**Syllabus Reference 4.7: Balance of payments problems –**

***Webnote 338***

**Marshall Lerner condition[[1]](#footnote-1)**

**A**

**National Income effect:**

If a depreciation leads to a fall in imports the country that produced these goods will suffer a fall in their income. If the domestic country exports to these countries its exports may also suffer.

Also, falling income levels may reduce pressure on prices in the trading partners so domestic goods appear relatively inexpensive.

**Marshall Lerner Condition**: **what is it?**

* When the value of a currency falls the price of exports in foreign currency falls and the quantity demanded will increase leading to more of the currency being spent – if demand for exports is elastic.
* The extent of the increase depends on the price elasticity of demand for exports.
* The fall in the value of the currency increases the price of imports. The amount spent on imports will fall provided the demand for imports is elastic.
* Overall the BOP will improve following a depreciation if:

1. **PED of M added to**
2. **PED of X is negative, and > 1**
3. **In other words a loss in value of the currency will improve the BOP if the addition of the elasticity of demand for exports and the elasticity of demand for imports is greater than negative 1**

**B**

**F**

**C**

**D**

# Absorption approach- definition

What is the effect of a depreciation that improves export earnings and therefore national income?

Examines the balance of payments from a Keynesian perspective i.e. the ability of the economy to absorb an increase in demand for exports. For example, if the economy is at full employment, expenditure switching policies will lead to inflation. The economy must be deflated first to provide excess capacity so the economy can meet the higher demand from abroad.

**Notes**

**BoP Surplus**

**Problems of a balance of payments surplus – some examples**

* One country's surplus is another's deficit - the country with the deficit may introduce protectionist measures
* Dutch disease effect - in the I 950s the Dutch discovered natural gas in the Netherlands; the gas was exported and generated large balance of payments surpluses, but the increase in demand for Dutch gas led to an increase in the exchange rate, which made Dutch companies uncompetitive. In the UK, North Sea oil brought about surpluses but led to appreciation of the pound, which damaged UK industry's competitiveness
* If the exchange rate is fixed, a balance of payments surplus will increase the domestic money supply (a surplus means there is excess demand for the currency so the authorities must sell currency). This increase in the money supply can lead to inflation

**Reducing a balance of payments surplus:**

* reflate to boost demand (AD) and so increase imports
* remove import controls
* revalue the currency (fixed rates)

**Reducing a balance of payments deficit:**

* expenditure switching policies (m to x expenditure)
* expenditure reducing policies (reduce ad)

**Ped: Exports**

* Ped for most manufactured (processed) exports tends to be elastic as a result of intense competition
* Exporters of commodities (food) generally face inelastic demand for their goods at least in the short run
* Chad: 1997-1999

Some 94.9 % of all of Chad’s merchandise exports were unprocessed primary commodities

**YeD**

* X and M are likely to be inelastic over time for commodities and elastic for

Manufactures.

**G**

**H**

**PeD: Imports**

* Ped for most imports tends to be elastic over time. (substitutes can be found) Inelasticity is only likely to be a short run consideration.
* Difficult to generalise as situations differ from country to country and industry to industry

***Webnote 338***

**>**

**L**

**Short Run and Long Run Price Elasticities**

**Ped**  **Short Run Long run**

**Germany** **X(0.1) X(0.3)**

**M(0.2) M(0.6)** **Short/long run Ped (x+m) (0.3) (0.9)**

**Japan (0.6) (1.3)**

**US (1.1) (1.8)**

**UK (0.2) (2.2)**

**Source:blink and dorton p.299**

**J**

**Imports and Exports: Ped and Yed**

* **Imports and Exports: Ped and Yed play a key role in terms of influencing economic performance.**
* **If ped is elastic then exchange rate fluctuations play a significant role in terms of the revenue lost to the export sector. E.g. exchange rate depreciation sees a 20 % decrease in value of currency then the result in terms of export prices is that foreigners must now pay 20% less for the goods. TR of the exports will rise. Ped for exports is greater than 1. (see examples in box L below)**

**qd X rises 20% i.e. export revenues rise by more than 20%**

**i**

**Example of how Marshall Lerner relates to BoP**

**Elastic (x prices fall) (m prices rise) BoP Effect**

**ER Ped X Ped M IMPROVES**

**TR (money in) TR (money**

**out)**

**Inelastic (x prices fall) (m prices rise)**

**ER Ped X Ped M WORSENS**

**TR (money in) TR (money**

**out)**

**see task 2 below for an example of how this works**

**out)**

**Task 1:**

**Explain the link between the Marshall-Lerner condition and the J-curve effect.**

Candidates **may** include any of the following:

explanation of the Marshall-Lerner condition

explanation of the J-curve effect

a diagram showing the J-curve

explanation that in the short-run, PED for exports and imports is expected to be inelastic, with the combined elasticities being less than one

in the long-run, the PED for exports and imports are expected to increase such that the combined elasticities will be greater than one

a current account deficit may be reduced by a depreciation/devaluation, but due to the inelastic

demand for exports and imports, the current account balance is likely to worsen in the short run (J-curve)

in the long-run, as the elasticity of demand for exports and imports increases, the current account balance will improve (Marshall-Lerner)

Candidates may define a number of concepts correctly but to reach Levels 3 and 4 candidates must attempt to explain the linkage.

Examiners should be aware that candidates may take a different approach, which if appropriate

should be rewarded.

***Webnote 338***

**Exam Questions:**

Explain the link between the Marshall Lerner Condition and the J-Curve effect. (2006.Nov.HL2. Q5)

**Task 2:**

Draw diagrams for exports and imports to show how the Marshall Lerner condition affects the BoP when an exchange rate **falls**:

1. **Timbuktu**: PeD (X) = 0.6 and

PeD(M) = 1.3

**Note:** no distinction is made between long and short run as X and M can be elastic or inelastic in both short run and long run. See Blink page 299 for examples

**Note:**

Ped X (.6) +

PeD M (1.3)

= -1.9

>1 (elastic)

Therefore ….

BoP Improves as the ER falls.

Get it!!?

**Demand for X from Timbuktu Demand for M into Timbuktu**

**D1**

**(a) (b) d2**

**Px Pm**

**X**

**Less M**

**X = - > + BoP worse ( less money flowing in)**

**M = - > + BoP better (less money flowing out)**

**Marshall Lerner: 0.6 + 1.3 = 1.9 therefore:**

**Result: M effect > X effect**

A

Q

1. **See also J -curve webnote 414 and Blink chapter 27 page 299**

   **Notes:** [↑](#footnote-ref-1)