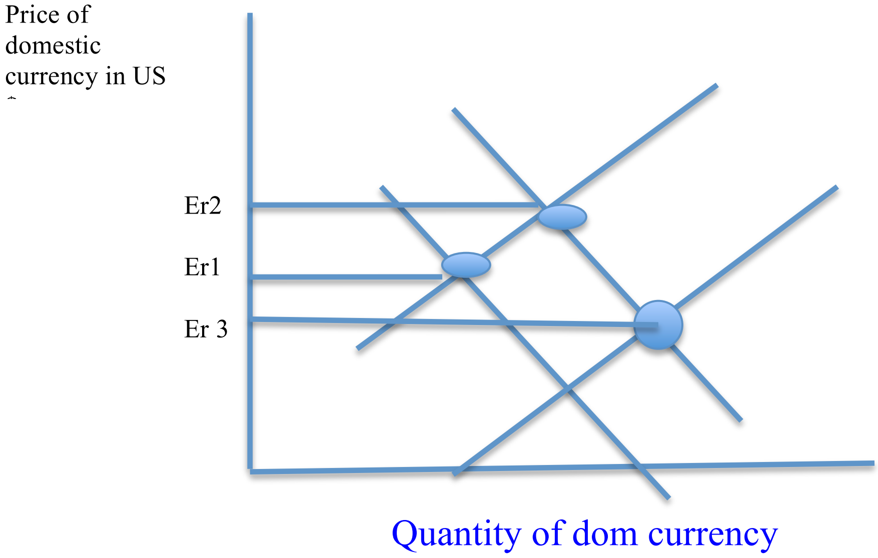
Webnote 333

Syllabus Reference 4. 3[1] : BoP – economic problems and some cures

Some Problems caused by a Balance of Payments Deficit

1. Harsh economic measures may be implemented by the government in its annual budget (current account) to cut down the level of spending on imported goods. (See circular flow of income –301- model to trace effects on National Income)
2. Bank credit may be curtailed (with its consequent effects on aggregate demand) in an attempt to curtail import expenditure.
3. Money can be diverted to encourage the setting-up of export oriented firms. Subsidies may be made available.
4. The income of the nation will be reduced as imports are a leakage from the circular flow of income.
5. If imports continually exceed exports, it is possible that the domestic currency will be classified as a "soft" currency, that is, one which is relatively cheap to purchase. However, this may benefit exports and in the long term have a beneficial outcome. See 4.5 Marshall Lerner condition as elasticity of exports and imports determines the impact on the balance of payments. If BoP deficit occurs then downward pressure will exist on currency and if the total elasticity of M + X > 1 then the BoP will start to improve as a result of cheaper exports and more expensive imports.

How do excessive imports leading to a balance of payments deficit (M>X) affect the value of the domestic currency?



Take a country that has an exchange rate of Er1.

As a result of trade X increases by 100 Million $ and M increases by 200 M $

The diagram opposite shows the effect on the domestic currency where by X shifts the domestic currency to Er2 but the increased imports with twice the value shifts the value of the currency to Er3

[1] TKB

6. Foreign borrowing may be required on the capital account to balance the figures, thus increasing our international indebtedness and committing further taxation to debt servicing.

Summary: see Details above

- Foreign reserves will fall
- Expenditure will have to be reduced in order to reduce import spending which results from our high MPM
- Imports are a leakage, so the circular flow of income will contract
- The value of the domestic currency will fall

Some cures for a Balance of Payments Deficit

Curing a Deficit

It is as difficult to cure a deficit, however, the following measures may assist:

1. Reduce the domestic consumption of foreign goods. (Direct Intervention: Advertising domestic production) See 7 below.
2. Increase the amount of domestic goods sold abroad. (Direct Intervention: Advertising domestic production)
3. Reduce government expenditure; this results in less money circulating and so less funds are available for import purchasing. (Fiscal policy)
4. Institute a deflationary monetary policy, which reduces the money supply and, consequently, the consumption of foreign goods. (Monetary Policy)
5. Devalue our currency in relation to other currencies so that imports are dearer and exports relatively cheaper. This is assuming fixed exchange rates. (Exchange Rate Policy) See 4.4 Devaluation and Revaluation

6. Place tariffs and NTB's (non tariff barriers) on incoming goods, but be mindful of EU regulations. Trading partners dislike barriers. (Direct Intervention: protectionism)
7. Pursue domestic campaigns to encourage the consumption of home-produced goods, but again be mindful of EU regulations i.e. unfair competition.

Summary: Details above

- Reduce imports
- Increase exports
- Introduce a deflationary fiscal and monetary policy
- Devalue the currency
- Erect trade barriers
- A "Buy French" campaign attempting to focus the French public on the need to preserve jobs in France