Absorption of trade via absorption can also

Absorption approach has the advantage of using macro variables and thus avoiding the difficult task of moving from partial to general equilibrium analysis. Statement: Absorption approach states that the effect of devaluation on the balance of trade of the devaluing country depends upon the resultant change in its income, the unabsorbed portion of its income (that is, exports) and the portion of absorbed income in the form of imports. Elaboration: Absorption approach is based upon the reasoning that, during a given period of time, total resources available to a country for use or, " absorption" are the sum of its income Y and its imports M, that is (Y + M).

Substitution and Income Effects of Devaluation: The effect of devaluation on balance of trade via absorption can also be analysed along the lines of substitution and income effects of a price change on demand. Devaluation changes relative prices (R) of exports and imports of a country (or their terms of trade) and thereby generates a substitution effect on absorption (symbolically, dR). Alexander calls this substitution effect as the " terms-of-trade effect".

Note that the value of dR itself is influenced by the extent of devaluation of the home currency. Similarly, devaluation also has an impact on income [= dY] of the devaluing country. This, in turn, causes a change in its absorption, the extent of which depends upon what may be called its ' propensity to absorb (a).

Thus, (adY) measures the " income effect of devaluation" on the absorption of the devaluing country. Accordingly, adding the substitution and income effects of devaluation on absorption by the devaluing country. Idle-Resources

Effect: It should be noted that the effect of devaluation on income of the devaluing country (that is, dY) is termed “ idle-resources effect” by Alexander. We need not go into a detailed discussion of the determinants of dY. However, it should be remembered that the value of dY cannot exceed the extent of idle productive capacity that exists in the devaluing country at the time of devaluation. Moreover, actual value of dY will be still smaller on account of several restrictive forces like time lags needed to bring about requisite adjustments in its production activities.

In particular, a country suffering from rigidities is likely to fail in producing enough of exportable goods. Also the effect of devaluation on trade balance would be smaller if foreigners do not want home country’s exportable goods. It should be noted that if devaluation is to result in an improvement in balance of trade of the devaluing country, its propensity to absorb (a) will have to be less than one and its additional consumption and investment would have to be less than the increase in its production.

Whether or not this would happen cannot be guaranteed. Alexander, however, mentions the “ absolute-price-level effect” which may keep additional absorption below the additional income. This may happen as follows. The devaluation has in general an inflationary impact upon the domestic economy. This induces the people to restore the real value of their cash balances by reducing their consumption and investment relative to their incomes. Moreover, aggregate consumption may be adversely affected by re-distribution of income against wages.

However, the exact direction and extent of “ absolute-price-level effect” can differ from item to item.