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Estd. 1917

Monetary Approach to BoP Adjustment

Siddharth Bhardwaj
Assistant Professor
Dept. of Economics
Patna College
Patna University
Patna 5

INTRODUCTION

- The monetary approach to BoP adjustment explains the change in BoP in terms of demand and supply of money in the economy

- BoP deficit as per this approach is a monetary phenomenon and can be corrected by monetary measures

ASSUMPTIONS

1. The law of one price holds good for identical goods sold anywhere
2. There is perfect substitution in consumption in all markets.
3. The level of output is determined exogenously
4. All countries are assumed to be fully employed with wage price flexibility
5. Sterilisation is not possible in fixed exchange rate regime
6. Demand for money is a stock demand and is stable function of income price wealth and interest rate

EXPLANATION

- The demand for money is a stable function of income price and interest rate
- The money supply is a multiple of monetary base consisting of domestic money and foreign exchange reserve of country
- Since in equilibrium the demand and supply of money are equal
- Any BoP deficit or surplus is represented by change in foreign exchange reserve of country

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- Under fixed exchange rate regime if for supposition the monetary authority increases domestic money supply with no change in demand for money leads to BoP deficit due to inflation.
- To maintain fixed exchange rate the monetary authority will sell forex and buy domestic currency leading to fall in forex reserve and money supply leading to restoration of BoP equillibrium

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- In flexible exchange rate regime when there is a BoP deficit or surplus then change in demand for money and exchange rate play a major role in the adjustment process without any outflow or inflow of forex reserve
- Suppose there is an increase in money supply by the authority leading to BoP deficit due to inflation.
- The deficit leads to depreciation of currency and rise in forex rate leads to rise in money demand equal to money supply without any outflow of forex reserve.

Criticism

1. Demand for money not stable
2. Full employment not possible
3. One price law invalid
4. Market imperfections
5. Sterilisation not possible
6. Link between money supply and BoP not valid
7. Neglects short run
8. Neglects economic policy

THANK YOU