

BOP Correcting Methods



Devaluation

Marshall-Lerner Condition

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

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*

Devaluation: Marshal Lerner Condition

- ❖ It may be noted that as a result of the *lowering of prices of exports*, export earnings will increase if the demand for a country's exports is *price elastic (i.e., $e_r > 1$)*
- ❖ And also with the *rise in prices of imports* the value of imports will fall if a country's demand for *imports is elastic*
- ❖ If demand of a country for *imports is inelastic*, its *expenditure on imports will rise instead of falling due to higher prices of imports*

- ❖ It is clear from above that *whether devaluation or depreciation* will lead to the rise in export earnings and reduction in import expenditure depends on *the price elasticity of foreign demand for exports and domestic demand for imports*
- ❖ *Marshall and Lerner* have developed a condition which states that *devaluation will succeed* in improving the balance of payments if *sum of price elasticity of exports and price elasticity of imports is greater than one*

- ❖ Thus, according to Marshall-Lerner Condition, *devaluation improves balance of payments if*

$$\underline{e_x + e_m > 1}$$

where

e_x stands for price elasticity of exports

e_m stands for price elasticity of imports

- ❖ If in case of a country $e_x + e_m < 1$, the devaluation will *adversely affect* balance of payments position instead of improving it
- ❖ If $e_x + e_m = 1$, devaluation will leave the disequilibrium in the balance of payments unchanged

Thank You