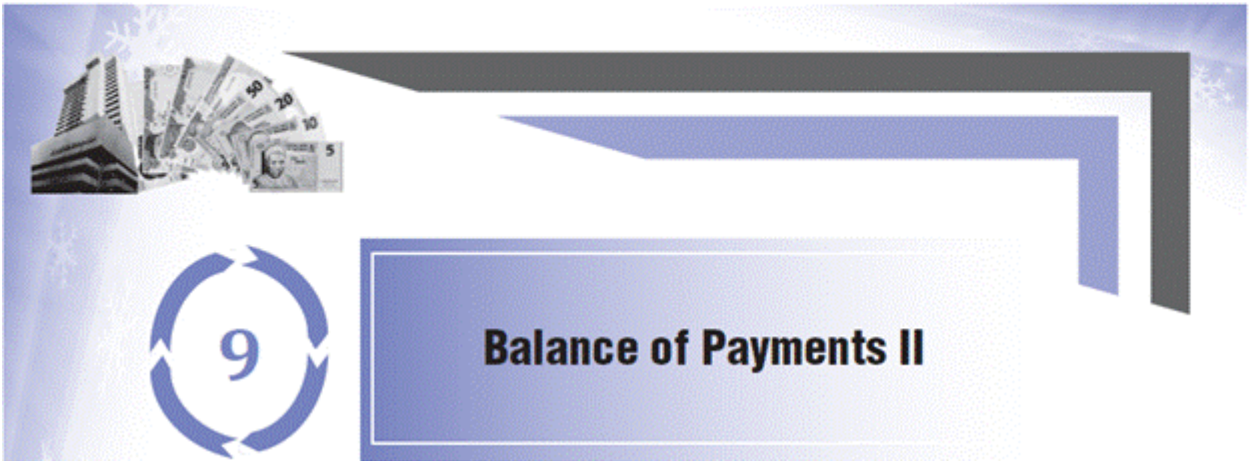
chapter 9



OBJECTIVES

At the end of this chapter, students should be able to:
â€¢ discuss the measures used in addressing weaknesses in a countryâ€™s balance of payments;
â€¢ examine balance of payments adjustments;
â€¢ examine the foreign exchange market and its free, fixed and stable rates;
â€¢ examine the monetary and fiscal policies as instruments for balancing payments;
â€¢ differentiate the exchange control between measures, borrowing and reserves.

9.1 Introduction

When a country has a balance of payments deficit or surplus, there is disequilibrium, and a number of adjustments may take place to bring about equilibrium. An excess of payments over receipts for the combined current and capital accounts is termed as deficit. Monetary movements are then said to be adverse. An excess of receipts over payments in the combined current and long-term capital accounts is also accounted for.

The surplus is marched by items in the monetary movements that are in this case said to be favourable. It is only when a country has a chronic weak balance that grave problems arise.

Persistently running deficits is dangerous for a country and radical measures to cure the weakness are required. This chapter will examine the weaknesses and adjustments of balance of payments, the foreign exchange market, monetary and fiscal policies as instruments for balancing payments and control measures.

9.2 The Gold Standard

The gold standard is the system of exchanging gold between countries and it serves as a measure used in bringing about equilibrium to a countryâ€™s balance of payments account. Under the old gold standard system of exchange, there were certain automatic correcting forces that operated to bring a countryâ€™s balance of payments to true balance.

In the case of a country running a deficit, i.e., payments exceeding receipts, the outflow of gold reduced the internal money supply since each countryâ€™s domestic currency had a full gold backing and was convertible into gold. The reduction in money supply will cause the following:

(a) Prices would fall as a result of contraction of spending.

(b) Unemployment would rise.

(c) Imports would contract as the ability to spend diminishes.

The effects of the above will set at work corrective tendencies that include the following:

(i) The countryâ€™s import spending would be reduced.

(ii) There will be a fall in home prices (locally produced), which results from a fall in home spending.

(iii) The fall in home price will make its goods cheaper compared to that of foreigners and exports will rise.

The above corrective measures will pull the initial balance of payments deficit back into balance. Similarly, a country running a surplus would experience corrective tendencies.

Money supply increases as gold flows in. Internal prices rise and import spending increases. With the internal price rise, foreigners buy less of its exports. The rise in imports and the fall in exports both operate to eliminate its surplus.

The banking system within each gold standard country would act to reinforce the corrective tendencies. A country in deficit experiences an outflow of gold, which means less cash in the banks, less banking lending and higher interest rates. This not only reduces home prices but also attracts inflow of gold.

On the other hand, a country with an export surplus gains gold, bank deposits rise, borrowing is easier and multiplier effect increases total spending, incomes and employment. Prices rise and export surplus is eliminated.

9.3 Freely Flexible Rates

A system of flexible rates allows each country to adopt any internal policy as it deems fit, leaving the rate to adjust itself to the internal price level.

Deficits and surpluses are removed by changes in the rate of exchange. As already known, a trade deficit means an excess of imports over exports and, consequently, a rise in the demand for foreign currency relative to its supply, i.e., if its price rises, each unit of home currency buys less of it. A trade surplus results in the reverse tendency.

Assume that the rate of exchange is N150:$1. If Nigeria is running a deficit, price mechanism might change in the rate of N100:$1. This is a depreciation.

Foreigners pay less for the naira, while Nigerians pay more for the dollar. However, a surplus will mean a change in the rate to N150:$1, with the value of naira appreciating or strengthening.
In this case, the naira would buy more of dollars, while the Americans would have to pay more dollars than they used to for the naira. Changes in the rate either way affect the flow of trade between countries and currency depreciation operates to remove the surplus. The mechanism is shown in Table 9.1 below:

Table 9.1 Flexible Exchange Rate Mechanism
Balance of Payments First Surplus Deficit

Effects on currency	Home currency	Appreciate	Depreciate
Value and payments	Import costs Exports	Fall	Rise
	Prices in foreign currency	Rise	Fall
Effect on trade	Export	Decrease	Increase
	Import	Increase	Decrease
Balance of payments ultimately		Surplus eliminated	Deficits made goods

Trade becomes risky and financial transactions between countries suffer similar risks.
At the same time, a country is not required to deflate as a result of a deficit, which is necessary under the â€˜ideal goldâ€™ standard.

9.4 Balance of Payments Adjustment

A persistent or long-term balance of payments deficit possesses a more difficult problem and needs more drastic measures to adjust it. It indicates that the country is living beyond its means and needs to apply some policy measures other than changes in the monetary movement accounts. These policy measures for adjustments include the following:

(A) Import reduction

We can achieve import reduction through any the following ways:
(i) Adoption of deflationary policy:
This reduces domestic income and demand, which in turn reduces imports. Elements of the policy include reduced bank lending and government spending as well as increased taxes. However, while a deflationary policy may reduce imports, it often has the undesirable side effect of increasing unemployment.
(ii) Import duties/quotas: The deficit country may wish to reduce imports simply by increasing import duties and/or imposing import quotas. This raises the effective prices of imported goods and can be expected to reduce their demand.
(iii) Exchange control measure: The country may impose exchange control regulations, the impact of which is to limit the amount of foreign currency made available for purchasing imports. It may also be used to curtail allowances for foreign travel and restrict investment abroad.
All these will reduce the debit side of the balance of payments account and will help to solve the deficit problem.

(B) Increase in exports

A country can achieve increase in exports through any the following ways:
(i) Reduction of domestic price: A more effective way of encouraging exports is by reducing the general level of domestic prices relative to the levels of those of foreign countries. This, however, will make the countryâ€™s exports cheaper in the world market, hence increasing the demand for them.
(ii) Taxes and subsidies: Exports can be encouraged directly by removing all local taxes on them and by subsidizing export producers. Trade fairs and better marketing networks will also help.
(iii) Economic integration: A country that wishes to protect her export trade may also join international organizations like the Organisation of Petroleum Exporting Countries (OPEC) and the Cocoa Producers Alliance (CPA), whose primary objective is to ensure high prices for the commodities through joint actions by producers.

(C) Devaluation

This is a policy of last resort that a country may be forced to implement as a means of reducing imports and increasing exports.
Devaluation occurs when a country reduces the exchange value of its currency in terms of other currencies. For example, if Nigerian currency is devalued, the new exchange rate will indicate that the value of naira has decreased in relation to dollar. As a result, the prices of Nigerian products will be generally lower for American consumers. Similarly Nigerians will find it more expensive to import from America and other countries because foreign prices are now higher relative to those of Nigeria.
Thus, devaluation makes exports cheaper and imports more expensive. The result is that exports are increased and imports reduced.

9.5 Foreign Exchange

Foreign exchange refers to the exchanging of a countryâ€™s local currency with a stock of currencies from other countries (including gold) for the purpose of international transactions over a period of time. All countries have their own monetary system, which follows that the purchase of goods and services between countries and the making of investment must involve the exchange of one countryâ€™s currency for another.

For example, a Nigerian merchant importing British wears must obtain the pounds sterling to make the purchase.

All international payments are principally the business of banks. These banks have either foreign branches or foreign banks acting as their agents. They make foreign exchange available to importers from the supply of foreign exchange that their customers have earned or received from other countries. Normally, any particular foreign currency they receive in excess of their own needs will have to be sold in the foreign exchange market to other countries or for naira or exchanged for naira at the central bank, which hold the countryâ€™s reserves. When the banks are short of foreign exchange for their customersâ€™ needs, they will have to buy more of it in the foreign exchange market or from the central bank.

The Foreign Exchange Market

The foreign exchange market is a combination of telephone- and internet-linked banks and broking firms that are authorized to deal in foreign exchange with each other and with the international market. Within the official limits, the prices of currencies move up and down daily. The rate of exchange at any time is simply the price of one currency in terms of another. In the Nigerian foreign exchange market, transactions with other currencies are subject to certain regulations, and members of the market can only buy and sell foreign exchange at prices determined by the market forces of demand and supply. The banks still ensure an upper and lower limit of the price of foreign currency. That is, they peg down the extent to which the price of foreign exchange rises and falls in accordance with rules that govern the countryâ€™s membership of the International Monetary Fund.

Free Rates

Free rates occur when the rate of exchange is allowed to be determined in the free market, where it would fluctuate as a result of forces of demand and supply. Allowing the exchange rate to run freely by market forces has the principal disadvantage of making trade risky due to the ease at which the rates fluctuate and this reduces the volume of transaction.

In addition, a free rate will be influenced by speculation dealings and the rate will â€˜swingâ€™ unnecessarily. For example, if speculators expect the rate to fall below a certain level, they may sell their foreign currencies while the going is good and their very action will cause the rate to fall. Similarly, speculators holding foreign currency will hold back their purchase of home currency while the rate is falling. With a flexible rate of exchange, a country can pursue its own monetary policies and leave the rate of exchange to settle where it may. Also, movements of the rate act as a corrective measure upon adverse balance in its external accounts. An advance balance will be reflected in its own currency becoming cheaper to foreigners. This tends to reduce imports thus stimulating greater foreign demand for its exports, while the adverse balance is rectified.

Fixed and Stable Rates

This is a situation where the rate of exchange is automatically fixed. This is seen in gold standards where each currency has full convertibility into gold coinage. For example, Â£1 and 25 French Francs were the same. Therefore, Â£1 exchange against 25 Francs and the rates of exchange only diverged from this to the extent of the cost of insured gold shipment between London and Paris. No trader in either country will pay more than this because the purchase of gold in one centre and its sale in the other made the exchange of currencies cheaper.

This is a direct purchase of currency at an unfavourable rate. From 1925 to 1931, the gold standard was restored in a modified form by Britain. Gold coins were no longer in circulation and bank notes were only convertible into gold for a minimum figure of around 1,700 pounds.

Other countries adopted similar systems and some tied their rates to sterling, like Nigeria.

The worldwide economic collapse in 1931 brought an end to the gold standard. With the bank failures and the onset of a deep trade depression in Europe and America, holders of the sterling rushed to convert their paper pounds into gold. The drain from London reached such proportions that the British Government abandoned the gold standard and sterling ceased to be converted into gold; from 1931 to the second world war, most countries were off gold standard, but the challenge of relative stable exchange rates possessed a lot of problems. These problems gave birth to the International Monetary Fund (IMF), which was formed in 1945 with the following functions:

(a) To help member countries establish a par value or official exchange rate for their currencies in terms of gold or reserved currency like the American dollar.

(b) To assist the countries in maintaining the exchange value of their currencies at a near par.

Monetary and Fiscal Policies

Monetary policies are policies aimed at controlling money supply in an economy. They make use of instruments like interest rates, reserve ratios, etc., However, fiscal policies aim at controlling the same money supply but use instruments like tax and government expenditure.

A country with a balance of payments deficit can use contractionary monetary (increase in rate of interest) and fiscal (increase in tax or reduction in government expenditure) policies to create a low price and income levels and decrease out payments. This will lead to a reduction in importation of capital goods and will restore the equilibrium in the balance of payments. Similarly, a country that has balance of payments surplus can employ expansionary fiscal and monetary policies. However, these policies can also affect the level of distribution of local income and employment, which conflicts with the requirements of domestic economic objectives.

Exchange Control

During 1931 to 1939, exchange rates were subjected to government controls in all the industrial countries. Apart from governmental stabilization funds, various forms of exchange controls were practiced, whereby the purchase and sale of currencies were closely restricted. Nazi Germany was the prime culprit in this because foreign currency was ruthlessly rationed out to its residents, and only government-approved imports were possible. Priority was given to stateâ€™s need to purchase essential raw materials and build up its military potential.

Wholesale intervention in foreign exchange dealing by Germany and other states had a stagnating effect upon world trade. Exchange controls, while they may be used to stabilize rates of exchange and prevent adverse balance in particular nations, have a damaging effect upon the volume of trade when practised widely by many countries.

Apart from the various policies discussed above, direct controls can be used to restore equilibrium in the balance of payments.

Types of control available include quantitative restriction (quota), duties on imports (tariffs) and other special measures to increase earning of foreign exchange such as export subsidies as a remedy for deficit.

Borrowing

A country faced with diverse balance of payments deficit can ask for loans from friendly countries, especially the advanced nations of the world. Such loans, if granted, can help to increase the level of reserve that the borrowing country has. This to some extent can help in the restoration of equilibrium in the balance of payments.

The Reserves

The gold and foreign currency reserves are managed by the central bank, which intervenes in the foreign exchange market to buy or sell foreign currency in order to pay the exchange rate. When a country is in deficit, the reserves are usually used in helping to finance it.

Consequently, the Nigerian reserve had to bear a heavy stack during 1954â€“1964 when there was a net loss in reserve of over 8% (the loss in 1955 and 1962 were Â£229 million and Â£183 million, respectively, given the biggest annual losses in the period). The reserve constitutes the central reserve of the entire sterling area. This comprises of all the common wealth countries (except Canada) and they settle their mutual debts in sterling

transfer.
Apart from stresses and strains upon the reserves for our own balance of payments deficits, there has been a threat from the imports. This is one of the major reasons the Federal Government of Nigeria banned the importation of certain commodities.
Reserves are very essential in correcting the disequilibrium of balance of payments.

Summary

â€¢ **The gold standard:** This is a system of exchanging gold between countries that serves as a measure used in bringing equilibrium to a countryâ€™s balance of payments account.
â€¢ **The freely flexible rates:** This is a system of exchange rate that allows a country to adopt any internal policy it pleases, leaving the exchange rate to adjust itself to the internal price level by market forces.
â€¢ **Balance of payments adjustments:** A country that faces a persistent balance of payments deficit must take more drastic measures to adjust it. The measures include the following:
(a) Import reduction: Reducing import by the reduction of bank lending and government expenditure.
(b) Increase in exports: This can be encouraged by removing all local taxes on them and subsidizing export producers.
(c) Devaluation: This is a policy of last resort that a country may be forced to implement. It is the reduction of the value of their currency.
â€¢ **Foreign exchange:** This is the exchanging of a countryâ€™s local currency with a stock of currencies from other countries (including gold) for the purpose of international transaction over a period of time.
â€¢ **The foreign exchange market:** This is a combination of telephone- and internet-linked banks and broking firms that are authorized to deal in foreign exchange with each other and with international markets.
â€¢ **The free rates:** This occurs when the rate of exchange is allowed to be determined in the free market.
â€¢ **Fixed and stable rates:** This occurs when the rate of exchange is automatically fixed.
â€¢ **Monetary policies:** These policies control money supply in an economy by the manipulation of interest rates.
â€¢ **Fiscal policies:** These policies control money supply in an economy by manipulation of tax and government expenditure.
â€¢ **Expenditure control:** This is where the government controls the rate of exchange of foreign currencies by the use of such policies as stabilization funds.

Class Activities

1. The teacher should guide students in tracing and discussing the development of foreign exchange market in Nigeria.
2. The teacher should illustrate to students how gold standard was used to

solve the problem of disequilibrium in a balance of payments.

Revision Questions

Objective Questions

1. A summary of all the receipts and payments of a country in international transactions is called:
(a) Terms of trade
(b) Balance of payments
(c) Balance of payments adjustment
(d) Capital account
2. Devaluation of a currency in a country
is likely to lead to:
(a) Increasing population
(b) Increasing imports
(c) Goods becoming cheaper
(d) Reduced exports **(SSCE 2002)**
3. In an attempt to correct a deficit balance of payments, a country may decide to increase:
(a) Domestic goods
(b) Imports
(c) Domestic expenditure
(d) Tax on infant industries **(SSCE 2006**)
4. A country whose economy is buoyant is likely to have:
(a) A week currency
(b) Devolution from time to time
(c) A strong currency
(d) Balance of payments problem **(SSCE 2007)**
5. A surplus in the balance of payments should be used to:
(a) Subsidize multinational companies
(b) Build infrastructure for friendly nations
(c) Make donations to developed countries
(d) Buy investment overseas **(SSCE 2010**)

Essay Questions

1. (a) Explain the following:
(i) Devaluation
(ii) Depreciation of currency
(b) Outline three measures that can be adopted to correct balance of payments deficit. **(SSCE 2009)**
2. How can a huge national debt affect the economy of a country?
3. Distinguish between free and fixed exchange rates.
4. Explain the following: borrowing, reserves and exchange control.
5. Explain how monetary and fiscal policies can be used to control money supply in an economy.

Glossary

Gold standard: This is a system of exchanging gold between countries and it serves as a measure used in bringing about equilibrium to a countryâ€™s balance of payments account.

Freely flexible rates: These are rates that allow each country to adopt any internal policy that pleases her and leave the rate to adjust itself to the internal price level.

Devaluation: This is a policy that a country may implement as a means of reducing imports and increasing exports. Devaluation occurs when a country reduces the exchange value of its currency in terms of other currencies.

Free rates: This occurs when the rate of exchange is allowed to be determined in the free market, where it would fluctuate as a result of forces of demand and supply.

Monetary policies: These are policies aimed at controlling money supply in an economy and they make use of instruments like interest rates, reserve ratios, etc.

Fiscal policies: These policies aim at controlling money supply and use instruments like tax and government expenditure.