chapter 8

At the end of this chapter, students should be able to:
â€¢ explain balance of payments concepts such as; trade balance, current account balance and overall balance;
â€¢ identify the different ways of dealing with balance of payments disequilibrium;
â€¢ explain the development of Nigeriaâ€™s balance of payments.

8.1 Introduction

Countries of the world are engaged in international trade with each other and are closely linked financially with those they trade with. A balance of payments indicates whether a country is solvent or not, thus paving her way in the world or whether she is in debt. The problem of debt is usually related to developing countries of the world; of which Nigeria is inclusive.
It is vital for a country to free herself from persistent weakness of balance of payments accounts in order to ensure the maintenance and improvement of the standard of living of her citizens. This chapter shall examine the meaning of balance of payments, financing the deficit, balancing items, measurement of balance of payments, causes of disequilibrium, corrective forces arising from international disequilibrium, gold movements and the development of Nigeriaâ€™s balance of payments.

8.2 Meaning of Balance of Trade/Balance of Payments

Balance of trade: The balance of trade of a country shows the relation between the values of her exports and imports. This is calculated periodically, usually a year. If the exports exceed the imports, the country is said to have an export surplus, and if viceversa, the country has an import

surplus. If
a country has an export surplus, the country has a favourable balance of trade. On the other hand, if it has an import surplus, the country has an adverse or unfavourable balance of trade.
Note: The balance of trade concerns both the visible and the invisible trade.
â€¢ Visible items of trade include agricultural products, chemicals, machineries, industrial equipments and host of other tangible items.
â€¢ Invisible items of trade include shipping, banking, insurance and other intangible services.
Balance of payments: A balance of payment is the recorded account of all financial transactions that have taken place over a period (mostly one year) between one country and the outside world. It is an account that shows the relationship between a countryâ€™s receipts from other countries and payments to other countries.
This process of buying and selling requires payments, not only for imports or exports, but also for other transactions like banking, insurance, shipping and other services rendered to her or by her to foreigners. As a country makes payments abroad, two sides of balance of payments can be clearly identified as the payment or debit and the receipt or credit sides.

8.3 Current and Capital Accounts
(i) Current account: The current account deals with payment receipts for goods and services and other items of current income and expenditure. It can be distinguished from the long-term capital account in that the latter is specifically concerned with investment and loans. The current account consists of two parts:
(a) The visible balance (or balance of trade): This deals with the payments and receipts arising from the imports and exports of goods only. This includes manufactured/semi-manufactured goods and raw materials, e.g., food, drugs, machinery, industrial equipments, crude oil, agricultural products, etc.
(b) The invisible account: This includes in totality the receipts and payments arising from services received from or rendered to other countries. These services include shipping, aviation, tourism, banking, insurance, etc. together with profit from investments, interests on past loans, travel expenditure and expenditure of the government in giving aid to other countries, maintaining military bases and financing diplomatic representation.
The invisible and visible accounts together comprise the current balance and the difference between the two accounts will give rise to either a deficit or a surplus in the current account.
(ii) Capital account: The capital account is a record of all receipts and payments associated with; long-term investment lending and borrowing, short-term lending and borrowing as well as changes in the countryâ€™s foreign assets and liabilities within a given period (usually one year). It therefore shows the actual transfer of money from one country to another.
The major items of the capital account are described as follows:

(a) Long-term lending and borrowing:
Long-term loans and aids received from abroad are credit items. However when the country gives such loans as aid, the record is entered on the debit side of the capital account.
(b) Direct foreign investment: A country may invest abroad. It may also receive investments from other countries. Foreign capital used to establish industries or long equity interests in a country enters the credit side of the countryâ€™s capital account. But if a country invests in another country, it gets a debit entry in its capital account.
(c) Short-term lending and borrowing: Short-term foreign loans are normally used to finance excess of input over exports. In other words, the value of goods and services received but not immediately paid for is regarded as a short-term loan and placed on the credit side of the capital account.
(d) Foreign exchange reserves or assets: International trade involves the use of different currencies.
Thus, in the process of importation and exportation, a country pays out and receives foreign currencies. The country tends to accumulate such foreign currencies. But when it spends more than it receives in the process of trade, its foreign currency reserve will fall. Therefore, when there is a deficit in the current and capital accounts taken together, foreign currency reserves may be drawn as means of paying for the excess.

8.4 Financing the Deficit

A balance of payments deficit occurs when the combined receipts on the current and long-term capital accounts are less than the corresponding payments. The difference between the receipts and payments constitutes the deficit. This means, generally, that the country is importing (paying out) more than it is exporting (receiving).
A balance of payments deficit may be described as short-term or long-term and different measures are required in financing them as follows:
(a) Financing a short-term deficit: A balance of payment deficit can be described as short-term when the deficit occurs within 1 or 2 years. Such a problem may arise as a result of a sudden fall in the demand and price of an important export product. The following measures can be taken:
(i) A reduction in the countryâ€™s private holdings of foreign currency (reserve) to finance the deficit
(ii) A short-term borrowing from abroad to finance the deficit
(iii) A combination of a little of both â€˜(i)â€™ and â€˜(ii)â€™

(b) Financing a long-term deficit:
A balance of payments is described as long-term when the deficit is consistent over a longer period (say over 3 years). It is a clear sign that the country is living beyond its means.
The following measures can be taken to correct this situation:
(a) The country should endeavour to live within her means by reducing imports and increasing exports.
(b) A long-term loan will be required for the country to put in place measures

that will increase and sustain their output to attain their domestic needs and increase their export over the years.

On the other hand, the surplus in a combined current and long-term capital account is also accounted for. The surplus is matched by items in the monetary movements that are in this case said to be favourable. It has the following effects:

(a) It reduces liabilities to foreigners.

(b) It gives rise to countryâ€™s foreign reserves.

(c) It increases the claim of a country over other foreign currencies.

Therefore, if a balance of payments is surplus, the surplus will be matched by a net minus total in the monetary movement, showing what the surplus comprises and how it has been used.

The Balancing Item

In theory, the monetary movement total should match exactly the balance of payments. A deficit of N20 m should be accounted for with an adverse monetary balance of N20 m. A surplus of N10 m should be brought back by a favourable monetary balance of N10 m. In practice, the accounting procedure is far from perfect and a large number of transactions escape unrecorded. For accounting purposes, a balancing item is introduced to strike the balance.

For example, let us look at Table 8.1 below:

Table 8.1 Final Accounts

Item	₦ in million	₦ in million	₦ in million
	2009	2010	2011
Current balance	+209	−273	−412
Balance of long-term capital	−187	−185	−344
Balance of payments (identified)	+22	−458	−756
Balancing item	+41	+300	+35
Monetary movements	−63	+158	+721

The balancing items are the figures that square up the account. The sum of each column now is zero, and total positive items equal total negative items. The fact that, on the average, the balancing item is usually positive means that more receipts than payments have gone unrecorded.

8.5 Balance of Payments Disequilibrium

A countryâ€™s balance of international payment is said to be in equilibrium when its receipts are equal to its payments on account of its transactions with other countries. Therefore, disequilibrium is experienced when the total receipts on both current and capital accounts of the countryâ€™s balance of payments are not equal to the payments made.

One of the basic problems of international economic payment is: finding effective means for restoring external balance to a country whose balance of payments is seriously in surplus or in deficit. However, this problem is closely bound up with the problem of maintaining a high and stable level of economic activity or what is called full employment. The following are the causes of disequilibrium in a countryâ€™s balance of payments:

(a) Structural change in the foreign demand for a countryâ€™s export. This change may arise from any of the following:

(i) Changes in consumersâ€™ taste abroad, from the development of cheaper or better supplies of substitute products in other countries.

(ii) Changes in transfer cost of export or import products.

(iii) The exhaustion of natural resources from which a countryâ€™s imported export raw materials are derived may be responsible for fall of exports.
(b) Natural disaster or elements that destroy the current supply of exportable goods.
(c) A world depression that may cause a sharp fall in the demand for manufactured goods.
(d) Cyclical fluctuations of trade within the country itself with accompanying inflation of prices tend to disturb the balance of payments.
(e) Sizeable changes in the direction and volume of long-term capital movements or long-term investment lending may prove embarrassing to both the borrowers and the lenders alike.
(f) Weakness in a countryâ€™s currency leads to a fall in the demand of that currency and affects the countryâ€™s balance of payments negatively.
(g) War is very destructive and disrupts normal trade between nations. It upsets the existing equilibrium.

Corrective Forces Arising from Internal Disequilibria

(a) The effects of gold movements upon internal price levels of the countries concerned bring about some structural changes in the economy of the affected countries as it explains how such countries can maintain equilibrium by using the quality theory of money. According to this view, an unfavourable debt balance for one country increases exchange rates to the gold export point, and this results in an outflow of gold. Applying the quantity theory, the loss of gold reduces the volume of bank reserves, causes a fall of credit and leads to a fall in price level.
On the other hand, countries with a favourable debt balance gain gold. As a result, credit expands and price level rises. Thus, equilibrium is restored by the following:
(a) Reducing prices in the country with an unfavourable debt balance of payments.
(b) Increasing prices in the country with a favourable debt balance of payments.

(b) Spontaneous causes: This method of restoring and maintaining international equilibrium operates through changes in income levels of concerned countries.
According to this view, a country having disequilibrium in its balance of payments loses purchasing power by an amount equal to the deficiency. On the other hand, countries having favourable balance of payments receive additional purchasing power. For income changes from spontaneous forces to restore equilibrium in the balance of payments, the following should be considered:
(a) The size of the multiplier in the concerned countries.
(b) The extent to which changes in the income level in each affects the magnitude of their respective imports, i.e., their marginal propensity to import.

Spontaneous correctives: This occurs when changes in long-term capital movements threaten the balance of payments of a lending country. For example, if America lends money to Nigeria and Nigeria wishes to use the money to buy American goods, Nigeria would spend the money on American goods and this will not change the price levels of both America and Nigeria. If Nigeria require goods from other countries outside America or Nigerian goods, the income and price level of America will fall, while the income and price level of Nigeria will rise. This will expand Americaâ€™s export and expand Nigerian import level.

8.6 Gold Movements and the Balance of Payments Disequilibrium

Gold movements between countries serve as a means of balance of payments disequilibrium.
Gold moves from the debtor to the creditor country and it has no direct and immediate influence upon their money supply. The money supply of the creditor country would have already increased and that of the debtor country decreased by the spontaneous factors to the amount of payment differences. What the gold movement does is it validates the transfer of purchasing power that has already occurred. Gold movements lead to the following:
(a) The debtor country loses gold from its bank reserves, while the creditor country gains more gold in its bank reserve.
(b) The loss of gold puts a deflationary pressure on the banking system of the debtor country and an inflationary pressure on that of the acquiring country.
(c) The debtor country experiences higher interest rates and money becomes short in supply for them, while the gold-acquiring country experiences an easy flow of money and lower discount rates. The changes in discount rates set in motion two separate and distinct forces that help to check the outflow of gold. They are as follows:
(i) The movement of short-term capital into the debtorâ€™s country in response to the higher discount helps in dampening the pressure upon the debtor countryâ€™s gold supply. However, this develops quickly.
(ii) The stimulation of business activities, prices and imports when the discount rate falls (this is because of gold imports) and the reduction of business activities, prices and imports when the discount rate increases. Each of these requires structural changes in the economy of the country involved.

Challenges of restructuring an economy to restore to equilibrium

The ease and rapidity with which a countryâ€™s balance of payments may be restored to equilibrium depends to a large extent upon the type of commodities that make up its imports and exports.

Case Study

If a country with an adverse balance of payments normally imports high-priced consumable and durable goods, it will find it relatively easy to reduce the value of such import because of postponing the purchase of durable goods. Moreover, there is the possibility of switching from the purchase of high- to low-priced consumption goods. The loss of income and purchasing power, which results from the adverse balance of payments, will tend to bring a fall in imports as mentioned above.

In contrast, a country that imports foodstuffs and raw materials while exporting high-grade finished products (e.g., automobile, electronics, etc.) may find it difficult to readjust its balance of payments either by expanding its exports or by reducing its imports.

The restoration of equilibrium in the balance of payments may be swiftly achieved and early too when the disturbing forces are relatively small and temporary in nature.

In the absence of wars and acute prolonged depression, disturbances, though constantly appearing, are in fact small, and restoration of equilibrium occurs smoothly and successfully.

8.7 Nigeriaâ€™s Balance of Payments and its Development

Nigeria, as a developing country, has suffered from acute balance of payments problems due to an increase in the demand for various capital goods. The increase in the income level and standard of living among its citizens has led to an increase in the demand for consumption of imported goods. Nigeria, prior to 1955, earned sufficient currencies to meet her expanding importation because of the following conditions:

(a) There was an increase in demand for her products in the world market immediately after the Second World War. Exports from Nigeria include palm products, groundnut, columbine, timber, cocoa, etc. and these products commanded high prices in the foreign trade.

(b) Effective restrictions were placed on the importation of certain goods from foreign countries. However, the little quantity that could be imported had to be channelled through the mother country; Britain.

(c) There was an encouragement on the establishment of import-substituting industries. Most of the products consumed were locally-made.

(d) There was no major economic development then. Hence, there was little or no importation of capital goods as the colonial administration concentrated on maintenance of law and order.

(e) Nigerians were not free to use foreign exchange due to restrictions. This was effective because they were attached to foreign monetary systems. Therefore, they were not allowed to move their goods at will.

However since 1955, Nigeria has been confronted with the problem of balance of payments deficits due to the following factors:

(i) Reduction in the demand and hike in the prices of most of her major export products, thus leading to a decrease in export earnings.

(ii) Since independence in 1960, economic development began in earnest in Nigeria. Every state of the federation embarked on various national economic development programmes. This entailed the use of capital goods profusely, which were all imported.

(iii) The primary products that constituted a large percentage of Nigerian export earnings could not counter the amount spent on the importation of capital goods.
(iv) Loans were raised for various projects particularly between 1979 and 1983 and interests were paid on these loans.
(v) With the growth of civilization, incomes started to rise and higher standard of living closely followed. It consequently increased the importation of luxurious goods.
(vi) Foreigners determined the prices of primary products that Nigeria sold, e.g., oil, etc., while the prices of what were imported were also fixed by them.
This is so because Nigeria and indeed other developing countries cannot manufacture these capital goods even though the goods occur prominently in the standard of living items.

Summary

Balance of payments: This is the recorded account of all financial transactions that have taken place over a given period between one country and the other.
Balance of trade: This shows the relationship between the value of a countryâ€™s exports and that of her imports.
Current account: This deals with payments for goods and services and other items of current income and expenditure. The invisible trade part of the account includes transportation, insurance, travel and tourism, investment income and other services.
Final balance: This deals with bringing both current and long-term capital accounts together gives us a final identified balance.
Financing the deficit: The following are points in favour of deficit coverage: reduction of reserves, payment in foreign exchange, short-term capital flow, short-term borrowing, increase in a countryâ€™s indebtedness, reduction in a countryâ€™s private holding of foreign exchange and increase in a countryâ€™s official borrowing.
Financing the surplus: This surplus is marched by items in the monetary movement.
Balancing items: This is introduced to strike a balance in the balance of payments accounts.
Balance of payments disequilibrium: This occurs when the total receipts of both the current and the capital accounts of a countryâ€™s balance of payments is not equal to the payments received.
Causes of disequilibrium
(a) Structural change in the demand for a countryâ€™s exports
(b) Natural catastrophe
(c) World economic depression
(d) Cyclical fluctuation
(e) Sizeable changes in the direction of capital movement
(f) Abrupt and heavy movements of short-term capital

Class Activities

1. The teacher should use simplified balance of payments statistics or statements obtained from the Central Bank of Nigeria publication or the Federal Office of Statistics to illustrate key concepts such as the meaning and components of balance of payments to the students.
2. The teacher should ask students to deliberate on methods of financing deficits, examining the peculiarities of each method and situations where they can be applied.

Revision Questions

Objective Questions

1. Which of the following groups of accounts make up the balance of payments?
(a) Current account, multiple account and capital account
(b) Monetary movement account, company account and international account
(c) Cash account, double entry account and current account
(d) Capital account, current account and monetary movement account
2. Which of the following is part of the capital account of the balance of payments?
(a) Net investment from abroad
(b) Import of meeting
(c) Insurance
(d) Transportation cost **(SSCE 2003)**
3. When the value of a nationâ€™s exports is greater than its imports:
(a) A favourable balance of trade exists
(b) An unfavourable balance of payments exists
(c) The net foreign trade is zero
(d) Inflation occurs
4. Which of the following are examples of transfer payments?
(a) Gifts and donations
(b) Rents and rates
(c) Profits and dividends
(d) Internal and external debts **(SSCE 2007)**
5. A countryâ€™s balance of payments is in deficit when:
(a) A countryâ€™s payments for imports of invisible goods are greater than her receipts from exports of invisible goods
(b) The total receipts from her export of visible and invisible goods are greater than her payments for visible and invisible imports
(c) It can record a surplus on current account of balance of payments accounts
(d) The total payments for visible and invisible imports are greater than the total receipts from her exports of visible and invisible goods **(SSCE 2010)**

Essay Questions

1. (a) Explain the term â€˜balance of payments deficitâ€™.

(b) What four measures can be taken to reduce the balance of payments deficit of a country?
2. (a) What is balance of payments account?
(b) What are its component parts?
(c) What do they show?
3. (a) What are the main causes of disequilibrium in the balance of payments?
(b) Show how it can be restored to equilibrium position.
4. Explain clearly Nigeriaâ€™s balance of payments and its development.
5. What are the determinants of balance of payments disequilibrium?

Glossary

Balance of trade: The balance of trade of a country shows the relation between the values of her exports and imports.
Balance of payments: This is the recorded account of all financial transactions that have taken place over a period (mostly one year) between one country and the outside world.
Current account: This deals with payment receipts for goods and services and other items of current income and expenditure.
Capital account: This is a record of all receipts and payments associated with long term investment lending and borrowing, short-term lending and borrowing as well as changes in the countryâ€™s foreign assets and liabilities within a given period.