Theoretical Approaches to Rebalancing the Balance of Payments: A Literature Review

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Abstract : The issue of rebalancing the balance of payments has received ongoing attention in economic literature, prompting the development of various theoretical frameworks aimed at restoring external equilibrium. This review critically examines the main strands of thought that have shaped this discussion. It first explores the automatic adjustment mechanisms proposed by classical economists, emphasizing their reliance on price and income changes. It then examines administered adjustment theories, including the absorption approach, the critical elasticities framework, and the monetary approach to the balance of payments. By combining these perspectives, the review provides a structured understanding of the conceptual development and policy implications of balance of payments adjustment strategies.

Keywords: *Balance of Payments Adjustment, External Equilibrium, Automatic Mechanisms, Absorption Approach, Elasticities Approach, Monetary Theory, Current Account Deficits, Macroeconomic Policy, International Economics, Disequilibrium Dynamics.*

JEL Codes : F10-F60, F31, F41, F43

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I. INTRODUCTION

Persistent current account deficits continue to be a widespread issue in both advanced and developing economies. These imbalances, often accompanied by increasing external debt, pose serious risks to macroeconomic stability and highlight the importance of analyzing and addressing the current account. Since the introduction of floating exchange rates in 1973, the current account has increasingly become the main indicator of a country's need for macroeconomic adjustment, surpassing the broader balance of payments (Salop & Spitaller, 1980). The need to reduce, or ideally eliminate, current account deficits remains a central focus in economic policy discussions. A substantial body of research has developed to explore how external equilibrium can be restored, producing various theoretical models with differing conclusions. These models range from classical automatic adjustment mechanisms to more interventionist, policy-driven strategies. Despite these efforts, persistent deficits are still a common feature of many economies, especially in the Global South, making balance-of-payments imbalances an ongoing concern in both scholarship and practice. This paper offers a critical review of the main theoretical approaches to rebalancing the balance of payments. It analyzes their conceptual foundations, assumptions, and limitations. A distinction is made between automatic adjustment mechanisms, rooted in traditional economic thought, and interventionist approaches, which focus on policy intervention and structural changes.

II. AUTOMATIC REBALANCING METHODS FOR THE BALANCE OF PAYMENTS

Balance-of-payments imbalances have historically played a key role in international economic theory. Classical models highlight two main automatic adjustment mechanisms: one involving changes in relative prices, and the other through fluctuations in overall income.

- *Adjustment Through Price Mechanisms*

The classical theory of external adjustment, first explained by David Hume (1754) and later expanded by Ricardo, J.S. Mill, and Taussig, suggests a self-correcting process under the gold standard. In this system, national currencies were defined in terms of gold at fixed gold points, which helped anchor monetary values and enable international settlements.

In a balance-of-payments deficit, gold outflows decrease the domestic money supply. According to the quantity theory of money, this reduction causes domestic prices to fall. Lower prices improve the competitiveness of domestic goods, boost exports, and cut imports, ultimately narrowing the trade deficit.

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On the other hand, surplus countries receive gold inflows, which increase the money supply and raise domestic prices. This inflationary impact reduces export competitiveness and boosts imports, thereby reversing the surplus. Through these balanced movements of gold and goods, the classical model predicts an automatic return to external equilibrium.

However, this model has faced significant criticism. Nogaro (1904) questioned the idea of a direct causal link between gold flows and balance-of-payments results, pointing out that international settlements often happen through financial instruments like bills of exchange rather than physical gold transfers. Meade (1952) also challenged the idea that the process is automatic, arguing that price-level adjustments often reflect intentional policy interventions aimed at achieving both internal and external balance.

For such price-based rebalancing to work effectively, several strict conditions must be met: real wage flexibility, a shared adjustment burden between surplus and deficit countries, sufficient international reserves, open trade policies, and the lack of fixed-currency debt obligations. Additionally, effective adjustment requires that the total of marginal propensities to import stays below one and that import-demand price elasticities are greater than one.

Alternative perspectives, advanced by Bastable (1889), Wicksell (1918), and Viner (1937), shift the analytical focus from relative prices to total demand. These scholars argue that, with prices held constant, a deficit indicates a decrease in total demand in the deficit country and a rise in total demand in the surplus country. Equilibrium is thus reestablished through changes in demand rather than price adjustments. The main difference from Hume is that, in these views, price changes are not necessary for rebalancing.

- *Adjustment Through Changes in National Income*

The second automatic mechanism for rebalancing the balance of payments operates through changes in aggregate income, often analyzed using the foreign-trade multiplier framework. In this context, an exogenous rise in exports acts as an injection into national income, while savings and imports are leakages from the circular flow of income. The size of the multiplier depends on the inverse of the sum of the marginal propensities to save and to import. Equilibrium occurs when total leakages equal the initial injection.

An increase in exports leads to higher real income, which then boosts demand for both domestically produced goods and imports. As income keeps rising, the growth in imports eventually offsets the initial export gain, helping to restore external balance. Conversely, a decrease in exports triggers a contractionary cycle, lowering income and import demand. The speed and effectiveness of this adjustment depend largely on the marginal propensity to import: the higher its value, the quicker imports respond, and the faster the adjustment process spreads across trading partners.

Although automatic adjustment mechanisms seem appealing in theory, historical experience, especially during the interwar period and the Great Depression, showed their limitations. The inability of these mechanisms to stabilize external accounts during severe economic hardship led to a shift toward policy-driven, or managed, methods for balance-of-payments adjustment, focusing on discretionary actions and structural reforms.

III. ADMINISTERED APPROACHES FOR BALANCE-OF-PAYMENTS REBALANCING

Adjustment policies involve coordinated fiscal, monetary, and structural measures aimed at restoring external balance during balance-of-payments deficits. The limits of automatic adjustment mechanisms, especially visible during the Great Depression, led to a shift toward policy-based solutions. As external restrictions grew tighter and macroeconomic stability became more fragile, discretionary intervention gained importance. The International Monetary Fund (IMF), created as a key part of post-war monetary governance, formalized several frameworks for balance-of-payments adjustment, including the absorption approach, the elasticity approach, and the economic approach.

- *The Absorption Approach*

Formulated by Sidney Alexander (1952), the absorption approach views the balance of payments as the difference between a nation’s total output (aggregate resources) and its total expenditure (aggregate absorption). In this model, a trade deficit occurs when domestic absorption surpasses national output, indicating that the country is consuming more than it produces. Therefore, adjustment requires a reduction in absorption, meaning a contraction in the overall demand for goods and services.

Assuming supply constraints near full employment, this approach advocates demand-management policies to decrease domestic spending. Meade (1952) suggested using a mix of monetary and fiscal tools: tightening monetary policy with higher interest rates to limit credit growth and reduce private consumption and investment; and balancing the budget through spending cuts (such as subsidies, transfers, and current expenses) along with raising indirect taxes to generate revenue and restrain demand.

Despite its analytical clarity and operational simplicity, the absorption approach has limitations. It tends to view external imbalances as merely an issue of excess demand, overlooking structural factors like imported inflation, which is especially important in developing economies. Additionally, the recommended austerity measures might hinder economic growth and, under certain conditions, worsen inflationary pressures. When possible, supply-side policies aimed at increasing productive capacity provide a more balanced approach to external adjustment. Finally, the approach’s narrow focus on the trade balance ignores the importance of capital flows and financial account movements, which are vital parts of the modern balance-of-payments framework.

- *The Elasticity Approach*

The elasticity approach, widely supported by the International Monetary Fund (IMF), focuses on using exchange rate adjustments, such as devaluation or depreciation, as a way to restore external balance. The theoretical basis suggests that a decrease in the domestic currency's value improves external competitiveness by changing relative prices: imports become more costly in domestic currency, while exports become cheaper in foreign currency. These price changes are expected to impact trade volumes over time, helping to improve the current account, as long as trade flows respond to price changes.

- *The Success of this Mechanism Depends on Several Key Elasticities:*

- ✓ The price elasticity of foreign demand for the country's exports
- ✓ The price elasticity of the domestic export supply
- ✓ The price elasticity of domestic demand for imports
- ✓ The price elasticity of foreign import supply

Two different effects influence the path of the trade balance. In the short term, the price effect typically has a negative impact: import prices increase in domestic currency, while export prices decrease in foreign currency, which can worsen the current account deficit. Over the medium term, however, the volume effect may prevail if the relevant price elasticities are sufficiently high. In these cases, export volumes increase and import volumes decrease, resulting in an improvement in the current account. This process is described by the Marshall–Lerner condition, which states that the sum of the absolute values of the export and import demand elasticities must be greater than one for devaluation to correct external imbalances effectively.

While theoretically persuasive, the elasticity approach relies on a level of price responsiveness that may not be realistic, especially in economies with rigid production systems, limited export diversity, or high dependence on imports. Additionally, the delay between price changes and volume responses adds uncertainty to the policy's success, particularly in situations of severe external vulnerability.

- ➢ *The Monetary Approach to the Balance of Payments*

In response to the social and economic costs linked to demand-compression policies, the International Monetary Fund (IMF) adopted the monetary approach to balance-of-payments adjustment, notably formalized in Polak's (1957) model. This framework suggests a causal relationship from changes in the money supply to variations in nominal income, depending on the level of leakages, mainly through imports. This view contrasts with the Keynesian paradigm, which states that income levels determine the demand for money.

The monetary approach is based on the quantity theory of money and supported by Friedman's empirical findings, which show a strong link between monetary aggregates and economic activity. Two key assumptions form the foundation of the model.

- The demand for money is a stable function of income.
- The supply of money is determined externally and is independent of money demand.

Despite different ideas about external imbalance, both the absorption and monetary approaches agree on a common policy: limiting domestic credit growth. Polak took this principle further by suggesting that central bank foreign exchange reserves should always cover at least 20 percent of domestic credit creation, strengthening monetary discipline and external solvency.

However, the monetary approach has faced criticism. Kaldor (1970) questioned the assumed direction of causality in the model, arguing that a statistical correlation between money and income does not necessarily indicate a causal relationship. He argued that it is more likely for the level of economic activity to influence the amount of money, rather than the other way around. This critique emphasizes the need to be cautious when interpreting monetary dynamics and their effects on external adjustment.

IV. CONCLUSION

The persistence of balance-of-payments deficits has long been a key focus of study in international economics. The state of external accounts, especially the current account, continues to influence macroeconomic policy discussions and remains a major concern for organizations like the International Monetary Fund (IMF). In addition to identifying the root causes, a significant body of research has examined the theoretical and practical ways to address external imbalances.

This review has categorized the main theoretical contributions into two broad groups. The first includes automatic adjustment theories, which depend on market-driven mechanisms, specifically price and income changes, to restore balance. The second covers administered adjustment models, which focus on policy interventions in handling external disequilibria. Each group provides unique analytical insights and policy recommendations, reflecting different assumptions about economic behavior and institutional capacity.

Both strands have informed a broad range of empirical studies, and contemporary research increasingly uses dynamic stochastic general equilibrium (DSGE) models to simulate adjustment processes under different structural conditions. A promising area for future research is critically assessing how well DSGE frameworks improve our understanding of balance-of-payments adjustment, especially in developing economies with structural weaknesses and limited policy options.

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