larger than in response to other three shocks. Moreover, this effect is persistent with the rupee being lower even at the two-year horizon. Dollar reserves also fall on impact and stay about 0.5% lower at the two-year horizon. The stock market and 10-year government bond yield fall on impact but recover somewhat faster. Thus, overall an adverse oil supply shock has large effects on both macroeconomic and financial market variables. Moreover, these effects are felt contemporaneously and they persist over the medium term.

One common theme emerges from the four shocks about the response of the 10-year government bond rate. In response to these adverse shocks, which cause disruption in the financial markets and lower economic activity, the typical response of monetary policy makers would be to ease interest rates to help the economy recover. While we do see that typically the government bond rate tends to decline, the magnitude of the fall is quite small. We think this is an important point that needs to be explored more. There are two reasons why this could be happening. First, it could be the case that the Reserve Bank of India is not responding enough to offset these shocks. But even if the Reserve Bank of India is recognizing these shocks and responding appropriately by changing policy rates, it could be the case that the monetary transmission mechanism is not effective. Indeed, there is corroborating evidence for this latter explanation. For a prominent paper, see the recent work of Mishra et al. (2016).

FIGURE 8: SVAR response to oil supply shock

INSERT FIGURE 8 HERE

*Notes:* SVAR estimated response of monthly industrial production, consumer price index, USD/INR nominal exchange rate, ten-year government bond rate, stock market index, and total reserves (excluding gold) outstanding to a one standard deviation identified shock to oil supply. Shaded areas represent one standard deviation confidence intervals. Standard errors are bootstrapped as in Gertler & Karadi (2015). The sources for data series are described in the text. Sample: February 1994 - December 2017. See text for details. *Authors’ own calculations*.

***4.3 Discussion: Resilience versus Integration***

Our results suggest that the exposure of Indian output to the foreign shocks is lower relative to an index of advanced economies but comparable to an index of BRICS economies. In the appendix, we make direct comparisons of the responsiveness of Indian economy to that of China, Russia, Brazil and South Africa. We also evaluate how the responsiveness of Indian economy may have changed over time. Given increased financial integration in the later sample, this sub-sample analysis is a suggestive evidence in assessing the role of resilience and the lack of integration in the estimated responsiveness of Indian economy. In order to keep the discussion focused here, the graphs are presented in the appendix. We only summarize the results with goal of drawing broad policy lessons.

We find that, with the exception of China, Indian economy reacts less to these foreign shocks relative to these counterpart countries. This suggests that in facing an adverse international shock, the Indian economy is more resilient than other developing countries. But on the flip side, since the estimated model’s effects are symmetric, it implies that the Indian economy may also miss out from the positive effects of beneficial international shocks.

The word *resilience* is a broad term that may capture variety of reasons for attenuated responsiveness of Indian economy to foreign shocks. For example, lack of financial or trade integration could explain subdued responsiveness. To a first-order, we use ’resilience’ to denote forces, structural or policy-initiated, that are distinct from the lack of integration. This is done because we can conduct sub-sample analysis to provide a suggestive evidence whether increased integration has implied greater responsiveness or not.

With the growing integration of India into the world economy, one might expect that the responsiveness of the Indian economy to international shocks has changed over time. To test this, we estimate the impulse responses for India by splitting our sample into two halves (pre and post December 2005). But for most of the variables (including output) we do not find statistically significant differences in the responses. What explains this phenomenon? A comprehensive analysis of this question would investigate any structural changes in the Indian economy and the response of policymakers. While this exercise lies outside the scope of this paper, our results provide some suggestive evidence on the role that monetary policymakers might have played.

Central banks can respond to international shocks primarily by changing their policy interest rates or intervening in exchange rate markets, at least in terms of conventional policy tools. A common pattern that also emerges in the analysis is the modest response of the 10-year government bond rate to these adverse global shocks. This has potentially important implications from a policy stabilization perspective. For example, policymakers may consider easing of interest rates in response to adverse international shocks. For the oil supply shock, the central bank faces a clear trade-off as output falls, but prices rise. Thus, if the central bank is worried more about higher inflation then it may want to refrain from lowering rates and accept the downturn in economic activity. But the US monetary policy and uncertainty shocks have effects that look like domestic demand shocks. In this case there is no longer a tradeoff and optimal monetary policy from conventional models dictates that the central bank lower rates.

In light of this, we think there are two different ways to interpret our results of relative non-responsiveness of the 10-year interest rate. First it is possible that the Reserve Bank is not responding strongly with interest rate changes to the international shocks, either because they fail to identify the shocks in a timely manner or if they perceive the tradeoff as too costly. Alternatively, the Reserve Bank is indeed responding to these shocks by changing interest rates but that the transmission mechanism of monetary policy in India is weak and thus there are no substantial effects on the long rate.

But the Reserve Bank of India has also intervened in the exchange rate market in response of international events. Our results from the split-sample estimation show that in response to adverse monetary and oil shocks, the Indian rupee depreciates less in the more recent sample. One potential factor could be the actions (or anticipated actions) of the Reserve Bank of India becoming stronger in the last decade or so. Our results highlight that disentangling these different channels is important to understand the role of monetary policy in overall stabilization policy

***4.4 Variance Decomposition for Indian economy***

We now consider what each shock implies about the contribution to the forecast error variance of the core Indian macro variables. In principle these quantities can be calculated from the local projection framework, however we found that in practice the estimates implied that the total contribution of the shocks would add up to more than 100%. This is a finding that is common in the literature, see for example Ramey (2016). Thus, we use the structural vector autoregression (SVAR) framework to compute the forecast error variance decompositions. We include all four shocks at the same time in the following order: i) economic policy uncertainty shock, ii) geopolitical risk shock, iii) monetary policy shock and iv) oil supply shock. While the total share of the forecast error variance to these four shocks is not affected by the ordering the relative contribution of each shock can be affected by the ordering. We found that in practice the relative shares are similar regardless of the ordering that we choose. The baseline sample runs from January 1997 to December 2017.

TABLE 1 presents these variance decompositions. The top left panel shows the contribution of the U.S. monetary policy shock. On impact, this shock has a small contribution, explaining about 1–2% of the movement in the macro and financial variables. At longer horizons we see a substantially bigger effect, explaining 13% of variation in output at the 1 to 4-year horizon. The U.S. monetary policy shock also has a similar long-term impact on the stock market and the 10-year bond rate explaining roughly 10% at longer horizons. Somewhat surprisingly, the contribution of the monetary policy shock to the exchange rate is smaller. We also note that the shock does not explain much of the contribution to prices.

TABLE 1: Individual shock contribution to the forecast error variance

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | Monetary Policy Shock | | | | |  | Economic Policy Uncertainty Shock | | | | |
|  | 1 | 6 | 12 | 24 | 48 |  | 1 | 6 | 12 | 24 | 48 |
| Stock market | 1.800 | 3.913 | 12.282 | 10.164 | 9.199 |  | 3.103 | 5.560 | 4.651 | 4.879 | 5.078 |
| USD/INR | 0.843 | 0.654 | 1.650 | 2.082 | 2.568 |  | 1.972 | 1.153 | 0.746 | 1.371 | 5.219 |
| 10 yr bond | 2.572 | 0.447 | 8.494 | 11.728 | 7.327 |  | 0.078 | 4.169 | 5.085 | 3.190 | 2.516 |
| Dollar Reserves | 2.013 | 0.670 | 8.938 | 6.387 | 4.113 |  | 0.011 | 3.938 | 10.007 | 13.408 | 7.207 |
| Inflation | 1.835 | 0.724 | 3.160 | 3.680 | 5.066 |  | 0.000 | 1.557 | 1.804 | 1.597 | 1.046 |
| Ind. Prod. | 1.738 | 0.027 | 13.506 | 13.817 | 12.286 |  | 0.080 | 3.239 | 4.441 | 5.066 | 8.928 |

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | Geopolitical Risk Shock | | | | |  | Oil Supply Shock | | | | |
|  | 1 | 6 | 12 | 24 | 48 |  | 1 | 6 | 12 | 24 | 48 |
| Stock market | 0.679 | 1.074 | 1.865 | 2.058 | 2.770 |  | 1.926 | 3.044 | 5.380 | 6.854 | 6.189 |
| USD/INR | 0.665 | 0.337 | 0.565 | 1.635 | 1.791 |  | 0.497 | 10.290 | 10.209 | 12.324 | 9.143 |
| 10 yr bond | 1.208 | 0.633 | 0.429 | 0.493 | 5.498 |  | 2.295 | 9.044 | 6.500 | 4.257 | 4.032 |
| Dollar Reserves | 0.005 | 0.160 | 1.712 | 2.414 | 6.543 |  | 2.038 | 2.504 | 2.002 | 2.471 | 3.028 |
| Inflation | 0.260 | 6.009 | 8.654 | 9.319 | 10.237 |  | 0.668 | 0.311 | 6.475 | 5.415 | 3.520 |
| Ind. Prod. | 0.003 | 0.580 | 0.944 | 0.953 | 0.742 |  | 4.814 | 15.524 | 13.663 | 16.504 | 13.027 |

*Notes: Authors’ own calculations*

The top right panel shows the contributions of the economic policy uncertainty shock. This shock also does not explain much of the contemporaneous contribution to output or inflation. But it has a more substantial amount of contribution at the 1-year horizon, explaining 4% of variation in output and 2% in inflation. At longer horizons the effect on output is even bigger explaining close to 9% of the variation. This shock also has relatively bigger effects on the Dollar reserves. At the 1-year horizon it explains 10% respectively of the dollar reserves. Finally, this shock also explains around 5% of the long-term variation in the exchange rate and stock market.

The geopolitical risk shown in the bottom left panel. Similar to the policy uncertainty shock, it has small effects on output and inflation at shorter horizons. The peak contribution to output is less than 1%. However, this shock has a bigger effect on prices. For inflation, the peak effect is in the long run (four years out) at around 10%. This shock also contributes significantly to the long-term variation in dollar reserves and the 10-year government bond rate, with contributions of 7% and 5% respectively.

Finally, the bottom right panel shows the oil supply shock. Here we see substantially larger effects for output, even at the short and medium horizons. At the six-month horizon, oil supply shocks explain 15% of the variation in output. At longer horizons the contributions remain sizeable, with 16% explained at 2 years and 13% explained at 4 years. The effects of inflation are largest around the one to two-year mark explaining around 5 to 7% of the variation. The oil supply shock is also the highest contributor to the US Dollar Indian Rupee exchange rate from all the four shocks we have considered, explaining 12% of the variation at the two-year horizon.

TABLE 2 shows the sum of the contributions of the four shocks. They explain around 32% of the variation in output at the 1-year horizon and over 34% of the variation at the 4-year horizon. For inflation, these numbers are lower at 20% at the 1-year horizon and 2-year horizon. In the long-run the four shocks combine to explain close to 20% of the financial market variables as well. The overall picture emerges that these four shocks form a substantial component of the variation in output and inflation for the Indian economy, especially the monetary policy and oil prices shocks.

TABLE 2: Sum of contribution of four shocks to the forecast error variance

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | 1 | 6 | 12 | 24 | 48 |
| Stock market | 7.507 | 13.592 | 24.179 | 23.955 | 23.236 |
| USD/INR | 3.977 | 12.435 | 13.170 | 17.412 | 18.721 |
| 10 year bond | 6.154 | 14.292 | 20.509 | 19.667 | 19.372 |
| Dollar Reserves | 4.066 | 7.272 | 22.659 | 24.681 | 20.891 |
| Inflation | 2.763 | 8.600 | 20.094 | 20.011 | 19.869 |
| Ind. Prod. | 6.636 | 19.370 | 32.553 | 36.340 | 34.983 |

*Notes: Authors’ own calculations*

We think that these numbers should be interpreted as representing an upper bound of the effects of these shocks. As mentioned earlier, we also ran our SVAR and LP estimation by using the IIP gap and year-over-year inflation rate, rather than the log-level specification presented in the baseline results. When we redo the variance decomposition calculations using the “gap” specification for the macro variables we find that the contribution of the shocks is somewhat diminished. This is especially true for output. The total contribution to industrial production from the four shocks drops to 16% at the 1-year horizon and 18% at the four-year horizon. While still sizeable, these numbers are definitively smaller than the 35% range for the baseline specification. The reduction in the contribution comes primarily from the monetary policy and oil supply shock.

Further, there are two more qualifiers that we should mention with this analysis. First, the usual disclaimer about omitted variable bias about vector auto-regressions applies here. In other words, if there are important variables that we are missing then the variance decompositions numbers have the potential to be overstated. We address this concern in the online appendix and show that our results are similar when we include a variety of other Indian macro variables. Second, this analysis looks at the net aggregate effects of these foreign shocks. If there are distributional effects of these shocks, it is possible that those effects cancel out and we are missing important transmission mechanisms. While we do not undertake this disaggregated analysis, we believe it to be a promising area for future research.

**5. Conclusion**

Recently there have been increasing concerns about the resilience of the Indian economy to international developments. This paper is an attempt to understand the quantitative relevance of foreign shocks for the Indian economy and to shed some light on the transmission mechanisms.

Our analysis finds substantial effects of three main foreign shocks to the macroeconomy: US monetary policy, economic policy uncertainty and oil shock. We do not find a major role of geopolitical risk shocks. The spillovers associated with US monetary policy as well as increase in global economic uncertainty have quantitatively significant bearings on Indian financial markets consistent with the global financial cycle narrative. The effects of these shocks are similar to what we would expect with domestic demand shocks. On the other hand, oil shocks act as textbook adverse supply shocks. After an adverse supply shock, there is a simultaneous drop in output and an increase in prices and this effect is persistent. The shock also causes a general worsening of financial conditions with a reduction in total reserves, depreciation of the rupee and a fall in stock prices. Among the external shocks considered, consumer price inflation is largely driven by the uncertainty shocks and the oil supply shocks.

These four shocks combined can explain up to 35% of the variation in Indian output at business cycle frequencies. Thus, while the size of the effect is substantial, the response of Indian output is lower relative to the response of an index of world output and also lower relative to output of peer developing countries. This suggests that Indian economy is relatively more resilient to international shocks. However, this resilience potentially comes at the cost of India not reaping the gains from beneficial global shocks. Our results also highlight an important implication about counter-cyclical policy responses to stabilize the business cycle. In response to adverse foreign shocks, which cause disruption in the financial markets and lower economic activity, the main tool of monetary policy makers would be to lower interest rates to help the economy recover. While the government bond rate tends to decline in response to these shocks, the magnitude of the fall is modest. Given that the foreign shocks are quantitatively relevant, our analysis suggests that quantifying the role of counter-cyclical policy should be an important agenda for further research.

We conclude with an important caveat. Our analysis provides insights for the transmission of four key foreign shocks. Since our aim is to use the instrumental variables strategy to guide our analysis, we were limited in the choice of instruments available and hence the nature of foreign shocks that we could investigate. We believe, and have hopefully convinced the reader, that these are quantitatively relevant shocks. Yet there are important transmission mechanisms particularly through the banking system, variations in foreign currency denominated debt-issuances by private sector, and trade linkages that have not been explored here. We leave it to future research to bring more data and novel econometric techniques that can guide us in understanding the resilience of the Indian macroeconomy.

**6. References**

Baker, S. R., Bloom, N. & Davis, S. J. 2016. “Measuring economic policy uncertainty,” *The Quarterly Journal of Economics*,131(4), 1593–1636.

Barnichon, R. & Brownlees, C. 2018. “Impulse response estimation by smooth local projections,” *Review of Economics and Statistics,* 101(3), 522-530.

Baumeister, C. & Hamilton, J. D. 2019. “Structural interpretation of vector autoregressions with incomplete identification: Revisiting the role of oil supply and demand shocks,” *American Economic* Review, 109(5), 1873–1910.

Bhattarai, S., Chatterjee, A. & Park, W. Y. 2017. “Global spillover effects of us uncertainty,” *Working Paper*.

Bruno, V. & Shin, H. S. 2015. “Capital flows and the risk-taking channel of monetary policy,” *Journal of Monetary Economics* 71, 119–132.

Caballero, R. J. & Kamber, G. 2019, “On the global impact of risk-off shocks and policy-put frameworks.” *NBER Working Paper No. 26031.*

Caldara, D. & Iacoviello, M. 2018. “Measuring geopolitical risk,” *FRB International Finance Discussion Paper* (1222).

Carney, M. 2016. “Uncertainty, the economy and policy,” *Bank of England Speech.*

Carriero, A., Mumtaz, H., Theodoridis, K. & Theophilopoulou, A. 2015. “The impact of uncer- tainty shocks under measurement error: A proxy svar approach,” *Journal of Money, Credit and Banking* 47(6), 1223–1238.

Gertler, M. & Karadi, P. 2015. “Monetary Policy Surprises, Credit Costs, and Economic Activity,” *American Economic Journal: Macroeconomics* 7(1), 44–76.

Ghosh, T., Sahu, S. & Chattopadhyay, S. 2017. “Households’ inflation expectations in India: Role of economic policy uncertainty and global financial uncertainty spillover,” Technical report, Indira Gandhi Institute of Development Research, Mumbai, India.

Gilchrist, S. & Zakrajek, E. 2012. “Credit Spreads and Business Cycle Fluctuations,” *American Economic Review* 102(4), 1692–1720.

Jordà, O. 2005. “Estimation and inference of impulse responses by local projections,” *American* E*conomic Review, 95(1),* pp. 161–182.

Jordà, O., Singh, S.R. & Taylor, A. M. 2020. “The long-run effects of monetary policy,” NBER Working Paper no. 26666.

Kilian, L. 2009. “Not all oil price shocks are alike: Disentangling demand and supply shocks in the crude oil market,” *American Economic Review* 99(3), 1053–69.

Lakdawala, A. 2018. “The growing impact of US monetary policy on emerging financial markets: Evidence from India.” *Michigan State University Working Paper Series.*

Lakdawala, A. 2019. “Decomposing the effects of monetary policy using an external instruments svar,” *Journal of Applied Econometrics* 34(6), 934-950.

Mertens, K. & Ravn, M. O. 2013. “The dynamic effects of personal and corporate income tax changes in the united states,” *The American Economic Review* 103(4), 1212–1247.

Miranda-Agrippino, S. & Rey, H. 2018. “US monetary policy and the global financial cycle.” NBER Working Paper No. 21722

Mishra, P., Montiel, P. & Sengupta, R. 2016. “Monetary transmission in developing countries: Evidence from India,” *in* ‘Monetary Policy in India’, Springer, pp. 59–110.

Nakamura, E. & Steinsson, J. 2018. “High frequency identification of monetary non-neutrality,” *The Quarterly Journal of Economics* 133(3), 1283–1330.

Obstfeld, M. 2019. “Global dimensions of US monetary policy,” Technical report, Conference on Monetary Policy Strategy, Tools, and Communication Practices at the Chicago Fed.

Plagborg-Møller, M. & Wolf, C. K. 2019. “Local projections and vars estimate the same impulse responses.” *Working Paper.*

Rajan, R. 2015. “Competitive monetary easing: is it yesterday once more?” *Macroeconomics and Finance in Emerging Market Economies* 8(1-2), pp. 5–16.

Ramey, V. A. 2016. “Macroeconomic shocks and their propagation,” *in* ‘Handbook of macroeconomics’, Vol. 2, Elsevier, pp. 71–162.

Ramey, V. A. & Zubairy, S. 2018. “Government spending multipliers in good times and in bad: evidence from us historical data,” *Journal of Political Economy* 126(2), pp. 850–901.

Rey, H. 2015. “Dilemma not trilemma: The global financial cycle and monetary policy independence,” Technical report, National Bureau of Economic Research.

Shin, H. S. 2014. “The second phase of global liquidity and its impact on emerging economies,” *in* ‘Volatile Capital Flows in Korea’, Springer, pp. 247–257.

Stock, J. H. & Watson, M. 2002. “Disentangling the channels of the 2007-09 recession,” *Brookings Papers on Economic Activity: Spring 2012* p. 81.

Stock, J. H. & Watson, M. W. 2018. “Identification and estimation of dynamic causal effects in macroeconomics using external instruments,” *The Economic Journal* 128(610), 917–948.

**A. Appendix: Results from local projections estimation strategy**

***A.1 Baseline results for India from LP-IV estimation***

We directly estimate the IRFs for six Indian macro variables available at monthly frequency: industrial production, consumer price index, nominal exchange rate USD/INR, yields on ten-year government bonds, stock market index and USD value of total foreign reserves (minus gold) as a measure of international liquidity (coded as RAXG\_USD in IMF/IFS). Following Mishra et al. (2016), we de-trend the seasonally-adjusted industrial production using HP filter with monthly frequency smoothing parameter of 14400. We refer to this variable henceforth as industrial production gap (*ipgap*). In the SVAR-IVs, we directly use the seasonally adjusted monthly industrial production from the IMF/IFS database along with linear time trends.

One advantage of using LPIVs instead of SVARs is that we can do not need to have a balanced sample across all horizons. We can use more information for estimating the IRFS at shorter horizons. Our sample starts in July 1994 and extends up to January 2018.

The IRFs are computed from the second stage local projections estimation method described in Equation 6. The graphs plot the at each horizon. While the US Federal Reserve has a legal mandate to focus explicitly on three domestic variables, shocks identified for the US economy may be predictable by foreign economy's conditions (Obstfeld 2019). As such, we control for twelve lags of industrial production gap, consumer price level-based inflation and the instrument/external shock. Because of shorter sample length, we only add six lags of other variables namely, nominal exchange rate USD/INR, yields on ten-year government bonds, stock market index, USD value of total foreign reserves (minus gold) and world industrial production index obtained from Baumeister & Hamilton (2019). The countries included in this index account for 79 percent of world petroleum product consumption and 75 percent of the IMF World Economic Outlook estimate of global GDP. When estimating IRFs for oil supply shocks, we also control for six lags of global oil production (millions barrels/day), changes in oil inventories as ratio of last year's global oil production, and real spot price of West Texas Intermediate oil.

FIGURES 9­­–13 report the LP-IV estimated impulse responses to the four main shocks of interest. A caveat with local projections estimation is the irregular shape of the impulse responses compared to relatively smooth IRFs obtained with VAR estimation. One could potentially smooth out these IRFs using methods developed in the literature (Barnichon & Brownlees 2018). That requires taking a stand on what turning points are the truth or noise. As a result, we chose to report the LP-IV based IRFs. SVAR based IRFs reported in the next section can be seen as the extreme case of the IRFs obtained with structural assumptions on dimension reduction.

***A.1.1 Monetary policy shocks***

FIGURE 9­­ reports the LP-IV estimated impulse responses to US monetary policy shocks. Consistent with the global financial cycle hypothesis, we find that US monetary policy has important spillovers to the Indian economy. The rupee depreciates on impact and exhibits a persistent depreciation with respect to the USD. The Indian stock market index gradually falls, and stock of foreign reserves gets depleted. The ten-year Indian government bond yields and consumer price level falls.

***A.1.2 Economic Policy Uncertainty Shocks***

FIGURE ­10 reports the LP-IV estimated impulse responses to increase in global economic policy uncertainty. Industrial production falls, rupee depreciates, and consumer prices falls. Stock market initially falls to recover after one year.

Since the economic policy uncertainty measure only starts in 1997, we also estimate the IRFs with respect to one standard deviation in VIX orthogonalized to past Indian macro variables as well as world industrial production. FIGURE 11­­ reports the LP-IV estimated impulse responses to increase in VIX measure of uncertainty in the global financial markets. The effects are more pronounced with this shock, while we do not claim identification of the exogenous shock in this case. The impulse responses are similar to global economic policy uncertainty shocks largely because of high correlation between the two series.

***A.1.3 Geopolitical Risk Shocks***

FIGURE 12­­ reports the LP-IV estimated impulse responses to increase in geopolitical risk in rest of the world. There is no significant effect on industrial production, while price level falls in response to the global geopolitical risk. Somewhat surprisingly, we find an increase in industrial production roughly 14 months after the shock. However, the financial variables seem to move in India's favor with improvement in value of foreign reserves holdings. This would be consistent with India being a relatively safe option when there is increase in geopolitical risk in rest of the world.

***A.1.4 Oil Supply Shocks***

FIGURE 13­­ reports the LP-IV estimated impulse responses to increase in oil prices because of reduction in supply. Industrial production gap falls and recovers eight months after the shock. Reliance on oil imports implies that consumer prices go up in India, rupee depreciates and foreign reserves go down.

***A.2. Comparison to World and BRICS***

We next document the responses of world industrial production and industrial production in the BRICS block to the external shocks. We believe this is useful for at least two reasons. One, the response of WIIP and BRICS-IP is helpful to understand the nature of the foreign shock, whether it is contractionary and expansionary. Second, it can help place benchmark on the quantitative magnitudes one should expect when we go to India specific macro variables.

Our measure of WIIP is an extended version of the OECD's index of monthly industrial production in the OECD and six major other countries developed by Baumeister & Hamilton (2019). The countries included in this index account for 79 percent of world petroleum product consumption and 75 percent of the IMF World Economic Outlook estimate of global GDP. Our measure of BRICS-IP is average of industrial production obtained for Brazil, China, Russia, and South Africa from World Bank’s *Global Economic Monitor*. Further, we control for past twelve lags of the instrument and world industrial production in our regression to account for predictability of these shocks to past lags as well as to improve precision of our estimates. In addition, we control for twelve lags of US federal funds rate, US industrial production, and US CPI inflation. When estimating the IRFs for oil supply shocks, we also control for twelve lags of global oil production (millions barrels/day), changes in oil inventories as ratio of last year's global oil production, and real spot price of West Texas Intermediate oil. This is important to identify the oil supply shocks from oil demand and other confounding factors.

FIGURE 14­­ plots the impulse responses to the shocks described earlier, namely, shocks to US monetary policy, economic policy uncertainty, geopolitical risk and global oil supply shocks.

Consistent with the hypothesis of global financial cycle (Miranda-Agrippino & Rey 2018), we find that contractionary surprises in US federal funds rate indeed have contractionary effects on world industrial production, and BRICS industrial production. Similarly, surprise increases in economic policy uncertainty and world oil prices cause a reduction in world industrial production.

The magnitude of responses of Indian industrial production are comparable to the average response of Brazil, China, Russia and South Africa.

***A.3 Figures for local projections estimation***

FIGURE 9: LP baseline responses to one standard deviation monetary policy shocks

INSERT FIGURE 9 HERE

*Notes:* Response of monthly industrial production, consumer price index, USD/INR nominal exchange rate, ten-year government bond rate, stock market index, and total reserves (excluding gold) outstanding to a one standard deviation identified shock to US monetary policy rate. Shaded areas represent one standard deviation confidence intervals. Standard errors are heteroskedasticity and autocorrelation robust Newey West standard errors. The sources for data series are described in the text. Sample: April 1994 - December 2017. See text for details. *Authors’ own calculations*.

FIGURE 10: LP baseline responses to one standard deviation economic policy uncertainty shocks

INSERT FIGURE 10 HERE

*Notes*: Response of monthly industrial production, consumer price index, USD/INR nominal exchange rate, ten-year government bond rate, stock market index, and total reserves (excluding gold) outstanding to a one standard deviation identified shock to global economic policy uncertainty. Shaded areas represent one standard deviation confidence intervals. Standard errors are heteroskedasticity and autocorrelation robust Newey West standard errors. The sources for data series are described in the text. Sample: February 1997 - December 2017. See text for details. *Authors’ own calculations*.

FIGURE 11: LP baseline responses to one standard deviation movements in VIX

INSERT FIGURE 11 HERE

*Notes*: Response of monthly industrial production, consumer price index, USD/INR nominal exchange rate, ten-year government bond rate, stock market index, and total reserves (excluding gold) outstanding to a one standard deviation change in VIX. Shaded areas represent one standard deviation confidence intervals. Standard errors are heteroskedasticity and autocorrelation robust Newey West standard errors. The sources for data series are described in the text. Sample: Sample: April 1994 - December 2017. See text for details. *Authors’ own calculations*.

FIGURE 12: LP baseline responses to one standard deviation Geopolitical Risk Shocks

INSERT FIGURE 12 HERE

*Notes*: Response of monthly industrial production, consumer price index, USD/INR nominal exchange rate, ten-year government bond rate, stock market index, and total reserves (excluding gold) outstanding to a one standard deviation identified shock to geopolitical risk measure. Shaded areas represent one standard deviation confidence intervals. Standard errors are heteroskedasticity and autocorrelation robust Newey West standard errors. The sources for data series are described in the text. Sample: April 1994 - December 2017. See text for details. *Authors’ own calculations*.

FIGURE 13: LP baseline responses to one standard deviation oil supply shocks

INSERT FIGURE 13 HERE

*Notes*: Response of monthly industrial production, consumer price index, USD/INR nominal exchange rate, ten-year government bond rate, stock market index, and total reserves (excluding gold) outstanding to a one standard deviation identified shock to oil supply. Shaded areas represent one standard deviation confidence intervals. Standard errors are heteroskedasticity and autocorrelation robust Newey West standard errors. The sources for data series are described in the text. Sample: April 1994 - December 2017. See text for details. *Authors’ own calculations*.

FIGURE 14: Industrial Production response to one standard deviation shock

INSERT FIGURE 14 HERE IN FOUR PANELS

|  |  |
| --- | --- |
| A: Monetary Policy Shock  INSERT FIGURE14TOPLEFT\_MP.PDF | B: Economic Policy Uncertainty Shock  INSERT FIGURE 14TOPRIGHT\_EPU.PDF |
| C: Geopolitical Risk Shock  INSERT FIGURE14BOTTOMLEFT\_GPR.PDF | D: Oil Supply Shock  INSERT FIGURE 14BOTTOMRIGHT\_OIL.PDF |

*Notes*: Response of industrial production of World (OECD + BRICS) region, BRICS region and India to a one standard deviation shock. Shaded areas represent one standard deviation confidence intervals. Standard errors are heteroskedasticity and autocorrelation robust Newey West standard errors. WIIP is an extended version of the OECD's index of monthly industrial production in the OECD and six major other countries developed by Baumeister & Hamilton (2019). The BRICS industrial production data is from World Bank Global Economic Monitor. The sources for shocks are described in the text. Sample: April 1994 - December 2017. See text for details. *Authors’ own calculations*.

***A.4 Additional Figures***

FIGURE 15: Industrial Production response to one standard deviation shock

INSERT FIGURE 15 HERE IN FOUR PANELS

|  |  |
| --- | --- |
| A: Monetary Policy Shock  INSERT FIGURE15TOPLEFT\_MP.PDF | B: Economic Policy Uncertainty Shock  INSERT FIGURE 15TOPRIGHT\_EPU.PDF |
| C: Geopolitical Risk Shock  INSERT FIGURE15BOTTOMLEFT\_GPR.PDF | D: Oil Supply Shock  INSERT FIGURE 15BOTTOMRIGHT\_OIL.PDF |

*Notes*: Response of industrial production of BRICS countries to a one standard deviation shock. Shaded areas represent one standard deviation confidence intervals. Standard errors are heteroskedasticity and autocorrelation robust Newey West standard errors. he BRICS industrial production data is from World Bank Global Economic Monitor. The sources for shocks are described in the text. Sample: April 1994 - December 2017. See text for details. *Authors’ own calculations*.

FIGURE 16: LP responses to one standard deviation monetary policy shocks

INSERT FIGURE 16 HERE

*Notes*: Response of monthly industrial production, consumer price index, USD/INR nominal exchange rate, ten-year government bond rate, stock market index, and total reserves (excluding gold) outstanding to a one standard deviation identified shock to US monetary policy rate. Shaded areas represent one standard deviation confidence intervals. Standard errors are heteroskedasticity and autocorrelation robust Newey West standard errors. The sources for data series are described in the text. Solid Blue line plots the estimated IRF for full sample from April 1994 to December 2017. The dashed brown line plots the estimated IRF for post 2005 sample from January 2006 to December 2017. See text for details. *Authors’ own calculations*.

FIGURE 17: LP responses to one standard deviation economic policy uncertainty shocks

INSERT FIGURE 17 HERE

*Notes*: Response of monthly industrial production, consumer price index, USD/INR nominal exchange rate, ten-year government bond rate, stock market index, and total reserves (excluding gold) outstanding to a one standard deviation identified shock to global economic policy uncertainty. Shaded areas represent one standard deviation confidence intervals. Standard errors are heteroskedasticity and autocorrelation robust Newey West standard errors. The sources for data series are described in the text. Solid Blue line plots the estimated IRF for full sample from April 1994 to December 2017. The dashed brown line plots the estimated IRF for post 2005 sample from January 2006 to December 2017. See text for details. *Authors’ own calculations*.

FIGURE 18: LP responses to one standard deviation change in VIX

INSERT FIGURE 18 HERE

*Notes*: Response of monthly industrial production, consumer price index, USD/INR nominal exchange rate, ten-year government bond rate, stock market index, and total reserves (excluding gold) outstanding to a one standard deviation change in VIX. Shaded areas represent one standard deviation confidence intervals. Standard errors are heteroskedasticity and autocorrelation robust Newey West standard errors. The sources for data series are described in the text. Solid Blue line plots the estimated IRF for full sample from April 1994 to December 2017. The dashed brown line plots the estimated IRF for post 2005 sample from January 2006 to December 2017. See text for details. *Authors’ own calculations*.

FIGURE 19: LP responses to one standard deviation movement in Geopolitical Risk shocks

INSERT FIGURE 19 HERE

*Notes*: Response of monthly industrial production, consumer price index, USD/INR nominal exchange rate, ten-year government bond rate, stock market index, and total reserves (excluding gold) outstanding to a one standard deviation identified shock to geopolitical risk measure. Shaded areas represent one standard deviation confidence intervals. Standard errors are heteroskedasticity and autocorrelation robust Newey West standard errors. The sources for data series are described in the text. Solid Blue line plots the estimated IRF for full sample from April 1994 to December 2017. The dashed brown line plots the estimated IRF for post 2005 sample from January 2006 to December 2017. See text for details. *Authors’ own calculations*.

FIGURE 20: LP responses to one standard deviation movement in oil supply shocks

INSERT FIGURE 20 HERE

*Notes*: Response of monthly industrial production, consumer price index, USD/INR nominal exchange rate, ten-year government bond rate, stock market index, and total reserves (excluding gold) outstanding to a one standard deviation identified shock to oil supply. Shaded areas represent one standard deviation confidence intervals. Standard errors are heteroskedasticity and autocorrelation robust Newey West standard errors. The sources for data series are described in the text. Solid Blue line plots the estimated IRF for full sample from April 1994 to December 2017. The dashed brown line plots the estimated IRF for post 2005 sample from January 2006 to December 2017. See text for details. *Authors’ own calculations*.

1. See for example Shin (2014) [↑](#footnote-ref-1)
2. They find that shocks to policy rate do transmit to the bank lending rates in India, albeit imperfectly. However, the predicted bank lending rates do not seem to drive aggregate demand in their estimation. [↑](#footnote-ref-2)
3. In terms of other interest rates and policy indicators, we also looked at the commercial bank lending rate. Results reported here are robust to including the series for the commercial bank lending rate. [↑](#footnote-ref-3)