MEASURES TO CORRECT BALANCE OF PAYMENT

(Note: This lecture is taken from Internet for teaching purpose)

Monetary Measures for Correcting the BoP ↓

The monetary methods for correcting disequilibrium in the balance of payment are as follows

1. Deflation

Deflation means falling prices. Deflation has been used as a measure to correct deficit disequilibrium. A country faces deficit when its imports exceed exports.

Deflation is brought through monetary measures like bank rate policy, open market operations, etc or through fiscal measures like higher taxation, reduction in public expenditure, etc. Deflation would make our items cheaper in foreign market resulting a rise in our exports. At the same time the demands for imports fall due to higher taxation and reduced income. This would built a favourable atmosphere in the balance of payment position. However Deflation can be successful when the exchange rate remains fixed.

2. Exchange Depreciation

Exchange depreciation means decline in the rate of exchange of domestic currency in terms of foreign currency. This device implies that a country has adopted a flexible exchange rate policy.

Suppose the rate of exchange between Indian rupee and US dollar is $1 = Rs. 40. If India experiences an adverse balance of payments with regard to U.S.A, the Indian demand for US dollar will rise. The price of dollar in terms of rupee will rise. Hence, dollar will appreciate in external value and rupee will depreciate in external value. The new rate of exchange may be say $1 = Rs. 50. This means 25% exchange depreciation of the Indian currency.

Exchange depreciation will stimulate exports and reduce imports because exports will become cheaper and imports costlier. Hence, a favourable balance of payments would emerge to pay off the deficit.

Limitations of Exchange Depreciation :-

1. Exchange depreciation will be successful only if there is no retaliatory exchange depreciation by other countries.
2. It is not suitable to a country desiring a fixed exchange rate system.
3. Exchange depreciation raises the prices of imports and reduces the prices of exports. So the terms of trade will become unfavourable for the country adopting it.
4. It increases uncertainty & risks involved in foreign trade.
5. It may result in hyper-inflation causing further deficit in balance of payments.
3. Devaluation

Devaluation refers to deliberate attempt made by monetary authorities to bring down the value of home currency against foreign currency. While depreciation is a spontaneous fall due to interactions of market forces, devaluation is official act enforced by the monetary authority. Generally the international monetary fund advocates the policy of devaluation as a corrective measure of disequilibrium for the countries facing adverse balance of payment position. When India's balance of payment worsened in 1991, IMF suggested devaluation. Accordingly, the value of Indian currency has been reduced by 18 to 20% in terms of various currencies. The 1991 devaluation brought the desired effect. The very next year the import declined while exports picked up.

When devaluation is effected, the value of home currency goes down against foreign currency. Let us suppose the exchange rate remains $1 = Rs. 10 before devaluation. Let us suppose, devaluation takes place which reduces the value of home currency and now the exchange rate becomes $1 = Rs. 20. After such a change our goods becomes cheap in foreign market. This is because, after devaluation, dollar is exchanged for more Indian currencies which push up the demand for exports. At the same time, imports become costlier as Indians have to pay more currencies to obtain one dollar. Thus demand for imports is reduced.

Generally devaluation is resorted to where there is serious adverse balance of payment problem.

Limitations of Devaluation :-

1. Devaluation is successful only when other country does not retaliate the same. If both the countries go for the same, the effect is nil.
2. Devaluation is successful only when the demand for exports and imports is elastic. In case it is inelastic, it may turn the situation worse.
3. Devaluation, though helps correcting disequilibrium, is considered to be a weakness for the country.
4. Devaluation may bring inflation in the following conditions :-
   i. Devaluation brings the imports down, When imports are reduced, the domestic supply of such goods must be increased to the same extent. If not, scarcity of such goods unleash inflationary trends.
   ii. A growing country like India is capital thirsty. Due to non availability of capital goods in India, we have no option but to continue imports at higher costs. This will force the industries depending upon capital goods to push up their prices.
   iii. When demand for our export rises, more and more goods produced in a country would go for exports and thus creating shortage of such goods at the domestic level. This results in rising prices and inflation.
   iv. Devaluation may not be effective if the deficit arises due to cyclical or structural changes.

4. Exchange Control

It is an extreme step taken by the monetary authority to enjoy complete control over the exchange dealings. Under such a measure, the central bank directs all exporters to surrender their foreign exchange to the central authority. Thus it leads to concentration of exchange
reserves in the hands of central authority. At the same time, the supply of foreign exchange is restricted only for essential goods. It can only help controlling situation from turning worse. In short it is only a temporary measure and not permanent remedy.

**Non-Monetary Measures for Correcting the BoP ↓**

A deficit country along with Monetary measures may adopt the following non-monetary measures too which will either restrict imports or promote exports.

1. **Tariffs**

Tariffs are duties (taxes) imposed on imports. When tariffs are imposed, the prices of imports would increase to the extent of tariff. The increased prices will reduced the demand for imported goods and at the same time induce domestic producers to produce more of import substitutes. Non-essential imports can be drastically reduced by imposing a very high rate of tariff.

**Drawbacks of Tariffs :-**

1. Tariffs bring equilibrium by reducing the volume of trade.
2. Tariffs obstruct the expansion of world trade and prosperity.
3. Tariffs need not necessarily reduce imports. Hence the effects of tariff on the balance of payment position are uncertain.
4. Tariffs seek to establish equilibrium without removing the root causes of disequilibrium.
5. A new or a higher tariff may aggravate the disequilibrium in the balance of payments of a country already having a surplus.
6. Tariffs to be successful require an efficient & honest administration which unfortunately is difficult to have in most of the countries. Corruption among the administrative staff will render tariffs ineffective.

2. **Quotas**

Under the quota system, the government may fix and permit the maximum quantity or value of a commodity to be imported during a given period. By restricting imports through the quota system, the deficit is reduced and the balance of payments position is improved.

**Types of Quotas :-**

1. the tariff or custom quota,
2. the unilateral quota,
3. the bilateral quota,
4. the mixing quota, and
5. import licensing.
Merits of Quotas :-

1. Quotas are more effective than tariffs as they are certain.
2. They are easy to implement.
3. They are more effective even when demand is inelastic, as no imports are possible above the quotas.
4. More flexible than tariffs as they are subject to administrative decision. Tariffs on the other hand are subject to legislative sanction.

Demerits of Quotas :-

1. They are not long-run solution as they do not tackle the real cause for disequilibrium.
2. Under the WTO quotas are discouraged.
3. Implements of quotas is open invitation to corruption.

3. Export Promotion

The government can adopt export promotion measures to correct disequilibrium in the balance of payments. This includes substitutes, tax concessions to exporters, marketing facilities, credit and incentives to exporters, etc.

The government may also help to promote export through exhibition, trade fairs; conducting marketing research & by providing the required administrative and diplomatic help to tap the potential markets.

4. Import Substitution

A country may resort to import substitution to reduce the volume of imports and make it self-reliant. Fiscal and monetary measures may be adopted to encourage industries producing import substitutes. Industries which produce import substitutes require special attention in the form of various concessions, which include tax concession, technical assistance, subsidies, providing scarce inputs, etc.

Non-monetary methods are more effective than monetary methods and are normally applicable in correcting an adverse balance of payments.

Drawbacks of Import Substitution :-

1. Such industries may lose the spirit of competitiveness.
2. Domestic industries enjoying various incentives will develop vested interests and ask for such concessions all the time.
3. Deliberate promotion of import substitute industries go against the principle of comparative advantage.