

**Comment on Larry A. Sjaastad's
"Recent Balance of Payments Experience
in Latin America"**

By Michael Connolly*

Professor Sjaastad's essay is a welcome one in an important way: namely, it very neatly applies an increasingly important small-country trade model, the *Swan-Salter* framework, to a policy area of considerable concern; balance of payments problems in Latin America. In my comments, I would like to provide the geometric equivalent of *Sjaastad's* algebraic model in order to illustrate primarily the innate strength of the model in this context, and secondarily to highlight a minor weakness in emphasis regarding adjustment to the historically unprecedented trade deficits pointed out by *Sjaastad*. These trade deficits have been associated with the large scale increase in indebtedness by the Latin American countries analyzed. Finally, apart from my fundamental agreement with the ingenious application of the model, I will disagree with some of *Sjaastad's* remarks concerning the recent devaluations of the Mexican peso.

First, consider a country which produces and consumes a composite good, tradeables (imports and exports), whose home price is determined by world prices via the exchange rate, and another good, non-tradeables, whose domestic price is determined by domestic supply and demand. Beginning from an initial equilibrium in both markets, consider the effects of an increase in borrowing from abroad. Initially, expenditure on both tradeables and non-tradeables rises. However, the price of traded goods goes unchanged but a trade deficit results, while the price of non-traded goods rises to clear the domestic market. This is the very situation depicted by *Sjaastad*, and can be illustrated in the following graph due to *Swan* and *Salter* (cf. Fig. 1).

It depicts a moment in the process of adjustment to new foreign borrowing which has, as pointed out by *Sjaastad*, the effect of increased deficits (from none to $P' C'$), and a rise in the price of non-traded goods relative to traded goods (reflected by the steeper slope of the line passing through P' compared to P). There can be no disagreement with the

* University of Florida, Gainesville.