The following are the major causes producing disequilibrium in the balance of payments of a country.

1. Cyclical Fluctuation: Cyclical disequilibrium in different countries is caused by their cyclical fluctuations, their phases and magnitude. World trade shrinks during depression while trade flourishes during prosperity

2. Structural Changes: Structural disequilibrium is caused by the structural changes brought by huge development and investment programmes in the developing economies. Such economies may have high propensity to import for want of capital for rapid industrialization, while export may not be boosted up to that extent.

3. Development Expenditure: Development disequilibrium is caused by rapid economic development which results in income and price effects. The less developed countries in the early stage of development are not self sufficient. Income, savings and investment are abysmally low. They depend upon developed countries for import of commodities, capital and technology. Export potential is low and import intensity is high. So the LDCs suffer from adverse BoP.

4. Consumerism: Balance of payments position of a country is adversely affected by a huge increase in consumption. This increases the need for imports and decreases the capacity to export.

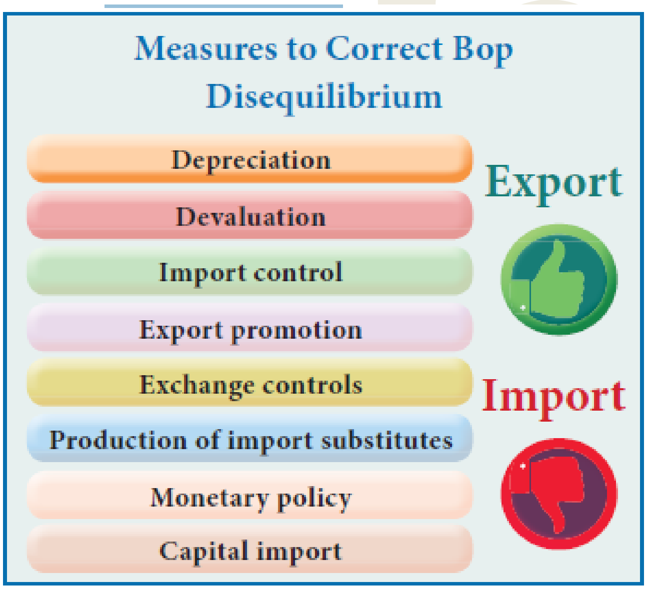
5. Demonstration Effect: Deficit in the balance of payments of developing countries is also caused by demonstration effect which influences the people in UDCs to imitate western styled goods. This will raise the propensity to import causing adverse balance of payments. This is good for the developed countries.

6. Borrowing: International borrowing and investment may cause a deficit in the balance of payments. When the international borrowing is heavy, a country's balance of payments will be adverse since it repays loans with interest. Servicing of debt is a huge burden. That is why the UDCs are forced to borrow more.

7. Technological Backwardness: Due to technological backwardness, the people (Indians) are unable to use the energy (Solar) available with them. As a result they import huge petroleum products from foreign countries, increasing the trade deficit.

8. Global Politics: The rich countries (Eg.USA) need to sell their weapons to promote their economy and generate employment. Hence, wars between countries (for example Iran and Iran, Pakistan and India) are stimulated In order to win the wars, the poor countries are forced to buy the weapons from weapon – rich countries, using their export earnings and creating trade deficit. Thus UDCs are trapped forever.

Measures to Correct BOP Disequilibrium



There are a number of measures available for correcting the balance of payments disequilibrium. They are divided into two broad groups, namely, (i) automatic correction and (ii) deliberate measures.

I. Automatic Correction If the market forces of demand and supply are allowed to play freely, equilibrium will be automatically restored in course of time. Under the free exchange rate system, the automatic adjustments of the balance of payments can take place through changes in the variables like price, interest, income and capital flows.

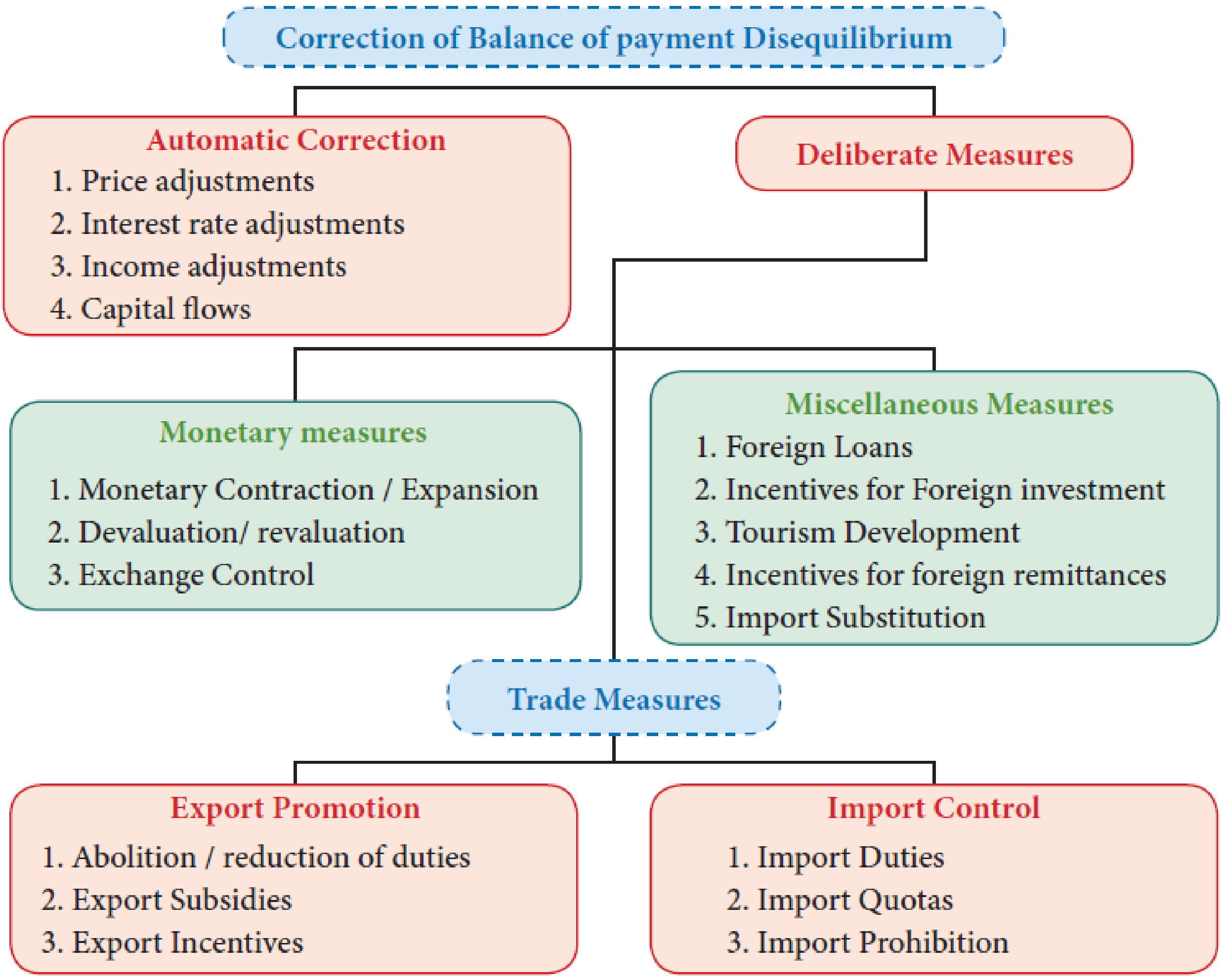
1. Price Adjustments As a result of foreign exchange outflow from a deficit country to a surplus country, there will be a fall in the money supply in the deficit country and increase in the money supply in the surplus country. This will result in rise in the price in the surplus country which will encourage imports and discourage exports. Fall in prices in the deficit country will encourage exports and discourage imports, leading to restoration of BoP equilibrium.

2. Interest Rate Adjustments

The contraction or expansion of money supply resulting from the BoP deficit or surplus leads to a rise or fall in the interest rates. A rise in interest rate in the deficit country will encourage investors to withdraw their funds from abroad and invest in their home country. The opposite happens in the surplus country.

3. Income Adjustments

A nation with payments surplus will experience rising income which will increase imports and thereafter equilibrium is restored in Balance of Payments.



4. Capital Flows

Changes in the interest rate consequent to the BoP disequilibrium will encourage capital flows from the surplus nations to deficit nations helping restoration of the BoP equilibrium.

II. Deliberate Measures

The deliberate measures may be broadly grouped into (a) monetary measures (b) trade measures and (c) miscellaneous measures.

a. Monetary Measures

1. Monetary Contraction

High domestic price level is responsible for high imports and low exports. In order to control inflation, the central monetary authority controls credit. As a result, the prices come down and exports increase. This will help to correct adverse BoP. However, if credit is controlled, investment will decline, production will go down, prices will increase. This is the cause of confusion between government and RBI in India in 2010s.

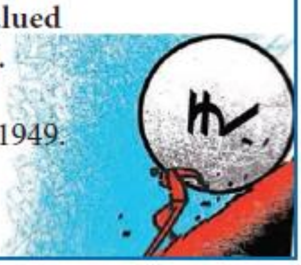
2. Devaluation

Devaluation means deliberate reduction of the official rate at which domestic currency is exchanged for another currency. In other words, devaluation refers to a reduction in the external value of a currency in the terms of other currencies. For instance, instead of 70 ₹ per US$, making ₹ 80 per US$.

Devaluation of Indian Currency

Indian rupee was devalued three times since 1947.

1. On 29th September, 1949.
2. On 6th June, 1966
3. On 1st July, 1991



A country with fundamental disequilibrium in the balance of payments may devalue its currency in order to stimulate its exports and discourage imports to correct the disequilibrium. Devaluation makes exports cheaper and imports dearer. That means making Indian good cheaper for foreigners, and foreign goods costlier for Indians.

3. Exchange Control

Exchange control means the state intervention in the forex market. It is a popular method employed to influence the balance of payments position of a country. Under exchange control, the government or central bank assumes complete control over the foreign exchange reserves and earning of the country. The recipients of foreign exchange, like exporters, are required to surrender foreign exchange to the government / central bank in exchange for domestic currency. By virtue of its control over the use of foreign exchange, the government can control imports. Does it happen in India? Too much of imports control would invite more and more smuggled goods. Smuggling of gold into Indian airports regularly happens, as per the reports in the media.

III. Trade Measures

Trade measures include measures to promote exports and to reduce imports.

1. Export Promotion

Exports may be encouraged by i).reducing or abolishing export duties, ii). providing export subsidy, iii).encouraging export production by giving monetary, fiscal, physical and institutional incentives. (Then local people and domestic industries would suffer)

2. Import Control

Imports may be controlled by i).imposing or enhancing import duties, ii).restricting imports through import quotas, iii).licensing and even prohibiting altogether the import of certain non- essential items. But this would encourage smuggling.

IV. Miscellaneous Measures

In addition to the measures mentioned above, there are a number of other measures that can help make the balance of payments position more favourable, like i). foreign loans, ii).encouraging foreign investment in the home country, iii).development of tourism to attract foreign tourists, iv).providing incentives to enhance inward remittances and v). import substitution.