14 Internal Balance and External Balance

14.1 Introduction

The discussion of Chapters 6 and 7 (see in particular sections 6.2 and 7.2) shows that a change in aggregate demand has consequences both for internal balance and for external balance. As regards the internal consequences, what emerges from these chapters is that a reduction in aggregate demand tends to drive the economy towards balance when demand is excess and away from balance when demand is deficient. Conversely, an increase in aggregate demand means a movement towards balance when demand is deficient and a movement away from balance when demand is excess. The external consequences of changes in aggregate demand arise from the short-run link between aggregate demand and real imports. A reduction in aggregate demand induces a fall in the quantity of imports (a movement down the short-run import function); and, given all the other elements in the external situation, this means a movement towards short-run external balance if international reserves are decreasing and away from balance if they are increasing. Conversely, an increase in aggregate demand induces a short-run increase in real imports and a movement towards external balance if the reserves are increasing and away from balance if they are decreasing.

Another conclusion which emerges from Chapters 6 and 7 is that both the internal situation and the external situation are affected by shifts in the short-run import function. An upward shift in this function, arising, for example, from an increase in the home–foreign price ratio, has the same implications for internal balance as a reduction in aggregate demand – both changes mean a decrease in \((D - M)\) – and a downward shift the same implications as an increase in aggregate demand. Moreover, an autonomous increase in real imports tends to restore short-run external balance if the reserves are increasing and to intensify the lack of balance if they are decreasing, and vice versa.

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Given these conclusions, it seems natural to inquire whether it is possible for the authorities to achieve simultaneous internal and external balance by one type of policy manipulation only — by manipulating aggregate demand alone or by manipulating the import function alone; and if not, in what ways the two types of policy manipulation should be combined. The object of the present chapter is to consider these and other closely related questions in some detail. We shall begin, in the next section, by presenting a very simple diagram and using this diagram to exhibit a distinction which will play an important part in the subsequent argument.

14.2 Zones of Economic Unhappiness

The basis of our diagram is a very simple static model derived from relationships (3.2) and (3.4). The model is:

\[ Y = D - M \]  \hspace{1cm} (14.1)

\[ M = \alpha + \beta D = \alpha + \beta(Y + M) = \frac{\alpha}{1 - \beta} + \frac{\beta}{1 - \beta} Y. \]  \hspace{1cm} (14.2)

Here \( Y, D \) and \( M \) denote, respectively, a stationary equilibrium level of real gross domestic product, aggregate demand and real imports, and \( \alpha \) and \( \beta \) are two positive constants. We treat aggregate demand as a datum, the implication being that the authorities are able to manipulate aggregate demand at will. Relationship (14.2) is regarded as being subject to shifts with changes in the variables incorporated in \( Z^2 \). In particular the import function will shift upwards with an increase in the home–foreign price ratio and vice versa.

We now proceed to show relationships (14.1) and (14.2) on a two-dimensional diagram in which \( Y \) is measured vertically and \( M \) horizontally. With \( D \) as a datum, relationship (14.1) can be shown on such a diagram as a family of negatively sloping straight lines with a vertical intercept of \( D \) and a numerical slope of unity. The line \( BC \) (Fig. 14.1) is a member of this family. A member corresponding to a higher value of \( D \) will be parallel to \( BC \) and further to the right, while a member corresponding to a lower value of \( D \) will be parallel and further to the left.

For given values of the ‘import data’ (variables incorporated in \( Z^2 \)), relationship (14.2) appears on Fig. 14.1 as a straight line with a horizontal intercept of \( \alpha/(1 - \beta) \) and a slope to the vertical axis of \( \beta/(1 - \beta) \), a line such as \( LE \). This line can also be regarded as one