CHAPTER III

BALANCE OF PAYMENTS – THEORETICAL FOUNDATIONS

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3.1 DEFINITION OF BALANCE OF PAYMENTS

Balance of payments (BOP) of a country is a systematic summary statement of a country’s international economic transactions during a given period of time, usually a year. The study of balance of payments represents macroeconomic aspect of international economics.

As cited in Lindert (2002) Kindleberger defines “The balance of payments of a country is a systematic record of all economic transactions between residents of that country and the rest of the world during a given period of time.”

The International Monetary Fund defines the term Balance of Payments more clearly and explicitly as follows – “the balance of payments is a statistical statement that systematically summarises for a specific time period, the economic transactions of an economy with the rest of the world. Transactions, for the most part between residents and nonresidents, consists of those involving goods, services, and income;
those involving financial claims on, and liabilities to, the rest of the world; and those
(such as gifts) classified as transfers, which involve offsetting entries to balance – in
an accounting sense - one sided transaction.” ²

In general, Balance of Payments (BOP) of a country is “a systematic record of all
economic transactions between the residents of the reporting country and the
residents of the rest of the world for a given period of time usually a year.” Thus, it
comprises all types of transactions of a country like – exports and imports of goods
and services, purchase and sale of foreign assets, foreign direct investment and
portfolio investment as well as borrowing from and lending to the rest of the world.

3.1.1 Importance of Balance of Payments

A study of BOP is important because –

- It serves as an indicator of the changing international economic or financial
  position of a country.
- It helps in formulation of a country’s monetary, fiscal and trade policies.
- It helps in determining the influence of foreign trade & transactions on the
  level of national income of a country.
- It is useful to banks, firms, financial institutions and individuals which are
  directly or indirectly involved in international trade and finance.
- It is an economic barometer of nation’s progress vis-à-vis rest of the world.

3.2 BALANCE OF PAYMENTS ACCOUNTING

The BOP accounts of a country is constructed on the basis of an accounting
procedure known as double entry book-keeping. Double entry book keeping means
that each international transaction is recorded twice, once as a credit entry and once
as a debit entry of equal amount. The reason for this is that in general every transaction has two sides that is credit and debit.

When a payment is received from a foreign country, it is a credit transaction or credit entry, while payment to a foreign country is a debit transaction or debit entry. In a country’s BOP, credit transactions or entries are entered with a positive sign (+), and debit transactions or entries are entered with a negative sign (-).

In general, the credit transactions would include - exports of goods and services, unilateral receipts such as gifts, grants etc. from foreigners, borrowings from abroad, investments by foreigners in the country, (capital inflows) and official sale of reserve assets including gold to foreign countries and international agencies. While, the debit transactions would include - import of goods and services, unilateral payments such as gifts, grants, etc. to foreigners, lending to foreign countries, investments by residents in foreign countries, (capital outflows) and official purchase of reserve assets or gold from foreign countries and international agencies.

These credit and debit transactions are shown vertically in the balance of payments account of a country. Horizontally they are divided into three categories: :- the current account, the capital account and the official settlements account or the official reserves account.

3.3 STRUCTURE OF BALANCE OF PAYMENTS

The Balance of Payments of a country is mainly divided into two types of accounts –

(1) Current Account (2) Capital Account.

(1) **Current Account** – The current account of a country’s balance of payments consists of all transactions related to trade in goods, services, income and unilateral transfers. The current account includes following items -
(a) *Merchandise Exports & Imports* – Merchandise exports and imports are the most important items in the current account. In general, it covers a significant portion of total transactions recorded in the BOP of a country. Generally, exports are calculated on free on board (f.o.b.) basis which means that the costs of transportation, insurance, etc. are excluded. Generally, imports are calculated on carriage, insurance and freight (c.i.f.) basis which means that costs of transportation, insurance and freight are included.

(b) *Invisible Exports & Imports* - Invisible exports & imports also known as service exports & imports are another important component of current account. Important invisible items would include – travel, insurance, transportation, investment income in the form of profits, dividends, etc. and Government not included elsewhere (g.n.i.e).

(c) *Unilateral Transfers* – Unilateral transfers or transfer payments are the third important component of current account. Unilateral transfers include gifts, grants, etc. either received from abroad (credits) or given abroad. (debits). They are one sided transactions, without a *quid pro quo* that has a measurable value. The unilateral transfers could be official or private.

(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 lending and borrowing 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. The capital account mainly consists of –

a) *Borrowing from & Lending to Foreign Countries* – Borrowing from foreign countries are credit entries because they are receipts from foreign countries. Lending to foreign countries are debit entries because they are payments to
foreign countries. This borrowing or lending could be of short term i.e. up to one year or long term i.e. more than one year. Borrowing from & lending to foreign countries could be also called as net sale of assets to foreigners and net purchases of assets from foreigners.

b) **Direct Investment & Portfolio Investment** – Direct investment is investment in enterprises located in one country but effectively controlled by residents of another country. As a rule, direct investment takes the form of investment in branches and subsidiaries by parent companies located in another country. Portfolio investment refers to purchases of foreign securities that do not carry any claim on control or ownership of foreign enterprises. In brief, borrowing from foreign countries and direct & portfolio investment by foreign countries represent *capital inflows*. On the other hand, lending to foreign countries and direct & portfolio investment in foreign countries represent *capital outflows*.

In broader terms, real or income creating transactions are entered into current account of BOP, while financial or capital transactions are entered into capital account of BOP. Lindert (2002) remarks that “Balance –of –payments accounting is unique in that it shows all the real and financial flows between a country and the rest of the world.”

(3) **Other Components** - Apart from the above two main accounts, BOP of a country also includes some other entries like – (a) Transactions with IMF, (b) SDR allocations, (c) Errors & Omissions and (d) Official settlements / Reserve account.

Table 3.1 shows broad structure of a balance of payments statement.
### Table 3.1: Broad Structure of Balance of Payments

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>Particulars</th>
<th>Credits (+)</th>
<th>Debits (-)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Current Account</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>*(A)Exports</td>
<td><em>(B)Imports</em></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(a)Goods</td>
<td>(a)Goods</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(b)Services</td>
<td>(b)Services</td>
<td></td>
</tr>
<tr>
<td></td>
<td>*(C) Unilateral Transfer</td>
<td><em>(C) Unilateral Transfer</em></td>
<td></td>
</tr>
<tr>
<td></td>
<td>receipts from abroad</td>
<td>payments to abroad</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(Gifts, grants, etc. recd)</td>
<td>(Gifts, grants, etc. given)</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Capital Account</td>
<td>(a)Borrowing from Foreign Countries / Net sale of assets to foreigners</td>
<td>(a)Lending to Foreign Countries / Net purchases of assets from foreigners</td>
</tr>
<tr>
<td></td>
<td>(b) Direct &amp; Portfolio Investment by Foreign Countries</td>
<td>(b)Direct &amp; Portfolio Investment in Foreign Countries</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Errors &amp; Omissions</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Overall Balance of Payments</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Official Settlement / Reserves Account</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### 3.4 Balances Within the Balance of Payments Statement

As the BOP statement is constructed on the basis of double entry book keeping, the total credits will be always equal to total debits.\(^a\) We can find out net balances\(^b\) for different items in the balance of payment statement. However, from the policy makers point of view some of the important balances are –

**1) Balance of Trade** - There are two definitions with reference to the concept of balance of trade or trade balance. (a) Narrow definition and (b) Broad definition.
(a) **Narrow Definition** – The narrow definition considers “Balance of trade as the difference between the value of merchandise (or goods) exports and the value of merchandise (or goods) imports.” In this sense, it can be called as – Merchandise balance or Goods balance.

Economists like James Meade and others do not accept this narrow definition and consider it as wrong and insignificant from the point of view of national income of the country. Moreover, this narrow definition was useful during mercantilist period when services constituted an insignificant portion of the international trade. This narrow definition is not useful today when services transactions have assumed growing importance in international trade.

(b) **Broad Definition** – The broad definition of balance of trade is given by economist James Meade and is accepted by most of the modern economists. In the broader sense, “Balance of trade is the difference between the value of goods & services exported and imported by a country.” Balance of trade in this sense is also known as Balance of Goods & Services.

In the familiar macro-economic equation,

\[ Y = C + I + G + (X - M) , \]

in which \( Y \) = National income, \( C \) = Consumption, \( I \) = Investment, \( G \) = Government expenditure, \( X \) = Exports of Goods & Services, \( M \) = Imports of Goods & Services, the expression \( X - M \) denotes balance of trade in Meade’s terms. Balance of trade is national income injection and for that reason it is better to use Meade’s concept of balance of trade. Equating balance of trade with goods balance alone is to ignore the importance of service balance as a factor determining national income.

(2) **Balance of Current Account** – The concept of balance of current account or current account balance is broader than the concept of balance of trade. It is said to
be mirror image of capital account including official reserves. The current account balance includes the sum of three balances – merchandise balance, services balance and unilateral transfers balance. In other words, it includes trade balance (in Meade’s terms) and transfers balance.

\[
\text{Balance of Current Account} = \text{Merchandise balance} + \text{Services Balance} + \text{Unilateral transfers balance}.
\]

The current account reflects the value of the flow of goods, services, income and gifts between the home country and the foreign countries. Current account balance refers to the net of these flows. The balance of current account can be either surplus or deficit. A current account surplus means an excess of exports over imports of goods, services investment income and unilateral transfers. A current account deficit means excess of imports over exports of goods, services, investment income and unilateral transfers. In other words, if the sum of the exports of goods, services, investment income and unilateral transfers is greater than the sum of the imports of goods, services, investment income and unilateral transfers, then there will be current account surplus and vice versa.

**Importance of the Concept of Balance of Current Account** - The balance of current account is a very important concept, as it shows the flow aspect of a country’s international transactions. It represents bottom line of a nation’s income statement. It shows the change in reporting country’s net foreign wealth. As pointed out by Salvatore (2005) –“The current account lumps together all sales and purchases of currently produced goods & services, and investment income, and unilateral transfers and provides the link between the nation’s international transactions and its national income. Specifically, a current account surplus stimulates domestic
production, while a current account deficit dampens domestic production and income.”

The concept of current account balance is linked with national income accounting and its components in the following manner:

(a) Link with national saving and domestic investment - A country can do two things with its national savings (S): (i) Invest in home country (I_d) or (ii) Invest in foreign country (I_f). Hence, \( S = I_d + I_f \). Therefore, a country’s net foreign investment (current account balance - CAB) equals the difference between national saving and domestic investment. i.e.

\[
CAB = I_f = S - I_d
\]

Thus, the concept is synonymous with net foreign investment in national income accounting.

(b) Link with domestic production, income and expenditure – A country’s current account balance is the difference between its domestic production of goods and services and its total expenditure on goods and services.

A country’s national output may be represented as -

\[
Y = C + I_d + G + X - M \ldots \ (1)^c
\]

Where \( Y \) = National product/ output, \( C \) = domestic consumption, \( I_d \) = domestic investment, \( G \) = Government expenditure, \( X \) = exports of goods & services, \( M \) = imports of goods & services. \( C, I_d \) and \( G \) all include purchases of both domestically produced and imported goods & services. But, imports must be subtracted separately because imports are not demand for the home country’s products.

A country’s total expenditure on goods and services i.e. \( C + I_d + G \) is sometimes referred to as absorption (A). It can be represented as -

\[
A = C + I_d + G \ldots \ (2)
\]
Therefore, \( Y = A + (X - M) \ldots (3) \)

The above analysis implies that national product (\( Y \)) differs from national expenditure or absorption (\( A = C + I_d + G \)) by the amount of current account balance, or the difference between exports and imports of goods and services (including gifts), or \( X - M \).

In a nutshell, the current account balance (CAB) in a balance of payment statement implies – (a) the difference between exports of goods & services & imports of goods & services (\( X - M \)), (b) Net foreign investment (\( I_f \)), (c) The difference between national savings and domestic investment (\( S - I_d \)), and (d) The difference between national product and national expenditure / absorption (\( Y - A \)).

(3) **Balance of Capital Account** – Until recently, capital account was not a significant component of balance of payments. This was because of severe restrictions adopted by the countries on international capital movements. However, in due course of time due to liberalization of trade, the countries have also eased or removed their restrictions on international capital movements. Normally, the capital account consists of all types of capital inflows and outflows. In general, it is observed that the developing countries have surplus in their capital account, while the developed countries have deficit in their capital account.

(4) **Overall Balance of Payments** - It is the sum of the balance of current account and balance of capital account (including errors & omissions). In some countries, overall balance is also called as official settlement balance. The overall balance of payments may either balance, or have a surplus, or have a deficit. In general it can be said that (a) If the overall surplus in the BOP was caused by current account surpluses but not capital account surpluses, then the surplus may be a good sign for the country. (b) If the overall deficit in the BOP was caused by current account
deficit rather than capital account deficits, then the deficit may be considered as a
bad sign for the reporting country. Thus, not only the extent but location of overall
surplus or deficit is important. It is to be noted that different nations use different
measures of the overall balance of payments surplus or deficit. Some compare the
net increase in their official reserves with the net rise in a wide definition of liquid
foreign claims against the country. Others simply measure the change in official
reserves alone.

3.5 EQUILIBRIUM & DISEQUILIBRIUM IN BALANCE OF PAYMENTS
A country’s balance of payments is said to be always ‘balanced’ in accounting sense
so there would be no ‘imbalance’ in a country’s BOP. However, we come across the
term ‘equilibrium’ or ‘disequilibrium’ in relation to a country’s BOP. This is
because the term ‘balance’/ ‘imbalance’ is used in accounting sense while the term ‘
equilibrium’ / ‘disequilibrium’ is used in economic sense. As Sodersten (1980)
remarks - “The problem of judging equilibrium position of a country’s balance of
payments becomes fairly complicated and soon takes us outside the sphere of book –
keeping.” Thus, while analyzing the equilibrium /disequilibrium in balance of
payments one has to consider the nature of international transactions in the BOP.

3.5.1 Autonomous & Accommodating Transactions
The nature of international transactions could be autonomous or accommodating.

(a) **Autonomous Transactions** – Autonomous transactions are those transactions
that take place regardless of the size of other items in the balance of
payments. They are also called as ‘above the line transactions.’ All the
transactions in the current and capital account are autonomous because they
are undertaken for business or profit motives and are independent of balance
of payments situations. They are the cause of BOP situation. For accounting purposes it is reasonable to treat all the current and capital account transactions as autonomous or above the line transactions. In brief, all the credit and debit entries in the current and capital accounts are regarded as ‘autonomous’ transactions.

(b) **Accommodating Transactions** – Accommodating transactions are those transactions which are undertaken deliberately to correct disequilibrium in balance of payments. They are also called as ‘below the line transactions’. They are the result of balance of payments situation. The transactions in the official reserve account are of accommodating nature undertaken by monetary authorities to bring balances in the balance of payments. In brief, all the credit and debit entries in the Official reserve account are regarded as accommodating transactions.

### 3.5.1.1 Definition of Equilibrium / Disequilibrium in Balance of Payments

The distinction between autonomous and accommodating transactions is useful in defining equilibrium / disequilibrium (surplus / deficit) in balance of payments.

(a) **Equilibrium in BOP** - A country’s balance of payments is said to be in equilibrium when its autonomous receipts (credits) are equal to its autonomous payments (debits).

\[
\text{Equilibrium in BOP} \rightarrow \text{Autonomous Receipts} = \text{Autonomous Payments}
\]

(b) **Disequilibrium in BOP** - A country’s balance of payments is said to be in disequilibrium when its autonomous receipts (credits) are not equal to its autonomous payments (debits).

\[
\text{Disequilibrium in BOP} \rightarrow \text{Autonomous Receipts} \neq \text{Autonomous Payments}
\]
Disequilibrium in BOP could be in the form of surplus or deficit in the balance of payments.

(1) *Surplus in BOP* – When the autonomous receipts (credits) are greater than autonomous payments (debits), the balance of payments will be in surplus or favourable. In other words, if total credits are more than total debits in the current and capital account (including errors & omissions), the net credit balance measures the surplus in the nation’s balance of payments. This surplus is settled with an equal amount of net debit in the official reserves account.

(2) *Deficit in BOP* – When the autonomous receipts (credits) are smaller than autonomous payments (debits), the balance of payments will be in deficit or unfavourable or adverse. In other words, if total debits are more than total credits in the current and capital accounts (including errors & omissions), the net debit balance measures the deficit in the nation’s balance of payments. This deficit is settled with an equal amount of net credit in the official reserve account.

The analysis of equilibrium & disequilibrium in balance of payments is summarized in table 3.2.

3.5.2 Types of Disequilibrium

Disequilibrium in balance of payments can be classified as follows:

(a) *Temporary Disequilibrium* – Temporary disequilibrium in the form of deficits or surpluses tend to last for a short period of time. They are the result of temporary changes in the economy like crop failure, seasonal fluctuations, effect of weather on agricultural production, etc. Such a disequilibrium may occur once a while and gets automatically corrected. It does not pose a serious problem for a country.
(b) **Fundamental Disequilibrium** – There is no precise definition of the term fundamental disequilibrium. Economists generally define fundamental disequilibrium as - “*a deep rooted persistent deficit or surplus in the BOP of a country.*” It is a chronic BOP deficit, according to IMF. It is of long term nature and a matter of serious concern for the country.

(c) **Cyclical Disequilibrium** – Cyclical fluctuations in the business activity also lead to BOP disequilibrium. Cyclical disequilibrium occurs because – (i) Trade cycles follow different paths and patterns in different countries. (ii) Different countries follow different stabilization programmes. (iii) Differences in price and income elasticities of demand for imports.

(d) **Structural Disequilibrium** – Structural disequilibrium occurs due to structural changes in the economy. Some of the structural changes would include – changes in technology, changes in tastes and preferences, changes in long – term capital movements, etc.

**3.5.3 Causes of Disequilibrium**

The factors leading to disequilibrium (surplus or deficit) in balance of payments could be broadly categorized into three –

1. **Economic factors** – The important economic factors are (a) structural changes in the economy, (b) changes in exchange rates (overvaluation / undervaluation), (c) Changes in the level of foreign exchange reserves, (d) Cyclical fluctuations, (e) Inflation / deflation (f) Developmental expenditure undertaken by developing countries, etc.

2. **Social factors** – The social factors may include changes in tastes & preferences due to demonstration affect, population growth rate, rate of urbanization, etc.
(3) **Political factors** – The political factors may include – political stability / instability in a country, war, change in diplomatic policy, etc.

### Table 3.2 : Equilibrium & Disequilibrium in Balance of Payments

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>Nature of transactions</th>
<th>BOP Situation</th>
<th>Official Reserve Account</th>
<th>Changes in Foreign Exchange Reserves</th>
</tr>
</thead>
<tbody>
<tr>
<td>01</td>
<td>Autonomous Receipts = Autonomous Payments [ Total credits = Total debits in current &amp; capital accounts (including errors &amp; omissions)]</td>
<td>Equilibrium in Balance of Payments</td>
<td>Zero ( i.e. No credit or debit entry)</td>
<td>No change</td>
</tr>
<tr>
<td>02</td>
<td>Autonomous Receipts ≠ Autonomous Payments</td>
<td>Disequilibrium in Balance of Payments</td>
<td>Credit or Debit entry</td>
<td>Increase or Decrease</td>
</tr>
<tr>
<td>02 A</td>
<td>Autonomous Receipts &gt; Autonomous Payments [ Total credits &gt; Total debits in the current and capital accounts (including errors &amp; omissions)]</td>
<td>Surplus in Balance of Payments = Favourable BOP</td>
<td>Net Debit entry</td>
<td>Increase</td>
</tr>
<tr>
<td>02 B</td>
<td>Autonomous Receipts &lt; Autonomous Payments [ Total debits &gt; Total credits in the current &amp; capital accounts (including errors &amp; omissions)]</td>
<td>Deficit in Balance of Payments = Unfavourable BOP, Adverse BOP.</td>
<td>Net Credit entry</td>
<td>Decrease</td>
</tr>
</tbody>
</table>

### 3.5.3.1 Implications of Disequilibrium

A disequilibrium (surplus or deficit) in balance of payments is considered as undesirable for a country. However, the implication of disequilibrium depends on location or source and duration. In this context the following generalizations are possible –
a) With respect to location it could be said that a surplus in the combined current and capital accounts should be considered desirable for a country. On the other hand, a deficit in the combined current and capital account should be considered as undesirable for the country.

b) With respect to duration it could be said that if the disequilibrium (surplus / deficit) is temporary or short term, then it is not much a serious concern for the country. But, if the disequilibrium (surplus / deficit) is persistent or long term, it is a matter of serious concern for the country and needs corrective policy action.

c) A fundamental disequilibrium (in the form of deficit) is undesirable because
   – (i) Under a system of fixed exchange rates it forces the country to go for devaluation, while under flexible exchange rates it causes depreciation in the external value of the currency. (ii) It would lead to an increase in external debt of the country and may lead to external debt trap. (iii) It leads to depletion in foreign exchange reserves and again makes the position of country extremely vulnerable. (iv) It makes the country totally dependent on the loans supplied by international organizations and foreign governments and raises serious doubt about the maintenance of its external sovereignty.

d) It is observed that disequilibrium in the form of surpluses are very rare while disequilibrium in the form of deficits are a common phenomenon. Hence, in practice, the term disequilibrium is normally associated with deficits in BOP.
3.6 MEASURES TO CORRECT DISEQUILIBRIUM IN BALANCE OF PAYMENTS

The policy makers in different countries of the world always aim at achieving equilibrium in the balance of payments over a period of time. As pointed out above, disequilibrium in the form of deficit is a matter of grave concern for the country. Hence, if the country has a deficit in its BOP, then efforts are made by policy makers to either remove or at least reduce the deficit and bring adjustment in its BOP.

The adjustment measures to correct disequilibrium in BOP can broadly divided into two types – (A) Automatic (B) Policy Induced or Deliberate.

(A) **Automatic Adjustment** – Under automatic adjustment, as the name implies, the BOP adjustment comes about automatically, and it is not brought about deliberately by government policy or intervention. The burden of adjustment is on the economy and market forces and not on the government. It is argued that under automatic adjustment if market forces of demand and supply are allowed to have a free play, in course of time, BOP equilibrium will be automatically restored. Assuming fixed or flexible exchange rates, the automatic adjustment in BOP takes place through changes in prices, interest rates, income and capital flows. Thus, under automatic adjustment there is no government intervention. However, it is to be noted that automatic adjustment does not confirm to reality and has unwanted side effects.

(B) **Policy Induced or Deliberate Measures** – Under policy induced adjustment, there is government intervention in correcting disequilibrium in BOP. As the name implies, deliberate measures are undertaken by the government to correct disequilibrium in BOP. The government tries to correct disequilibrium through its policy instruments like – monetary & fiscal policy, trade policy, devaluation,
exchange controls etc. Thus, BOP adjustment becomes a matter of policy. However, the government policies designed to correct disequilibrium in BOP cannot neglect the internal problems related to the economy like unemployment, inflation, economic growth etc.

3.6.1 Policy Induced Measures

The most important objectives of a nation are: (a) internal balance, (b) external balance (c) a reasonable rate of growth, (d) an equitable distribution of income and (e) adequate protection of the environment, etc. In the present context, internal balance and external balance are the two objectives or targets of government policy. Internal balance refers to the achievement of full employment and price stability. While external balance refers to the achievement of equilibrium in balance of payments. Thus, internal balance is achieved by reducing inflation and unemployment to zero and external balance is achieved by reducing BOP deficits and surpluses to zero. Generally, government places priority on internal over external balance, but they are sometimes forced to switch their priority when faced with large and persistent external imbalances. The government through its various policy instruments tries to achieve internal balance and external balance.

To achieve the objectives of internal & external balance the main policy instruments at the disposal of government are as follows –

1) Monetary & Fiscal Policy (Expenditure – Changing Policies) – Monetary and fiscal policy are the two tools or instruments through which the twin objectives of internal and external balance are achieved. Monetary policy affects the economy through changes in money supply and interest rates. An expansionary monetary policy will increase the money supply and decrease interest rates. While a contractionary monetary policy will decrease the
money supply and increase interest rates. An expansionary monetary policy will lead to increase in the level of investment, output, income and imports. On the other hand, a contractionary monetary policy will work in the opposite way.

Fiscal policy affects the economy through changes in government expenditure and taxes. An expansionary fiscal policy means an increase in government expenditure and/or decrease in taxes, while a contractionary fiscal policy means a decrease in government expenditure and/or increase in taxes. An expansionary fiscal policy will lead to increase in production, income and imports, while contractionary fiscal policy will do the opposite.

It is to be noted that the effects of monetary policy on the BOP situation of a country are highly predictable, whereas the effects of fiscal policy on the BOP are less predictable. These policies seek to achieve internal & external balances by altering the aggregate level of demand for goods and services, both domestic and imported, by increasing or reducing the aggregate expenditure in the economy. Hence, these two policies are also called as ‘expenditure changing policies.’

Economists like Trevor Swan and others have identified four possible cases (zones) of internal and external imbalance which calls for an appropriate mix of monetary and fiscal policy. The four cases are - (1) Unemployment – BOP Surplus (2) Inflation – BOP Surplus (3) Inflation – BOP deficit (4) Unemployment – BOP Deficit. It is argued that an expansionary monetary & fiscal policy is suitable for solving the problem of unemployment & BOP surplus. (Case 1). While, a contractionary monetary & fiscal policy is suitable for solving the problem of inflation and BOP deficit. (Case 3). But, the situation of inflation & BOP surplus (Case 2) and unemployment & BOP deficit (Case 4) represent a policy dilemma. This is because reducing inflation needs a contractionary policy while reducing BOP
surplus needs an expansionary policy. Similarly, reducing unemployment needs an expansionary policy while reducing BOP deficit needs a contractionary policy. Hence, both the cases need appropriate assignment of monetary & fiscal policies.

Trevor Swan (1955)\(^7\) argued that a country should achieve internal as well as external balances simultaneously by using a flexible exchange rate policy and monetary & fiscal policy package on the other. According to Swan, the role of attaining external balance should be given to the flexible exchange rate system (through currency devaluation / revaluation), while monetary & fiscal policy should take care of internal balance. However, his solution is not accepted by economists because when the economy follows monetary & fiscal policies simultaneously for achieving internal balance (one target), it moves away from external balance (the other target). (Case 2 & 4).

Swan Diagram\(^8\) : Trevor Swan’s analysis can be explained by Swan Diagram. (Fig.3.1).

Fig. 3.1 : The Swan Diagram
In fig. 3.1 the vertical axis measures the exchange rate, and the horizontal axis measures the real domestic expenditure or absorption. Points on the EE curve refer to external balance, with points to the left indicating external surplus and points to the right indicating external deficit. Points on the YY curve refer to internal balance, with points to the left indicating internal unemployment and points to the right indicating internal inflation. The crossing of EE and YY curves defines the four zones of external and internal imbalance and helps us to determine the appropriate policy mix to reach external and internal balance simultaneously at point F. If the economy is not at point F, then it is in disequilibrium, i.e. it is in one of the four zones. When the economy follows expenditure changing monetary and fiscal policies simultaneously in zones II & IV, to achieve internal balance (one target) it moves away from external balance (the other target).

*Mundell’s Assignment Rule*: Mundell has given solution to the solve the dilemma with the help of assignment. The assignment problem involves the pairing of a particular policy instrument with a particular target. According to the principle of effective market classification developed by Mundell the policy assignment is stable when each policy instrument is assigned to that target on which it has relatively the most influence. Robert Mundell’s (1962) assignment rule provides a useful guideline for assigning policy tasks to monetary and fiscal policies. According to him, under fixed exchange rates, assigning monetary policy for external balance and fiscal policy for internal balance would be an “appropriate” assignment. Thus, for solving Unemployment – BOP deficit case, the country should adopt expansionary fiscal policy and contractionary monetary policy. While for solving Inflation – BOP
surplus case, the country should adopt contractionary fiscal policy and expansionary monetary policy. Hence, Mundell’s assignment rule calls for a judicious mix of monetary & fiscal policy. Mundell’s analysis can be summarized in table 3.3.

Table 3.3: Monetary – Fiscal Policy Mix for Internal & External Balance

<table>
<thead>
<tr>
<th>State of Balance of Payments</th>
<th>State of the Domestic economy</th>
<th>State of the Domestic economy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Surplus</td>
<td>High Unemployment</td>
<td>Rapid Inflation</td>
</tr>
<tr>
<td></td>
<td>A Expansionary Monetary &amp; Fiscal Policies</td>
<td>C Contractionary Fiscal Policy &amp; Expansionary Monetary Policy</td>
</tr>
<tr>
<td>Deficit</td>
<td>B Expansionary Fiscal Policy &amp; Contractionary Monetary Policy</td>
<td>D Contractionary Monetary &amp; Fiscal Policies</td>
</tr>
</tbody>
</table>

2) Devaluation (Expenditure Switching Policy) - Devaluation means reduction in the external value of the country’s currency undertaken by the government officially. It is a deliberate action taken by the government deliberately and legally. Devaluation does not change internal purchasing power of a currency. A country devalues its currency in order to correct its BOP deficit. Devaluation is considered as ‘expenditure switching policy’ because it switches expenditure from imported goods to domestic goods & services. Thus, when a country with BOP deficit devalues its currency, the domestic price of its imports increases and the foreign price of its exports falls. This makes exports cheaper and imports costlier. Now the foreigners can buy more goods by paying less money than before devaluation. This encourages exports. This causes expenditure to be switched from foreign to domestic goods as the country’s exports increase and the country produces more to meet the domestic and foreign demand for goods. On the other hand, with imports
becoming costlier than before, they decline. Thus, with the rise and exports and fall in imports, BOP deficit is corrected. It is to be noted that the IMF considers devaluation as a means to correct fundamental disequilibrium in a country’s BOP but it is to be used only as a last resort.

**Effects of Devaluation** - Theoretically it is said that devaluation would – (a) encourage exports and discourage imports of goods and services and thereby improve trade balance and current account balance. (b) It would encourage capital inflows and improve capital account balance. The two tendencies together would improve the overall BOP situation of the country. (c) The effect of devaluation on terms of trade depends on demand and supply elasticities for exports and imports. (d) The effect of devaluation on national income depends on whether devaluation improves or worsens terms of trade. If the terms of trade improve, national income will rise and vice versa.

**Conditions for the success of Devaluation** – The success of devaluation depends on some essential conditions which are as follows –

- The demand for exports & imports should be fairly elastic. In other words, it should satisfy Marshall – Lerner condition.

- The supply of exports should be adequate to meet the increased demand for exports after devaluation.

- There should be domestic price stability after devaluation.

- Devaluation will be successful only if other countries do not devalue their currencies simultaneously. In other words, there should not be retaliation.
There should be international cooperation. In other words, the other countries should not adopt measures to counter the effects of devaluation. Such measures would include – increase in tariff duties, export subsidies, etc.

Devaluation cannot be successful in isolation, so it should be supported by monetary, fiscal and other trade policy measures.

There are also two issues which are associated with the effects of devaluation. They are (a) J – Curve effect and (b) Currency – Pass through relationship.

(a) **J – Curve Effect** - It is generally argued that devaluation will initially deteriorate trade balance, and later on improve trade balance. In other words, following a devaluation or depreciation of the domestic currency, the balance of trade typically worsens for several months before it eventually improves. This phenomenon is known as J- curve, because the trade balance traces a J –shaped curve through time. Thus, J – curve effect shows the time path of the response of trade flows to devaluation. Fig. 3.2 shows a typical J – curve.¹⁰

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**Fig. 3.2 :- A Typical “J - Curve”**

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¹⁰ Source: International Monetary Fund.
In fig. 3.2, trade balance is measured on vertical axis, and time is measured on horizontal axis. Assuming that the original trade balance is zero, a devaluation or depreciation of the nation’s currency will first result in deterioration of the nation’s trade balance before showing a net improvement after time A.

(b) Currency – Pass through Relationship – The effect of devaluation also depends on currency – pass through relationship. *The extent to which changing currency values lead to changes in import and export prices is known as currency – pass through relationship.* It is theoretically assumed that a given change in the exchange rate brings about a proportionate change in import prices. In practice, however, this relationship may be less than proportionate, thus weakening the influence of a change in the exchange rate on the volume of trade.

Empirical evidence suggests that in reality there is partial pass –through, with significant time lags. For example, for United States, it is estimated that for every 10 percent change in the value of the dollar, both import prices and export prices change about 6 per cent.

3) Exchange Control – Exchange control also forms a part of expenditure – switching policy because they too aim at switching of expenditure from imported goods and services to domestic goods and services. Exchange control serves the dual purpose of restricting imports and regulating foreign exchange.

Under the exchange control, the whole foreign exchange resources of the nation, including those currently occurring to it, are usually brought directly under the control of the exchange control authority. The exchange control authority is usually
the government or central bank of the country. Dealings and transactions are regulated by the exchange control authority.

The recipients of foreign exchange like exporters are required to surrender foreign exchange to the exchange control authority in exchange for domestic currency. The exchange control authority allocates the foreign exchange on the basis of national priorities.

Exchange control methods could be direct and indirect. Direct methods would include – intervention and regulation in matters concerning exchange rates, foreign exchange restrictions, multiple exchange rate policies, exchange clearing agreements, etc. Indirect methods would include – import tariffs & quotas, export subsidies, etc.

4) **Trade Policy Measures** – Trade policy measures would include measures which would reduce imports and promote exports. The important trade policy measures are - (a) Import controls (b) Export promotion.

(a) **Import controls** - A country may control its imports by imposing or increasing import duties, restricting imports through import quotas, licensing, prohibiting altogether the import of certain non essential items, etc.

(b) **Export promotion** – A country would promote exports by reducing or abolishing export duties, providing export subsidies, encouraging production of exportables, provide monetary, fiscal, physical and institutional incentives and facilities to exporters, etc.

To sum up, there are four policy induced measures to correct disequilibrium in balance of payments. They are (1) Monetary & fiscal policy, (2) Devaluation, (3) Exchange control and (4) Trade policy measures. However, in practice none of
these measures are used in isolation. On the contrary, majority of them are used together and hence can be said to be complimentary to each other.

3.7 SUMMARY

Balance of Payments is said to be a systematic record of all international economic transactions during a given period of time, usually a year. The study of balance of payments represents macroeconomic aspect of international economics. As it is based on double entry book – keeping, balance of payments always balances in the accounting sense of the term. The current account and capital account are the two main components of the balance of payments statement. From an economist point of view, within the balance of payments statement – trade balance, current account balance, capital account balance and overall balance are important. The distinction between autonomous and accommodating transactions is useful in defining equilibrium / disequilibrium (surplus / deficit) in balance of payments. Equilibrium in BOP would mean that its autonomous receipts are equal to autonomous payments. While disequilibrium in BOP means that its autonomous receipts are not equal to autonomous payments. When autonomous receipts are greater than autonomous payments there is surplus in BOP, and when autonomous receipts are less than autonomous payments there is a deficit in BOP. Disequilibrium in the BOP can be in the form of temporary, fundamental, cyclical and structural. Disequilibrium in BOP is caused by economic, social and political factors. Disequilibrium in the form of deficit is a matter of grave concern for the country. Hence, if the country has a deficit in its BOP, then efforts are made by policy makers to either remove or at least reduce the deficit. The measures to correct disequilibrium can be automatic or policy induced. However, in reality most of the countries adopt policy induced measures to correct
disequilibrium in BOP. Some of the policy induced measures are – (a) Monetary – Fiscal policy mix, (b) Devaluation, (c) Exchange control and (d) Trade policy measures.

Monetary policy affects the economy through changes in money supply and interest rates. While Fiscal policy affects the economy through changes in government expenditure and taxes. According to Mundell, monetary policy should be used to achieve internal balance, while fiscal policy should be used to achieve external balance.

Devaluation means reduction in the external value of the country’s currency undertaken by the government officially. It is a deliberate action taken by the government deliberately and legally. Theoretically it is said that devaluation would encourage exports and discourage imports of goods and services and thereby improve trade balance and current account balance. However, the success of devaluation depends on several factors like – achievement of Marshall – Lerner condition, no retaliation by other countries and the use of appropriate monetary, fiscal and trade policies. Exchange control serves the dual purpose of restricting imports and regulating foreign exchange. Under exchange control, the foreign exchange resources of the country are usually brought directly under the control of the exchange control authority. Finally, trade policy measures would include import controls and export promotion. Some of the important import control measures are – import duties and quotas. Some of the export promotion measures would include - providing export subsidies, encouraging production of exportables, providing incentives and facilities to exporters, etc. It is pertinent to note that most of the policy induced measures are used together and hence they are complimentary to each other.
NOTES & REFERENCES

NOTES

a. Therefore, in accounting sense, balance of payments of a country always balances.

b. While finding out net balances in each case, a surplus results if the credits exceed the debits, a deficit results if credits fall short of debits.

c. This equation is the national income identity for an open economy.

d. This method of measuring the surplus or deficit in balance of payments is correct only under fixed exchange rate system and not under a flexible exchange rate system or a managed exchange rate system.

e. When accounting balance is produced with the help of accommodating transactions there is said to be BOP adjustment.

f. In the present study, henceforth, the term ‘disequilibrium’ would imply ‘deficit’ in BOP, unless otherwise specified. Similarly, measures to correct disequilibrium would imply measures to reduce the deficit.

g. It was the economist James Meade who shifted the emphasis from automatic adjustment mechanism to policy induced adjustment mechanism.

h. This is in conformity with Tinbergen Principle which states that for any economic policy to be successful, the number of policy instruments must be equal to the number of objectives.

i. Higher the value of multiplier, greater is the increase in national income and more favourable is the BOP result.

REFERENCES


