

Monetary Approach to the BOPs (Fixed Exchange Rate)

Presented By

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Balance of Payments

- Record of transactions of the residents of a country with the rest of the world during a given period of time.
- **Disequilibrium-** Deficit or Surplus

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- According to the Monetary Approach, BOPs disequilibrium is purely a monetary phenomenon.
 - Money plays a crucial role
 - Adjustments happen under two cases-
 - ❑ **Flexible Exchange Rate**
 - ❑ **Fixed Exchange Rate**

Under Fixed Exchange Rate

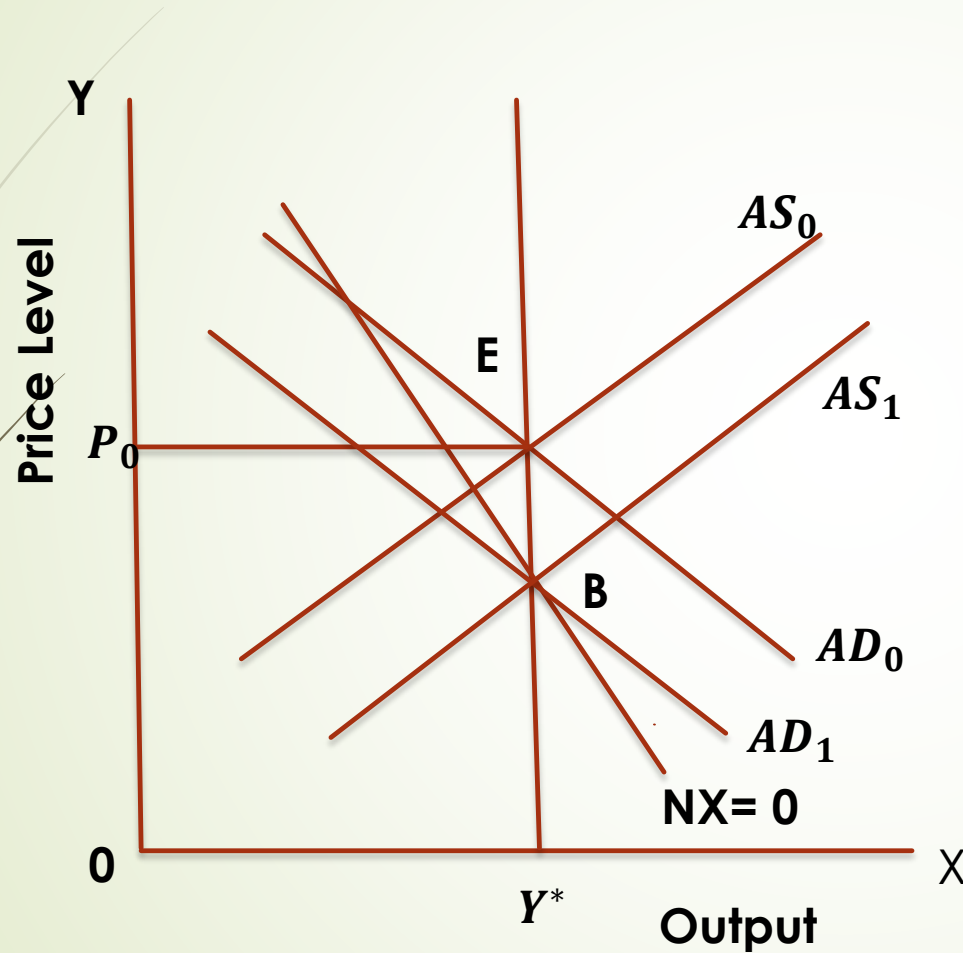
➤ Deficit

Import > Export ➔ Deficit in BOPs ➔ Demand for foreign currency ↑ ➔ Foreign currency appreciates ➔ Domestic currency depreciates ➔ CB keeps the exchange rate fixed by selling the foreign exchange reserves (US Dollar, Euro) ➔ Money supply ↓ ➔ with fixed money stock AD curve slopes downward ➔ Price of domestic economy ↓ ➔ export ↑ ➔ balance is achieved.

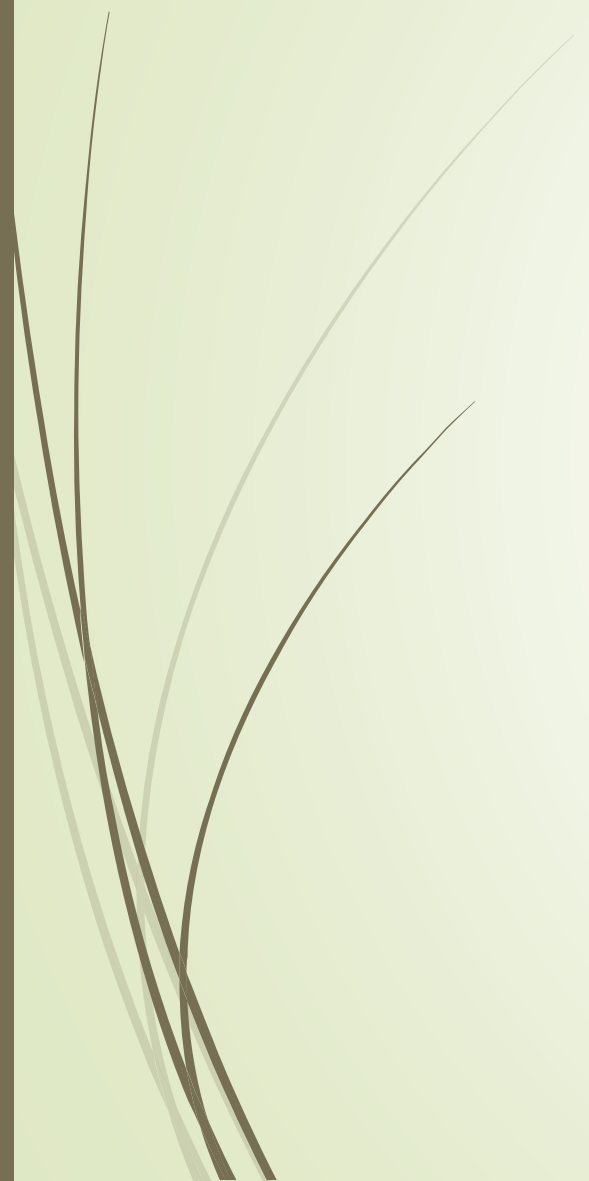
➤ Surplus

Export > Import ➔ Surplus in BOPs ➔ Supply of foreign currency ↑ ➔ Domestic currency appreciates ➔ CB buys foreign exchange to keep the exchange rate fixed ➔ Money supply ↑ ➔ domestic price ↑ ➔ Export ↓ ➔ Import ↑ ➔ Equilibrium is established.

➤ **BOPs adjustment with a fixed exchange rate**



- **AD** slopes downward,
 - Real Balance Effect
 - Interest Effect
 - Trade Effect
- **AD** in open economy is, **$AD = AE + NX$**
- **NX** curve slopes downward, to balance **$X = M$** .
- Equilibrium is at **E**, **AD_0** and **AS_0** intersect.
- Deficit occurs as a result of increase in money expansion \rightarrow spending $\uparrow \rightarrow$ import \uparrow it will be corrected by contraction in money supply, **AD** shifts to **AD_1** \rightarrow **P** $\downarrow \rightarrow$ real wages \uparrow and **AS** shifts to **AS_1** Export $\uparrow \rightarrow$ Balanced.
- If surplus occurs, can be corrected through expansion in money supply. Money supply \uparrow
- **P** $\uparrow \rightarrow$ Export $\downarrow \rightarrow$ import $\uparrow \rightarrow$ Balanced.



Thank You