30
CHAPTER

# BALANCE OF PAYMENTS : MEANING AND COMPONENTS

## 1. MEANING

The balance of payments of a country is a systematic record of all its economic transactions with the outside world in a given year. It is a statistical record of the character and dimensions of the country's economic relationships with the rest of the world. According to Bo Sodersten, "The balance of payments is merely a way of listing receipts and payments in international transactions for a country."[1] B. J. Cohen says, "It shows the country's trading position, changes in its net position as foreign lender or borrower, and changes in its official reserve holding."[2]

## 2. STRUCTURE OF BALANCE OF PAYMENTS ACCOUNTS

The balance of payments account of a country is constructed on the principle of double-entry book-keeping. Each transaction is entered on the credit and debit side of the balance sheet. But balance of payments accounting differs from business accounting in one respect. In business accounting, debits (–) are shown on the left side and credits (+) on the right side of the balance sheet. But in balance of payments accounting, the practice is to show credits on the left side and debits on the right side of the balance sheet.

When a payment is received from a foreign country, it is a credit transaction while payment to a foreign country is a debit transaction. The principal items shown on the credit side (+) are exports of goods and services, unrequited (or transfer) receipts in the form of gifts, grants, etc. from foreigners, borrowings from abroad, investments by foreigners in the country, and official *sale* of reserve assets including gold to foreign countries and international agencies. The principal items on the *Debit* side (–) include imports of goods and services, transfer (or unrequited) payments to foreigners as gifts, grants, etc., lending to foreign countries, investments by residents to foreign countries, and official *purchase* of reserve assets or gold from foreign countries and international agencies.

1. Bo Sodersen, *International Economics*, 2/e, 1980.
2. B.J. Cohen, *Balance of Payments Policy*, 1969.

These credit and debit items are shown vertically in the balance of payments account of a country according to the principle of double-entry book-keeping. Horizontally, they are divided into three categories : the current account, the capital account, and the official settlements account or the official reserve assets account.

The balance of payments account of a country is constructed in Table 1.

**Table 1. Balance of Payments Account**

| *Credits (+) (Receipts)* | *Debits (–) (Payments)* |
|---|---|
| *1. Current Account* | |
| *Exports* | *Imports* |
| (a) Goods | (a) Goods |
| (b) Services | (b) Services |
| (c) Transfer Payments | (c) Transfer Payments |
| *2. Capital Account* | |
| (a) Borrowings from Foreign Countries | (a) Lending to Foreign Countries |
| (b) Direct Investments by Foreign Countries | (b) Direct Investments in Foreign Countries |
| *3. Official Settlements Account* | |
| (a) Increase in Foreign Official Holdings | (a) Increase in Official Reserve of Gold and Foreign Currencies |
| *Errors and Omissions* | |

**1. Current Account.** The current account of a country consists of all transactions relating to trade in goods and services and unilateral (or unrequited) transfers. Service transactions include costs of travel and transportation, insurance, income and payments of foreign investments, etc. Transfer payments relate to gifts, foreign aid, pensions, private remittances, charitable donations etc. received from foreign individuals and governments to foreigners.

In the current account, merchandise exports and imports are the most important items. Exports are shown as a positive item and are calculated f.o.b. (free on board) which means that costs of transportation, insurance, etc. are excluded. On the other side, imports are shown as a negative item and are calculated c.i.f. which means that costs, insurance and freight are included. The difference between exports and imports of a country is its *balance of visible trade* or merchandise trade or simply *balance of trade*. If visible exports exceed visible imports, the balance of trade is favourable. In the opposite case when imports exceed exports, it is unfavourable.

It is, however, services and transfer payments or invisible items of the current account that reflect the true picture of the balance of payments account. The balance of exports and imports of services and transfer payments is called the *balance of invisible trade*. The invisible items alongwith the visible items determine the actual current account position. If exports of goods and services exceed imports of goods and services, the balance of payments is said to be *favourable*. In the opposite case, it is unfavourable.

In the current account, the exports of goods and services and the receipts of transfer payments (unrequited receipts) are entered as credits (+) because they represent receipts from foreigners

On the other hand, the imports of goods and services and grant of transfer payments to foreigners are entered as debits (–) because they represent payments to foreigners. The net value of these visible and invisible trade balances is the balance on current account.

**2. Capital Account.** The capital account of a country consists of its transactions in financial assets in the form of short-term and long-term lendings and borrowings, and private and official investments. In other words, the capital account shows international flow of loans and investments, and represents a change in the country's foreign assets and liabilities. Long-term capital transactions relate to international capital movements with maturity of one year or more and include direct investments like building of a foreign plant, portfolio investment like the purchase of foreign bonds and stocks, and international loans. On the other hand, short-term international capital transactions are for a period ranging between three months and less than one year.

There are two types of transactions in the capital account—private and government. Private transactions include all types of investment : direct, portfolio and short-term. Government transactions consist of loans to and from foreign official agencies.

In the capital account, borrowings from foreign countries and direct investment by foreign countries represent capital inflows. They are positive items or credits because these are receipts from foreigners. On the other hand, lending to foreign countries and direct investments in foreign countries represent capital outflows. They are negative items or debits because they are payments to foreigners. The net value of the balances of short-term and long-term direct and portfolio investments is the *balance on capital account.*

Sodersten and Reed refer to the *external wealth account* of a country which shows the stocks of foreign assets held by the country (positive item) and of domestic assets held by foreign investors (liabilities or negative item). The net value of a country's assets and liabilities is its balance of indebtedness. If its assets are more than its liabilities, then it is a *net creditor*. If its liabilities are more than its assets, then it is a net debtor.[3]

*Basic Balance*. The sum of current account and capital account is known as the basic balance.

**3. The Official Settlements Account.** The official settlements account or official reserve assets account is, in fact, a part of the capital account. But the U.K. and U.S. balance of payments accounts show it as a separate account. "The official settlements account measures the change in nation's liquidity and non-liquid liabilities to foreign official holders and the change in a nation's official reserve assets during the year. The official reserve assets of a country include its gold stock, holdings of its convertible foreign currencies and SDRs, and its net position in the IMF." It shows transactions in a country's net official reserve assets.

**Errors and Omissions.** Errors and ommissions is a balancing item so that total credits and debits of the three accounts must equal in accordance with the principles of double entry book-keeping so that the balance of payments of a country always balances in the accounting sense.

## 3. Is Balance of Payments Always in Equilibrium ?

Balance of payments always balances means that the algebraic sum of the net credit and debit balances of current account, capital account and official settlements account must equal zero. Balance of payments is written as

$$B = R_f - P_f$$

where, $B$ represents balance of payments,

$R_f$ receipts from foreigners,

3. Bo Sodersten and Geoffery Reed, *International Economics*, 3/e, 1994.

$P_f$ payments made to foreigners

When $B = R_f - P_f = 0$, the balance of payments is in equilibrium.
When $R_f - P_f > 0$, it implies receipts from foreigners exceed payments made to foreigners and there is *surplus* in the balance of payments. On the other hand, when $R_f - P_f < 0$ or $R_f < P_f$ there is *deficit* in the balance of payments as the payments made to foreigners exceed receipts from foreigners.

If net foreign lending and investment abroad are taken, a flexible exchange rate creates an excess of exports over imports. The domestic currency depreciates in terms of other currencies. The exports becomes cheaper relatively to imports. It can be shown in equation form :

$$X + B = M + I_f$$

Where $X$ represents exports, $M$ imports, $I_f$ foreign investment, $B$ foreign borrowing

or $$X - M = I_f - B$$

or $$(X - M) - (I_f - B) = 0$$

The equation shows the balance of payments in equilibrium. Any positive balance in its current account is exactly offset by negative balance on its capital account and vice versa. In the accounting sense, the balance of payments always balances. This can be shown with the help of the following equation :

$$C + S + T = C + I + G + (X - M) \qquad [\because Y = C + S + T]$$

or $$Y = C + I + G + (X - M)$$

where $C$ represents consumption exepnditure, $S$ domestic saving, $T$ tax receipts, $I$ investment expenditures, $G$ government expenditures, $X$ exports of goods and services, and $M$ imports of goods and services.

In the above equation

$C + S + T$ is $GNI$ or national income ($Y$), and

$C + I + G = A$,

where $A$ is called 'absorption'.

In the accounting sense, total domestic expenditures $(C + I + G)$ must equal current income $(C + S + T)$ that is $A = Y$. Moreover, domestic saving $(S_d)$ must equal domestic investment $(I_d)$. Similarly, an export surplus on current account $(X > M)$ must be offset by an excess of domestic savings over investment $(S_d > I_d)$. Thus the balance of payments always balances in the accounting sense, according to the basic principle of accounting. In the accounting system, the inflow and outflow of a transaction are recorded on the credit and debit sides respectively. Therefore, credit and debit sides always balance. If there is a deficit in the current account, it is offset by a matching surplus in the capital account by borrowings from abroad or/and withdrawing out of its gold and foreign exchange reserves, and vice versa. Thus, the balance of payments always balances in this sense also.

## 4. Measuring Deficit or Surplus in Balance of Payments

*If the balance of payments always balances, then why does a deficit or surplus arise in the balance of payment of a country?* It is only when all items in the balance of payments are included that there is no possibility of a deficit or surplus. But if some items are excluded from a country's balance of payments and then a balance is struck, it may show a deficit or surplus.

There are three ways of measuring deficit or surplus in the balance of payments.

*First*, there is the *basic balance* which includes the current account balance and the long-term capital account balance.

*Second*, there is the *net liquidity balance* which includes the basic balance and the short-term private non-liquid capital balance, allocation of SDRs, and errors and ommissions.

*Third*, there is the *official settlements balance* which includes the total net liquid balance and short-term private liquid capital balance.

If the total debits are more than total credits in the current and capital accounts, including errors and omissions, the net *debit balance* measures the *deficit* in the balance of payments of a country. This deficit can be settled with an equal amount of *net credit balance* in the official settlements account. On the contrary, if total credits are more than total debits in the current and capital accounts, including errors and omissions, the *net debit* balance measures the *surplus* in the balance of payments of a country. This surplus can be settled with an equal amount of *net debit* balance in the official settlements account.

The relationship between these balances is summarised in Table 2 below.

Table 2

| Balance | | |
|---|---|---|
| Trade balance | $a$ | |
| Transfer payments balance | $b$ | Autonomous |
| *Current Account Balance* | $c\ (= a + b)$ | Items |
| Long-term capital balance | $d$ | |
| *Basic Balance* | $e\ (= c + d)$ | |
| Short-term private non-liquid capital balance | $f$ | |
| Allocation of SDRs | $g$ | Accommodating |
| Errors and omissions | $h$ | Items |
| *Net Liquidity Balance*......... | $i\ (= e + f + g + h)$ | |
| Short-term private liquid capital balance | $j$ | |
| *Official Settlements Balance*. | $k\ (= i + j)$ | |

Autonomous and Accommodating Items

Each balance would give different figure of the deficit. The items that are included in a particular balance are placed 'above the line' and those excluded are put 'below the line'. Items that are put above the line are called *autonomous items*. Items that are placed below the line are called *settlement or accommodating or compensatory* or *induced items*. All transactions in the current and capital accounts are autonomous items because they are underaken for business or profit motives and are independent of balance of payments considerations. According to Sodersten and Reed, "Transactions are said to be autonomous if their value is determined independently of the balance of payments". Whether there is *BOP* deficit or surplus depends on the balance of autonomous items. If autonomous receipts are less than autonomous payments, BOP is in deficit and vice versa.

"Accommodating items on the other hand are determined by the net consequences of the autonomous items", according to Sodersten and Reed. They are in the official reserve account. They are compensating (induced or accommodating) short-term capital transactions which are meant to correct a disequilibrium in the autonomous items of balance of payments.

But it is difficult to determine which item is compensatory and which is autonomous. For instance, in the table given above, the main difference in the three balances is their treatment of short-term capital movements which are responsible for deficit in the balance of payments. The basic balance places short-term private non-liquid capital movements below the line while the net liquid balance puts them above the line. Similarly, the net liquid balance places short-term private liquid capital movements below the line and the official settlements balance puts them above the line. Thus, as pointed out by Sodersten and Reed, "Essentially the distinction between autonomous and accommodating items lies in the motives underlying a transaction, which are almost impossible to determine"[4].

4. Bo Sodersten and G. Reed, *International Economics*, 3/e, 1994, Italics added.

**Conclusion.** The above analysis is based on the assumption of fixed exchange rates. Thus a deficit (or surplus in the balance of payments is possible under a system of fixed exchange rates. But under freely floating exchange rates, there can in principle be no deficit (or surplus) in the balance of payments. The country can prevent a deficit or (surplus) by depreciating (or appreciating) its currency. Further, balance of payments always balances in an ex-post accounting sense, according to the basic principle of accounting. Lastly, such a balance of payments can be in equilibrium only if there are no compensating transactions.

## ALANCE OF TRADE AND BALANCE OF PAYMENTS

The *balance of payments* of a country is a systematic record of its receipts and payments in international transactions in a given year. Each transaction is entered on the credit and debit side of the balance sheet (see Table 1). The principal items on the credit side are : (1) Visible exports which relate to the goods exported for which the country receives payments. (2) Invisible exports which refer to the services rendered by the country to other countries. Such services consist of banking, insurance, shipping, and other services rendered in the form of technical know-how, etc., money spent by tourists and students visiting the country for travel and education, etc. (3) Transfer receipts in the form of gifts received from foreigners. (4) Borrowings from abroad and investments by foreigners in the country. (5) The official sale of reserve assets including gold to foreign countries and international institutions.

The principal items on the debit side are : (1) Visible imports relating to goods imported for which the country makes payments to foreign countries. (2) Invisible imports in the form of payments made by the home country for services rendered by foreign countries. These include all items referred to under (2) in the above para. (3) Transfer payments to foreigners in the form of gifts, etc. (4) Loans to foreign countries, investments by residents in foreign countries, and debt repayments to foreign countries. (5) Official purchase of reserve assets or gold from foreign countries and international institutions.

If the total receipts from foreigners on the credit side exceed the total payments to foreigners on the debit side, the balance of payments is said to be *favourable*. On the other hand, if the total payments to foreigners exceed the total receipts from foreigners, the balance of payments is *unfavourable*.

The *balance of trade* is the difference between the value of goods and services exported and imported. In contains the first two items of the balance of payments account on the credit and the debit side. This is known as "balance of payment on current account." Some writers define the balance of trade as the difference between the value of merchandise exports and imports. Prof. Meade regards this way of defining the balance of trade as wrong and of minor economic significance from the point of view of the national income of the country. In equation form, the balance of payments of $Y = C + I + G + (X - M)$ which includes all transactions which give rise to or exhaust national income. In the equation, $Y$ refers to national income, $C$ to consumption expenditure, $I$ to investment expenditure, $G$ to government expenditure, $X$ to exports of goods and services and $M$ to imports of goods and services. The expression $(X - M)$ denotes the balance of trade. If the difference between $X$ and $M$ is zero, the balance of trade balances. If $X$ is greater than $M$, the balance of trade is *favourable*, or there is *surplus* balance of trade. On the other hand, if $X$ is less than $M$, the balance of trade is in *deficit* or is *unfavourable*.

## 6. Disequilibrium in Balance of Payments

A disequilibrium in the *BOP* of a country may be either a deficit or a surplus. A deficit or surplus in *BOP* of a country appears when its autonomous receipts (credits) do not match its autonomous payments (debits). If autonomous credit receipts exceed autonomous debit payments, there is a surplus in the *BOP* and the disequilibrium is said to be *favourable*. On the other hand, if autonomous debit payments exceed autonomous credit receipts, there is a *deficit* in the *BOP* and the disequilibrium is said to be unfavourable or adverse.[5]

### Causes of Disequilibrium

There are many factors that may lead to a BOP deficit or surplus:

**1. Temporary Changes (or Disequilibrium).** There may be a temporary disequilibrium caused by random variations in trade, seasonal fluctuations, the effects of weather on agricultural production, etc. Deficits or surpluses arising from such temporary causes are expected to correct themselves within a short time.

**2. Fundamental Disequilibrium.** Fundamental disequilibrium refers to a persistent and long-run *BOP* disequilibrium of a country. It is a chronic *BOP* deficit, according to *IMF*. It is caused by such dynamic factors as : (1) Changes in consumer tastes within the country or abroad which reduce the country's exports and increase its imports. (2) Continuous fall in the country's foreign exchange reserves due to supply inelasticities of exports and excessive demand for foreign goods and services. (3) Excessive capital outflows due to massive imports of capital goods, raw materials, essential consumer goods, technology and external indebedness. (4) Low competitive strength in world markets which adversly affects exports. (5) Inflationary pressures within the economy which make exports dearer.

**3. Structural Changes (or Disequilibrium).** Structural changes bring about disequilibrium in BOP over the long run. They may result from the following factors: (*a*) Technological changes in methods of production of products in domestic industries or in the industries of other countries. They lead to changes in costs, prices and quality of products. (*b*) Import restrictions of all kinds bring about disequilibrium in *BOP*. (c) Deficit in *BOP* also arises when a country suffers from deficiency of resources which it is required to import from other countries. (*d*) Disequilibrium in *BOP* may also be caused by changes in the supply or direction of long-term capital flows. More and regular flow of long-term capital may lead to *BOP* surplus, while an irregular and short supply of capital brings *BOP* deficit.

**4. Changes in Exchange Rates.** Changes in foreign exchange rate in the form of overvaluation or undervaluation of foreign currency lead to *BOP* disequilibrium. When the value of currency is higher in relation to other currencies, it is said to be overvalued. Opposite is the case of an undervalued currency. Overvaluation of the domestic currency makes foreign goods cheaper and exports dearer in foreign countries. As a result, the country imports more and exports less of goods. There is also outflow of capital. This leads to unfavourable *BOP*. On the contrary, undervaluation of the currency makes *BOP* favourable for the country by encouraging exports and inflow of capital and reducing imports.

**5. Cyclical Fluctuations (or Disequilibrium).** Cyclical fluctuations in business activity also lead to *BOP* disequilibrium. When there is depression in a country, volumes of both exports and imports fall drastically in relation to other countries. But the fall in exports may be more than that of imports due to decline in domestic production. Therefore, there is an adverse *BOP* situation.

---

5. The distinction between deficit and disequilibrium in *BOP* should be clearly understood. The former refers to ... above whereas disequilibrium refers to a deficit or surplus in *BOP*.

On the other hand, when there is boom in a country in relation to other countries, both exports and imports may increase. But there can be either a surplus or deficit in *BOP* situation depending upon whether the country exports more than imports or imports more than exports. In both the cases, there will be disequilibrium in *BOP*.

**6. Changes in National Income.** Another cause is the change in the country's national income. If the national income of a country increases, it will lead to an increase in imports thereby creating a deficit in its balance of payments, other things remaining the same. If the country is already at full employment level, an increase in income will lead to inflationary rise in prices which may increase its imports and thus bring disequilibrium in the balance of payments.

**7. Price Changes.** Inflation or deflation is another cause of disequilibrium in the balance of payments. If there is inflation in the country, prices of exports increase. As a result, exports fall. At the same time, the demand for imports increase. Thus increase in export prices leading to decline in exports and rise in imports results in adverse balance of payments.

**8. Stage of Economic Development.** A country's balance of payments also depends on its stage of economic development. If a country is developing, it will have a deficit in its balance of payments because it imports raw materials, machinery, capital equipment, and services associated with the development process and exports primary products. The country has to pay more for costly imports and gets less for its cheap exports. This leads to disequilibrium in its balance of payments.

**9. Capital Movements.** Borrowings and lendings or movements of capital by countries also result in disequilibrium in *BOP*. A country which gives loans and grants on a large scale to other countries has a deficit in its *BOP* on capital account. If it is also importing more, as is the case with the USA, it will have chronic deficit. On the other hand, a developing country brorrowing large funds from other countries and international institutions may have a favourable *BOP*. But such a possibility is remote because these countries usually import huge quanties of food, raw materials, capital goods, etc. and export primary products. Such borrowings simply help in reducing *BOP* deficit.

**10. Political Conditions.** Political condition of a country is another cause of disequilibrium in *BOP*. Political instability in a country creates uncertainty among foreign investors which leads to the outflow of capital and retards its inflow. This causes disequilibrium in *BOP* of the country. Disequilibrium in *BOP* also occurs in the event of war or fear of war with some other country.

## Implications of Disequilibrium

A disequilibrium in the balance of payments whether a deficit or surplus has important implications for a country.

A deficit in the combined current and capital accounts is regarded as undesirable for the country. This is because such a deficit has to be covered by borrowing from abroad or attracting foreign exchange or capital from abroad. This may require paying high interest rates. There is also the danger of withdrawing money by foreigners, as happened in the case of the Asian crisis in the late 1990s. An alternative may be to draw on the reserves of the country which may also lead to a financial crises. Moreover, the reserves of a country being limited, they can be used to pay for *BOP* deficit upto a limit.

But the above analysis of a combined current and capital account deficit is not correct in practice. The reason being that a current account deficit is the same thing as a capital account surplus. However, it is beneficial for a country to have a current account deficit even if it equals capital account surplus in *BOP*. In the short-run, the country may benefit from a higher level of consumption through import of goods and consequently a higher standard of living. But the excess of imports over exports may be financed by foreign investments in the country. These

may lead to increased production, employment and income in the country. In the long-run, foreign investors may purchase large assets in the country and thus adversely affect domestic industry as is the case with *MNCs* (multinational corporations).

The current account deficit in *BOP* of a country may have either good or bad effects depending on the nature of an economy.

Take a country where domestic industries are rapidly growing and it has current account BOP deficit. These industries offer a high rate of return on their investment. This would, in return, attract foreign investments. As a result, the country would have a capital account surplus due to the inflow of capital and a current account deficit. This current account deficit is good for the economy. No doubt, the external debt of the country increases, but this debt is being utilised to finance the rapid growth of the economy. The real burden of this debt will be very low because it can be repaid out of higher income in the future.

On the contrary, a country having an inefficient and unproductive domestic industry will be adversely affected by its current account *BOP* deficit. The country borrows from abroad to finance the excess of spending over consumption. To attract foreign borrowings, the country will have to pay high interest rates. These will increase the money burden of the debt. The real burden of the debt will also increase because of the low productive capacity of domestic industries. If the current consumption is being financed by foreign borrowings, the wealth of the economy will decline. This, in turn, will lead to either a reduction in domestic expenditure or a change in government policy so as to control the rising debt.

On the other hand, if foreign borrowings are being used to finance real investment, the current account *BOP* deficit will be beneficial for the economy. A higher rate of return on real investment than the interest on foreign borrowings would increase the country's wealth over time through rise in its national income. Thus a current account *BOP* deficit is not always undesirable for a country.

## 7. Measures to Correct Deficit in Balance of Payments[6]

When there is a deficit in the balance of payments of a country, adjustment is brought about automatically through price and income changes or by adopting certain policy measures like export promotion, monetary and fiscal policies, devaluation and direct controls. We study these as follows:

### 1. Adjustment through Exchange Depreciation (Price Effect)

Under flexible exchange rates, the disequilibrium in the balance of payments is automatically solved by the forces of demand and supply for foreign exchange. An exchange rate is the price of a currency which is determined, like any other commodity, by demand and supply. "The exchange rate varies with varying supply and demand conditions, but it is always possible to find an equilibrium exchange rate which clears the foreign exchange market and creates external equilibrium."[7] This is automatically achieved by depreciation of a country's currency in case of deficit in its balance of payments. Depreciation of a currency means that its relative value decreases. Depreciation has the effect of encouraging exports and discouraging imports. When exchange depreciation takes place, foreign prices are translated into domestic prices. Suppose the dollar depreciates in relation to the pound. It means, that the price of dollar falls in relation to the

6. If the question relates to disequilibrium in *BOP*, then measures opposite to whatever are given in the paras should also be explained relating to *BOP* surplus, such as appreciation, revaluation, etc. The best answer would be to write at the end of each para : The opposite measures would be adopted in case of *BOP* surplus. Mention the measures in the dotted portion.

pound in the foreign exchange market. This leads to the lowering of the prices of U.S. exports in Britain and raising of the prices of British imports in the U.S. When import prices are higher in the U.S., the Americans will purchase less goods from the Britishers. On the other hand, lower prices of U.S. exports will increase exports and diminish imports, thereby bringing equilibrium in the balance of payments.

## 2. Devaluation or Expenditure-Switching Policy

Devaluation raises the domestic price of imports and reduces the foreign price of exports of a country devaluing its currency in relation to the currency of another country. Devaluation is referred to as expenditure switching policy because it switches expenditure from imported to domestic goods and services. When a country devalues its currency, the price of foreign currency increases which makes imports dearer and exports cheaper. This causes expenditures to be switched from foreign to domestic goods as the country's exports rise and the country produces more to meet the domestic and foreign demand for goods with reduction in imports. Consequently, the balance of payments deficit is eliminated.

## 3. Direct Controls

To correct disequilibrium in the balance of payments, government also adopts direct controls which aim at limiting the volume of imports. The government restricts the import of undesirable or unimportant items by levying heavy import duties, fixation of quotas, etc. At the same time, it may allow imports of essential goods duty free or at lower import duties, or fix liberal import quotas for them. For instance, the government may allow free entry of capital goods, but impose heavy import duties on luxuries. Import quotas are also fixed and the importers are required to take licenses from the authorities in order to import certain essential commodities in fixed quantities. In these ways, imports are reduced in order to correct an adverse balance of payments. The government also imposes exchange controls. Exchange controls have a dual purpose. They restrict imports and also control and regulate the foreign exchange. With reduction in imports and control of foreign exchange, visible and invisible imports are reduced. Consequently, an adverse balance of payment is corrected.

## 4. Adjustment through Capital Movements

A country can use capital imports to correct a deficit in its balance of payments. A deficit can be financed by capital inflows. When capital is perfectly mobile within countries, a small rise in the domestic rate of interest brings a large inflow of capital. The balance of payments is said to be in equilibrium when the domestic interest rate equals the world rate. If the domestic interest rate is higher than the world rate, there will be capital inflows and the balance of payments deficit is corrected.

## 5. Adjustment through Income Changes

Given the foreign exchange rate and prices in a country, an increase in the value of exports, causes an increase in the incomes of all persons associated with the export industries. These, in turn, create demand for other goods and services within the country. This will raise the incomes of persons engaged in the latter industries and services. This process will continue and the national income increases by the value of the multiplier.

### 6. Stimulation of Exports and Import Substitutes

A deficit in the balance of payments can also be corrected by encouraging exports. Exports can be encouraged by producing quality products, by increasing exports through increased production and productivity, and by better marketing. They can also be increased by a policy of import substitution. It means that the country produces those goods which it imports. In the beginning, imports are reduced but in the long run exports of such goods start. An increase in exports cause the national income to rise by many times through the operation of the foreign trade multiplier. The foreign trade multiplier expresses the change in income caused by a change in exports. Ultimately, the deficit in the balance of payments is removed when exports rise faster than imports.

### 7. Expenditure-Reducing policies

A deficit in the balance of payments implies an excess of expenditure over income. To correct it, expenditure and income should be brought into equality. For this expenditure reducing monetary and fiscal policies are used. A contractionary or tight monetary policy relates to increase in interest rates to reduce money supply and a contractionary fiscal policy relates to reduction in government expenditure and or increase in taxes. Thus expenditure reducing policies reduce aggregate demand through higher taxes and interest rates, thereby reducing expenditure and output. The reduction in expenditure and output, in turn, reduces the domestic price level. This gives rise to switching of expenditure from foreign to domestic goods. Consequently, the country's imports are reduced and the balance of payments deficit is corrected.

## Exercises

1. Enumerate the principle items in the balance of payments of a country. How can a deficit in the balance of payments be corrected?
2. "Balance of Payments always balances." Elucidate. But how do you explain disequilibrium in balance of payments.
3. Distinguish between balance of payments and balance of trade. How can an unfavourable balance of payments be corrected?
4. What are the causes of an adverse balance of payments? Give suggestions to remove a unfavourable balance of payments?
5. Distinguish between : (*a*) Balance of Current Account and Balance of Capital Account; (*b*) Autonomous Balance and Overall Balance; (*c*) Autonomous Transactions and Accommodating Transactions; (*d*) Deficit and Disequilibrium in Balance of Payments.