



Balance of Payment in Nigeria: Absorption Approach and Criticisms.

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ABSTRACT

This paper examined Balance of payments absorption approach and its criticism. However, three approaches to balance of payments are: Elasticity approach, Monetary approach and Absorption approach with emphasis on the absorption approach. Prior to 1993, balance of payment was divided into three parts and later subdivided into two major components: the current account and the capital account. The policy implications indicated that when output goes up, a country strives to increase outputs, so that it can have basis for more export or the country reduces import or both. Secondly, the country increases export and reduces import to earn more income, that is, domestic absorption. The effect of devaluation on balance of payment was highlighted to include income effects, terms of trade effects, real cash balance effects, money inclusion effect, income distribution effect and expenditure – Reducing policies. Finally some criticisms and recommendations were advanced.

Keywords: Balance, Payment, Nigeria, Absorption, Approach and criticism

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1. INTRODUCTION

Balance of Payments is an overall statement of a country's economic transactions with the rest of the world over some period, often a year (Dwivedi, 2010). A table of the balance of payments shows amounts received from the rest of the world and amounts spent abroad. The current account include exports and imports, that is visible trade, and receipts from and spending abroad on services such as tourism. It also include receipts of property incomes from abroad and remittances of property income abroad, and receipts and payment of international transfers, that is gift. The capital account of the balance of payments includes inward and outward foreign direct investment, and sales and purchases of foreign securities by residents and of domestic securities by non-residents. The third element in the balance of payments in changes in official foreign exchange reserves (Ali Abbas, 2010).

Over all payments, including changes in foreign exchange reserves, must balance by definition, but this is not true for any one category of payments. The balance of payments on current account is the difference between total receipts and expenditures on current account: if receipts exceed spending, there is a current account surplus, and if spending exceeds receipts there is a current account deficit. The balance of payments on capital account is the difference between receipts and expenditures on capital transactions with the rest of the world. Receipt comes from sale of securities or real capita assets to non-residents; expenditures are on loans to non-residents or purchase of real assets abroad. Changes in foreign exchange reserves are equal to the sum of the current and capital account surpluses. A balance of payments problem or crisis means that the balance of payments situation is not sustainable. This may be because foreign exchange reserves are being run down, or because they are being maintained, but only by borrowing abroad at a rate that cannot continue for long before foreign lenders get too worried about the safety of their loans to provide any more.



A balance of payment crisis differs from a problem only in the speed at which exhaustion of exchange reserves or borrowing capacity is approaching: a problem calls for action sometime, a crisis for immediate action (Dhliwaye, 1996). Balance of payments is one of the objectives of Macroeconomics, which has a significant role to play in the economic development of any nation, both developing and developed economies. In the current economic dispensation, the economy of the world is linked; thus globalization and trade liberalization have made possible the production of goods and services and subsequently sold in the world market. So long as international trade takes place and money flows, then recording of the transaction is done in the balance of payment account. The recording takes the normal accounting principles of debit and credit entries or positive and negative sign. Take Nigeria as the domestic country and United States as the "rest of the world", all international transaction that give rise to an inflow of Naira to Nigeria are entered as credits in the Nigeria Balance of Payments accounts. Outflow of naira are shown as debits, and are entered with a minus sign. Similarly, inflow of dollars to the United States are credits to the US balance of payments accounts but outflows are debits, (Begg, Fischer and Dornbusch 2005).

The preparation and presentation of balance of payment follows the accounting double principle concept.

The transaction recorded in Balance of Payment (BOP) are many and include the following:

- (i) Receipt and payment of goods and services exported and imported.
- (ii) Unilateral transfer in terms of receipt and payment. They are one sided transactions because they do not involve quid-pro-quo.
- (iii) Inflow and outflow of capital in various forms.
- (iv) Changes in BOP account of the countries and official liabilities.

All these items are normally recorded in BOP tables in terms of receipts (credit) and payments (debit) then the economy can easily have various balances such as balance of trade, current account balances, capital account balances and overall BOP balances. Nigeria's has recorded deficit balance of payment in recent times (B.O.P statistical year book, 2016). Unlike in the early 50s and late 90s, where the structure of the Nigerian economy was predominantly agrarian (agriculture) and its share to the gross domestic product (GDP) was relatively high, in other words, about 60%, while the other sectors of the economy accounted for the 40%. Then the BOP was surplus. The Nigerian Economy started dwindling in the early 70s immediately after the oil glut.

In the early 80s, the oil market weakened, substantial external and fiscal imbalances emerged. These were financed by public sector borrowing, depleting international reserves and large accumulation on payment arrears on external trade credits and as such created problems in our BOP. In 1984, the austerity measures were introduced to redress the lagging deficits in the country's BOP, these included: slashing of budgetary expenditures, administrative control for import licenses, and upward review of tariffs. This led to the adoption of the structural adjustment programme [SAP] in 1986, which has amongst other things, combined exchange rates and trade policy reforms to promote economic efficiency and long term growth in the stabilization policies designed to restore BOP equilibrium and price stability. The BOP was divided into three components prior to 1993 but has been henceforth divided into two major components as shown below:

(1) Current Account: It is divided into two components: Current account consists of balance of trade and balance of services. Balance of Trade is a summary of receipts and payments for visible export and import for a period of one year. It also includes summary of receipts and payments for invisible export and import over a period of time.

(2) Capital Account: records international transactions in financial assets. Therefore it is a summary of outflow of financial capital between a country and the rest of the world, over a period of one year.

The current account and the capital account imbalance of payments has been the major bane to economic development in Nigeria. This bane is resulting from the high external and internal debt ratio, inflation, interest rate, macroeconomic variables instability, etc.

The banes have been attempted to be solved by the government of Nigeria through fiscal and monetary policies, structural adjustment program, and stabilization policy. Most of these policies were introduced by the World Bank and the international monetary fund (IMF) (Obadan, 2013).



The structure of Nigeria economy is predominantly non-oil export (NOE) and/or oil export (OE). In most recent times the contribution of NOE sectors on the one hand to the GDP has been dwindling and/or while on the other hand; the OE sector has been contributing significantly to the GDP. Foreign trade (or international trade) is comprised of export and import (export minus import). However, the balance of trade is equal to export minus import. Sometimes, export will be greater than import or vice versa or both are equal to zero. The latter is the case of Nigeria; the reason is not far-fetched because our importations are consumable goods and luxuries (ostensible) instead of industrial machineries (Oloye, 2012).

2. APPROACHES TO BALANCE OF PAYMENT COMPUTATION

In literatures, three major approaches have been mainly used in the computation of balance of payment across countries over the years. The approaches are: Elasticity Approach, Absorption Approach and the Monetary Approach. However this paper is focused on the Absorption approach to balance of payment and its criticisms.

2.1 Elasticity Approach

This approach was put forward by a British economist; Alfred Marshall but was later refined by another economist Marshall Learner. It is a theory of the Balance of Trade. It shows how a change in exchange rate can bring about a change in balance of trade position of a country. It states that for a favorable balance of payment, the elasticity of imports and exports of a country should sum up to unity. The elasticity approach tries to predict the outcome policy changes will have on the balance of payments. For example, this approach illustrates how exchange rates will affect the balances. Further, the elasticity approach assumes that if the BOP is in equilibrium, devaluation can improve the balance of payments. However, for devaluation to function successfully, the total of price elasticity of domestic and foreign demand for imports has to increase. When a country devalues a currency, it improves the balance of payments under ideal conditions. This ideal condition is known as the Marshall-Lerner condition. The Marshall-Lerner condition states; that a currency devaluation will eventually improve the balance of payments. In order to accomplish this increase in the BOP, however, the sum of demand elasticity for imports and exports has to increase that is greater than one (Welfens P.J.J, 2009). When a country devalues its currency, the price of exports will decrease. This, in theory, will increase the demand for these exports. However, for increase demand to occur, the exported products have to be elastic products (Shuaib, Ekeria and Ogedengbe, 2015).

2.2 Monetary Approach

This approach is an extension, of the neoclassical quantity theory of money. This approach is credited to David Hume - **price specie flow mechanism** but J.J Polark popularized it: an IMF staff. This approach emphasizes the role of money in balance of payment adjustment process. Unlike the elasticity's and absorption approaches, the monetary approach to balance of payment (MABP) incorporates both the current account (trade in goods and services] and trade in financial assets.

This is a theory by Sydney Alexander (1952) that analyses trade balance as difference between aggregate domestic income and aggregate domestic expenditure (absorption). The theory

The basic premise is that any balance of payments disequilibrium is based on monetary disequilibrium, or the difference between the amount of money people want to hold and the amount supplied by monetary authorities (Jhinghan, 2006].

2.3 Absorption Approach To Balance Of Payment

This is a theory by Sydney Alexander (1952) that analyses trade balance as difference between aggregate domestic income and aggregate domestic income and aggregate domestic expenditure (absorption). The theory emphasizes on how domestic spending on domestic goods changes relative to domestic output. The theory focuses on current account balance and balance of trade which is viewed as the difference between what the economy produces and what it takes for domestic use. In economics, absorption is the total demand for all final marketed goods and services, as the absorption is equal to the sum of all domestically produced goods consumed locally and all imports. Therefore, absorption approach is a theory of balance of trade in goods and services that emphasizes how domestic spending changes relative to domestic production. It is equal to the national income $[Y = C + G + (X - M)]$ minus the balance of trade $(X - M)$. The term was coined and its relation to the balance of trade identified by Sidney Alexander in 1952. The term "absorption" is often used in real estate to access demand for leasing space.



The central tenet of the absorption approach is that a favorable configuration of price elasticity may not be sufficient to produce a positive balance of payments effect resulting from devaluation.

The starting point of the absorption approach is the national income identity:

$$Y = C + I + G + X - M \quad \text{-----(1)}$$

Where

Y = national income;

C = private consumption of goods and services purchased at home and from abroad;

I = total investment by firms as well as by government;

G = government expenditure on goods and services;

X = exports of goods and services; and

M = imports of goods and services; and

National income identity can be used to explain the current account as the difference between optimal savings and investment decisions. Combining C + I + G expenditure terms into a single term, A, representing domestic absorption (ie total domestic expenditure] and X - M terms into B, net exports /trade balance, we get:

$$Y = A + B \quad \text{-----(2)}$$

Thus national income is the sum of absorption and the trade balance. It follows that the trade balance must always be the difference between income and absorption, as given by

$$B = Y - A \quad \text{-----(3)}$$

Thus if $Y > A$, the trade balance is in surplus, while if $Y < A$, it is in deficit.

3. POLICY IMPLICATIONS

This model has two policy implications for the balance of trade. For a deficit situation of a country:

- (a) Either output goes up, i.e. a country strives to increase output so that it can have basis for more export or the country has to reduce import or it does both.
- (b) Domestic absorption will have a cut back deliberately so that output will be freed which can be sold abroad. That is, export increases and import reduces to earn income. Hence, trade imbalances are eliminated.

Mathematically:

If devaluation is to affect the trade balance, it can do so in two ways:

- (i) It can change production as a result of an induced change in absorption and (ii) It can change the amount of real absorption associated with any given level of real income. Thus a change in the trade balance (dB) is equal to the difference between the change in output (dY) and the change in absorption (dA);

$$dB = dY - dA \quad \text{-----(4)}$$

Devaluation leads to two effects on the absorption of goods and services in a devaluing country.

First, devaluation leads to an increase in real income, which boosts real DE



Equation (6) is useful because it provides answers to three basic questions pertaining to the processes whereby;

- (i) devaluation affects income,
 - (ii) a change in income affects absorption, and
 - (iii) devaluation affects absorption directly at any given level of income.
- These questions consumption (absorption) proportionately to the increase in income (ie. cdY).

Secondly, devaluation has a direct effect on absorption (DE):

$$dA = cdY - DE. \text{ -----(5)}$$

Where

c is the propensity to absorb, which is equal to the propensity to consume plus the propensity to invest and DE is the direct effect of devaluation on absorption. Substituting equation(5) into equation(4), we obtain.

$dB = (1 - c) dY + DE$ (also pertain to the values of c and DE). To provide answers to these questions in precise terms, one has to take into consideration the entire economic structure of the devaluing country and the rest of the world (Dhliwayo Moosa & Bhatti 2010).

4. EFFECTS OF DEVALUATION ON BALANCE OF PAYMENT

(i) **Income Effects**

If there are idle resources, devaluation increases exports and reduces imports of the devaluing country. Therefore, with the expansion of export and import - competing industries, income increases. The additional income so generated in the economy will further increase income via the multiplier effect. This will lead to improvement in BOP situation. On the other hand, if resources are fully employed in the economy, devaluation cannot correct an adverse BOP because national income cannot rise. Rather, prices may increase thereby reducing exports and increasing imports, hence worsening the BOP situation.

(i) **Terms of Trade Effect**

The effect of devaluation on national income is also through its effects on the terms of trade. The conditions under which devaluation worsens the terms of trade, national income will be adversely affected and vice versa. Generally, devaluation worsens the terms of trade because the devaluing country has to export more goods in order to import the same quantity as before. Consequently, the trade balance deteriorates and national income declines. If prices are fixed, after devaluation, the terms of trade will improve because exports increase and imports decline. The importing country pays more for increased exports of the devaluing country than it receives from its imports. Thus the trade balance of the devaluing country improves and its national income rises.

(iii) **Real Cash Balance Effects**

When a country devalues its currency, its domestic price rises. If the money supply remains constant, the real value of cash balances held by the people falls. In order to replenish their cash balances, people start saving more. This can be possible only by reducing their expenditure and absorption. This is the real cash balance of devaluation. If people hold assets and if devaluation reduces their real cash balances, they sell them. This reduces the price of assets and increases the interest rate. This, in turn, will reduce investment and consumption, given the constant money supply. As a result, absorption will be reduced. This is the asset effect of real cash balance effect of devaluation.

(iv) **Money Illusion Effect**

The presence of money illusion also tends to reduce direct absorption. When prices rise due to devaluation, consumers think their real incomes have fallen, even when their money income has risen. They have the money illusion under whose influence they reduce their consumption expenditure or direct absorption.



(v) **Income Redistribution Effect**

Direct absorption falls automatically if devaluation redistributes income in favour of people with high marginal propensity to save and against those with high propensity to consume. If the marginal propensity to consume of workers is higher than those of profit-earners, absorption will be reduced. Further, when money incomes of lower income groups increase with devaluation, they enter the income tax bracket. When they start paying income tax, they reduce their consumption as compared with higher income groups which are already paying the tax. This leads to reduction in absorption in case of the former.

(vi) **Expenditure-Reducing Policies**

Direct absorption is also reduced if the government adopts expenditure-reducing monetary fiscal policies which are deflationary. They will make devaluation successful in reducing BOP deficit. But they will create unemployment in the country.

5. CRITICISM OF THE INCOME ABSORPTION APPROACH

1. Neglects Price Effects approach, fails to recognize the negative price effects of devaluation, which is very important in any developing country.
2. It focuses mainly on the balance of trade as a proxy to balance of payment, neglecting other components of balance of payment such as imbalance of service, balance of capital and financial accounts. Therefore, it does not sufficiently capture the aggregate consumption taking place between a country and the rest of the world.
3. For the approach to be effective, marginal propensity to consume (MPC) and marginal propensity to invest (MPI) must be accurately estimated. Estimation of MPC and MPI are very vital in using absorption approach. In reality, estimation of these propensities is pretty difficult especially in the developing countries. Hence, this approach is unlikely to accurately measure financial transactions between countries.
4. Theoretically, it is expected that the resources realized from reduction in absorption would be utilized to improve trade balance. However, such assumption is not always feasible. The absorption approach fails as a corrective measure of BOP deficit under a fixed exchange rate system. When prices rise with devaluation, people reduce their consumption expenditure. With money supply remaining constant, interest rates rises which brings a fall in output along with absorption. Thus devaluation will have little effect on BOP deficit (David, Fisher and Dornbush, 2005).



6. RECOMMENDATION

1. Since the civilians took over power there has been massive misappropriation of public funds, the government of the day has to adjust its reckless spending, so that monetary authorities can review its monetary and credit policies so as to stimulate investment, to foster economic growth and development, -thereby improving the balance of payment.
2. Government needs to exercise discipline in curtailing its non-productive expenditures in order to reduce its budget deficit and in ensuring that its spending is reflected on the- current account using the absorption approach.
3. Export promotion and import substitution strategies should be embarked upon by the Federal Ministry of Trade and Investment to increase the non-oil exports and reduce the volume of imports. This will further reduce the balance of payments deficits and the over-valuation of the official naira exchange rate which in recent times have been very high when compared to other currencies in the international: market and the parallel market.
4. The Nigerian economy is plagued with fiscal deficit as a result of increase in money supply (inflation). Hence, the financing of fiscal deficit through increase in money supply must be checkmated by The monetary authorities, by being proactive in its monetary policies and keeping inflation at a single digit level.
5. Government should encourage the exportation of non-oil goods into the world market, since this sector has fallen sharply on its contribution to GDP.

7. CONCLUSION

From this study, it is conclusive to say that there has been persistent and rising fiscal deficit in Nigeria, thus the country's balance of payment profile is characterized by more years of deficit than surplus. Therefore, in trying to achieve and maintain a healthy balance of payment position, to safe guard the external value of national currency, there is need for fiscal discipline, active government participation for development and relevant trade policies.



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