The weaknesses of the elasticity approach to balance-of-payments adjustment can be summed up by saying that it is partial-equilibrium analysis; it ignores supply conditions and cost changes as a result of devaluation, and it tends to neglect the income and expenditure effects of exchange-rate changes. At the very least the elasticities used by the approach ought to be total elasticities, not partial elasticities. But taking the total elasticities of exports and imports is tantamount to examining the relation between the balance of payments and the functioning of the economy as a whole. This insight is the starting-point of the absorption approach to the balance of payments which was originally developed by Alexander (1952) and subsequently elaborated on by Johnson (1958), though, arguably, with misleading conclusions.¹

The absorption approach consists of regarding the balance of payments not simply as the excess of residents' receipts from foreigners over residents' payments to foreigners but rather as the excess of residents' total receipts over total payments. Formally

$$B = R_F - P_F$$  \hspace{1cm} (4.1)

where $R_F$ is receipts by residents from foreigners, and $P_F$ is payments by residents to foreigners. Since, however, all payments by residents to residents ($R_R$) are simultaneously receipts by residents from residents ($P_R$), $B$ can be written as

$$B = R_F + R_R - P_F - P_R$$  \hspace{1cm} (4.2)
The Absorption Approach to the Balance of Payments

Hence

\[ B = R - P \]  

(4.3)

where \( R \) is total receipts by residents, and \( P \) is total payments by residents.

The absorption approach can either be applied to the balance of payments as a whole or to the balance of payments on current account. In the latter case the balance of payments is the difference between national income and national expenditure. Taking the national income equation \( Y = C + I + X - M \), and labelling total expenditure \( A \) (for absorption), we have

\[ B = X - M = Y - A \]  

(4.4)

The balance of payments on current account is the difference between national output (income) and national expenditure. Within this framework any policy for balance-of-payments correction can be evaluated in terms of whether it raises \( Y \) relative to \( A \), because this is the condition for balance-of-payments improvement. Since from the income equation, \( Y - C \) equals saving (\( S \)), the balance of payments can also be expressed as

\[ B = X - M = S - I \]  

(4.5)

and any balance-of-payments correction policy can also be evaluated in terms of whether it raises saving relative to investment.

Policies to raise \( Y \) are termed \textit{expenditure-switching} policies and must not be accompanied by an equal rise in \( A \) if the balance of payments is to improve. Devaluation, tariffs, quotas on imports, subsidies to exports, and price and quantity adjustments of all kinds to increase exports and reduce imports are all examples of expenditure-switching policies. At full employment, when \( Y \) cannot increase, expenditure-switching must be accompanied by reductions in \( A \) if the balance of payments is to improve. Otherwise there would be no resources to devote to meeting the increased demand for exports and import substitutes. Reducing \( A \) by itself, of course, would cause unemployment. Policies to reduce \( A \) are called \textit{expenditure-reducing} and must not be accompanied by an equivalent fall in \( Y \) if the balance of payments is to improve. Expenditure-reducing policies accompanying expenditure-