"Partial" Approaches to Balance-of-Payments Adjustment Yield Consistent Predictions Under Identical Assumptions

By

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I. Introduction

There are two competing "partial" approaches to the analysis of balance-of-payments adjustment: the monetary approach and the components approach [see, for example, Frenkel et al., 1980]. These approaches differ not only in their choice of the proximate determinants of international reserve flows, but also with respect to the assumptions (theories) on which they are based. It is generally agreed that "in a fully specified general equilibrium system any excess supply of money is balanced by an offsetting excess demand for goods and non-monetary assets, so that the balance of payments components approach and the monetary approach are equivalent in a fully specified model” [Bilson, 1979, p. 202]. In fact, Frenkel et al. [1980, pp. 59of.] have demonstrated how the said approaches "may be reconciled in the context of a more general model that embraces the essential features of both". Nevertheless, as Bilson [1979, p. 202f.] immediately adds: "It is, however, equally true that the predictions that arise from restricted versions are often conflicting”. And it is these "restricted" or "partial" models that are used in the great majority of empirical investigations of balance-of-payments flows [see, for example, the survey by Kreinin and Officer, 1978].

A number of works, including those of Bilson [1979], Frenkel and Johnson [1976], Frenkel et al. [1980], Girton and Nattress [1977], Kierzkowski [1979] and Mundell [1968], implicitly or explicitly make the assertion that the conflicting predictions referred to above are a result of inconsistent assumptions only – preferences over proximate determinants should not matter. Hence: "... the monetary approach should in principle give an answer no different from that provided by a correct analysis in terms of the other accounts [i.e., the current and capital accounts]” [Frenkel,
Johnson, 1976, p. 22; italics added]. However, several prominent econ-
omists seem to disagree with this assertion [see, for example, Kreinin,
Officer, 1978] and continue to write as if the choice of proximate deter-
minants *per se* were of consequence for the issue at hand. The purpose of this paper is to argue that those who assert the irrele-
van ce of the choice of proximate determinants as an explanation for the conflicting predictions of the aforesaid partial models are right. Using two prototype partial models, we shall demonstrate below that even restrictive models yield perfectly consistent predictions *provided* the analyst does not lose sight of the fact that these models pertain to the same country; that is, provided assumptions are kept intact in shifting between sets of proximate determinants. We believe that the aforementioned proviso is the essential ingredient of the "correct analysis" referred to by Frenkel and Johnson in the quotation cited above. Since the disagreements between the proponents of the monetary and components approaches relate, in particular, to the *signs of the impact effects* of various exogenous shocks on balance-of-payments flows [see, for example, Kreinin, Officer, 1978; Frenkel et al., 1980], this will be our focus of attention as well.

In Part II below we briefly review the sort of analysis that provides a basis for the claim that the two most popular partial models of balance-of-payments adjustment yield conflicting predictions. Then, in Parts III and IV, we proceed to use two prototypes for the said models to compare their predictions under identical assumptions — global monetarist and Keynesian — with the purpose of demonstrating that once discrepancies between underlying assumptions are removed, the choice of proximate determinants is inconsequential for predictions pertaining to the *direction* of balance-of-payments flows. Finally, Part V contains some concluding comments.

II. Two Prototype "Partial" Models

The basis for the claim that the monetary and components approaches to balance-of-payments adjustment yield conflicting predictions can be identified with the help of two simple partial models. Consider first the following model for the monetary approach:

\[ M^* = M^* \] (I)

* Frenkel et al. [1980, p. 582] agree with us on this point and, in addition to the Kreinin-Officer survey, they also cite the papers by Johnson [1977] and Magee [1976] in support of the same claim.

* The discussion of this part follows very closely that of Frenkel *et al.* [1980].

* A fixed-exchange-rate world is assumed throughout this paper.