THE MONETARY APPROACH TO BALANCE OF PAYMENTS: A TAXONOMY WITH A COMPREHENSIVE REFERENCE TO THE LITERATURE

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ABSTRACT

This paper provides a taxonomy of the monetary approach to the balance of payments with a comprehensive reference guide to the literature. The paper very briefly reviews the three major alternative theories of balance of payments adjustments. These theories are the elasticities and absorption approaches (associated with Keynesian theory), and the monetary approach. The paper focuses on the monetary approach to balance of payments and points to the long-run and short-run lines of research within the monetary approach to balance of payments. Throughout, the paper provides a comprehensive set of references corresponding to each point discussed. Together, these references exhaust the existing literature on the monetary approach to balance of payments.

INTRODUCTION

This paper provides a taxonomy of the monetary approach to the balance of payments with a comprehensive reference guide to the literature. The paper very briefly reviews the three major alternative theories of balance of payments adjustments. These theories are the elasticities and absorption approaches (associated with Keynesian theory), and the monetary approach. The paper focuses on the monetary approach to balance of payments and points to the long-run and short-run lines of research within the monetary approach to balance of payments, as reviewed by Ardalan (2003a and 2003b). Throughout, the paper provides a comprehensive set of references corresponding to each point discussed. Together with references in Ardalan (2003a and 2003b), these references exhaust the existing literature on the monetary approach to balance of payments.

DIFFERENT APPROACHES TO THE BALANCE OF PAYMENT ANALYSIS

Three alternative theories of balance of payments adjustment are reviewed in this section. They are commonly known as the elasticities, absorption, and monetary approaches.

The elasticities approach applies the Marshallian analysis of elasticities of supply and demand for individual commodities to the analysis of exports and imports as a whole. It is generally assumed that exports depend on the price of exports, and imports depend on the price of imports. These relations are then translated into elasticities, by differentiating the above equation with respect to the exchange rate. A criterion for a change of the balance of trade in the desired direction can be
established, assuming that export and import prices adjust to equate the demand for and supply of
exports and imports.

The absorption approach seeks to look at the balance of trade from the point of view of
national income accounting. It is useful in pointing out that an improvement in the balance of trade
calls for an increase in production relative to absorption.

The monetary approach looks at the balance of payments as the change in the monetary base
less the change in the domestic component. The monetary approach assumes that the domestic assets
component of the monetary base is unaffected by balance of payments flows. The monetary
approach assumes full-employment and an integrated world markets.

The concentration on the absolute, rather than relative, price level is a notable point of
departure from the Humean monetary approach that long preceded Keynes. In Hume, the domestic
price level can vary from purchasing power parity due to stock disequilibrium in the domestic
money market. Such a variation in relative price levels gives rise to changes in trade flows which
affect the balance of payments, and hence the domestic money stock in the long run. The monetary
approach, on the other hand, often relies on the excess demand for money to directly affect the
overall balance rather than via a change in relative price levels. It should be pointed out that both
the Humean adjustment process and the monetary approach have the same implications with respect
to the price level in the long run.

A FOUNDATIONAL COMPARISON OF THE THREE APPROACHES

The preceding pages present a brief review of the three major approaches to the balance of
payments—elasticities, absorption, and monetary. It may be noted that the three approaches are all
correct and assert identical propositions, even if capital movements are included when all variables
are defined as ex-post, realized entities.

RESEARCH ON THE MONETARY APPROACH TO BALANCE OF PAYMENTS

Research on the monetary approach to the balance of payments can be divided into two
different approaches; one focuses on the long-run equilibrium, the other considers the adjustment
mechanism and the channels through which equilibrium is reached. The first approach is based on
the reserve flow equation developed by H. G. Johnson (1972). Testing was undertaken by J.R.
Zecher (1974) and others. The second approach is based on theoretical work of S.J. Prais (1961),
with corresponding empirical work undertaken by R. R. Rhomberg (1977) and others.

CONCLUSION

This paper very briefly reviewed three alternative theories of balance of payments
adjustments. These theories were the elasticities and absorption approaches (associated with
Keynesian theory), and the monetary approach. The paper focused on the monetary approach to
balance of payments, pointed to the long-run and short-run lines of research within the monetary
approach to balance of payments, and listed a comprehensive set of references corresponding to each
line of research. Accordingly, the reference section together with referenced cited in Ardalan (2003a and 2003b) exhausted the literature on the monetary approach to balance of payments.

This is a comprehensive list of references in the context of the monetary approach to balance of payments which have discussed the other approaches to balance of payments.


This is a comprehensive list of references regarding the modern revival, theoretical foundation, further development, and review articles related to the theory, assumptions, features, and empirical work on the monetary approach to balance of payments.


Review Articles: Kreinin and Officer (1978), Magee (1976), and Whitman (1975).


This is a comprehensive list of references in the context of the monetary approach to balance of payments which discuss or incorporate the real-balance effect.


This is a comprehensive list of references related to discussions of criticisms of the monetary approach to balance of payments.


This is a comprehensive list of references in the general context of the monetary approach to balance of payments which discuss sterilization.


This is a comprehensive list of references which discuss the weak and strong forms of the monetary approach to balance of payments.


This is a comprehensive list of references to the Humean origin of the monetary approach to balance of payments.

This is a comprehensive list of references in the context of the monetary approach to balance of payments which discuss the compatibility of the monetary approach with other approaches to the balance of payments.


This is a comprehensive list of references in the context of the monetary approach to balance of payments which discuss the historical background of the monetary approach.


This is a comprehensive list of references which discuss the Keynesian-monetarist controversy in the context of the monetary approach to balance of payments.


REFERENCES
