

The Monetary Approach to the Balance of Payments and Exchange Rate : Empirical Evidence Relating Specifically to India

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I. An Outline of the Monetary Approach

The theory of balance of payments, which is basically concerned with the analysis of policies for maintaining balance-of-payments equilibrium, is one of the most controversial subjects in what is today known as International Macroeconomics. The rediscovery of the monetary approach to the balance of payments by Mundell (1968) and Johnson (1972) has led to a series of fresh discussions on this subject. This is evident from the growing number of research papers in academic journals of international stature.

The analytical results of the monetary approach are diametrically opposed to those of the traditional approaches. For instance, one conclusion derived from the Keynesian open-economy multiplier approach is that the balance of payments tends to worsen in the process of economic growth. The monetary approach in this situation predicts an exactly opposite kind of payments behaviour $1/$. Until the advent of the monetary approach, it was believed that what happened "below the line" (balancing transactions) was the result of what happened "above the line" (regular transactions). The monetary approach offers here an exactly opposite view. That is, the build-up of liquid liabilities (assets) is not necessarily the result of a deficit (surplus) in trade, services, gifts and private lending. It could be opposite! The analytical results of the monetary approach appear to be controversial. However, in spite of its controversial nature, the monetary approach has become popular among researchers and policy-makers. One important reason for the popularity of this approach is the loss of faith in the efficacy of the so-called traditional policy prescriptions such as devaluation, tariffs and quotas. Another important reason is the simplicity of this approach.

The monetary approach views the balance of payments as essentially (but not exclusively) a monetary phenomenon and regards the relationship between the demand for and supply of money as the critical determinant of the balance of payments of an economy. This approach identifies disequilibrium in the balance of payments with disequilibrium in the money market and assets that the inequality between the demand for and supply of money, under fixed exchange rates, is reflected in the payments disequilibrium. According to the monetary approach, any disparity between the actual and desired money balances, under fixed exchange rates,