9. DISEQUILIBRIUM & CORRECTIVE MEASURES

Q:1 Explain Autonomous and Accomodating Flows?

(A) **Autonomous and Accomodating Flows :-** BOP of a Country is Prepared on Double Entry Book-keeping System which always balances.
But in Reality BOP of a Country shows either Surplus balance OR Deficit balance.
IF a Country is balancing BOP by using its Reserves or by selling Gold. It is Deficit or Disequilibrium in BOP. There are Two types of Transactions :-

1. Autonomous Transactions :-
2. Accomodating Transaction

1. **Autonomous Flows:-** Autonomous Flows are Non-Debt Flows. There is no Liability on the recipient Country to repay the amount. All receipts are in the form of Foreign Direct Investment and Portfolio investment a which are Non-Debt Flows.
Autonomous Flows helps to equalise BOP. All the transactions in Current and Capital account are Autonomous because they are Undertaken for business motive or for earning Profits.
All the transactions of Exports, Imports of goods and Services, movement of Capital goods for Profit making

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are Autonomous transaction.

2. **Accomodating Transactions :-** As BOP may be Surplus or Deficit so to adjust (offset) the balance, Accomodating transactions are helpful to maintain balance.

IF Automous Receipts > Autonomous Payments = Surplus BOP
IF Autonomous Payments > Autonomous Receipts = Deficit BOP

Accomodating Flows may be in the Form of Loan or a Gift From Foreign Country. A Loan can be received From Foreign Firm, Foreign company or any International Organisation to balance BOP.

Any imbalance or deficit in Current Alc is Corrected through Adjustment in Capital Account Surplus. when Capital Alc Surplus is Less than Current Alc deficit, we will have a Negative Over all balance. Such deficit Can be adjusted by reducing Foreign Exchange Reserves of Country

The balance of Payment is always balances. when all the items above and below the line are taken together and the deficit/surplus in Autonomous items is Corrected by accomodating items.

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Q:2 Explain Various Causes of Disequilibrium ?
OR what are main Causes of BOP Disequilibrium ?

(A) Causes of Disequilibrium in BOP :-

Any disequilibrium in the BOP is the result of imbalance between receipts and Payments for imports and exports.

Causes of Disequilibrium

(I) Import-Related Causes (II) Export Related Causes (III) other Causes

(I) Import-Related Causes :- The rise in imports has been the most important factor responsible for Large BOP deficits. The main Causes of rapid-expansion of Import are :—

1. **Population Growth :-** Due to Population Growth, Demand for imported goods may increase like- Food and Non-Food items. This increase the demand for imported goods which result in BOP disequilibrium.
   Example - Demand for imports is high in India and China due to population growth.
2. **Development Programme :-** In developing Countries, Government implement Various development Programmes. It require more import of Raw-materials, Capital goods, Technology etc. which result in BOP deficit.
3. **Import of Essential goods :-** Many Countries do not have enough supply of essential goods like- Crude Oil or Capital goods which are required to be import so this will adversely affect on BOP Position.
4. **Reduction of Import Duties :-** Due to reduction in import duties, demand for Various imported goods increase. This increase the deficit in BOP Position.

5. **Inflation :-** Inflation in domestic markets may increase the demand for cheaper imported goods. This increase the deficit in BOP position.

6. **Demonstration Effect :-** Higher income group (rich people) always wants to maintain higher standard of living. So they try to imitate foreign country's life style due to demonstration effect which increase demand for imports.

(II) Export-Related Causes :-

Every year Export earnings are increasing but it is not enough to satisfy growing needs of Imports

Following are the main causes of Decrease in Exports:-

1. **Increase in Population :-** Goods which are produced for export purpose are consumed by growing population. This reduces the export earning of the country leading to BOP disequilibrium.

2. **Inflation :-** when there is inflation in domestic market, export becomes costlier. This reduce the demand for export goods which result in Trade deficit.

3. **Appreciation of Currency :-** Appreciation of Domestic currency against foreign currencies result in lower foreign exchange to exporters. This reduce exports which results in Trade Deficits.

4. **Discovery of Substitutes :-** Due to Technological

development, new substitutes entered in market.
Example → Plastic for Rubber, Synthetic Fibre for Cotton etc.
This will reduce demand for raw-materials.

5. Technological Development :- Technological development in importing Countries may reduce their imports. This can be possible when they start producing those goods which they were importing earlier. It will have Negative effect on Exporting Countries.

6) Protectionist Trade Policy :- Protectionist Trade Policy of Importing Country would encourage domestic producers by giving them incentives and subsidies. This will have Negative effect on Exporting Countries.

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(III) Other Causes :-

1. Flight of Capital :- Due to speculative reasons, Countries may Lose Foreign Currency or Gold stock. Investors may also withdraw their investment which result in BOP disequilibrium.

2. Globalisation :- Globalisation and the Rules of WTO have brought a Liberal and Open environment in global trade. It have Positive as well as negative effects on imports, Exports and investments.

3. Cyclical Changes :- International Trade is also affected by Trade cycles. Recession in one developed Country may affect the rest of the world.

Example Financial Crisis in 2008.

4. Structural Adjustments :- In recent years, many economies are being Liberalised. As a result investment, income and other variables are changing which bring impact on imports and Exports.

5. Political Factors :- Now a days Political Stability may increase Productive resources of economy. This will have a direct effects on Imports and Exports.

Q:3 Explain Various types of Disequilibrium in BOP?

(A) Types of Disequilibrium in BOP :-

1. Structural Disequilibrium :- Structural disequilibrium is found when there are Structural changes in the economy which affect demand and Supply relations in Commodity and factor market.

Some of the structural disequilibrium are —

i) A Shift in demand due to change in Taste, Preference, Fashions, income etc. would increase or Decrease demand For imported goods will result in BOP disequilibrium.

ii) When Demand For Commodity in Foreign market declines due to availability of New and Cheaper Substitutes. It will reduce Country's Exports which results in Deficits.

iii) IF Supply is affected due to Crop Failure, shortage

of raw-materials, strikes, Political Instability etc. It will reduce Country's Export which result in Deficits.

iv) Natural Calamities Like - earthquake, Cyclone, floods or war also results in structural changes causing disequilibrium in BOP.

v) Changes in the rate of international capital movements may also result in structural disequilibrium.

vi) Institutional Changes that takes Place within or Outside the Country may result in BOP disequilibrium

Example :- Changes in Import Tariffs, Quotas, result in Structural disequilibrium.

(2) Cyclical Disequilibrium :- Economic activities are subject to business cycles. There are four phases of Trade Cycles :-

i) Boom/ Prosperity ii) Recession
iii) Depression iv) Recovery Period.

During Boom Period, Imports may increase continuously due to increase in demand for imported goods.

But during Recession and Depression, imports may be reduced due to Fall in Demand.

But during Recession, Exports may increase due to fall in prices. Thus Cyclical Disequilibrium in BOP may result due to :- i) Different Trade Cycles in economy.

ii) Different income Elasticities of Demand.
iii) Different Price Elasticities of Demand.

(3) Short-Run Disequilibrium :- Short-run disequilibrium is found for a year or for few years. This BOP disequilibrium is Temporary in nature. It can be corrected through short-term borrowings or other adjustment in the Capital Account.

Main Causes are-

i) Failuare of Crops ii) Favourable Monsoons.

iii) Strikes iv) Industrial Peace or Unrest.

v) Import of goods may increase Exports etc.

International borrowings or Lending for a short-Period would Cause Short-run disequilibrium.

(4) Long-Run Disequilibrium :- Long-Run disequilibrium means a Continuous deficit or surplus in the balance of payments of a Country. It is also known as Secular disequilibrium or Fundamental disequilibrium. According to IMF- Fundamental disequilibrium remain For Long-Period due to BOP deficits.

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Main Causes For Long-Run disequilibrium are—

i) Continuous increase in Demand For imported goods and Services due to growing Population.

ii) Continuous Price Changes, mostly rise in price will result in Inflation. It makes Exports Costlier and Imports Cheaper. (e.g) increase in Crude oil Prices.

iii) Demand for Exports decrease due to Technological improvements in importing Countries.

iv) More demand for imports for Planned Economic Development

v) More Domestic investment as compare to Domestic Savings

(5) Monetary Disequilibrium :- Monetary Disequilibrium takes place on account of inflation or Deflation. Due to inflation, Exports becomes Costlier and Imports become Cheaper. Such situation will affect BOP equilibrium.

(6) Exchange Rate Fluctuations :- High degree OF Fluctuations in exchange rate may affect BOP Position.

Example :- IF Indian Rupee gets appreciated against Dollar, then Indian Exporter will receive Less amount OF foreign exchange but Indian importer has to Pay higher amount of foreign Currency. Such situation will badly affect BOP situation.

Q:4 Discuss the Expenditure Adjustment Policy to Reduce Deficits in Balance of Payments.

(A) Expenditure Changing / Adjusting Policy :-

" Expenditure Changing / Adjusting means Expenditure Reducing to Correct deficit and Expenditure increasing to bring down the Surplus."

(B) Policy Instruments

1. Monetary Policy
   - i) Reduction in Exp.
   - ii) Increase in Exp.
2. Fiscal Policy
   - i) Reduction in Exp.
   - ii) Increase in Exp.

1. Monetary Policy :- Monetary Policy of RBI, brings Changes in Supply of money through its Quantitative and Qualitative measures.

Generally RBI use Quantitative measures to reduce Supply of money.

example- i) increase in interest Rate.
ii) increase in CRR and SLR Reserve Ratios.
iii) Open market operations (OMO) etc.

This monetary policy is called Tight / Dear monetary Policy.

EFFECT :

i) Reduction in Expenditure :- A Tight Monetary Policy reduce expenditure on investments which reduce income and imports. A tight monetary Policy will reduce Price which encourage Exports. Hence it improve BOP Position of economy.

ii) Increase in Expenditure :- Easy Monetary Policy of RBI helps to reduce a Surplus in BOP.

Easy monetary Policy helps to increase investment expenditure which leads to increase income and imports. At the same time Prices of goods and services increase which discourage Exports.
Thus, Easy monetary policy cause unfavourable movement in the BOP which reduce Surplus in BOP.

2. Fiscal Policy :- Government adopt Two instruments in fiscal Policy to correct disequilibrium in BOP.
They are —
i) Tax Rates
ii) Government Exp.

Effect

i) Reduction in Expenditure :- When Government reduce Public Expenditure, It will decrease Transfer Payments such as Oldage Pension, Family allowances etc. It likely to reduce Public Consumption and investment Expenditure. It will Lead to Fall in income and imports. It will also reduce the Prices which may encourage Exports. Thus reduction in Public Expenditure improve balance of trade and BOP of Country.

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ii) Increase in Expenditure :- A Surplus in BOP can be corrected by —
i) Reduction in Taxes
ii) increase in Govt. Expenditure.
A reduction in Direct and Indirect Taxes increase

Demand for goods and services.
A reduction in Direct Tax rate will increase the Disposable income of tax-payers, which increase demand for good and services.
Similarly an increase in government expenditure will also increase demand for goods and services which increase price of goods and services and discourage Exports.
Thus, Fiscal Policy can reduce surplus in BOP by reducing Tax rate and increasing Public Expenditure.

Both Monetary and Fiscal Policies are used to Correct BOP disequilibrium but Fiscal Policies are more effective means to Correct BOP Position.

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(c) Success of Expenditure Adjustment Policy

The Success of Expenditure Adjustment Policy to Correct BOP disequilibrium depends Upon Following Conditions :—

1. **Flexibility of Income and Prices :-** Both income and Price should be Flexible so that efforts taken by government bring effective results.
2. **Elastic Demand for Exports and Imports :-** A Lower Price always helps to increase Exports and Lower Income should reduce Imports. Thus Demand For exports and imports must be relatively elastic So that Policy measures like Deflation or

Devaluation should bring expected results in correcting disequilibrium.

3) **Co-operation by other countries :-** Other Countries which get affected by Expenditure Adjusting Policy may take Suitable measures to Protect their interest. So it is necessary to get Co-operation by Other countries while using Expenditure Adjusting Policy.

Q:5 Examine Expenditure Switching Policy to correct disequilibrium in Balance of payment?

(A) Expenditure Switching Policy :-

" Expenditure Switching Policy means Switching Domestic Expenditure from Imported goods to domestic goods through the change in relative Prices of imports and Domestic goods. "

(B) Policy Instruments :-

1. Devaluation | Revaluation
2. Depreciation | Appreciation

1. Devaluation :- " Devaluation is an act of monetary authority where the value of the domestic currency is reduced in terms of Foreign currency ".

Example :- Exchange Rate is ₹70 = $1.

Devaluation makes Exports Cheaper and Imports will become Costlier. Suppose $1 = ₹73.5 it means Indian currency is declined by 5%.

Thus Devaluation helps to increase Exports and Reduce Imports.

2. Depreciation / Appreciation :-

"Depreciation is like Devaluation Lowers the Value of domestic currency"

Devaluation is an official act mainly a Fixed Exchange Rate system. But Depreciation of currency takes Place in Competitive Exchange market due to market Forces.

Thus Devaluation and Depreciation make Exports Cheaper and Imports Costlier.

© Effects of Devaluation / Depreciation :-

1) Effects on Export-Import :- Due to Devaluation and Depreciation Policies, Exports become Cheaper and Imports become Costlier. It increase income of economy which helps to correct BOP disequilibrium.

2) Inflationary Effect :- Devaluation will increase the demand for goods in Foreign market which results in Inflationary effect in Home Country.

3. Deflationary Effect :- Due to Devaluation, Imports become Costlier. It means demand for other Country's good get reduced which bring Deflationary Effect in Foreign Country.

4. **Balance of Trade Effect :-** Due to Depreciation and Devaluation, Exports of country increases and restricts the Imports. Thus it helps to improve deficit BOP Position.

Similarly effects of Revaluation and Appreciation are same. Due to Revaluation, Domestic goods will become Costlier and imports will be Cheaper. Due to Revaluation and Appreciation, there is decline in foreign Exchange Reserves.

(D) Conditions For the Success of Devaluation

Due to Devaluation and Depreciation, exports will be Cheaper and Imports become Costlier. Devaluation helps the country to increase Exports and restrict imports to improve deficit in BOP Position. The Success of Devaluation and Depreciation, depends upon many conditions as follows :—

1. **Elasticity of Demand For Exports :-** When the demand is more elastic than the change in Price, then if currency is devalued by 10%, the exports must increase by more than 10%. But when elasticity of demand for exports is equal to One or Less, then devaluation will not help to reduce deficit in BOP Position.

2. **Elasticity of Demand For Imports :-** It is necessary

to reduce imports to correct deficit BOP Position Here Devaluation will be Successful when Elasticity of Demand for imports is greater than one.

3. Elasticity of Supply of Exports :- If the demand for exports increases then country has to increase supply of Export goods to meet the increased demand. Elasticity of Supply of Exports depends upon - the availability of inputs, mobility of factors of production etc.
But in many developing countries, there in insufficient Supply of Raw-materials, infrastructual facilities which reduce supply of Export goods.

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4. Elasticity of Supply of Imports :- In Case of Devaluation and Depreciation, imports become costlier The major suppliers of imports must be in a position to adjust the supply of their Exports. If a country able to adjust its exports as per reduced demand in domestic country. then supply is elastic in nature

5. Co-Operation by other Countries :- Devaluation and Depreciation makes the exports cheaper. It will affect the export trade of other countries whose currency remain stable. To be competitive in the world market, they are also forced to devalue their currencies. Thus, it is essential to get co-operation from other countries while using devaluation policy.

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6. Control of Domestic Price level :- A devaluation or depreciation do not directly affect Domestic Price level. If imports in the form of inputs in Production Process may affect the domestic price. Increased Exports also brings in more foreign Currency which in turn may increase domestic money supply and domestic Price Level. Government and Monetary Authorities adopt Various Fiscal and Monetary Policies to control domestic Price-line.

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Q:6 Select the Correct answer and rewrite the Statement :-

1. A deficit in balance of Payments
   a- Accomodative Flow.
   a) accomodative Flow b) more borrowing
   c) Increase Direct investment Abroad d) None of the above.
2. Devaluation Results in. **a- cheaper Exports**
   a) Cheaper exports b) Cheaper imports
   c) immediate increase in domestic Prices.
3. Devaluation to be Successful the sum of Export-Import demand elasticities must be
   b- Greater than one
   a) equal to one b) greater than one c) Less than one.
4. Depreciation of a Currency takes place through
   b- market Forces
   a) Central Bank b) Market Forces c) IMF

5. To Reduce Surplus, domestic currency should be
b- Revalued.

a) devalued b) Revalued c) Depreciated.

6) Deflation through Expenditure adjusting measures
C- increases Exports.

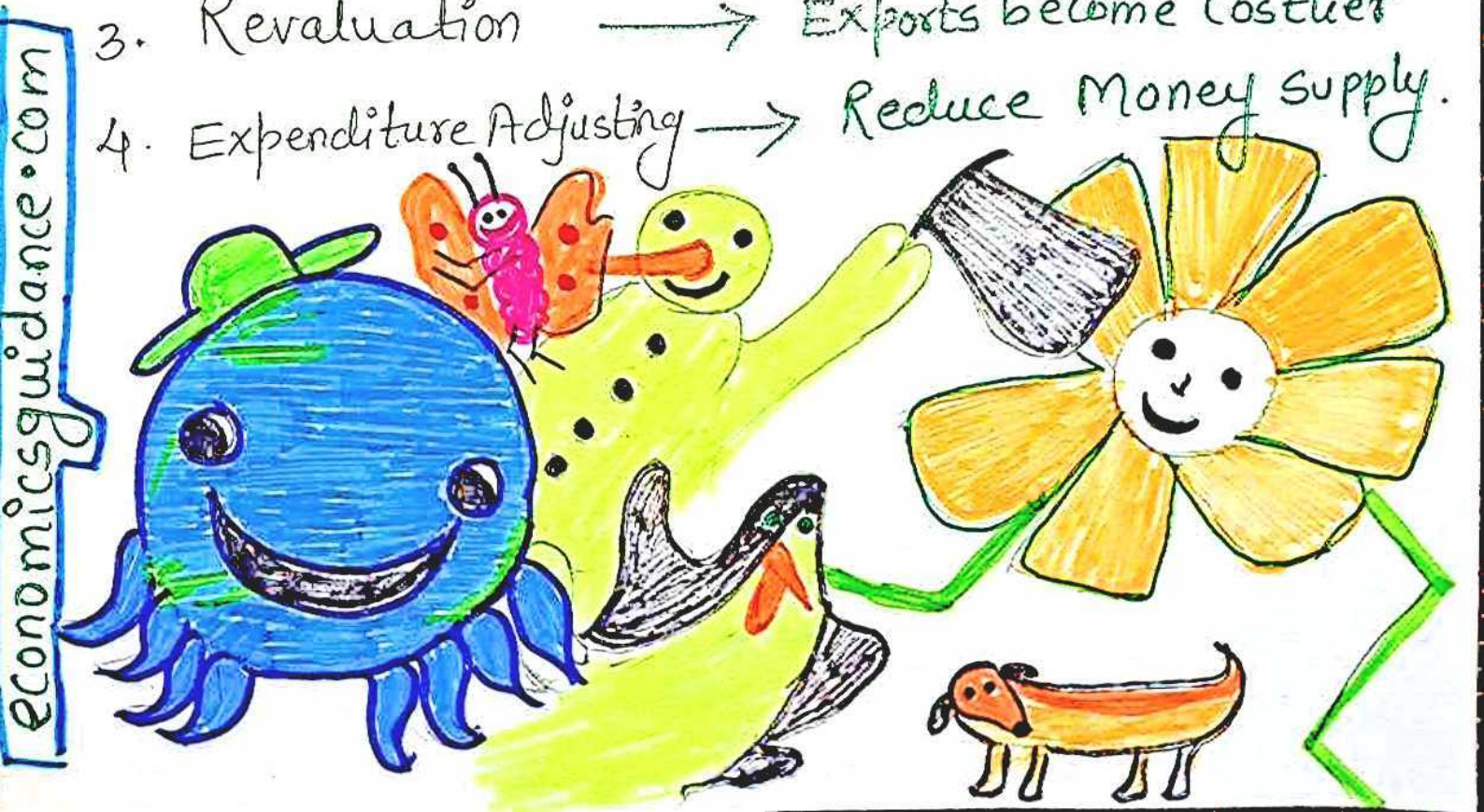
a) increases imports b) attract foreign capital
c) increases Exports.

7. Expenditure changing methods Uses
C- both (a) and (b).

a) Monetary measures b) Fiscal measures
c) both (a) and (b).

Q:7 Match the Following statements :-

1. Fundamental Disequilibrium → Long-Term disequilibrium
2. Expenditure Switching → Increase in Exports of Devaluing Country.
3. Revaluation → Exports become Costlier
4. Expenditure Adjusting → Reduce Money supply.



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