Autonomous Items also known as '***above the line items***' – are those international transactions which happen due to profit earning motive.

All profit oriented international transactions – like export and import are autonomous transactions.

Autonomous transactions are called '*autonomous' because they happen on their own accord and not because of a country's BOP scenario.'*

Autonomous transactions will include imports and exports (current account transactions) and also lending or borrowing of loans (cross border) or payment or receipt of interests thereon.

These transactions will happen as when the originator of the transaction – i.e. importer/ exporter/ borrower/ lender/ etc. wants to transact. These transactions are not meant to establish BOP identity.

Accommodating Items or '***below the line items***' are those which originate to 'accommodate' the BOP scenario.

If there is BOP surplus or deficit then accommodating transactions are carried out in a deliberate manner to balance out the surplus/ deficit BOP.

Accommodating transactions compensate the surplus or deficit brought about by autonomous transactions. It seeks to bring equality between the payments and receipts of foreign exchange.

Usually we have **BOP deficit and that is *accommodated* by bringing in flow of foreign exchange in the form of FDI/ loan from IMF etc. to balance out the deficit or to lower the deficit.** Example: Drawings from SDR, borrowings from IMF or central banks of other countries etc. which have to be made to correct the disequilibrium in the autonomous items of balance of payments.

Types of Disequilibrium

Disequilibrium in balance of payments can be classified as follows : -

- Temporary Disequilibrium – Temporary disequilibrium in the form of deficits or surpluses tend to last for a short period of time. They are the result of temporary changes in the economy like - crop failure, seasonal fluctuations, effect of weather on agricultural production, etc. Such a disequilibrium may occur once a while and gets automatically corrected. It does not pose a serious problem for a country.

- Fundamental Disequilibrium – There is no precise definition of the term fundamental disequilibrium. Economists generally define fundamental disequilibrium as - "a deep rooted persistent deficit or surplus in the BOP of a country." It is a chronic BOP deficit, according to IMF. It is of long term nature and a matter of serious concern for the country.

- Cyclical Disequilibrium – Cyclical fluctuations in the business activity also lead to BOP disequilibrium. Cyclical disequilibrium occurs because (i) Trade cycles follow different paths and patterns in different countries. (ii) Different countries follow different stabilization programmes. (iii) Differences in price and income elasticities of demand for imports.

- Structural Disequilibrium – Structural disequilibrium occurs due to structural changes in the economy. Some of the structural changes would include changes in technology, changes in tastes and preferences, changes in long term capital movements, etc.

<u>Causes of Disequilibrium</u>

The factors leading to disequilibrium (surplus or deficit) in balance of payments could be broadly categorized into following three categories:

- Economic factors – The important economic factors are
  (a) structural changes in the economy
  (b) changes in exchange rates (overvaluation / undervaluation)

(c) Changes in the level of foreign exchange reserves

(d) Cyclical fluctuations

(e) Inflation / deflation

(f) Developmental expenditure undertaken by developing countries, etc.

- Social factors – The social factors may include changes in tastes & preferences due to demonstration affect, population growth rate, rate of urbanization, etc.

- Political factors – The political factors may include political stability / instability in a country, war, change in diplomatic policy, etc.

Measures to control disequilibrium in balance of payments

- Automatic Correction
- Deliberate Measures
  - Trade Measures
    - Export Promotion
    - Import Control
  - Monetary Measures
  - Devaluation
  - Miscellaneous Measures
    - Foreign Loans
    - Foreign Investments
    - Tourism Development
    - Foreign Remittances
    - Import Substitution

Automatic Correction

Under automatic adjustment , as the name implies, the BOP adjustment comes about automatically, and it is not brought about deliberately by government policy or intervention. The burden of adjustment is on the economy and market forces and not on the government. It is argued that under automatic adjustment if market forces of demand and supply are allowed to have a free play, in course of time, BOP equilibrium will be automatically restored.

Assuming fixed or flexible exchange rates, the automatic adjustment in BOP takes place through changes in prices, interest rates, income and capital flows. Thus, under automatic adjustment there is no government intervention. However, it is to be noted that automatic adjustment does not confirm to reality and has unwanted side effects.

Deliberate Measures

Under policy induced adjustment there is government intervention in correcting disequilibrium in BOP. As the name implies, deliberate measures are undertaken by the government to correct disequilibrium in BOP. The government tries to correct disequilibrium through its policy instruments like monetary & fiscal policy, trade policy, devaluation, exchange controls etc. Thus, BOP adjustment becomes a matter of policy. However, the government policies designed to correct disequilibrium in BOP cannot neglect the internal problems related to the economy like unemployment, inflation, economic growth etc.

The most important objectives of a nation are : (a) internal balance, (b) external balance (c) a reasonable rate of growth, (d) an equitable distribution of income and (e) adequate protection of the environment, etc. In the present context, internal balance and external balance are the two objectives or targets of government policy. Internal balance refers to the achievement of full employment and price stability.

- **Trade Policy Measures** – Trade policy measures would include measures which would reduce imports and promote exports. The important trade policy measures are

(a) Import controls
(b) Export promotion

(a) Import controls: A country may control its imports by imposing or increasing import duties, restricting imports through import quotas, licensing, prohibiting altogether the import of certain non essential items, etc.

(b) Export promotion: A country would promote exports by reducing or abolishing export duties, providing export subsidies, encouraging production of exportable, provide monetary, fiscal, physical and institutional incentives and facilities to exporters, etc.

- **Monetary Measures**

While external balance refers to the achievement of equilibrium in balance of payments. Thus, internal balance is achieved by reducing inflation and unemployment to zero and external balance is achieved by reducing BOP deficits and surpluses to zero. Generally, government places priority on internal over external balance, but they are sometimes forced to switch their priority when faced with large and persistent external imbalances. The government through its various policy instruments tries to achieve internal balance and external balance. To achieve the objectives of internal & external balance the main policy instruments at the disposal of government are as follows:

- Monetary & Fiscal Policy (Expenditure – Changing Policies) Monetary and fiscal policy are the two tools through which the twin objectives of internal and external balance are achieved. Monetary policy affects the economy through changes in money supply and interest rates. An expansionary monetary policy will increase the money supply and decrease interest rates. While a contractionary monetary policy will decrease the money supply and increase interest rates.

An expansionary monetary policy will lead to increase in the level of investment, output, income and imports. On the other hand, a contractionary monetary policy will work in the opposite way.

Fiscal policy affects the economy through changes in government expenditure and taxes. An expansionary fiscal policy means an increase in government expenditure and /or decrease in taxes, while a contractionary fiscal policy means a decrease in government expenditure and / or increase in taxes. An *expansionary fiscal policy will lead to increase in production, income and imports, while contractionary fiscal policy will do the opposite*.

It is to be noted that the effects of monetary policy on the BOP situation of a country are highly predictable, whereas the effects of fiscal policy on the BOP are less predictable. These policies seek to achieve internal & external balances by altering the aggregate level of demand for goods and services, both domestic and imported, by increasing or reducing the aggregate expenditure in the economy. Hence, these two policies are also called as 'expenditure changing policies.'

It is argued that an expansionary monetary & fiscal policy is suitable for solving the problem of unemployment & BOP surplus. While, a contractionary monetary & fiscal policy is suitable for solving the problem of inflation and BOP deficit.

So we can conclude that reducing inflation needs a contractionary policy, reducing BOP surplus needs an expansionary policy, reducing unemployment needs an expansionary policy and reducing BOP deficit needs a contractionary policy.

- Devaluation (Expenditure Switching Policy): Devaluation means reduction in the external value of the country's currency undertaken by the government officially. It is a deliberate action taken by the government deliberately and legally. Devaluation does not change internal purchasing power of a currency. A country devalues its currency in order to correct its BOP deficit. Devaluation is considered as 'expenditure switching policy' because it switches expenditure from imported goods to domestic goods & services. Thus, when a country with BOP deficit devalues its currency, the domestic price of its imports increases (because foreign goods have now become expensive i.e. devaluation of let us say Indian currency would be from1$ = 50 INR to 1$ = 80 INR) and the foreign price of its exports falls (i.e. your domestic goods have become cheaper for foreigners). This makes exports cheaper and imports costlier. Now the foreigners can buy more goods by paying less money than before devaluation. This encourages exports.

This causes expenditure to be switched from foreign to domestic goods as the country's exports increase and the country produces more to meet the domestic and foreign demand for goods. On the other hand, with imports becoming costlier than before, they decline. Thus, with the rise and exports and fall in imports, BOP deficit is corrected. IMF considers devaluation as a means to correct fundamental disequilibrium in a country's BOP but it is to be used only as a last resort.

- Exchange Rate Control: Exchange control also forms a part of expenditure – switching policy because they too aim at switching of expenditure from imported goods and services to domestic goods and services. Exchange control serves the dual purpose of restricting imports and regulating foreign exchange. Under the exchange control, the whole foreign exchange resources of the nation, including those currently occurring to it, are usually brought directly under the control of the exchange control authority. The exchange control authority is usually the government or central bank of the country. Dealings and transactions are regulated by the exchange control authority. The recipients of foreign exchange like exporters are required to surrender foreign exchange to the exchange control authority in exchange for domestic currency. The exchange control authority allocates the foreign exchange on the basis of national priorities.

Exchange control methods could be direct and indirect. Direct methods would include – intervention and regulation in matters concerning exchange rates, foreign exchange restrictions, multiple exchange rate policies, exchange clearing agreements, etc. Indirect methods would include – import tariffs & quotas, export subsidies, etc.

- Miscellaneous Measures
  - Foreign Loans: Deficit BOP can be corrected by government borrowing from foreign banks etc. since repayment of these loans is spread over a long period, this helps the government to remove the deficit in the balance of payments by utilizing the time gap.
  - Foreign Investments: By attracting foreigners in the country by offering them various incentives and concessions so that there is more capital inflow in the economy that helps government reduce deficit in BOP account.
  - Tourism Development: Increasing tourist by offering them various facilities like good hotels, transportation facility, concessional travel etc. this would increase the foreign exchange earnings of the country.

- Foreign Remittances: Government gives incentives to people working abroad. This helps in inflow of foreign exchange.
- Import Substitution: Producing substitutes of imported goods by providing various incentives and concessions to the domestic industries. This replaces foreign exchange outflow.