BOP Correcting Methods

Expenditure Switching Policies

Methods of correcting Adverse Balance of Payments

1. ***Trade Policy Measures***

- *Expanding Exports and Restraining Imports*

2. ***Expenditure Reducing Policies***

- *Tight Monetary Policy*
- *Concretionary Fiscal Policy*

3. ***Expenditure Switching Policies***

- *Devaluation- Marshal- Lerner Condition*
- *Income Absorption Approach to Devaluation*

4. ***Exchange Control***

Expenditure Switching Policies

- *A significant method* which is quite often used to correct fundamental disequilibrium in balance of payments is the *use of expenditure-switching policies*
- *Expenditure switching policies* work through *changes in relative prices*

- *Prices of imports* are *increased* by making *domestically produced* goods *relatively cheaper*
- Expenditure switching policies may *lower the prices of exports* which will *encourage exports* of a country
- In this way by *changing relative prices*, expenditure-switching policies help in correcting disequilibrium in balance of payments

- The important form of expenditure switching policy is the *reduction in foreign exchange rate of the national currency*, namely, *Devaluation*

- ***Devaluation***- *Reducing the value or exchange rate of a national currency with respect to other foreign currencies*

- It should be remembered that devaluation is made when a country is *under fixed exchange rate system* and occasionally decides to *lower the exchange rate of its currency* to improve its balance of payments

- Under the *Bretton Woods System adopted in 1946*, *fixed exchange rate system* was adopted, but to *correct fundamental disequilibrium* in the balance of payments, the countries were *allowed to make devaluation* of their currencies with the *permission of IMF*

- Now, *Bretton Woods System* has been *abandoned* and most of the countries of the world have *floated their currencies* and have thus adopted the *system of flexible exchange rates* as *determined by market forces of demand for and supply of them*

- However, even in the *present flexible exchange rate system*, the value of a currency or its exchange rate as determined by *demand for and supply of it can fall*

- *Fall in the value of a currency* with respect to foreign currencies as determined by demand and supply conditions is described as depreciation

- If a country permits its *currency to depreciate* without taking *effective steps* to check it, it will have the *same effects as devaluation*

- In *July 1991*, when *India was under Bretton-Woods* fixed exchange rate system, it *devalued its rupee* to the extent of about *20%*. (*From Rs. 20 per dollar to Rs. 25 per dollar)* to correct disequilibrium in the balance of payments

How Devaluation works?

- The *question is how devaluation* of a currency works to improve balance of payments
- As a *result of reduction* in the exchange rate of a currency with respect to *foreign currencies,* the prices of goods to be *exported fall*, whereas prices of *imports go up*
- This *encourages exports* and *discourages imports*

- *Exports are stimulated and imports are discouraged*, hence the deficit in the balance of payments will tend to be reduced

- Thus *policy of devaluation* is also referred to as *expenditure switching policy* since as a result of *reduction of imports*, people of a country *switches their expenditure* on imports to the domestically produced goods

- There are *two types of conditions or approaches* under which *Devaluation works*, these are:

- ***Devaluation- Marshal- Lerner Condition***
- ***Income Absorption Approach to Devaluation***

Thank You