An Estimated DSGE Open-Economy Model of the Indian Economy with Financial Frictions

Vasco Gabriel,
University of Surrey, China.

Paul Levine,
University of Surrey, China.

Bo Yang,
XJTLU and University of Surrey,
China.

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Abstract

We develop an open-economy DSGE model of the Indian economy and estimate it by Bayesian Maximum Likelihood methods using Dynare. We build up in stages to a model with a number of features important for emerging economies in general and the Indian economy in particular: a large proportion of credit-constrained consumers, a financial accelerator facing domestic firms seeking to finance their investment, 'liability dollarization' and incomplete exchange rate pass-through. Our estimation results support the inclusion of financial frictions in an otherwise standard small-open economy model. The simulation properties of the estimated model are examined under a generalized inflation targeting Taylor-type interest rate rule with forward and backward-looking components.

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