

Testing the Monetary Approach to Devaluation in India

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1 : INTRODUCTION

The theory of the Balance of Payment adjustment mechanism is traditionally viewed as a succession of approaches. The four conventional approaches are the Elasticity Approach, the Keynesian Multiplier or Income Approach, Absorption Approach and the Policy Approach that stresses the need for an internal and external balances.

During the recent decades, a fifth approach has emerged which highlights the importance of money in the adjustment process. The Monetary Approach (MA) to BoP was propagated in the 1950s chiefly by Polak (1957) and others of the I.M.F., and popularized in the 1960s and 1970s by Mundell (1968, 1971), Johnson (1972) and has now come to be considered as one of the important approaches to BoP in the 1970s and 1980s.

The contribution of MA goes far beyond the mere addition of money to the real elements in the adjustment process: monetary aspects are regarded as the core and essence of the adjustment mechanism and has pushed the other elements in the BoP adjustment process into oblivion.

According to the MA, devaluation is expected to influence the BoP through the demand for supply of money. A devaluation of a home country's currency will raise the domestic prices and the demand for money which would result in a temporary improvement in the BoP. However, such a surplus will continue until the money market equilibrium is restored. In the long run, devaluation is hardly expected to have any effect: it merely elevates the price level. In other words, the impact of devaluation is purely transitory in nature.

Conversely, currency appreciation is expected to exhibit a transitory BoP deficit by lowering the domestic prices. In short, exchange rate changes are definitely powerless to fetch everlasting changes in the BoP. Exchange rates, operating solely via., the domestic prices, initiate a temporary BoP surplus or deficit until the equilibrium is re-established. The monetarists