CBSE Test Paper-05

Chapter 05 Balance of Payments

1. Devaluation is a **(1)**
    a. Increase in the price of domestic currency in terms of all foreign currencies by the govt.
    b. Reduction in the price of foreign currency in terms of domestic currencies by the govt.
    c. Reduction in the price of domestic currency in the foreign exchange market by the govt.
    d. Reduction in the price of domestic currency in terms of all foreign currencies by the govt.
2. Balance of trade is in surplus when **(1)**
    a. the value of exports of goods is equal to the value of imports of goods
    b. None of these
    c. the value of exports of goods is greater than the value of imports of goods
    d. the value of imports of goods is greater than the value of exports of goods
3. Flexible exchange rate system has the advantage: **(1)**
    a. Automatic adjustment of balance of payments
    b. None of these
    c. Easy to borrow from world bank
    d. Encourages exports
4. Currency depreciation occurs when **(1)**
    a. decrease in the price of the domestic currency
    b. Increase in the domestic currency price of the foreign currency
    c. decrease in the domestic currency price of the foreign currency
    d. Increase in the price of the domestic currency
5. Define flexible exchange rate. **(1)**

6. How can Reserve Bank of India help in bringing down the foreign exchange rate which is very high? **(1)**

7. What is floating exchange rate? **(1)**

8. What are invisible items? **(1)**

9. Describe any three sources of demand for foreign exchange. **(3)**

10. Explain the meaning of deficit in BOP. **(3)**

11. Name two 'invisibles' of the balance of payments account. **(4)**

12. Giving reasons state whether the following statements are true or false:

    i. Excess of foreign exchange receipts over foreign exchange payments on account of accommodating transactions equals deficit in the balance of payments.
    ii. Export and import of machines are recorded in capital account of the balance of payments account. **(4)**

13. Explain the meaning of deficit in balance of payments (BOP). What are the major factors responsible for this? **(4)**

14. i. In which sub-account and on which side of Balance of Payments Account will foreign investments in India be recorded? Give reasons.
    ii. What will be the effect of foreign investments in India on exchange rate? Explain. **(6)**

15. Explain the distinction between Autonomous and Accommodating transations in balance of payments. Also explain the concept of balance of payments 'deficit' in this context. **(6)**

CBSE Test Paper-05

Chapter 05 Balance of Payments

Answers

1. d. Reduction in the price of domestic currency in terms of all foreign currencies by the govt.
   Explanation: Devaluation refers to fixed exchange regime where exchange rate is determined exogenously, by central bank.
2. c. the value of exports of goods is greater than the value of imports of goods
   Explanation: A trade surplus is an economic measure of a positive balance of trade, where a country's exports exceed its imports. A trade surplus represents a net inflow of domestic currency from foreign markets. trade surplus helps to strengthen a country’s currency; however, this is dependent on the proportion of goods and services of a country in comparison to other countries as well as other market factors. Countries can also highly control their currency through foreign investment efforts.
3. a. Automatic adjustment of balance of payments
   Explanation: Automatic adjustment of balance of payments
4. b. Increase in the domestic currency price of the foreign currency
   Explanation: Increase in domestic currency price of the foreign currency implies decrease in the purchasing power of domestic currency in terms of foreign currency.
5. The rate of exchange which is determined by the market forces of demand and supply of foreign currencies in the foreign exchange market, is termed as flexible exchange rate system.
6. The Reserve Bank of India can help to bring down the high foreign exchange rate by selling foreign exchange from its reserve. As a result ,the supply of foreign currency would increase in the foreign exchange market leading to the fall in its value.
7. Floating exchange rate also called the flexible exchange rate is the one where the exchange rate is determined by the forces of demand and supply.

8. Invisible items include export and import of services. They are invisible because they are intangible and they cannot be seen crossing the border. Invisibles are further classified as factir services and non factor services. viously
9. The demand for foreign exchanges arises because people need it to make payments. The three sources of demand for foreign exchange are given below:
    i. **Purchase of foreign goods by domestic residents:** To purchase foreign goods domestic residents need foreign exchange So, this results in demand for foreign exchange. It is also demanded to make payment for the purchase of assets like land, shares bonds etc. in foreign countries.
    ii. **Re-payments of international loans:** International loans have to be paid back in foreign exchange, so, this also results in demand for foreign exchange.
    iii. **Tourism:** Foreign exchange is required to meet expenditure incurred on foreign tours.

10. When autonomous foreign exchange payments exceeds autonomous foreign exchange receipts, the difference is called balance of payments deficit. In other words it means that the country imports more goods, services and capital than it exports.

11. Invisible items: They refer to all types of services which are rendered to rest of the world as exports or received from the rest of the world as imports. Services are invisible simply because they are not made of any matter or material.i.e. they are intangible and they cannot be seen crossing the border. Example:

    i. Export and import of services such as shipping, insurance and banking services.
    ii. Expenditure by the tourists.
12. i. It is true that excess of foreign exchange receipts over foreign exchange payments on account of accommodating transactions equals deficit in the balance of payments this is because accommodating transactions remove both surplus and deficit of Balance of Payments account. As outflow causes deficit, which has to fulfilled with inflows.
    ii. False. we know that exports and imports are recorded in the current account, therefore export and import of machines will also be recorded in current account of Balance of Payments account.
13. Deficit in balance of payment occurs when inflow of foreign exchange is less than the outflow of foreign exchange in the economy. It brings disequilibrium in the BOP.

Deficit in balance of payment implies that the foreign countries have some claims against the domestic country. In such situations,The central bank may sell foreign currency, foreign securities or gold or borrow from the IMF . The causes for deficit can be classified as

i. Economic causes
ii. Political causes
iii. Social causes.

Deficit BOP = When imports (Visible + Invisible) > Exports (Visible and Invisible).

Factors:

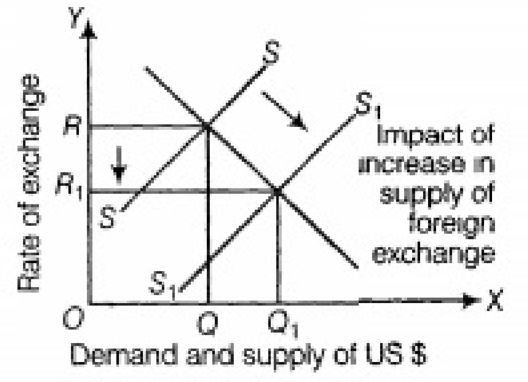
i. Large scale development expenditure which may cause large imports causing deficit in BOP.
ii. High domestic prices reduce exports.
iii. New sources of supply, new and better substitutes to existing products and change in costs results in deficit in BOP.
iv. Political instability may cause large capital outflows.

All these factors lead to more inputs or reduce exports which lead to deficit in BOP.

14. i. **In the credit side of the capital account of the Balance of Payments Accounts,** foreign investments in India will be recorded. Capital account records the capital transactions such as loans and investments between India and the rest of the world, which causes a change in the assets and liabilities status of the residents of the country or the government. One of the components of the capital account is 'foreign investment'. Foreign investment includes foreign direct investment (FDI) and foreign institutional investment (FII) or portfolio investment by the residents of a nation abroad or by the rest of the world in the domestic country. Investments made in the assets of a foreign country is FDI. Here, the assets of the foreign country are owned and controlled by the government or any resident within the domestic territory. On the other hand, FII means investment made in the assets of a foreign country. Here, the assets of the foreign country are not owned and controlled by the government or any resident within the domestic territory. So, foreign investments in India will be a part of this component and therefore will be recorded in the capital account. In the capital account, all transactions causing the flow of foreign exchange in the country are recorded on the credit side. Since

investments from abroad will cause a flow of foreign exchange in the country, therefore it will be recorded in the credit side.

ii. The market exchange rate will tend to fall due to foreign investment. The foreign investors who want to invest in India will increase the supply of foreign exchange. At the supply of foreign exchange rises, with demand remaining unchanged, the market exchange rate will fall, as is explained in the diagram given below



As the supply of foreign exchange increase, the exchange rate falls from OR to OR_1. This is a situation of appreciation of the domestic currency.

15. Autonomous transactions are the transactions between the residents of two countries which take place due to the consideration of profit. Autonomous items are not conditioned by the BoP status of the country, i.e. these are independent. These transactions are not done to establish identity of BoP. These are also known as ‘above the line items’ and take place in both the accounts of BoP, i.e. current and capital account.

Accommodating transactions are those transactions which are not done due to the consideration of profit but to restore identity of BoP. These are undertaken to maintain balance in the BoP account. These transactions correct the disequilibrium in autonomous items of BoP account. Accommodating transactions are also known as ‘below the line items’ and include foreign exchange reserves and borrowings to meet BoP deficit.

When the payments of a country on account of autonomous transactions exceed the receipts of the country on account of autonomous transactions, this difference is termed as BoP deficit.

BoP Deficit = Receipts on Account of Autonomous Transactions < Payments on Account of Autonomous Transactions.