

Abstract

The ongoing synchronized interest rate hike between advanced economies (AEs) and emerging market economies (EMEs) amidst an ensuing global financial slowdown, has once again highlighted that despite financial interventions implemented in the aftermath of 2008-09 crisis, the world economies especially small open countries remain highly exposed to global financial shocks. To design policies that can combat impact of external financial shocks and enhance resilience of domestic financial systems, it is important for policymakers to understand different pathways through which financial shocks are transmitted into domestic countries. An important channel, highlighted in the recent literature is the “global financial cycle” (Rey, 2013) driven by the US monetary policy. Though the literature discusses one common global financial cycle, none of the studies discuss cross-country financial cycles which might exist between individual countries. We find that there exist cross-country financial cycles, which unlike the global financial cycle that responds to US monetary policy shocks, is determined by the macro-financial linkages between the individual countries sharing cross-country financial cycles. Further, we find that the response of these cross-country financial cycles unlike the global financial cycle is less pronounced to the US monetary policy shocks. We further discuss the role of global financial cycle in causing monetary policy impairment in global economies. We find that different forms of global financial cycles have different implications for monetary policy. For equity, both inflows and outflows cycles have significant impact on monetary policy, however, for bond, only outflows cycle have a significant impact. This might be due to increase in importance of equity over bond flows over the years. In order to mitigate the impact of global financial cycle on monetary policy, macroprudential policy can be employed. This thesis discusses in detail of what all macroprudential policy instruments are effective in reducing monetary policy impairment. Lastly, we discuss implications of global financial cycle on economic cycles and other macroeconomic indicators for an EME such as India. We find that the “risk taking channel” is prominent in Indian case wherein the global financial cycle infiltrates the domestic financial cycle. However, the impact is asymmetric across different forms of financial cycles. While equity, credit and the leverage cycle impact domestic counterparts, the global housing cycle does not have any significant impact.