By :- Juli Kumari
Dept. of Economics

ECONOMICS

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MONETARY APPROACH TO BOP

Monetary approach regards balance of payments as a purely monetary phenomenon. Advocates of monetary approach argue that the disequilibrium in the balance of payments affects the supply and demand for money.

A/c to them, disequilibrium in the balance of payments is reflection of monetary disequilibrium and therefore can always be corrected by adjustment in money stock. In an open economy decrease or increase in foreign exchange reserves form the basis of expansion in money supply.

$$\boxed{\Delta M = \Delta D + \Delta R} \quad (1)$$

where, ΔM = change in money stock.
ΔD = change in domestic credit or asset of the Central Bank of a country.
ΔR = change in foreign exchang reserves

From eq^n (1), $\boxed{\Delta R = \Delta M - \Delta D}$ ——— (4)

From eq^n (4), it can be concluded that ΔR, i.e., change in foreign exchange reserves (assets) of a central Bank indicates the Balance of Payments of a country in a year.

A/c to Monetary approach, a deficit in balance of payments of an economy with a fixed exchange rate regime, implies a decline in the foreign exchange reserves of the central Bank which leads to the contraction of Money supply (M).

On the other hand, an increase in the foreign exchange reserves implies a surplus in balance of payments which causes expansion in money supply (M) in an open economy with a fixed exchange rate system.

A/c to Monetary approach, $\boxed{M^d = kPY}$

where, M^d = demand for money to hold
k = fraction of national income which people wants to hold in terms of money.
P = price level. Y = real national income

At equilibrium, $\boxed{M^d = M^S} \Rightarrow \boxed{kPY = M^S}$

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