Is Balance of payments always in Equilibrium ?

There exists a deficit or surplus in the balance of payments (BOPs). when $B = R_f = P_f$ the BOPs is in equilibrium, where B represents the balance of payments, R_f receipts from foreigners P_f payments made to foreigners. when $R_f - P_f > 0$, it implies receipts from foreigners exceed payments made to foreigners and there is surplus in the BOPs. On the other hand, when $R_f - P_f < 0$ or $R_f < P_f$ there is deficit in the BOPs as the payments made to foreigners exeed receipts from foreigners.

If net foreign lending and investment abroad are taken, a flexible exchange rate creates an exports over imports. The domestic currency depreciates in terms of others. The exports become cheaper relatively to imports. It can be shown in equation form :

$$X + B = M + I_f$$

where X represents exports, M imports, I_f foreign investments, B foreign borrowing.

$$\text{or} \quad X - M = I_f - B$$

$$\text{or} \quad (X - B) - (I_f - B) = 0$$

The equation shows the BOPs in equilibrium. Any positive balance in its current account is exactly offset by a negative balance on its capital account and vice-versa. In the accounting sense the BOPs always balances. This can be shown with the help of the following equation:

$$C+S+T = C+I+G+(X-M)$$

or $$Y = C+I+G+(X-M)$$

where C represents consumption expenditures, S domestic saving, T tax receipts, I investment expenditure, G govt. expenditures, X exports of goods and services and M imports of goods and services.

In the above equation C+S+T is GNI or national income (Y), and C+I+G = A where A is called "absorption". In the accounting sense, total domestic expenditures (C+I+G) must equal current income (C+S+T) that is A = Y. Moreover, domestic saving (S_d) must equal domestic investment (I_d). Similarly, an export surplus on current account ($X > M$) must be offset by an excess of domestic saving over investment ($S_d > I_d$). Thus, BOPs is always in equilibrium in the accounting sense.

When all the items in the balance of payments are included that there is no possibility of a deficit or surplus. But if some items are excluded from a country's balance of payments and then a balance is struck, it may show a deficit or surplus.

There are three ways of measuring the deficit or surplus in the balance of payments. First, there is the basic balance which includes the current account balance and the long-term capital account balance. Second, there is the net liquidity balance which includes the basic balance and the short-term private non-liquide capital balance, allocation of SDRs and errors and omissions. Third, there is the official settlements balance which includes the total net liquidity balance and short-term private liquid capital balance.

The relationship between these balances is summarised in Table – I below :-

Trade balance	a
Transfer payments balance	b
current account balance	$c (= a+b)$
Long-term capital balance	d
Basic balance	$e (= c+d)$
Short-term private non-liquid capital balance	f
Allocation of SDRs	g
Errors and omissions	h
Net liquidity balance	$i (= e+f+g+h)$
Short-term private liquid capital balance	j
Official settlements balance	$k (= i+j)$

Each balance would give a different figure of the deficit. The items that are included in a particular balance are placed "above the line" and those excluded are put "below the line". Items that are placed below the line are called "settlement" or "accommodating" or "compensatory" items. On the other hand, items that are put above the line are called "autonomous" items. In theoretical analysis, a disequilibrium in the BOPs means a balance on autonomous items, compensating short-term capital transactions are meant to redress a disequilibrium in the autonomous items of the BOPs.

The above analysis is based on the assumption of fixed exchange rates. Thus a deficit or surplus in the BOPs is possible under a system of fixed exchange rates. But under freely floating exchange rates, there can in principle be no deficit or surplus in the BOPs. Further, BOPs always balances in an ex-post accounting sense, according to the basic principle of accounting. Lastly, such a BOPs can be in equilibium only if there are no compensating transaction.