Disequilibrium in Balance of Payment

Though the credit and debit are written balanced in the balance of payment account, it may not remain balanced always. Very often, debit exceeds credit or the credit exceeds debit causing an imbalance in the balance of payment account. Such an imbalance is called the disequilibrium. Disequilibrium may take place either in the form of deficit or in the form of surplus.

Disequilibrium of Deficit arises when our receipts from the foreigners fall below our payment to foreigners. It arises when the effective demand for foreign exchange of the country exceeds its supply at a given rate of exchange. This is called an 'unfavorable balance'.

Disequilibrium of Surplus arises when the receipts of the country exceed its payments. Such a situation arises when the effective demand for foreign exchange is less than its supply. Such a surplus disequilibrium is termed as 'favorable balance'.

Causes of Disequilibrium in Balance of Payment

1. Population Growth

Most countries experience an increase in the population and in some like India and China the population is not only large but increases at a faster rate. To meet their needs, imports become essential and the quantity of imports may increase as population increases.

2. Development Programmes

Developing countries which have embarked upon planned development programmes require importing capital goods, some raw materials which are not available at home and highly skilled and specialized manpower. Since development is a continuous process, imports of these items continue for the long time landing these countries in a balance of payment deficit.

3. Demonstration Effect

When the people in the less developed countries imitate the consumption pattern of the people in the developed countries, their import will increase. Their export may remain constant or decline causing disequilibrium in the balance of payments.

4. Natural Factors

Natural calamities such as the failure of rains or the coming floods may easily cause disequilibrium in the balance of payments by adversely affecting agriculture and industrial production in the country. The exports may decline while the imports may go up causing a discrepancy in the country's balance of payments.

5. Cyclical Fluctuations

Business fluctuations introduced by the operations of the trade cycles may also cause disequilibrium in the country's balance of payments. For example, if there occurs a business recession in foreign countries, it may easily cause a fall in the exports and exchange earning of the country concerned, resulting in a disequilibrium in the balance of payments.

6. Inflation

An increase in income and price level owing to rapid economic development in developing countries, will increase imports and reduce exports causing a deficit in balance of payments.

7. Poor Marketing Strategies

The superior marketing of the developed countries have increased their surplus. The poor marketing facilities of the developing countries have pushed them into huge deficits.

8. Flight of Capital

Due to speculative reasons, countries may lose foreign exchange or gold stocks People in developing countries may also shift their capital to developed countries to safeguard against political uncertainties. These capital movements adversely affect the balance of payments position.

9. Globalization

Due to globalization there has been more liberal and open atmosphere for international movement of goods, services and capital. Competition has beer increased due to the globalization of international economic relations. The emerging new global economic order has brought in certain problems for some countries which have resulted in the balance of payments disequilibrium.

Methods to Correct Disequilibrium in Balance of Payments

Following are the main methods of Correct Disequilibrium in Balance of Payments:

1. Monetary Policy (Deflection)

Monetary policy may be devised to correct a deficit in the balance of payments of a country. The deficit occurs because of high import and exports. This is to be reversed.

In this regard, the country may adopt deflationary or dear money policy by raising the bank rate and restricting credit.

Under deflation, prices fall which makes exports attractive and imports relatively costlier.

This eventually leads to a rise in exports and a fall in imports.

The policy of money contraction or deflection keeps exchange rates unaffected and tries to correct the deficit in the Balance of payments through domestic changes.

However, deflation being in inexpedient, its Side Effects is dangerous to a poor Nation. It creates more unemployment and poverty.

Again a developing economy has to adopt an expansionary rather than a contraceptive monetary policy to cater to developmental needs..

2. Exchange Depreciation

Exchange depreciation means the decline in the rate of exchange of one country in terms of another.

For example – Assume- the Indian rupee exchanges for 65 Roubles of the Russian currency. If India experiences an adverse Balance of payments with regard to Russia, the Indian demand for Rouble will be rise.

Consequently, the price of Rouble in terms of Rupee will be appreciated in its external value.

Thus, the rate of exchange of Indian rupee in terms of rouble may change to 1 Rupee = 45 Roubles from 1 equal 45 balls this is known as 1 Rupee = 64 Roubles. This is known as Exchange Depreciation.

It is automatic and it helps in correcting a mild adverse Balance of payments.

This stimulates exports by making the domestic goods cheaper to the foreigners and thereby leading to favorable balance.

However, this method is not feasible under the present system of IMF which prescribes the fixed exchange rate system.

3. Devaluation

Devaluation of currency is another way that makes exports attractive.

The term Devaluation means a reduction in the official rate at which one currency is exchanged for another.

It is an alternative to exchange depreciation.

Devaluation is undertaken when the currency is found to be unduly overvalued.

Devaluation makes the Goods cheaper for foreigners. Exports will rise and imports decline.

The Success of Devaluation, however, depends on certain following factors:

- The demand elasticity for the exports must be greater than Unity.
- The elasticity of supply for the imports should be greater than Unity.
- Devaluation should not be exceedingly adverse because it will not do anything.
- There should not be retaliative action from other Nations, that is, other nations should not have the corresponding Devaluation that nullifies each other's gain.
- Devaluation of the country's "terms of trade" should not be exceedingly adverse otherwise it will not gain anything from trade.

Moreover, these are the following 'Drawbacks of Devaluation':

- It may lead to 'Inflationary' tendencies in the internal economy.
- It is nothing but the acknowledgment of a country's economic weakness.
- It puffs up the burden of Debt servicing.
- It takes considerable time to yield expected results.
- Its effect is strongly purgative i.e. violent.

4. Exchange Control

Restriction on the use of foreign exchange by the central banks called Exchange Control.

When exchange control is adopted, all the exporters have to surrender their foreign exchange earnings to Central Bank.

Under exchange control, the central bank releases foreign exchanges only for essential imports and conserves the rest of the balance.

This is the most direct method of curbing imports.

Exchange control, in General, deals with the balance of payments disequilibrium by suppressing the deficit that is only a symptom and not the Basic Trouble.

Exchange control deals with only the deficit, not its causes, and it may irritate those causes tending to create a more basic disequilibrium.

In other words, exchange control can prevent a complete breakdown, but it cannot eliminate a condition of disequilibrium.

Thus, exchange control offers no permanent solution to the problem of persistent disequilibrium.

It can, at best be justified only as a temporary measure, to gain time while other more fundamental adjustments made to restore equilibrium in the Balance of payments.

5. Fiscal Policy- Import Duties

Under this policy, import traffic tariff duties are imposed so as to make the import dearer with an overall aim of checking imports.

Imports get reduced and Balance of payments becomes favorable.

6. Import Policy (Import Quotes)

Under this mechanism, the government fixes a maximum quantity or value of a commodity to be imported.

This in turn reduces and the deficit is reduced and thereby the Balance of payments, the position is improved.

This measure has the immediate effect of checking imports as the marginal propensity to import becomes zero once the quota limit is reached.

To correct disequilibrium in Balance of payments import quotes are assumed to be better than import duties.

The quota has the immediate effect of restricting imports as the marginal prosperity to import become zero, once the quota-limited is reached.

Thus, the effect of quotas on quantitative restriction (QR) of imports is explicit. But the Balance of payments effects of import duties and not to certain.

7. Stimulating/Improving Export

To correct disequilibrium in the Balance of payments, it is necessary that exports should be increased; the government may adopt export programs for this purpose.

Export promotion programs include subsidies, tax concession to exporters, marketing facilities, incentives for exporters, reducing export duties, etc.

Further, to encourage exports the level of costs in the country may have to be brought down.

Thus, may involve cutting down on wages and interest rates and other incomes and also a contraction of currency to bring the prices down.

8. Foreign Loans

The government can also secure loans from foreign banks or foreign governments to reduce the deficit in the balance of payments.

Since the repayment of these loans is spread over a long period, this helps the government to remove the deficit in the Balance of payments.

During the currency of the loans, the government takes steps to improve its foreign exchange position.

9. Encouragement to Foreign Investment

The government induces the foreigners to make an investment in the country offering them all sorts of investors' incentives and concessions.

This provides the government with extra foreign exchanges which are utilized to reduce the deficit in the Balance of payments.

But while inviting the foreign capitalist to invest their capital within the country, the government sees to it that this does not produce any adverse repercussions on the economy.

10. Incentives to Foreign Tourist

The government may also encourage foreign tourists to visit the country in increasing numbers of offering them various facilities and constitutional travel.

This increases the foreign exchange earnings of the country with the help of which the deficit in the Balance of payments can be reduced.

11. Automatic Measures

The disequilibrium in the balance of payments may automatically disappear after sometime when certain forces came into operation in the country.

For example – The disequilibrium in the Balance of payments of a country under the gold standard was automatically corrected through the inflow and outflow of gold.

If the balance of payments was unfavorable there was an outflow of gold from the country causing a contraction in the volume of currency and credit, and ultimately a fall in the domestic price level.

This encouraged exports, while it discouraged imports. The equilibrium in the BOP was automatically restored after some time.

Similarly, the equilibrium in the Balance of payments of a country on the paper standard was automatically corrected through fluctuations in its rate of exchange.

For example – If the country's BOP was unfavorable, the demand for foreign exchange exceeded its supply, and consequently, the exchange value of its currency went down. The fall in its exchange value encouraged exports while it discouraged imports.

The Equilibrium in the BOP was automatically restored after the lapse of some time. The opposite process worked when the Balance of payments of the nation turned favorable.

The automatic measures discussed above did not produce the desired results in a short period.

Nor were they effective in dealing with a serious and fundamental disequilibrium in the BOP.

12. Miscellaneous Measures

These include- developing import-substituting Industries, postponing debt payments, check on inflation, check on smuggling, etc. All these may help in correcting disequilibrium in the Balance of payments.

To Sum up, some of the deficit in the balance of payments is not a desirable phenomenon for a nation.

The methods mentioned above aim at reducing imports and stimulating exports.

Of these, the trade measures are better and effective. It produces immediate results.

The Government of a nation may use this method in combination with other methods to eliminate or reduce a chronic deficit in the Balance of payments.