ABSTRACT

Thesis Title : Exchange Rate and Credit Policy for Maintaining Trade Balance and Inflation

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The main purpose of this study is to analyze the determinants of trade balance and inflation during the period 1965 - 1995 with emphasis on the impact of monetary disequilibrium that is the disequilibrium between demand for and supply of money on the variables. The small macroeconomic model is provided under the theory of Monetary Approach and Elasticity Approach to the Balance of Payments. The fundamental basis of Monetary Approach is that the balance of payments is essentially a monetary phenomenon and will be improved by monetary policy, while Elasticity Approach investigates the impact of exchange rate changes on the trade balance through elasticity of demand for imports and exports. The Model is constructed to explain dynamic responses of some macroeconomic variables and used for simulation to test the goodness-of-fit. These dynamic simulation results also provide the basis for deriving the dynamic effects of policy changes i.e exchange rate policy represented by devaluation and domestic credit policy represented by tight credit policy.

The results provide that monetary disequilibrium is the excess demand for real balances influencing export and import significantly as

indicated by Monetary Approach but the effect is very small. It implies that the changes of money supply through monetary policy, such as tight credit policy, willl give a small impact on trade balance. Policy simulation shows that devaluation reduces imports only slightly and also reduces unit value of exports in foreign currency in the year of devaluation. But it does not raise the demand for real balances as indicated by Monetary Approach. The reason is that the increasing of domestic price and inflation raise the cost of holding money. However, import is decreased by the relative price effect according to Elasticity Approach. In the second year, import decrease larger than the first year since the lags effects according to J-Curve Effect. In the long run, volume of imports finally increase and inflation is increased a little. Meanwhile, tight credit policy only decreases domestic price level and inflation in the first year of policy and only give small impact on export and import. In the medium-to-long-term, the most effect is on inflation, then declining the demand for real balances and worsen trade balance, only small magnitude,. Thus, if the objective is to achieve improvements in the trade balance, devaluation will get the objective in the long- term. If the objective is to maintain internal balance, price level, tight credit policy will decrease inflation only in the year of policy. In the long-term, tight credit policy can not maintain both internal and external balances.