

Estimating Backward Looking IS Curve for India

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The present study estimates the backward looking IS curve for India using monthly data over the period 1998 to 2016. The sample period is divided into two sub-samples, i.e., pre and post May 2011. The empirical results show that the link between the real interest rate and output gap, the important link in the monetary policy transmission process, is present in both the sample periods. It implies that the monetary policy does have an impact on the aggregate demand. From among the additional variables in the IS equation, only external demand and crude oil prices have significant and expected impact on the output gap.

I Introduction

The IS-LM models have played a dominant role in the evolution of macroeconomics for many decades. The variants of the IS-LM model are used as a standard tool for the analysis of macro-economic relations since 1930s. The orthodox Keynesian IS-LM model stemmed from Hicks's (1937) article entitled 'Mr Keynes and the Classics: A Suggested Interpretation'. Hicks version of the IS-LM model summarised the Keynesian views on the impact of different shocks and policy actions on output and interest rate. In the subsequent period, Hicks model was explained in greater details by Modigliani (1944) by introducing aggregate production function and labour market in it. Hansen (1949, 1953) further popularised the model in the US. Later on Mundell (1963) and Fleming (1962) proposed the open economy version of the traditional IS-LM model. Their model famously known as "Mundell-Fleming" or "IS-LM-BP" model further enhanced the traditional IS-LM model by adding the balance of payments dimension to it.

Since their inception in 1937, the IS-LM models provided a common ground for theoretical and policy debates involving macroeconomist and policy makers across policy domains, going from Keynesians vs Classicalists until the late 1960s, Keynesians vs monetarists in the early 1970s, and new Keynesians vs new classical economists in the recent times (Vercelli 1999). However, the period of 1970s, which was marked by the joint occurrence of high unemployment and inflation due to supply shocks led to the strong criticism of the traditional IS-LM model (King 2000). The IS-LM models were criticised on

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