

The Transmission of Fluctuations in Economic Activity from Abroad : Some Evidence from India

Smriti Mukherjee

I

Theory of transmission of macroeconomic disturbances from abroad has come into the forefront ever since the publication of Mundell-Fleming model in the sixties. Withdrawal of capital controls and adoption of floating exchange rates have directly contributed to the recent upsurge in interest in this particular area of international economics. Specific models relating to transmission of monetary and fiscal policy influences from one country to another have been developed and put to empirical testing. Notwithstanding the hi-tech nature of the models, all of them have one basic point in common i.e., they all stress the international aspect of cyclical fluctuation in economic activity. Fluctuations in economic activity in a major industrial country are capable of generating similar cycles abroad. Sometimes the cyclical movements may synchronise, sometimes they appear with a lag. As to the channel of this transmission, current account of balance of payments provides a major channel if there is restriction on free flow of capital. On the other hand if we have an integrated capital market, capital account transactions assume major proportions while speed of adjustment in the goods market becomes slower. The purpose of the present paper is to focus on the sensitiveness of Indian economy in the face of changes taking place in the rest of the world. To have a proper understanding of the nature of this sensitiveness relevant theories, their applicability to India, modifications attempted and results obtained are being discussed in the following sections.

The mechanism of transmission of macroeconomic disturbances from abroad through the current account is quite simple. Under a system of fixed exchange rates and zero mobility of capital the system will operate like this. For the sake of simplicity the world is divided into two countries-home(H) and foreign(F). Any decrease in aggregate expenditure in F will lead to decrease in import demand and H will experience a deficit in balance of trade. The deficit can be corrected by real depreciation which in the face of given nominal exchange rate implies a fall in price. Now a fall in price can come about only from a fall in income or output. Thus the interdependence in fluctuation of real output between F and H is established.