10
The Balance-of-Payments Equilibrium Growth Rate

In the long run a country cannot grow faster than the rate of growth of output consistent with balance-of-payments equilibrium on current account. We call this growth rate the balance-of-payments equilibrium growth rate ($y_B$). In this chapter the import and export functions specified in Chapters 8 and 9 are used to determine the balance-of-payments equilibrium growth rate and to highlight its major determinants. An attempt is then made to estimate the balance-of-payments equilibrium growth rate for a variety of countries, including the United Kingdom, using some simplifying, though not unrealistic, assumptions. It is shown how closely the actual growth experience of countries approximates to the rate of growth of exports divided by the income elasticity of demand for imports (i.e. $x/\pi$), except in the case of Japan, which has grown much slower than its balance-of-payments equilibrium rate and built up a massive balance-of-payments surplus. The findings of this chapter underline the importance of raising the rate of growth of exports to improve the balance of payments permanently, and lend support to export-led growth models (which are considered in the next chapter).

The importance of a healthy balance of payments for growth can be stated quite succinctly. If a country gets into balance-of-payments difficulties as it expands demand before the short-term capacity growth rate is reached, then demand must be curtailed, supply is never fully utilised, investment is discouraged, technological progress is slowed down, and a country's goods compared with foreign goods become less desirable, so worsening the balance of payments still further, and so on. A vicious circle is initiated. By contrast, if a country is able to expand
demand up to the level of existing productive capacity, without balance-of-payments difficulties arising, the pressure of demand upon capacity may well raise the capacity growth rate. There are a number of possible mechanisms through which this may happen: the encouragement to investment, which would augment the capital stock and bring with it technological progress; the supply of labour may increase by the entry into the work-force of people previously outside or from abroad; the movement of factors of production from low-productivity to high-productivity sectors; and the ability to import more may increase capacity by making domestic resources more productive. It is this argument that lies behind the advocacy of export-led growth, because it is only through the expansion of exports that the growth rate can be raised without the balance of payments deteriorating at the same time. Believers in export-led growth are really postulating a balance-of-payments constraint theory of why growth rates differ. It should be stressed, however, that the same rate of export growth in different countries will not necessarily permit the same rate of growth of output because the import requirements associated with growth will differ between countries, and thus some countries will have to constrain demand sooner than others for balance-of-payments equilibrium. The relation between a country’s growth rate and its rate of growth of imports is the income elasticity of demand for imports.

THE DETERMINATION OF THE BALANCE-OF-PAYMENTS EQUILIBRIUM GROWTH RATE

Balance-of-payments equilibrium on current account measured in units of the home currency may be expressed as

\[ P_{dt} X_t = P_{ft} M_t E_t \quad (10.1) \]

where \( X \) is the quantity of exports, \( P_d \) is the price of exports in home currency, \( M \) is the quantity of imports, \( P_f \) is the price of imports in foreign currency, \( E \) is the exchange rate (i.e. the home price of foreign currency), and \( t \) is time. In a growing economy, starting from equilibrium, the condition for balance-of-payments equilibrium through time is that the rate of growth of the value of exports equals the rate of growth of the value of imports, i.e.