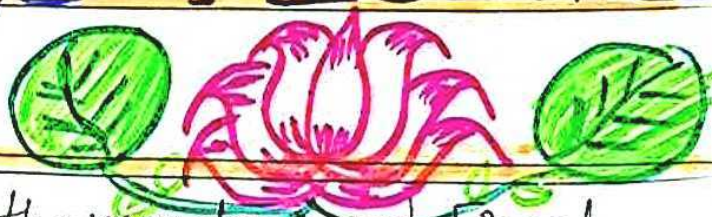
10. BOP ADJUSTMENTS MONETARY & FISCAL POLICIES



Q:1 Explain and evaluate the monetary and fiscal Policy alternatives as instruments of Bop adjustments?

[OR] Explain the Role of monetary and fiscal Policies in Correcting the disequilibrium in the BOP?

(A) Introduction :-

Monetary and fiscal Policies Plays an Important role in improving disequilibrium in Bop Position. The Bop disequilibrium may be- Surplus - Bop Position or Defcit - Bop Position. So there is need to correct Bop disequilibrium.

(B) Role of monetary Policy :-

1. **Tight monetary Policy**
2. **Easy monetary Policy**

Monetary Policy of the government brings changes in the money supply in the country which affect domestic interest rates. It of two types :-

1. **Tight Monetary supply :-** Central Bank adopt tight monetary policy to correct defcit in Bop. Central bank follows several measures like :-

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i) Increase in Bank Rate
ii) Increase in Cash Reserve Ratio - CRR.
iii) Increase in Statutory Liquidity Ratio - SLR
iv) Sale OF Bond / Debentures through open market operatio
v) Increase in Repo Rate and Reverse Repo Rate. etc.

Thus Tight monetary policy reduce money supply which increase interest rates.

Effects of Tight Monetary Policy

↓

Reduce in Money supply

↓

Rise in Rate of Interest

↓

Fall in Investment and Income

↓

Fall in Consumption Demand

↓

Fall in Price Level

↓

Increase in Exports

↓

Improves BOP Position

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i) Effect on Current A/c of BOP :- Due to reduction in money supply, Rate of interest increases which reduce Investment Demand, income and Reduce Consumption Demand. Reduction in Consumption demand may lead to Fall in Prices of goods and services. Now Exports will become Cheaper which increase Inflow of Foreign Currency and Improve BOP Position.

On the Other Sider, higher interest rate attract Foreign Investment but government borrowings and Expenditure can be reduced which improve deficit BOP Position.

ii) Effect on Capital Alc BOP:- During tight Monetary Policy, interest rate will increased which attract foreign capital InFlow and Reduce capital OutFlow. This will have Positive effect on Capital Alc BOP.

2. Easy Monetary Policy :- Central Bank adopt Easy Monetary Policy during BOP Surplus Position. The Central Bank, increase the supply of money which reduce interest rates. But it will increase Investment demand and Consumption Demand.

EFFECTS OF Easy monetary Policy

↓

Increase in money supply

↓

Fall in Interest Rates.

↓

Rise in Investment Exp.

↓

Rise in Consumption Demand

↓

Rise in Domestic Price Level

↓

Fall in Exports and Rise in Imports

↓

Surplus BOP balance Reduced.

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i) **Effect on Current A/c of BOP :-** Due to increase in money supply, there is fall in Interest Rate. It will discourage Savings but encourage Investments It will also increase Consumption Demand. It in increase domestic Price Level which reduce Exports but increase Imports. Thus, slowly BOP Surplus balance will start reducing.

ii) **Effect on Capital A/c of BOP :-** The fall in interest rates may increase Capital Out Flow which also reduce capital A/c surplus balance.

(C) Role of Fiscal Policy :-

1. Contractionary Fiscal Policy (During - Deficit - BOP)
2. Expansionary fiscal Policy (During - Surplus BOP)

The Fiscal Policy is Concerned with Taxes and Government Expenditure. The government get revenue From Tax and Non Tax Sources. The government incurr Public Expenditure on Various Development and non-development Programmes.

1. Contractionary Fiscal Policy to Correct Deficit BOP :-

Fall in Govt. Exp. and Rise in Tax Rates
↓
Reduce income of People
↓
Reduce Consumption Demand
↓
Fall in Price
↓
Rise in Exports and Fall in Imports.
↓
Improve in Deficit BOP

During this Policy, government reduce Public Expenditure or government may increase Taxes. Rise in Tax Rate will reduce the income and Consumption Expenditure of People. Fall in demand may Lead to Fall in Prices which helps to increase Export demand and Foreign currency. Thus Contractionary Fiscal Policy helps our economy to improve deficit BOP Position.

2] Expansionary fiscal Policy to correct Surplus BOP:-

Rise in Govt. Exp. and Fall in Tax Rates
↓
Increase Income of People
↓
Increase Domestic Demand
↓
Rise in Price Level
↓
Fall in Exports and Rise in Imports
↓
Decrease in BOP Surplus.

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During Expansionary Policy government increase Public Expenditure or government may reduce Tax Rates. Fall in Tax Rate will increase Disposable income of People which increase Consumption Expenditure of People. Rise in Consumption Demand may Lead to Rise in Prices which Reduce Demand For Export goods. But demand for imports is increasing which reduce Foreign Currency.

Thus, Expansionary fiscal Policy helps our economy to balance Surplus BOP Position.

Q:2 Explain the Mundell-Fleming Model?

(A) Mundell-Fleming Model :- According to Mundell-Fleming model, an economy cannot Simultaneously maintain a Fixed Exchange Rate, Free Capital Movement and an independent Monetary Policy. An economy can only maintain two of three at the same time.

This Model is an extension of the IS-LM Model which is developed by Robert Mundell and Marcus Fleming.

According to Mundell-Fleming View, Monetary Policy and Fiscal Policy have different Relative impact on Internal and External balance.

Due to Restrictive / tight monetary Policy Rate of interest increase which encourage Foreign Capital Inflow. But due to Restrictive / Contractionary Fiscal Policy Rate of taxes increase which discourage Foreign capital Inflow.

Thus, according to Mundell, monetary Policy has great effect on the External balance as compare to Fiscal Policy because Foreign Capital and Investments are more affected due to change in Interest Rates.

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(B) Assumptions :-

1. This theory assumed a small open economy with Perfect capital Mobility.
2. monetary Policy is mostly related to Changes in Rate of interest. The domestic rate of interest is equal to world Rate of interest.
3. Fiscal Policy is related to Surplus budget or Deficit Budget.
4. Spot and forward Exchange Rates are Same.
5. Production is subject to Constant Return to Scale.
6. Taxes and Savings increase with income.
7. Money wage-Rates are Fixed. Thus domestic Price level is remain Constant.
8. The Balance of Trade (BOT) depends upon income and Exchange Rate.

(C) Use OF Monetary and Fiscal Policy For Internal and External Stability :-

Internal balance requires that Aggregate Demand For domestic output should be equal to Aggregate supply of Domestic output at Full employment Level. There should not be inflationary or Recessionary Pressure.

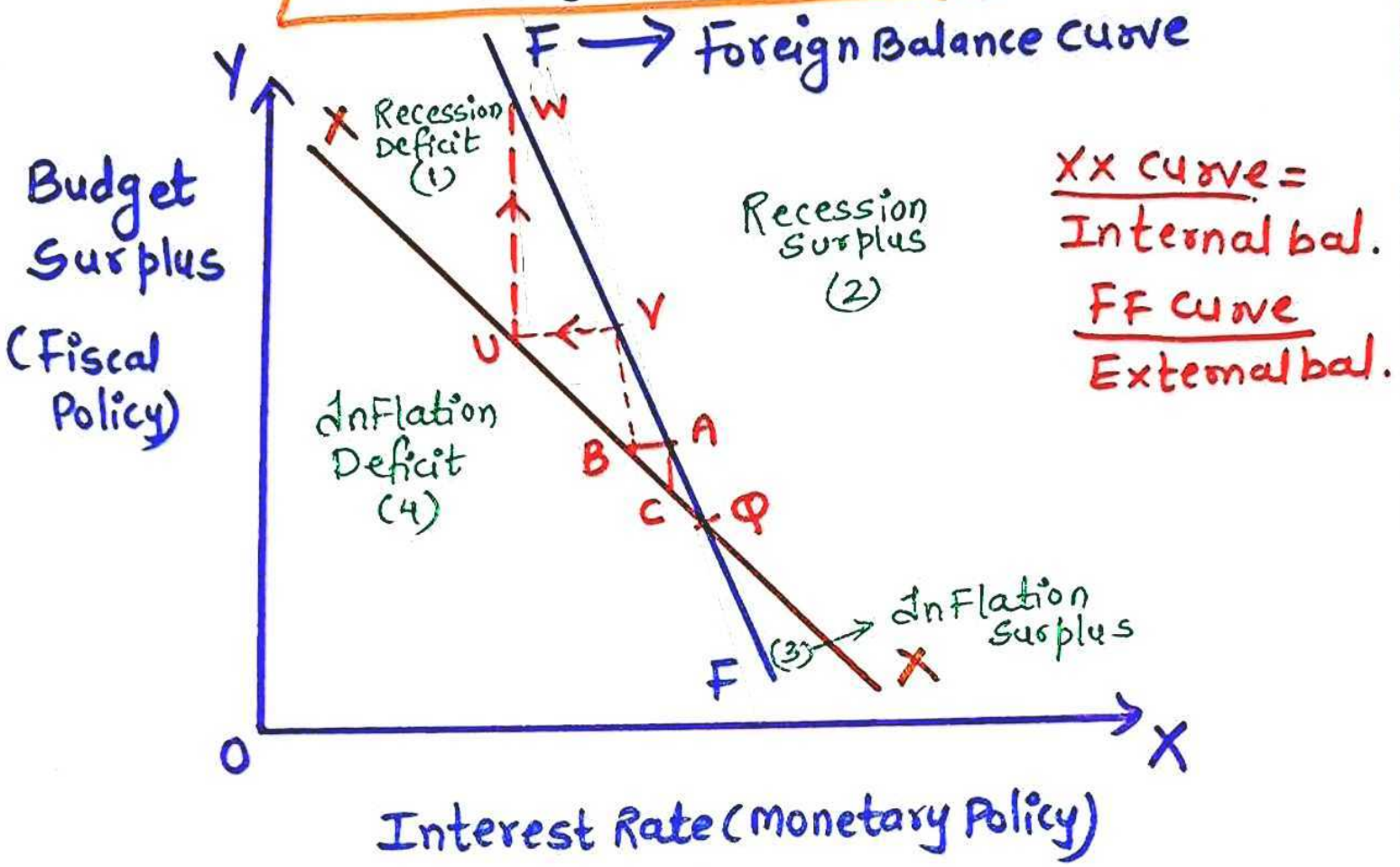
External Balance shows that - the balance of Trade is equal to Net Capital Exports at the Fixed Exchange Rate.

If Balance of Trade > Net capital Exports → Surplus

Bop and Exchange Rate Appreciate.

IF Balance of Trade < Net capital Exports → Deficit

Bop and Exchange Rate Depreciate.



An above diagram we Observe :—

1. FF-Line is the Foreign balance Curve which shows Locus of Pair of interest rates and Budget Surpluses which shows balance of Payment is in equilibrium.
2. FF-Line shows a Negative Slope because increase in the interest rates will reduce Capital OutFlow. It reduce Consumption expenditure and Imports which improve BOP Position.
3) But due to decrease in Budget-Surplus will increase government expenditure and Domestic Consumption expenditure. It increase the imports of goods which result in Deficit BOP Position.
4) Thus, any point on FF-Curve shows that- increase in interest rate will result in Surplus

BOP Position which have to be compensated by a reduction in the Surplus Budget to achieve equilibrium in BOP level.

5) XX-Line shows Internal balance of the economy. It is the Locus of the Pair of interest rates and Budget Surplus which maintain Internal balance.

6) Line-XX has a Negative Slope because an increase in interest rate will reduce budget surpluses.

7) Point above and to the Right side of XX-line show Recession but Points below and to the Left side of Line-XX shows inflation.

8) Line-XX interesect Line-FF at Point-Q Here economy enjoys equilibrium with internal and External balance.

9) There are Four-Disequilibrium Levels between internal and External balances —

1. Recession and Deficit BOP Position.
2. Recession and Surplus BOP Position.
3. InFlation and Surplus BOP Position.
4. InFlation and Deficit BOP Position.

(E) Two Possible Combinations

1. Stable Policy Combination
2. Unstable Policy Combination.

1. **Stable Policy Combination :-** According to Mundell, the government must use Monetary Policy to achieve External balance and Fiscal Policy For Internal balance. It will helps to bring stability in the economy.

Example :- In above figure. Deficit BOP starts from Point-B. To Correct this deficit, government increase Rate of interest to-A Level. This Restrictive monetary Policy will create Recession Problem which can be Solved by Expansionary fiscal Policy. It will help Our economy to reach at equilibrium - CQ.

2. **Unstable Policy Combinations :-** According to Mundell, when government use Fiscal Policy to achieve External balance and Monetary Policy to achieve internal balance then it will bring Unstable Conditions in the economy.

Example :- In above figure, Deficit BOP starts from Point B. To Correct this deficit, government Uses Fiscal Policy and try to increase Budget Surplus upto Point-V on FF line. At Point-V, we get equilibrium in BOP but it Create Recession Problem. To Solve the Problem of Recession, by Monetary Policy government has to reduce interest rates to U-Point. This will again result in Deficit in BOP. Again there is need to increase in Budget Surplus till

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equilibrium Level is achieved. Thus this combination brings Unstable conditions.

(F) Policy Measures For internal and External balance :-

1) **Recession + Bop Deficit :-** Here government has to raise, interest rates to achieve equilibrium in Bop Position and Deficit Budget must be followed to reduce Problem of Recession.

2) **Recession + Bop Surplus :-** Here government has to reduce interest rates to achieve equilibrium in Bop. Position and Deficit Budget must be Followed to reduce Problem of Recession.

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3) **Inflation + Bop Surplus :-** Here government has to reduce Rate of Interest to achieve equilibrium in Bop Position and Surplus Budget must be followed to reduce Problem of inflation.

4) **Inflation + Bop Deficit :-** Here government has to raise Rate of interest to achieve equilibrium in Bop Position and Surplus Budget must be followed to reduce Problem of Inflation.

(G) Criticism of the Model :-

1. **Ignore stagflation Problem :-** Stagflation is a situation in which inflation and Unemployment both exist in the economy. This theory do not

Consider Problem of Stagflation which is mostly found in Developed Countries.

2. **Long-time Lags :-** This theory assumed that there are no time Lags for the working of monetary and Fiscal Policies. But in reality both monetary and Fiscal Policies require Long time gap to achieve internal and External balances.

3. **Neglect Other Factors :-** Monetary Theory mainly Focused on Rate of Interest For Capital investment. But there are many other Factors Like- Exchange Rate Variations, Servicing of Public Debt etc. are Neglected by this theory.

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4. **Practical Restrictions :-** Monetary and Fiscal Policies are working under some Practical restrictions. Due to Political reasons some Policies do not follow Restrictive fiscal and Monetary Policies.

5. **Retards Capital Formation :-** when Restrictive Monetary Policy raise the Rate of interest, then it will attract more Capital investment and capital inflow in Home Country. Even government will increase Public Expenditure and reduce Taxation. Thus Overall Capital Formation of economy can be improved. But this will increase Burden of External Borrowings.

6. **Not a True adjustment Mechanism :-** Monetary and Fiscal Policy Combination is not a True

adjustment system to adjust BOP position but they help to bring stability in the economy. It is difficult to arrive at the right combination of monetary and fiscal policies simultaneously in different countries that will helps to achieve equilibrium.

Conclusion:- A monetary and fiscal policy Combination helps to correct disequilibrium in BOP position and Proper maintain internal & external balance.

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Q:3 Explain the Role of Monetary and Fiscal Policies in achieving Internal and External balances in IS-LM Framework? OR Explain monetary Fiscal Policy mix in correcting the Disequilibrium in BOP?

(A) BOP Adjustment - IS-LM model :-

Changes in monetary and fiscal policies in a IS-LM framework bring Changes in Internal and External balances-

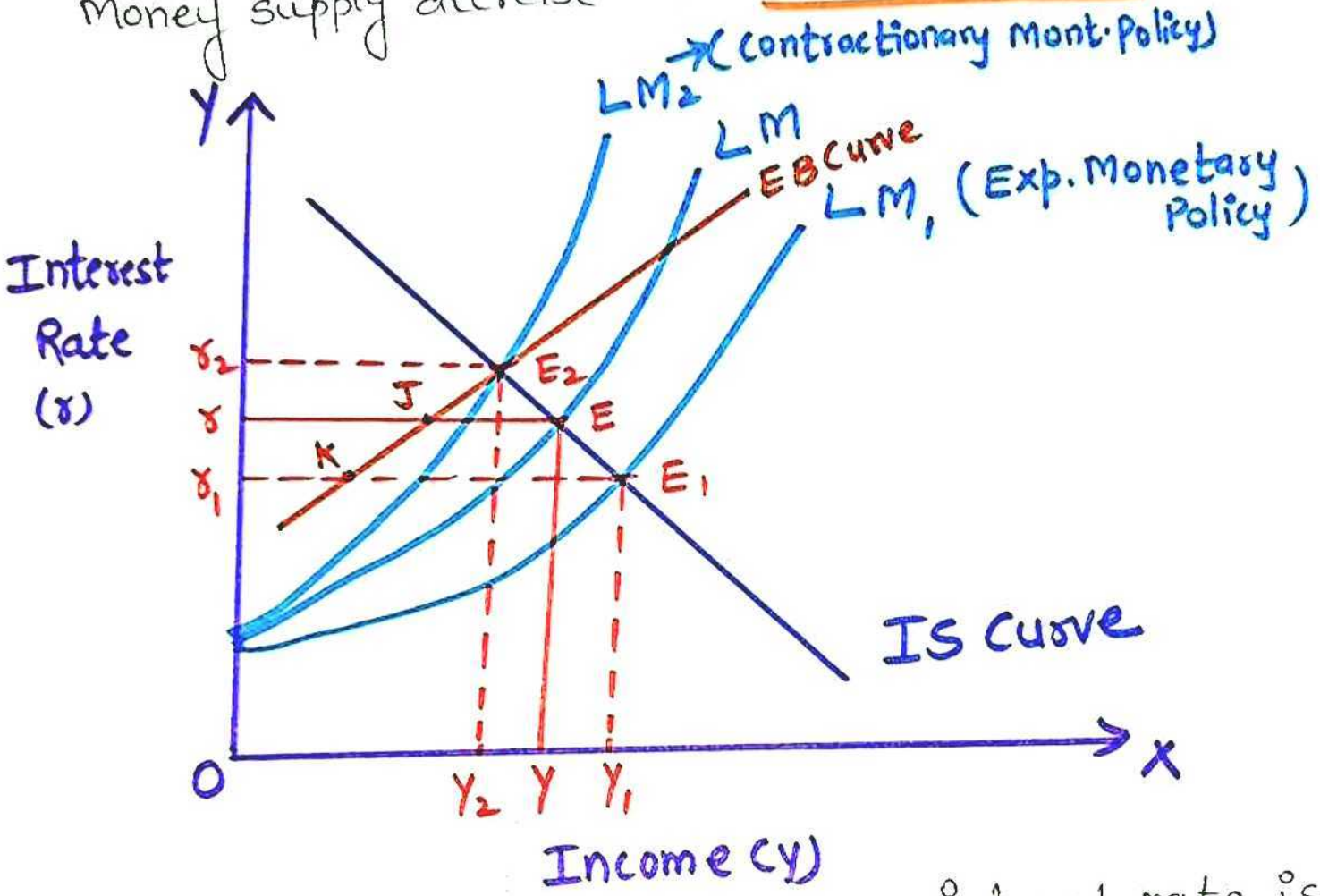
"Internal balance means achievement of Full employment with reasonable level of Price Stability."

"External balance means achievement of equilibrium in Balance of Payment."

(B) BOP Adjustment Through Monetary Policy:-

During Expansionary/ Easy monetary Policy money

Supply increase which reduce interest rates.
Similarly during Contractionary | tight monetary Policy, Money supply decrease which raise interest rates.



1) On x-axis, Income and on Y-axis interest rate is shown.
LM Curve shows money supply in the economy and IS Curve shows Investment Saving Curve.
EB Curve is the External Equilibrium Line.

2) IS Curve intersect LM Curve at Point E. Here Internal economy is in Equilibrium at Point-E.
Here interest rate = r and deficit in BOP = JE

3) If Govt. adopt Easy | Expansionary monetary Policy then LM Curve is shifted on Rightside - LM_1. we get New

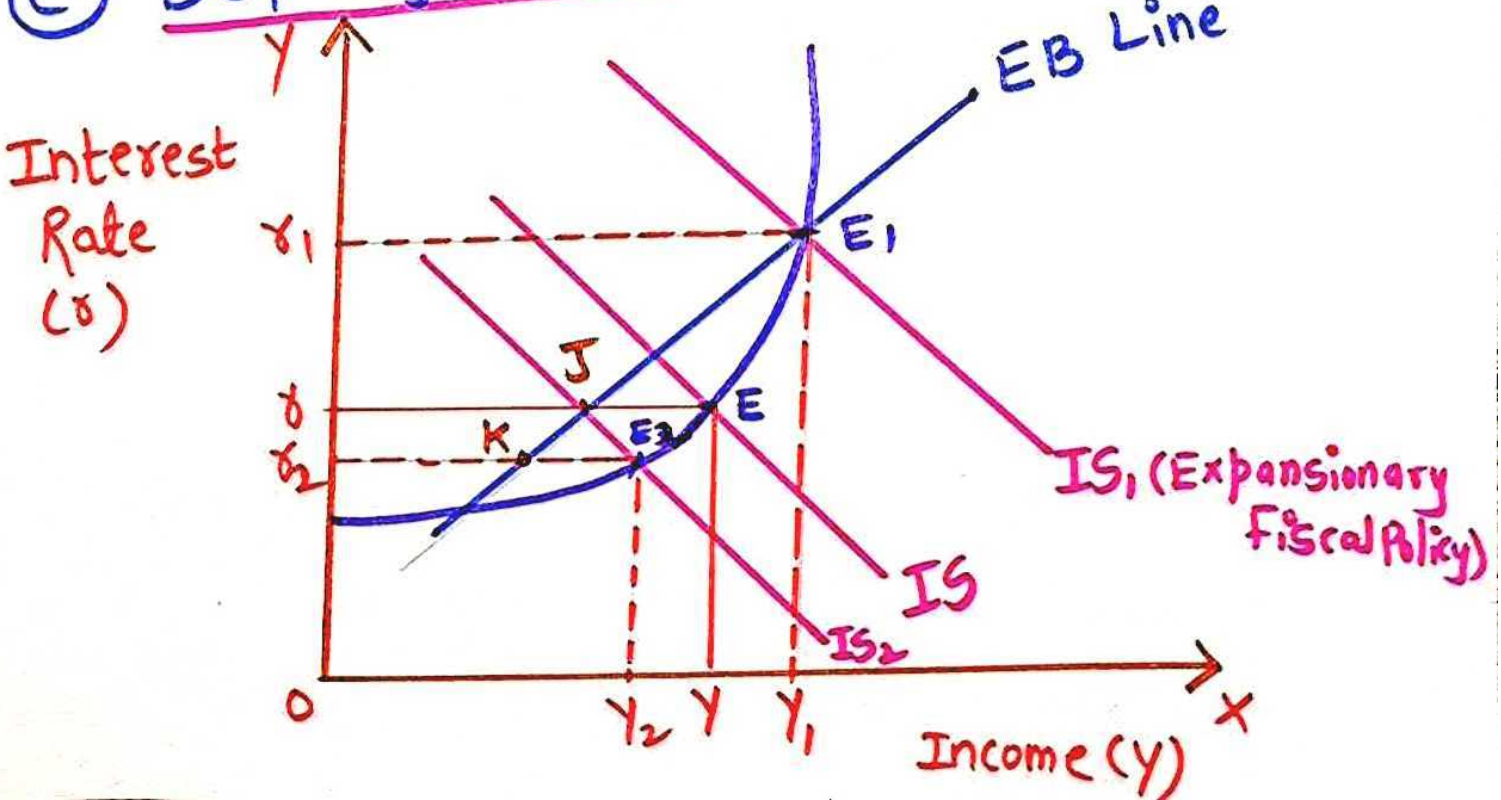
Equilibrium at E_1 which is Larger distance from EB line.

4) Thus, due to expansionary monetary Policy interest rate d. reduced to r_1 which increase investment, employment and income and imports. This Combined effect will increase in BOP deficit.

5) IF Government adopt Tight / contractionary Monetary Policy, them LM curve is shifted on Left-side - LM_2. we get New Equilibrium at E_2 which is near to EB Line.

6) Thus, due to Contractionary / Tight monetary Policy interest rate increased to r_2. which reduce investment, employment, income and imports. Thus at Point E_2 economy is in both Internal and External Equilibrium Position.

(C) BOP Adjustment through Fiscal Policy :-



1) LM Curve intersect IS Curve at Point-E. Here economy is enjoying Internal Equilibrium at Point-E and interest rate = γ.

2) When government adopt Expansionary Fiscal Policy, IS Curve is shifted to Right side- IS_1. Here, interest rate increase to γ_1.
But here EB = IS_1 = LM. It means economy achieve at internal and External Equilibrium balance at Equilibrium = E_1.

3) An increase in interest rate brings more Capital inflow Higher capital inflow and more imports results in both internal and external balances.

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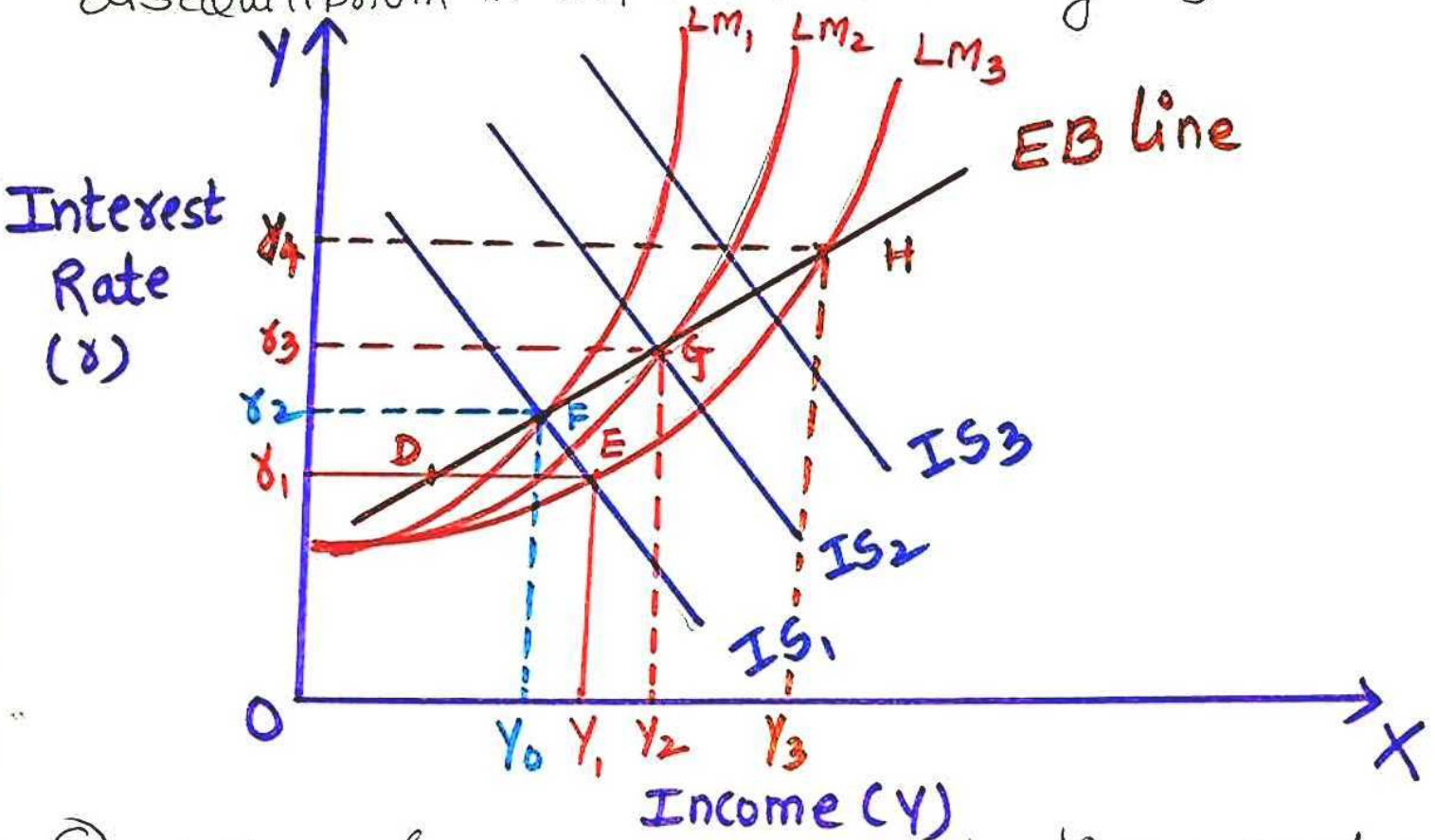
4) When government adopt Contractionary Fiscal Policy, IS Curve is shifted to Left Side- IS_2. We get new Equilibrium = E_2 and reduce in interest rate = γ_2. But here distance between line EB and E_2 increases = KE_2.

5) At Lower interest rate results in Outflow of Capital and at the same time Low income reduce imports, which increase deficits in BOP Position.

(D) BOP Adjustment through Monetary, Fiscal Policy Mix :-

Government donot use Monetary Policy and fiscal Policy Separately to correct BOP disequilibrium. But Government use both Monetary and Fiscal Policy measures together to correct

disequilibrium in BOP shown in following diagram :—



(1) Suppose Government adopt Contractionary monetary Policy. Initially economy enjoys internal equilibrium at Point E with - Y_1 - income and r_1 - interest Rates.

(2) The Contractionary monetary policy shift LM Curve to Left Side i.e LM_3 to LM_1.

Now $LM_1 = IS_1 = EB$ at Point F.

Here economy enjoys internal and External balances with Y_0 - income and r_2 - interest rates.

(3) If government adopt Expansionary Fiscal Policy, IS Curve shift to right side i.e IS_1 to IS_3.

Now $LM_3 = IS_3 = EB$ at Point H

Here economy again enjoys internal and External balances with Y_3 - income and r_4 - interest rates.

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(4) However, higher interest rate - r_4, greater income and employment - Y_3 will create problem of inflation.

(5) Thus Contractionary monetary Policy at Point - F and Expansionary Fiscal Policy at Point - H are not accepted by Government because they create more Problems than benefits.

(6) Thus here Government adopt Policy Mix i.e Contractionary Monetary Policy along with Expansionary Fiscal Policy. This Policy mix will Provide internal and External balances at a Point between F and H. i.e at Point - G

Thus Point - G is the Point of internal and External balances.

Q:4 State with reasons whether the following statements are True or False :-

1. To Promote exports Tight monetary Policy is to be followed.

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

2. Dear monetary Policy reduce imports.

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

3 Easy monetary Policy Promotes Exports.

Ans:- False. Reasons Q:1 - B Part - 2nd Point

4. A Fall in the interest rate attract foreign capital.

False. Reason Q:1 - B Part - 2nd Point

5) A Fall in government expenditure and increase in Tax increase Imports.

Ans. False Reasons:- Q:1 - C Part - 1st Point

6.) Expansionary Fiscal Policy worsen Trade and Current A/c balance.

Ans:- True. Reasons:. Q:1 - C-Part - 2nd Point.

Q:5 Select the Correct answer and rewrite the Statement :—

1. To Correct deficit in BOP monetary Policy requires to adopt. b - Tight Monetary Policy

a) Cheap Monetary Policy b) Tight Monetary Policy
c) Neutral Monetary Policy.

2. Expansionary Fiscal Policy b - Increase Deficits

a) Reduces deficit b) Increases deficit
c) neither (a) or (b)

3) To Correct inflation and deficit both monetary and Fiscal Policy must be b - Contractionary

a) Expansionary b) Contractionary c) Neither

4) To improve BOP deficit interest rate should be b - increased

a) decreased b) increased c) remain the same

5) To Reduce Surplus in BOP, Fiscal Policy should be b - Expansionary

a) Contractionary b) Exponsionary c) Neutral.

6) Easy Monetary Policy leads to b - Increase Imports

a) Decrease in Imports b) Increase in imports c) increase in Exports.

7. Contractionary Fiscal Policy Leads to
C- Decrease in InFlows of Foreign Capital.

a) Increase in government expenditure.
b) Increase in Imports.
c) Decrease in InFlows of Foreign Capital.

Q:6 Match the Following statements :-

1. Decrease in Price Level → Increases Exports.
2. Easy monetary Policy → Increase Imports
3. Contractionary Fiscal Policy → Improves Current A/c balance.
4. Increase in Interest Rates → Capital Flows In
5. Recession and Deficit → Expansionary fiscal Policy.
6. InFlation and Surplus → Contractionary Fiscal Policy.