

**भारतीय रिज़र्व बैंक**
RESERVE BANK OF INDIAवेबसाइट : www.rbi.org.in/hindiWebsite : www.rbi.org.inई-मेल/email: helpdoc@rbi.org.in

संचार विभाग, केंद्रीय कार्यालय, एस.बी.एस.मार्ग, मुंबई-400001

Department of Communication, Central Office, S.B.S.Marg, Mumbai-400001

फोन/Phone: 022- 22660502

May 24, 2021

DRG Study No. 46: Risk Premium Shocks and Business Cycle Outcomes in India

The Reserve Bank of India today released on its website the DRG Study* titled, "[Risk Premium Shocks and Business Cycle Outcomes in India](#)". The study is co-authored by Dr. Shesadri Banerjee, Shri Jibin Jose, and Shri Radheshyam Verma.

This study investigates the dynamic effects of financial shocks on the business cycle. Against the backdrop of high non-performing assets (NPAs) of banks, a financial shock is conceived to be a shock to the interest rate spread stemming from a change in the default risk of borrowers. It is termed as the risk premium shock and occupies the central stage in this study. Business cycle implications of such a shock have been characterised and quantified in two steps. At the outset, micro-level evidence on the effect of default risk on interest rate spread and credit growth is provided. Then, this micro-level evidence and predictions of dynamic stochastic general equilibrium (DSGE) models have been exploited to identify and estimate the impact of a risk premium shock using a sign-restricted VAR (SRVAR) model. The key findings are as follows:

- Bank-level panel data analysis shows that an increase in default risk leads to rise in interest rate spread and decline in credit growth.
- SRVAR model estimates suggest that a positive shock to risk premium increases the interest rate spread by 30 basis points and contracts credit and output by 75 and 40 basis points, respectively. It causes a downturn in consumption, investment and price of capital goods, while softening consumer prices.
- On the whole, the risk premium shock helps in explaining the cyclical variations in key macro-financial variables.

Press Release: 2021-2022/266**(Yogesh Dayal)**
Chief General Manager

*: Development Research Group (DRG) has been constituted in Reserve Bank of India in its Department of Economic and Policy Research to undertake quick and effective policy-oriented research backed by strong analytical and empirical basis, on subjects of current interest. The DRG studies are the outcome of collaborative efforts between experts from outside Reserve Bank of India and the pool of research talent within the Bank. These studies are released for wider circulation with a view to generating constructive discussion among the professional economists and policy makers. DRG Studies are published in RBI web site only and no printed copies will be made available.