11. Devaluation & Revaluation As Expenditure Switching Policies

Q:1 Explain devaluation and Revaluation as Expenditure Switching Policies?

(A) **Introduction:-** A deficit or Surplus in BOP Can be Corrected by Expenditure Switching Policies The main instrument to bring out changes in Relative Prices is Change in exchange rates i.e Devaluation OR Revaluation of Domestic Currency.

(B) **Devaluation :-** "Devaluation is an official act of Monetary Authority where the value of the Domestic Currency is reduced in terms of Foreign Currency".

Example :- Exchange Rate is ₹70 = $1. But due to devaluation Exchange Rate is ₹73.50 = $1. It means Indian Currency is devalued by 5%.

Devaluation makes Exports Cheaper and Imports become Costlier. Devaluation will helps to increase Exports and Reduce Imports.

Depreciation is like Devaluation Lowers the Value of Domestic Currency with the help of Market forces Depreciation and Devaluation have same effect

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On Exchange Rate.

(C) Revaluation / Appreciation :-

"Revaluation is an act of Monetary Authority where the value of Domestic Currency raise in terms of Foreign Currency"

Example → Exchange Rate is ₹ 70 = $1 after Revaluation Exchange Rate is ₹ 67.50 = $1. It means Indian Currency is Revalued by 5%.

Revaluation makes Exports Costlier and Imports Cheaper. Here imports of goods increased and Exports will Reduce.

(D) EFFects OF Devaluation :-

Devaluation helps the Countries to improve Current Alc. balance. This effects of Devaluation depends Upon- Elasticities of Demand for Exports and Imports.

According to Marshall - Lerner View -

i) IF the Sum of Elasticities of demand for Exports and Imports is greater than one then devaluation or Depreciation will help to improve Current Account balance:

ii) But if Sum of Elasticities of demand for Exports and Imports is Less than one then devaluation or depreciation will not improve Current Alc balance.

Example :- IF the Sum of Price elasticity of Demand for Imports in India and in USA is greater

than One, then a Fall in the Price of Indian goods brings a Favourable movement in Balance of Trade. It will increase India's export trade which improve deficit in BoP Position.

Thus main effects of Devaluation are :—

1. **Effects on Export-Import :-** Due to devaluation and Depreciation Policies, Exports become Cheaper and Imports become Costlier. It increase income of economy which helps to correct BoP disequilibrium

2. **Inflationary Effect :-** Devaluation will increase the demand for goods in foreign market which results in Inflationary effect in home country.

3. **Deflationary Effect :-** Due to Devaluation, Imports become Costlier. It means demand for Other Country's goods gets reduced which brings Deflationary effect in foreign Countries.

4. **Balance of Trade Effect :-** Due to Depreciation and Devaluation, Exports of country increases and restricts the Imports. Thus devaluation helps the country to Improve Current Account balance which helps to correct Deficit in Balance of Payments.

Q:2 Explain the effectiveness of devaluation in Correcting the BOP deficit ? OR
Explain the effectiveness of devaluation in terms of Marshall-Lerner Condition ?

(A) Effectiveness of Devaluation To Correct BOP-Deficit :-

A deficit in BOP is corrected by a devaluation or by depreciation Policy. Under Devaluation Value of Domestic Currency is reduced in terms of foreign currency, But Depreciation is an automatic increase in the value of Domestic currency under flexible Exchange Rates.
The effectiveness of devaluation in Correcting BOP deficit can be Observed under Two approaches.

I- The Elasticity Approach
II - Absorption Approach

(I) The Elasticity Approach :-

It is Traditional method to study effect of Devaluation/Depreciation on Current A/c balance. According to this method, The effectiveness of Devaluation to improve Balance of Trade depends upon Elasticities of Demand for Imports and Exports. This approach is mainly developed by Marshall and Lerner.

(B) Assumptions of Marshall-Lerner Condition

1. It is assumed that Balance of Trade is initially balanced.
2. There are Two Countries like - India and USA.
3. The Sum of the elasticities of demand for Exports and imports is greater than one.

i.e $n_x + n_m > 1$ → It will improve Trade balance

Devaluation will worsen the trade balance if.

$n_x + n_m < 1$ → worst Trade balance.

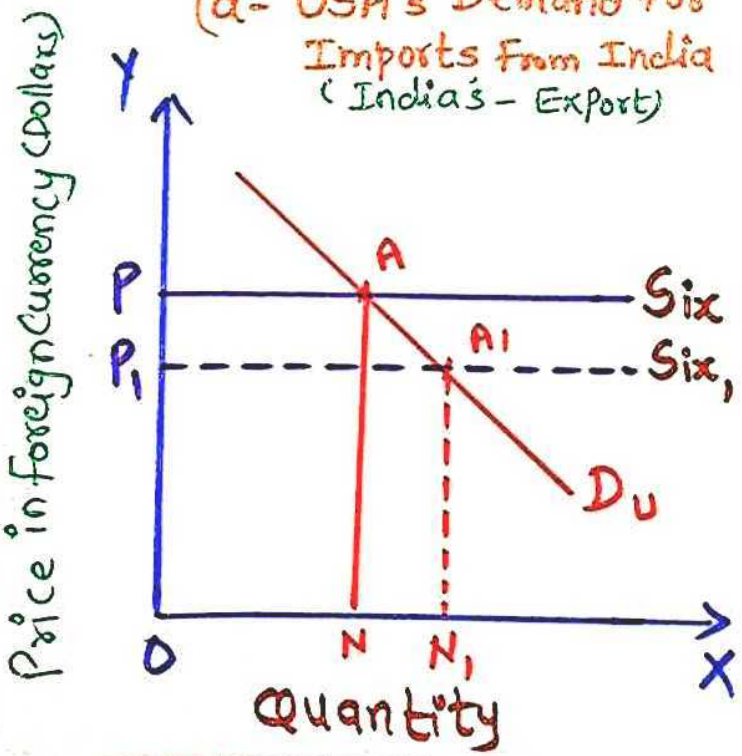
Devaluation will have no effect on Trade balance if

$n_x + n_m = 1$ → No effect on Trade balance

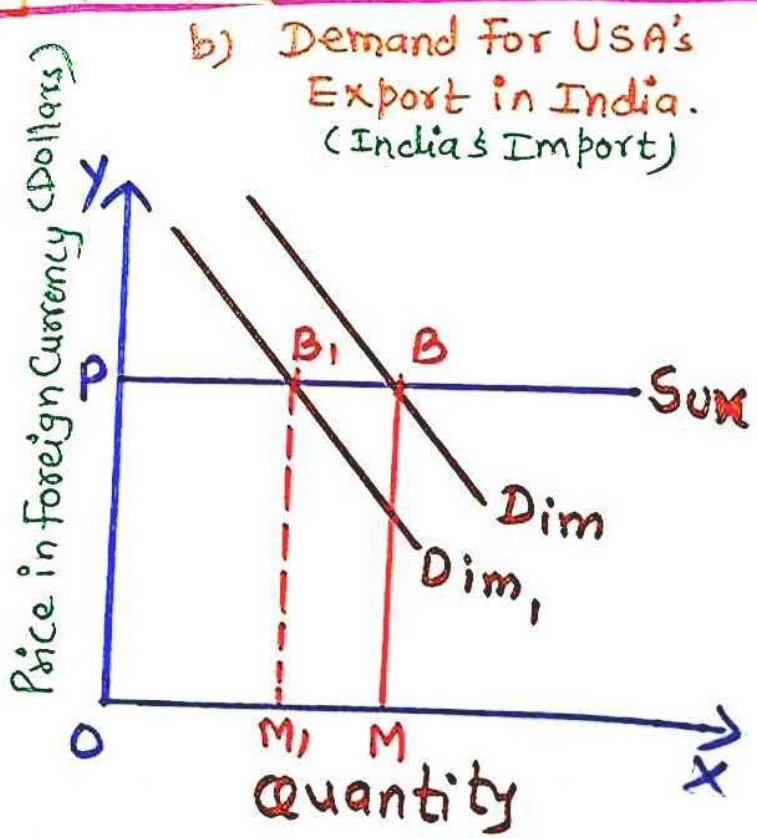
4) The elasticities of Supply of exports and Imports are infinite.

(C) Diagram :- (Elasticity of supply are Perfectly Elastic)

(a- USA's Demand For Imports From India (India's - Export)



b) Demand for USA's Export in India. (India's Import)



In above figure we observe —

1) figure-a shows India's Export to USA and fig-b shows India's Import from USA.

2) Curve-Six shows Supply Curve of India's Export and Curve-Sux shows Supply Curve of USA's Export.
Curve-Du shows USA's demand schedule for imports.
Curve-Dim shows India's demand schedule for imports.

3) Points A and B are equilibrium Points before Devaluation.
India Exports = ON Quantity to USA.
India earn Currency = PONA
India Imports = OM quantity from USA
India's Expenditure = POMB
India's Export Earning = India's Import Expenditure
PONA = POMB → Initially Trade is balanced.

4) But after Devaluation, Indian goods become Cheaper in USA. So India's Export's supply Curve is shifted to Six_1.
This change the Equilibrium position From A to A_1 in India's Export quantity rise from N to N_1.
Now India's Exports Earning = $P_1ON_1A_1$.

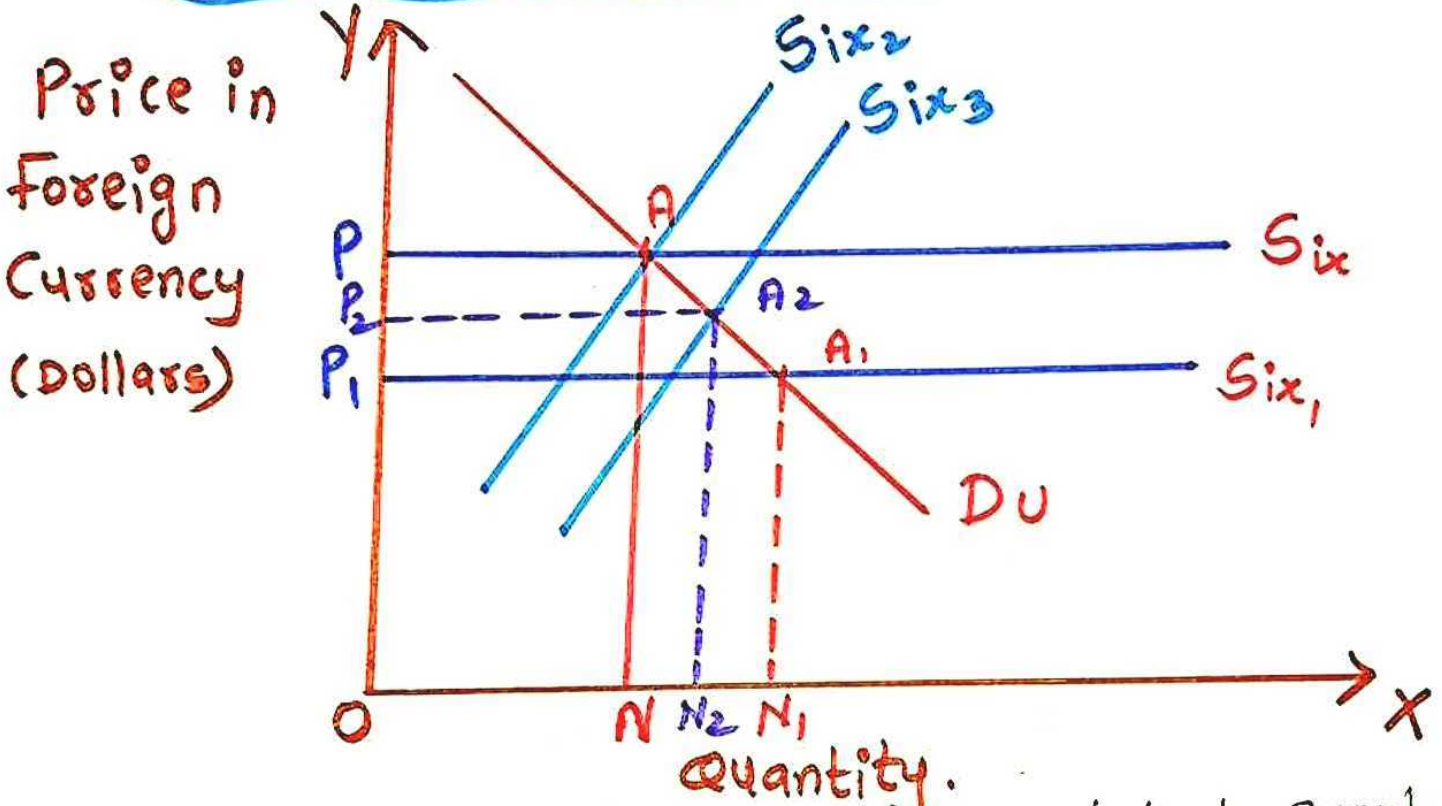
5) As USA's goods become expensive in India, So India's Imports have reduced which shift the Dim Curve to Left Side Dim_1.
Now Expenditure of India's Import = POM_1B_1

6) Thus India's Export earning > India's Import Expendi-

$$P_1ON_1A_1 > POM_1B_1$$

Thus devaluation helped the economy to improve trade balance in home country.

(D) Diagram - Elasticity of supply are not Perfectly Elastic



1) In above diagram - it is assumed that supply of Exports is not Perfectly elastic but it is Relatively Elastic.
Here India's Export supply Curve is Six_2 which Passes through Initial Equilibrium - A Level.

2) Due to Devaluation, Indians goods become Cheaper in terms of dollar. So here supply Curve shift to Right side - Six_3. we get New Equilibrium Position - A_2. Now India's Export Earning = $P_2ON_2A_2$

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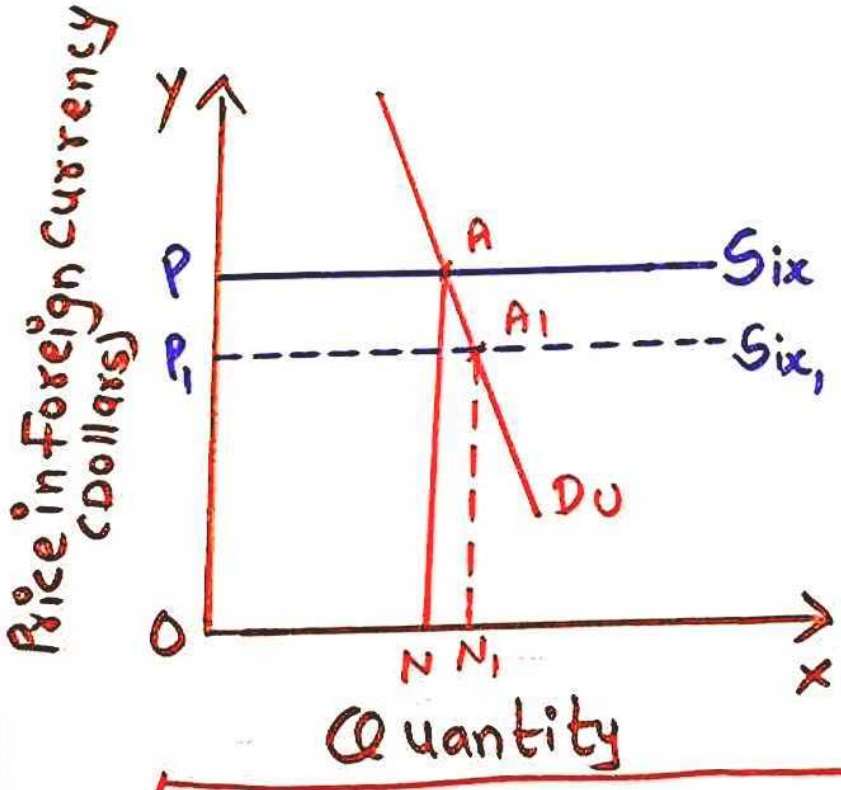
3) At Perfectly elastic Supply level Export earning was - $P_1ON_1A_1$
But when Supply Curve is Relatively Elastic, Export earning = $P_2ON_2A_2$. It is observed that

$$P_1ON_1A_1 > P_2ON_2A_2.$$

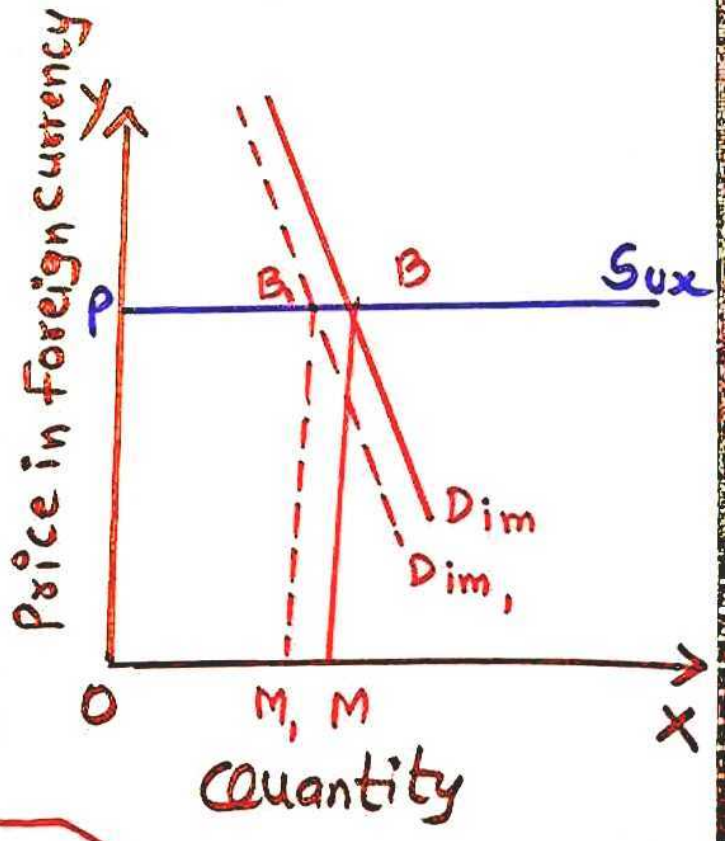
4) Thus, If the demand for Indian Exports is Relatively elastic, then devaluation will helps the economy to earn more foreign currency from increase in Exports.

(E) Diagram - Demand Elasticities of Exports and Imports are Relatively inelastic :-

a- India's Export



b- India's Import



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1) In the above diagram, we observe that initial Equilibrium Positions are A and B.
Here India's Earning from Export = PONA.
India's Expenditure for Imports = POMB.
As India's Exports = India's Imports = PONA = POMB.

2) After Devaluation, India's Rupee value fall to - P_1.
Now India's Earning from Export = $P_1ON_1A_1$
India's Expenditure for Imports = POM_1B_1

3) Thus, it is observed that Fall in India's Export earning is Larger than Fall in India's Import Expenditure.
Thus here devaluation worsen the trade balance.
Thus According to Marshall - Lerner condition -

i) Devaluation will improve the trade balance
when - $n_x + n_m > 1$

ii) Devaluation will worsen the trade balance
when - $n_x + n_m < 1$

iii) Devaluation will have no effect on trade balance
when - $n_x + n_m = 1$

Q:3 Explain the Absorption Approach in Correcting BOP-deficit ?

(A) Absorption Approach :-

Absorption Approach to measure effect of Devaluation was first introduced by- Sidney S. Alexander in 1952. It is a Complement to the Traditional elasticities approach.

The Absorption approach integrate the Price and income adjustment system.

Example :- Due to Devaluation / Depreciation, domestic Production increases due to Exports and Import Substitution. This increase National Income of economy.

Absorption Approach is based on National income in the open economy. where National Income is equal to —

$$Y = \underbrace{C+I+G}_{A} + \underbrace{(X-M)}_{B}$$

$$Y = A + B$$

$A = C+I+G$

$B = (X-M)$

$A = C+I+G$, The Consumption Expenditure, Investment Expenditure and Government Expenditure are part of National Income. It is also called Absorption.

$B = (X-M)$, The difference between Export and imports is the Trade Balance (TB) of a Country.

Thus $Y = A+B$

$B = Y-A$

It means Trade Balance is the difference between National Income and Absorption (Total Expenditure).

IF $A > Y \rightarrow$ Trade balance worsens
$A < Y \rightarrow$ Trade balance improves.

A Trade balance of Country improves when —

1) Increase in income (Y) is greater than Absorption (Y > A)
2) Income (Y) increases but Absorption Falls / remain constant.
3) Decrease in income (Y) but it is Less than decrease in Absorption (A).
4) Income remain Constant but Absorption (A) falls.

A Devaluation helps to reduce Absorption when income is redistributed from wage-earners to Profit-earners because Profit earners have higher Marginal Propensity to Save than wage-earners. On the Other Side, Devaluation Reduce the Value of Real Cash balance with People with reduce Consumption Expenditure. Even due to higher domestic Prices, People Pay higher taxes which also reduce Consumption Demand.

Thus government adopt Contractionary Fiscal and Monetary Policy to reduce domestic Absorption and improve Trade balance.

(B) Limitations of Absorption Approach :-

1. This theory has neglected the effect of devaluation on the Relative Prices.

2) Neglect importance of Resource allocation:-

Real national income can be increased by three ways:-

i) Through Full-employment of Resources.
ii) Through Terms of Trade
iii) Through Better allocation of Resources.

Alexander has given importance to Full-employment and Terms of trade. But he do not Consider the resource allocation effect of Devaluation.

3) Neglect effects of Shift of Relative Prices:-

Absorption Approach has neglect the effects of Shifts of Relative Prices and effects of increase in Price.

Example:- The Price increase will Reduce Real absorption Expenditure. It will have affect on Export and Imports of goods also.

Thus Alexander has given importance to changes in Price Level rather than on changes in Relative Prices.

4) Neglect effect of Substitution :-

According to Alexander, Terms of trade Can be divided into income and Substitution effect. Absorption Can be affected by income and Substitution effect. But this theory only Consider income effect. This theory has neglected effect of Substitution on Absorption.

5) Neglect Monetary Factors :- Absorption Approach has Neglected importance of Monetary Factors. Main aim of devaluation is to increase employment, Exports level by providing more money Supply and Credit facilities. But these monetary Factors are Neglected by this theory.

Q:4 Write a Short Note on- J-Curve effect.

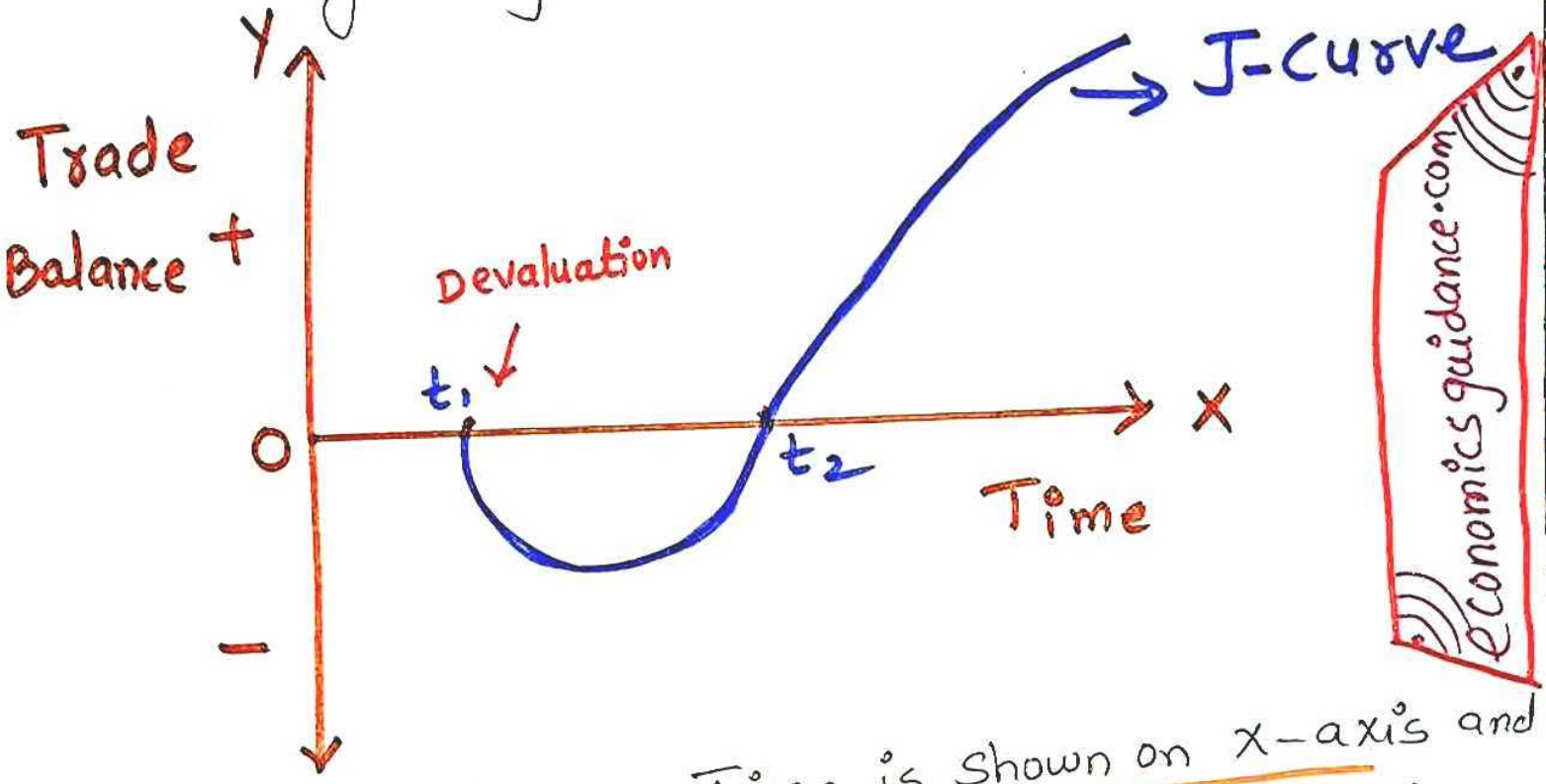
(A) Introduction :- The J-Curve theory was developed by - Goldstein and Khan which Says that- the trade deficit will be initially worsen after Currency devaluation.

The Nominal trade deficit initially grows after a devaluation but after Sometime, Quantity of Exports rises and Quantity of Imports fall and economy Slowly recovering from deficit Position to Surplus Position.

(B) J-Curve Effect :- J-Curve Phenomenon is Caused by Short-Run Elasticities of Demand for imports and Exports.

In a Very Short Period (First 6 months) after devaluation or depreciation, there is deficit in the Trade balance due small impact of Elasticities of Demand in Export and Imports. But with the Progress of time Volume of Exports increased and

Volume of imports reduced. Thus here economy is slowly improving Upward from Deficit Trade account towards Surplus Trade A/c shown in Following diagram :-



1) In above diagram, Time is shown on X-axis and Nations Trade balance is shown on Y-axis.
2) Government adopt devaluation/depreciation during time-t_1. But devaluation do not bring any immediate effect on Export Quantity and Import Quantity. Thus Here Trade Account Deficit become worsen after Devaluation.
3) But with Progress of time at t_2, Trade Balance start improving. Here Volume of Export increase and Volume of imports decrease. Thus Trade balance start improving towards Surplus and Curve take

Shape of J. So it is called J-effect of Devaluation | Depreciation.

© Reasons for Short-Run Elasticities

1) Devaluation | Depreciation cannot affect immediately on Export and Imports level because Export-Import are determined by Contracts which are Signed before Devaluation | Depreciation.

2) Consumers Taste, Preference, Choice, habits cannot Changed immediately due to Change in Price. Consumers need. Some time to Change their habits.

3) Producers, Traders Cannot change their Suppliers Quickly after devaluation. They wait for sometime until they get better Choice.

Q:5 Select the Correct answer and Rewrite statement:

1. What refers to Lowering the Value of Currency by government with respect to the SDR or US dollar?

Ans: a- Devaluation

a) Devaluation b) Depreciation c) Revaluation d) Appreciation.

2. The Devaluation will improve the Trade balance of devaluing Country, if the Sum of the Elasticities of demand For its Exports and its imports is

Ans:- b- greater than 1

a) equal to 1 b) greater than 1
c) Less than 1 d, equal to zero.

3. If the Devaluation of Rupee Leads to an increase in domestic Prices, what will be the effectiveness of the devaluation in correcting the deficit in the Balance of Payment? a- Less

a) Less b) more c) nil d) none of the above

4. According to which approach for the devaluation to improve the trade balance income must rise/or Absorption must Fall?

Ans:- b- Absorption.

a) Elasticities b) Absorption c) Keynesians
d) Marshall-Lerner Condition.

5) The Tendency of a nations Trade balance to deteriorate before it improves Following a devaluation is called

Ans:- J-Curve effect

a) J-Curve effect b) S-Curve effect
c) L-Curve effect d) None of the above.

Q:6 State with reasons whether the Following Statements are True or False :-

1. The main Form of expenditure Switching Policy used to reduce relative Prices is Devaluation.

Ans:- True. Reasons:- Q:1- B Part

2. The effectiveness of devaluation to improve the trade balance depends upon Marshall-Lerner Condition.

Ans:- True. Reasons:- Q:2- I Point

3) The Absorption approach to the effect of devaluation was First introduced by Marshall.

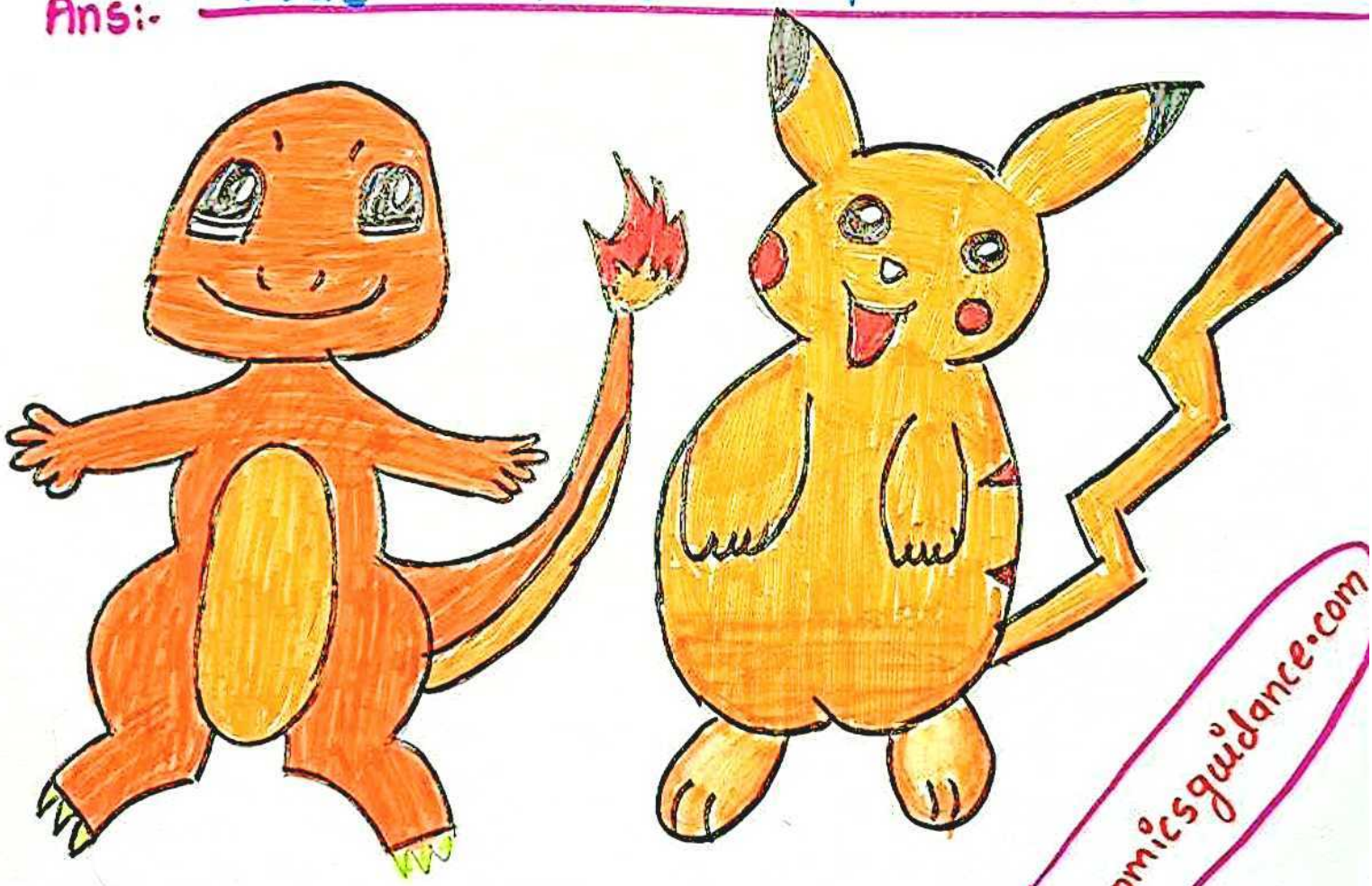
Ans:- False. Reasons:- Q:3- A Part

4) According to Absorption approach, For the trade balance to improve after devaluation income must rise and/or absorption must Fall.

Ans:- True. Reasons :- Q:3 A-Part.

5) According to J-Curve effect the trade balance deteriorate initially after devaluation and there after it improves.

Ans:- True. Reasons: Q:4 - A Part.



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