BOP Correcting Methods

Income Absorption Approach

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***

Income Absorption Approach to Devaluation

- A country should have *export surplus* for the success in *correcting disequilibrium* in the balance of payments by the *devaluation* tool
- If a country does not have adequate amount of *goods and services to be exported*, fall in their prices due to devaluation or depreciation will be of *no use*
- *Sidney S Alexander* explained it through *income-absorption approach*

- According to this approach, *trade balance* is the difference between *the total output of goods and services* produced in a country and *its absorption* by it
- By absorption of output of goods and services we mean how much of them is used up for consumption and investment in that country
- That is, absorption means the sum of consumption and investment expenditure on domestically produced goods and services

- Expressing algebraically we have;

$$\underline{\boldsymbol{B = Y - A}}$$

Where:

B = *trade balance or exportable surplus*

Y = *national income or value of output of goods and services produced*

A = *Absorption or sum of consumption and investment expenditure*

- It follows above that if *expenditure or absorption is less than national product*, it will have *positive trade balance* or exportable surplus

- To create this exportable surplus, *expenditure on domestically produced* consumer and investment goods should be *reduced* or *national product* must be *raised* sufficiently

- *Two conditions* should be fulfilled for the *success of devaluation* or depreciation in *correcting disequilibrium* in the balance of payments

- *Firstly*, the *sum of price elasticities of demand* for a *country's exports and imports* should be high (that is, *greater than one)* and,

- Secondly it should have *sufficient exportable surplus*

- The devaluation will also not be successful in the achievement of its aim if other *countries retaliate* and *make similar devaluation* in their currencies

Thank You