Syllabus Reference 4.7: Balance of payments problems –

Marshall Lerner condition[1]

Marshall Lerner Condition: what is it?

A

- 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

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.

BoP Surplus

C

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

Absorption approach- definition

D

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.

Reducing a balance of payments surplus:

F

- 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)

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

Ped: Exports

G

- 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.

PeD: Imports

H

- 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

i

Short Run and Long Run Price Elasticities

Ped	Short Run	Long run
Germany	X(0.1) M(0.2)	X(0.3) 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)

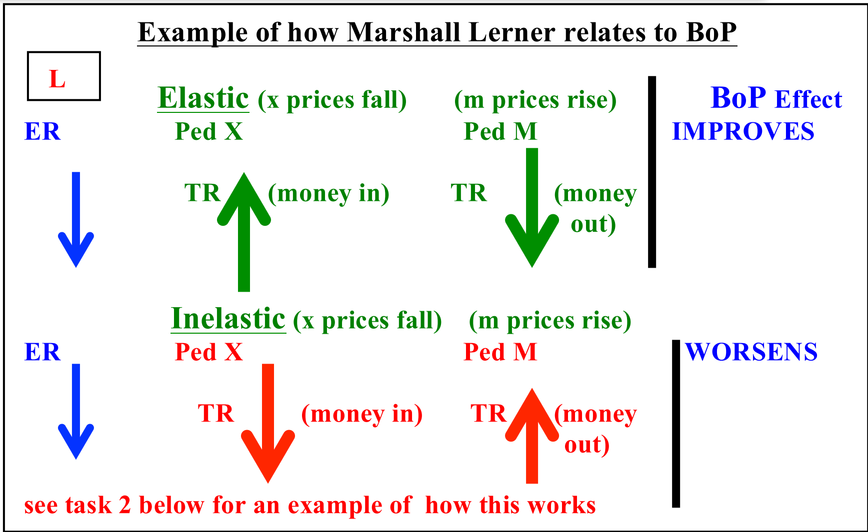
Source:blink and dorton p.299

Imports and Exports: Ped and Yed

J

- **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%



Task 1:	
Q	A

Task 2:		**Note:**