

Open Economy Macroeconomics

1. "As per the National Stock Exchange (NSE) data, dated 9th June, 2023, there was a net selling off worth 309 crore by Foreign Institutional Investors (FIIs) over the period of one month i.e., 9th May, 2023 – 9th June, 2023."

The above-mentioned transactions will be recorded on _____ side of _____ account of Balance of Payments of India. (2024)

(Choose the correct alternative to fill in the blanks)

- (A) Debit, Current
- (B) Credit, Capital
- (C) Credit, Current
- (D) Debit, Capital

Ans. (D) Debit, Capital

2. Surplus in Balance of Payments (BOP) refers to the excess of _____. (2024)

(Choose the correct alternative to fill in the blank)

- (A) Autonomous payments over Autonomous receipts
- (B) Current Account payments over Autonomous receipts
- (C) Capital Account receipts over Capital Account payments
- (D) Autonomous receipts over Autonomous payments

Ans. (D) Autonomous receipts over Autonomous payments

3. Suppose, the Balance of Trade of an imaginary economy shows a favourable balance of ₹ 500 crore. The values of merchandise exports are ₹ 1200 crore and transfer payments are ₹ 400 crore.

The value of merchandise imports would be ₹ _____ crore. (2024)

(Choose the correct alternative to fill in the blank)

- (A) 1700
- (B) 750
- (C) 700
- (D) 900

Ans. (C) 700

4. Distinguish between fixed exchange rate system and flexible exchange rate system. (2024)

Ans. Under the Fixed Exchange Rate System, the foreign exchange rate is fixed by the government. This exchange rate system helps in maintaining stability in the value of the domestic currency vis-à-vis foreign currencies.

Whereas;

Under the Flexible Exchange Rate System, the foreign exchange rate is determined by the interaction of market forces of demand and supply. Flexible exchange rate keeps fluctuating according to the demand and supply.

5. Read the following text carefully from "The Economic Times" dated 8th June, 2023 : (2024)

"The Reserve Bank of India's (RBI's) rate setting panel unanimously decided to keep the benchmark lending rate unchanged at 6.5%. The committee voted to remain focused on the withdrawal of accommodating monetary policy."

On the basis of given text and common understanding, answer the following questions:

(a) Identify and discuss the economic issue indicated in the above text.

Ans. Inflation in the economy may be the economic issue indicated in the above text. The situation of excess demand may be the underlying cause behind the decision taken by the Reserve Bank of India (RBI) to keep the benchmark lending rate unchanged at 6.5%.

(b) Discuss the likely consequence on money supply if the rate setting panel would have decreased the said rate.

Ans. If the rate setting panel would have decreased the benchmark lending rate, the commercial banks may reduce their lending rates. Consequently, it may encourage the borrowings by the general public leading to an increase in the money supply in the economy.

Previous Years' CBSE Board Questions

6.1 Balance of Payments Account – Meaning and Components

MCQ

- An Indian company receives a loan from a company located abroad. This transaction would be recorded on the ____ side of ____ account in India's Balance of Payment.
(a) Credit, Current (b) Debit, Current
(c) Credit, Capital (d) Debit, Capital
(2023) **U**
- Read the following statements carefully.
Statement-I : Balance of Payments account is always balanced in accounting sense.
Statement-II : Autonomous transactions, restore balance in Balance of Payments account.
In the light of the given statements, choose the correct alternative from the following:
(a) Statement-I is true but statement-II is false.
(b) Statement-I is false but statement-II is true.
(c) Both statements I and II are true.
(d) Both statements I and II are false. (2023)
- Identify, which one of the following is an intangible item in Balance of Payments (BoP).
(a) Export of food grains
(b) Import of crude oil
(c) Export of Information Technology (IT) services to U.S.A.
(d) Import of coal by steel company of India. (2023)
- _____ is the difference between value of export and import of services in a given period of time.
(a) Balance of trade
(b) Net Invisibles (services)
(c) Trade surplus
(d) Current account of BoP (Term-I, 2021-22) **R**
- Which of the following items will be entered on the credit side of current account in Balance of Payments of a country?
(a) Borrowings from abroad
(b) Import of machinery
(c) Export of tea
(d) Foreign Direct Investment (Term-I, 2021-22)
- In context of current account, identify the incorrect statement from the following:
(a) Export of goods and services are recorded as credit items.
(b) Import of goods and services are recorded as debit items.

- All transfer payments are recorded as debit items.
(d) All transfer receipts are recorded as debit items.
(Term-I, 2021-22)
- Which of the following statement is incorrect?
(a) Balance of Payment (BoP) is a flow concept.
(b) Balance of Trade include export and import of goods only.
(c) Charity to foreign countries is recorded in capital account of BoP.
(d) Balance of Payment is broader concept than Balance of Trade. (Term-I, 2021-22)
- Which of the following items is included in capital account of Balance of Payments of a country?
(a) Interest and rent received from abroad
(b) Income from banking services
(c) Remittances from abroad
(d) Foreign direct investment (Term-I, 2021-22) **An**
- Foreign exchange transactions dependent on other foreign exchange transactions are called :
(a) Current account transactions
(b) Capital account transactions
(c) Autonomous transactions
(d) Accommodating transactions (Delhi 2016)
- Foreign exchange transactions which are independent of other transactions in the balance of payments account are called :
(a) Current transactions
(b) Capital transactions
(c) Autonomous transactions
(d) Accommodating transactions (AI 2016)

VSA (1 mark)

- _____ is one of the most important sources of demand for foreign currency. (2020) **R**
- Give the meaning of Balance of Payments.
(Delhi 2017, AI 2014)
- Give the meaning of Balance of Trade. (Delhi 2014)

SAI (3 marks)

- "Capital account transactions lead to future claims." Defend or refute the given statement with valid arguments. (2023) **U**
- Indian investors lend abroad. In which sub-account and on which side of the balance of payments account such lending is recorded? Give reasons. (AI 2016)
- Name the broad categories of transactions recorded in the 'capital account' of the balance of payments accounts. (Delhi 2015)

17. Name the broad categories of transactions recorded in the 'current account of the balance of payments accounts. (Delhi 2015)
18. Where will sale of machinery to abroad be recorded in the balance of payments account? Give reasons. (Delhi 2015)
19. Where is 'borrowings from abroad' recorded in the balance of payments accounts? Give reasons. (AI 2015) (An)
20. Distinguish between current account and capital account of the balance of payments account on the basis of its components. (Delhi 2014 C)
21. Distinguish between balance of trade and balance on current account of the balance of payments account. (AI 2014 C)

SA II (4 marks)

22. Distinguish between autonomous and accommodating transactions of Balance of Payments account. Explain the significance of this distinction. (Delhi 2015 C, AI 2014) (An)
23. In the context of Balance of Payments account, state whether the following statements are true or false. Give reasons for your answer.
- Profits received from investments abroad is recorded in capital account.
 - Import of machines is recorded in current account. (AI 2015 C)

6.2 Balance of Payments Account - Surplus and Deficit

MCQ

24. 'Deficit' in Balance of Payment (BoP) refers to the excess of
- Current account payments over current account receipts.
 - Capital account payments over Capital account receipts.
 - Autonomous payments over Autonomous receipts.
 - Accommodating payments over accommodating receipts. (2023) (R)
25. Suppose, country X, has more inflation than country Y. Which of the following is most likely situation to happen in such a case, assuming other factors being constant?
- A surplus trade balance in country X
 - A deficit trade balance for country X
 - A rise in exports from country X to country Y
 - A deficit trade balance for country Y (2023)
26. If the value export of merchandise is ₹ 1,500 crore and imports of goods are 20 percent more than

exports. The value of imports and trade deficit will be ₹ _____ crores and ₹ _____ crores respectively

- 1800, 3300
- 1800, 300
- 1200, 300
- 1200, 3300 (Term-I, 2021-22)

VSA (1 mark)

27. What is 'current account deficit' in Balance of Payments? (Delhi 2014) (R)

SA I (3 marks)

28. Differentiate between Surplus in Balance of Trade and Current Account Surplus. (2023)
29. "Trade deficit must exist if a country is facing a situation of current account deficit." Justify the given statement. (2023) (U)
30. Explain the meaning of Balance of Payments deficit. (Delhi 2014)

6.3 Foreign Exchange Rate

MCQ

31. "Considering the depreciation of Indian Currency (₹) in the international market, the Reserve Bank of India (RBI) has decided to purchase Indian currency (₹) in open market." This represents ____ exchange rate system.
- fixed
 - flexible
 - managed floating
 - manipulated (2023) (Ap)
32. Price of one currency in relation to another currency, determined by the free market forces, is known as ____.
- Equilibrium Price
 - Fixed Exchange Rate
 - Foreign Exchange Rate
 - Flexible Exchange rate (Term-I, 2021-22)
33. Given below are two statements. One is Assertion (A) and another is Reason (R).
- Assertion (A) :** Foreign exchange rate supports the comparison of international costs and prices.
- Reason (R) :** Foreign exchange rate is the price of one currency in terms of another commodities.
- In the context to the above two statements which of the following is correct?
- Both A and R are true and R is the correct explanation of A.
 - Both A and R are true but R is not the correct explanation of A.
 - A is true but R is false.
 - A is false but R is true. (Term-I, 2021-22)
34. Given below are two statements. One is Assertion (A) and another is Reason (R).
- Assertion (A) :** Managed floating exchange rate

system is an amalgamation of fixed exchange rate and flexible exchange rate.

Reason (R) : Central Bank can manipulate the flexible exchange rate system.

In the context to the above two statements which of the following is correct?

- (a) Both A and R are true and R is the correct explanation of A.
- (b) Both A and R are true but R is not the correct explanation of A.
- (c) A is true but R is false.
- (d) A is false but R is true.

(Term-I, 2021-22)

VSA (1 mark)

- 35. What is floating exchange rate? (AI 2014)
- 36. What is 'managed floating exchange rate'? (AI 2014)
- 37. Define foreign exchange rate. (AI 2014)

SA I (3 marks)

- 38. "The central bank needs to intervene under the managed floating system".
Do you agree with the given statement? Support your answer with valid reasons. (2023) **Ap**

- 39. "Indian Rupee (₹) plunged to all time low of ₹ 74.48 against the US Dollar (\$)"

—The Economic Times

In the light of the above report, discuss the impact of the situation on Indian imports. (2019)

- 40. Describe any three sources of demand for foreign exchange. (Delhi 2015 C)
- 41. What are fixed and flexible exchange rates? (AI 2015)

LA (5/6 marks)

- 42. Discuss briefly the meaning of :
 - (a) Fixed Exchange Rate
 - (b) Flexible Exchange Rate
 - (c) Managed Floating Exchange Rate. (2018)

6.4 Determination of Exchange Rate in a Free Market

MCQ

- 43. Read the following statements carefully.
Statement-I : Depreciation of domestic currency may lead to a rise in exports.
Statement-II : Due to the depreciation of Indian National Rupee (₹), purchasing power of US Dollar (\$) may increase.
In the light of the given statements, choose the correct alternative from the following:
 - (a) Statement-I is true but statement-II is false.

- (b) Statement-I is false but statement-II is true.
- (c) Both statements I and II are true.
- (d) Both statements I and II are false. (2023)

- 44. Suppose, the price of one UK pound (£) has increased from ₹ 70 to ₹ 80, owing to market forces. This means that value of Indian Currency (₹) has _____.
 - (a) appreciated
 - (b) depreciated
 - (c) revalued
 - (d) devalued (2023) **Ap**
- 45. Other things remaining unchanged, when in a country the price of foreign currency rises, national income is :
 - (a) Likely to rise
 - (b) Likely to fall
 - (c) Likely to rise and fall both
 - (d) Not affected. (Delhi 2015)
- 46. Other things remaining the same, when in a country the market price of foreign currency falls, national income is likely :
 - (a) to rise
 - (b) to fall
 - (c) to rise or to fall
 - (d) to remain unaffected. (AI 2015)

SA I (3 marks)

- 47. Giving valid reasons, state whether the following statements are true or false:
 - (i) Dividend received from investment abroad is recorded on the credit of the capital account.
 - (ii) Depreciation of the Indian Currency will lead to promotion of Indian exports. (2023) **U**
- 48. Indian investors lend abroad. Explain the impact of this lending on market exchange rate. (AI 2016)
- 49. Give the meaning of 'devaluation and depreciation' of domestic currency. (AI 2015 C)
- 50. Recently government of India has doubled the import duty on gold. What impact is it likely to have on foreign exchange rate and how? (Delhi 2014)
- 51. Visits of foreign countries for sight seeing etc. by the people of India is on the rise. What will be its likely impact on foreign exchange rate and how? (Delhi 2014) **U**
- 52. How does giving incentives for exports influence foreign exchange rate? Explain. (Delhi 2014)
- 53. Explain the effect of appreciation of domestic currency on exports. (AI 2014)
- 54. Foreign exchange rate in India is on the rise recently. What impact is it likely to have on exports and how? (AI 2014)
- 55. When foreign exchange rate in a country is on the rise? What impact is it likely to have on imports and how? (AI 2014) **U**

56. "India is taking huge leaps in the index of Ease of doing Business; as result many MNCs are shifting their production base to India." In the light of the above statement, comment upon the flow of foreign exchange and its likely impact on the Indian Economy. (2020) **Ap**

57. The central bank takes steps to control rise in the price of foreign exchange. Explain the economic values it involves as far as the common man is concerned. (Delhi 2014 C)

58. Why does the demand for foreign currency fall and supply rises when its price rises? Explain. (Delhi 2017)

CBSE Sample Questions

6.1 Balance of Payments Account - Meaning and Components

MCQ

- Read the following statements carefully.
Statement I : Export of financial services by India will be recorded on credit side of current account.
Statement II : Foreign Direct Investment in India will be recorded on the credit side of capital account.
 In the light of the given statements, choose the correct alternative.
 (a) Statement I is true and statement II is false.
 (b) Statement I is false and statement II is true.
 (c) Both statements I and II are true.
 (d) Both statements I and II are false. (2022-23) **R**
- Given below are two statements, one labelled as Assertion (A) and the other as Reason (R).
Assertion (A) : Trade of invisible items between two nations is a part of capital account of Balance of Payment.
Reason (R) : Transaction that affect the asset-liability status of a country in relation to the rest of the world are known as Capital Account transaction.
 In the context to the above two statements which of the following is correct?
 (a) Both A and R are true and R is the correct explanation of A.
 (b) Both A and R are true but R is not the correct explanation of A.
 (c) A is true but R is false.
 (d) A is false but R is true. (Term-I, 2021-22)
- Given below are two statements, one labelled as Assertion (A) and the other as Reason (R).
Assertion (A) : Acquisition of a domestic (Indian) company by a foreign (Australia) company will be recorded on the credit side of Balance of Payments Account.
Reason (R) : It leads to outflow of foreign exchanges from the domestic economy.
 In the context to the above two statements which of the following is correct?

- Both A and R are true and R is the correct explanation of A.
- Both A and R are true but R is not the correct explanation of A.
- A is true but R is false.
- A is false but R is true. (Term-I, 2021-22) **Ap**

4. Under the Balance of Payments, structure of a nation, the two main categories of account are _____ and _____.
- Current account
 - Unilateral transfer account
 - Capital account
 - Loan account

Identify the correct alternatives from the following:

- i and ii
- i and iii
- iii and iv
- iv and i

(Term-I, 2021-22) **R**

5. From the following sets of statements in column I and II, choose the correct pair of statement.

Column I	Column II
(A) Exports of goods and services	(i) Excess of exports of goods over the Imports of goods
(B) Trade surplus	(ii) An element of invisible items
(C) Current transfers to rest of the world	(iii) Recorded as a positive item in the BoP account
(D) Portfolio investment	(iv) Foreign institutional investors

- A-i
- B-ii
- C-iii
- D-iv

(Term-I, 2021-22)

6. An Indian real estate company receives rent from Google in New York. This transaction would be recorded on _____ side of _____ account.
- credit, current
 - debit, capital
 - credit, capital
 - debit, current

(2020-21) **R**

SA I (3 marks)

7. Distinguish between autonomous and accommodating transactions in Balance of Payments Accounts. (2022-23)
8. State, giving valid reasons, whether the following statements are true or false.
- Current account in Balance of Payments records only the exports and imports of goods and services.
 - Borrowing from abroad are recorded in the Capital Account of the Balance of Payments on the debit side. (2020-21)

6.2 Balance of Payments Account – Surplus and Deficit

MCQ

9. Suppose that the Balance of Trade (BoT) of a nation, exhibits a surplus of ₹ 20,000 crores. The import of merchandise of the nation is half of the exports of merchandise to the rest of the world. The value of exports would be ₹ _____ crores.
(a) 30,000 (b) 40,000 (c) 24,000 (d) 35,000 (Term-I, 2021-22)
10. Given below are two statements, one labelled as Assertion (A) and the other as Reason (R).
Assertion (A) : If the receipts and payments on the current account are equal to each other, it depicts a situation of Current Account Surplus.
Reason (R) : A surplus Current Account means that the nation is a lender to other countries and a deficit Current Account means that the nation is a borrower from other countries.
In the context to the above two statements, which of the following is correct?
(a) Both A and R are true and R is the correct explanation of A.
(b) Both A and R are true but R is not the correct explanation of A.
(c) A is true but R is false.
(d) A is false but R is true. (Term-I, 2021-22)
11. Identify the correct pair of formula from the following options:
(a) Current Account Surplus = Receipts < Payments
(b) Current Account Surplus = Receipts > Payments
(c) Balance Current Account = Receipts ≠ Payments
(d) Current Account Deficit = Receipts ≤ Payments (2020-21) **(R)**

SA I (3 marks)

12. 'Trade Deficit must exist if a country is facing a situation of Current Account Deficit'.

Defend or refute the statement, with valid argument.

(2020-21) **(U)**

6.3 Foreign Exchange Rate

MCQ

13. 'Owing to the Russia-Ukraine crisis, the world is experiencing rising crude prices due to supply-side issues.' Identify the most likely impact on the Balance of Payments situation of the Indian economy from the following:
(a) Production of cars in India will rise.
(b) Production and sale of cycles in India will rise.
(c) Inflow of US Dollars in India will rise.
(d) Outflow of US Dollars from India will rise. (2022-23)
14. Identify which of the following statement is true?
(a) The Flexible exchange rate system gives the government more flexibility to maintain large stocks of foreign exchange reserves.
(b) In the Managed floating exchange rate system, the government intervenes to buy and sell foreign currencies.
(c) In the Managed floating exchange rate system, the central bank intervenes to moderate exchange rate fluctuations.
(d) In the Fixed exchange rate system, market forces fix the exchange rate. (2020-21) **(Ap)**

SA I (3 marks)

15. Explain, how exchange rate is determined under a free market exchange rate system. (2022-23)

6.4 Determination of Exchange Rate in a Free Market

MCQ

16. Two friends Mira and Sindhu were discussing the exchange rate system.
'Under this system, the exchange rate are determine by market forces of demand and supply. However, deliberate efforts are made by the competent authority to keep the exchange rates within a specific range'.
The above-mentioned statement was given by Sindhu, identify the type of exchange rate system she was talking about.
(a) Fixed Exchange Rate
(b) Floating Exchange Rate
(c) Managed Floating Exchange Rate
(d) Managed Fixed Exchange Rate (Term-I, 2021-22)

Previous Years' CBSE Board Questions

1. (c) : Credit, Capital
2. (a) : Statement-I is true but statement-II is false.
3. (c) : Export of Information Technology (IT) services to U.S.A.
4. (b) : Net Invisibles (Services)
5. (c) : Export of tea
6. (d) : All transfer receipts are recorded as debit items.
7. (c) : Charity to foreign countries is recorded in capital account of BoP.
8. (d) : Foreign Direct Investment
9. (d) : Accommodating transactions
10. (c) : Autonomous transactions
11. Import of goods and services
12. Balance of Payments is a statement of accounts showing all monetary transactions of a country with the rest of the world during a given period of time, generally one year.
13. Balance of trade (BoT) of a country shows its trade transactions with the rest of the world during a year. It is defined as the difference between the value of goods exported and value of goods imported in a given year. Goods exported and imported are known as visible items or merchandise. Symbolically, $BoT = V_x - V_m$ where V_x is the value of goods exported and V_m is the value of goods imported.
14. The given statement is defended.
Capital account records all international transactions of assets, where assets are different forms of wealth holding instruments. For example: money, bonds, stocks, government debts, external borrowings etc. All these instruments create future claims, one way or another. Thus, we may say that capital account transactions give rise to future claims.
15. Lending will be recorded in debit side in private-capital sub-account because this will take foreign exchange from the country.
16. Balance of payments on Capital Account is a statement of all capital inflows and outflows, during the period of an accounting year. Transactions recorded in capital account are :
(i) Borrowing (commercial borrowing and external assistance), (ii) Investments (foreign direct Investment and portfolio investment), (iii) NRI deposits, (iv) Banking capital, (v) Short-term debt, (vi) Rupee debt service, and (vii) other capital.
17. Current account records receipts and payment of foreign exchange on account of such transactions which

do not impact asset-liability status of a country in relation to rest of the world. Components of current account are:

- (i) Import and export of goods
- (ii) Import and export of services
- (iii) Unilateral transfers
- (iv) Factor incomes (COE, interest, dividend, etc.)

18. In current account because current account is that account which records exports and imports of goods and services and unilateral transfers. Sale of machinery involves inflow of foreign exchange that is the reason it will be recorded in the current account of balance of payments.

19. Borrowings from abroad are recorded in Capital Account. Borrowings from abroad can be private transactions or official transactions.

For example,

(a) All transactions relating to borrowings from abroad by private sector are recorded on the positive (credit) side as it is inflow of foreign currency.

(b) Similarly, transactions relating to borrowings from abroad by government sector are recorded on the positive (credit) side as it is inflow of foreign currency.

20. Components (or items of transactions) of current account :

- (i) Exports and imports of goods such as tea, jute, etc.
- (ii) Exports and imports of services such as shipping, insurance, banking, etc.
- (iii) Transfer receipts and payments such as gifts, donations, etc.
- (iv) Income receipts and payments such as investment income, wages, salaries, etc.

Components (or items of transactions) of capital account:

- (i) Foreign investment
- (ii) Foreign loans
- (iii) Banking capital and other capital
- (iv) Monetary movements

Related Theory



➤ There is a new classification in which Balance of Payments have been divided into three accounts. This is as per new accounting standards specified by IMF but RBI continues to publish data accounting to the old classification.

21. Balance of Trade : It is defined as the difference between the value of goods exported and value of goods imported during a year. It takes into the exchange of only visible items (or visible goods). It does not consider the exchange of services between the countries. Symbolically, $BoT = V_x - V_m$

Balance on Current Account : The current account of BoP records imports and exports of visible items (goods) and invisible items (services) and unilateral transfers (gifts and

donations). The net value of balances of visible trade and of invisible trade and of unilateral transfers is the balance on current account.

22.

Autonomous transactions	Accommodating transactions
Autonomous transactions refer to those international economic transactions that are undertaken with the sole motive of earning profit.	Accommodating transactions refer to those international economic transactions that are to correct the disequilibrium in the autonomous items.
They are also called 'above the line items' in BoP.	They are also called 'below the line items' in BoP.
They are independent of the BoP status of a country.	They depend on the BoP status of a country, as they are compensating short-term capital transactions that are undertaken to correct the disequilibrium in the autonomous items.

23. (i) True. Since, the capital account is where all international capital transfers are recorded.

(ii) True. Because it is a visible trade.

24. (c) : Autonomous payments over Autonomous receipts.

25. (b) : A deficit trade balance for country X.

26. (b) : 1800, 300

27. Current account deficit or CAD is the difference between the money coming in due to exports and the money going out due to imports. Current account deficit (or surplus) calculates the difference between the money obtained and sent from the country on the trade of goods and services as well as the movement of capital from domestic production factors abroad.

28.

Basis of Difference	Current account surplus	Surplus in balance of trade
Meaning	Current account surplus includes the favourable balance of both visible and invisible items.	Balance of Trade surplus includes a favourable balance of only visible items.
Concept	The current account balance is a wider concept, and it includes trade surplus.	Trade surplus is a narrow concept as it includes only a part of the current account

29. The given statement is refuted, as we know that: Trade Deficit will arise if a country's imports of visible items are more than the exports of visible items. Whereas; the

Current Account Deficit (CAD) occurs when the foreign exchange payments on account of visible, invisibles and current transfers are in excess over the foreign exchange receipts on account of visible, invisibles and current transfers.

Trade Deficit is a narrower concept as compared to the Current Account Deficit. Thus, a country may face a situation of CAD, even if the country has trade surplus, with greater negative balances on account of services and unilateral transfers.

30. Balance of Payments deficit is a situation when autonomous receipts are less than autonomous payments.

$$[\text{Current A/c} + \text{Capital A/c Receipts}] < [\text{Current A/c} + \text{Capital A/c Payments}]$$

Autonomous transactions are those transactions which are carried out with economic motive irrespective of the present position of the BoP.

This situation arises only on account of autonomous transactions.

Possible reasons for such situation : For fast development, developing countries import machines, technology, and other equipments. This leads to a high level of outflows of foreign exchange that can result in a deficit in the BoP account.

31. (c) : managed floating

32. (c) : Foreign Exchange Rate

33. (c) : A is true but R is false. Foreign exchange rate is the price of domestic currency with respect to another currency.

34. (c) : A is true but R is false. Central Bank can not manipulate the flexible exchange rate system.

35. Floating exchange rate is the system which determines the exchange rate through the market forces.

36. The managed floating exchange rate is the regime which determines the exchange rate through the market forces with the intervention of the monetary authority as and when required.

37. Foreign exchange rate refers to the rate at which the currency of one country is exchanged with the currency of another country.

38. Managed floating refers to a situation when the central bank intervenes to manage the exchange rate within the desired range. Thus, The RBI would sell dollars in the international money market to raise its supply and lower its exchange value. This would lead to revaluation of the Indian currency. On the other hand, Indian currency would be devalued when the RBI buys US dollars to raise its demand (and thereby its exchange value) in the international money market.

39. Indian rupee plunged to all time low ₹ 74.48 against US dollar. It is called depreciation in the value of Indian Rupee. It may lead to fall in imports as foreign goods will become costlier for the domestic consumers.

40. Foreign exchange is demanded by :
- domestic residents to purchase goods and services from other countries,
 - for sending gifts and grants to foreign countries (abroad),
 - by the domestic residents to purchase financial assets in particular country.

41.

Basis of Difference	Fixed Exchange Rate	Flexible Exchange Rate
Meaning	Fixed exchange rate refers to a rate which the government sets and maintains at the same level.	Flexible exchange rate is a rate that varies according to the market forces.
Determined by	Government or central bank	Demand and Supply forces
Changes in currency price	Devaluation and Revaluation	Depreciation and Appreciation

Related Theory

- Gold standard system of exchange rate abandoned because it requires gold reserves. This raised the demand for gold but the supply of gold was extremely scarce in relation to its demand.

42. (i) Fixed exchange rate is the rate which is officially fixed in terms of gold or any other currency by the government. The basic purpose of adopting this system is to ensure stability in foreign trade and capital movements. When value of domestic currency is tied to the value of another currency, it is known as 'Pegging'.
- (ii) Flexible exchange rate is that rate which is determined by the forces of demand and supply of foreign exchange. There is no official intervention in its determination.
- (iii) Managed floating system of exchange rate combines the features of both the fixed exchange rate as well as the flexible exchange rate. On one hand, the foreign exchange market is allowed to operate freely and on the other hand, there is an official declaration of rules or guidelines for the intervention by the monetary authority. In other words, the managed floating exchange rate regime determines the exchange rate through the market forces with intervention of the monetary authority as and when required.

Answer Tips

- Don't just fill your sheets. In practical subjects like macroeconomics, it is very important to write an organised answer, instead of a monotonous one. The examiner must not find it difficult to find and understand the answer that you have written.

43. (a) : Statement-I is true but statement-II is false.

44. (b) : depreciated

45. (a) : Likely to rise

46. (b) : to fall

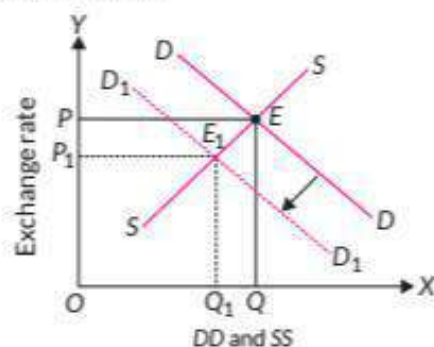
47. (i) False, dividend received from investment abroad is recorded in the credit side of current account.

- (ii) True. Depreciation of domestic currency implies that the domestic currency loses its value in relation to a foreign currency. More rupees are required to buy a dollar. So, exports are expected to increase.

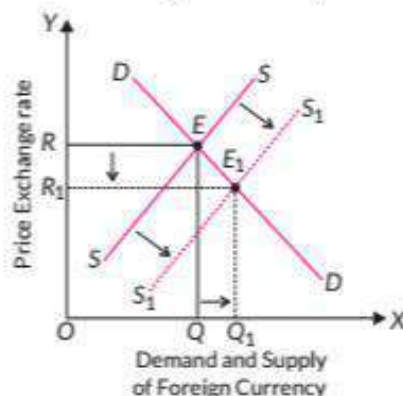
48. This will increase the demand of foreign exchange because supply of foreign exchange. The supply of foreign exchange in a particular country comes from (a) foreigners purchasing home countries goods and services through exports (b) foreigners investment in the home country and (c) flow of foreign exchange due to speculation. The supply curve of foreign exchange (say dollars) varies directly with the exchange rate. As the exchange rate rises, the supply of foreign exchange increases and vice versa.

49. When the value of domestic currency decreases in relation to foreign currency it is known as depreciation of currency. When Government of a country decreases the price of its currency in comparison to foreign currency it is known as devaluation of domestic currency. In this situation domestic currency is less valuable.

50. With a rise in the import duty of gold, the import of gold will fall. This reduces the demand for foreign currency. With the supply of foreign currency remaining same, the foreign exchange rate would fall. This implies appreciation of rupees.



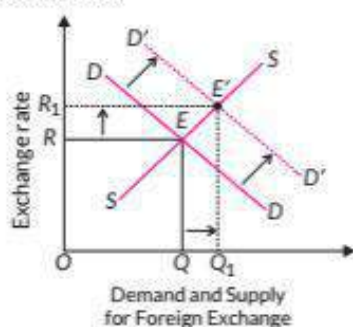
This can be explained diagrammatically :



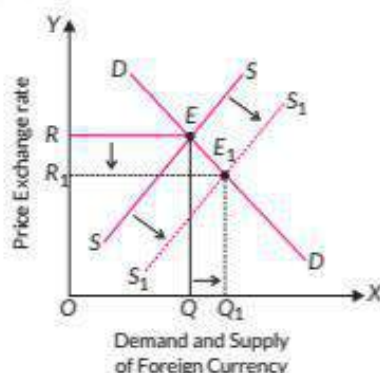
With the rise in exports the supply of foreign currency increases. In the diagram DD and SS are the initial demand curve and supply curve for foreign currency respectively. E is the initial equilibrium point, with OR as the equilibrium exchange rate. Rise in the supply of foreign currency would shift the supply curve from SS to S_1S_1 . With the shift in supply curve, the new equilibrium is established at point E_1 , where the exchange rate falls from OR to OR_1 and the demand and supply of foreign currency rises to OQ_1 . This represents a case of currency appreciation.

51. With the increase in the foreign visits of Indian, the demand for foreign currency increases. With the supply of foreign currency remaining same, the foreign exchange rises, implying a depreciation of rupees. This can be explained diagrammatically as follows.

In the diagram DD and SS are the initial demand curve and supply curve for foreign currency respectively. E is the initial equilibrium point, with OR as the equilibrium exchange rate. An increase in the demand for foreign currencies shifts the demand curve from DD to D_1D_1 . With the shift in demand curve, new equilibrium is established at point E_1 where the exchange rate rises from OR to OR_1 and the demand and supply of foreign currencies rises from OQ to OQ_1 . A rise in the exchange rate implies currency depreciation.



52. The incentives for exports boosts exports for one country. As a result of increase in exports the supply of foreign currency in the country increases. With demand remaining the same, this results in a fall in the exchange rate implying currency appreciation. This can be explained diagrammatically:



With the rise in exports the supply of foreign currency increases. In the diagram DD and SS are the initial demand curve and supply curve for foreign currency respectively.

E is the initial equilibrium point, with OR as the equilibrium exchange rate. Rise in the supply of foreign currency would shift the supply curve from SS to S_1S_1 . With the shift in supply curve, the new equilibrium is established at point E_1 , where the exchange rate falls from OR to OR_1 and the demand and supply of foreign currency rises to OQ_1 . This represents a case of currency appreciation.

53. Currency appreciation implies that domestic currency has become more expensive in terms of foreign currency.

For instance, if the exchange rate falls from $\$1 = ₹ 50$ to $\$1 = ₹ 48$ then we say that rupee has appreciated against the dollar. In such a situation the domestic country's export to foreign countries become expensive because now foreigners can purchase only ₹ 48 worth of goods instead of ₹ 50 worth of goods. This reduces the demand for exports.

54. A rise in the exchange rate say from $\$1 = ₹ 40$ to $\$1 = ₹ 50$ implies that domestic country's export to foreign countries have become cheaper because now foreigners can purchase ₹ 50 worth of goods for $\$1$, as compared to the earlier situation where they could purchase only ₹ 40 worth of goods for $\$1$. Thus, this raises the demand for exports.

55. When foreign exchange rate in a country is on the rise then the demand for foreign currencies will be low. Arise in the exchange rate from say, $\$1 = ₹ 40$ to $\$1 = ₹ 50$ implies that the goods from abroad become more expensive that is, it now cost ₹ 50 to purchase a commodity worth $\$1$ instead of ₹ 40 earlier. This would result in a reduction in the demand for the foreign commodities. Thus, there will be fall in imports.

Commonly Made Mistake

Students must not confuse foreign exchange rate with the currency of US dollar only. It can be in the context with any foreign currency.

56. India, with greater ease of doing business, may attract many more MNC's to shift their production base to India, thereby increasing the inflow of foreign exchange (say $\$$) to the Indian economy. This increase in foreign direct investments (FDI) by MNCs will lead to increase in the supply of foreign exchange in India leading to a fall in the rate of foreign exchange, i.e. Indian Rupee (₹) may appreciate. Increase in FDI will result in increase in production and hence may also generate employment opportunities in the Indian economy.

57. The Central Bank RBI in India takes steps to control foreign exchanges because it will create negative impact on economy; it gives rise to problems like inflation, it makes domestic goods costlier so the demand of domestic goods decreases so the RBI will take steps to control rise in foreign exchange. Controlling rise in price of foreign exchange makes imports cheaper. The economic value is that common man now has to pay less for goods and

services. However, the government needs to interfere in the system in order to restrict fluctuations in the exchange rate within certain limits.

58. The demand for foreign currency fall and supply rises when its price rises because domestic goods become cheaper. It induces the foreign currency to increase their imports from the domestic country. Hence, supply of foreign currency rises.

For example, if price of 1 US dollar rises from ₹ 53 to ₹ 59, it implies that exports to US will increase as Indian goods will become relatively cheaper. It will raise the supply of US dollars. When price of a foreign currency falls, its demand rises as more people want to make gains from speculative activities.

CBSE Sample Questions

1. (c) : Both statements I and II are true. (1)
2. (d) : A is false but R is true. Trade of invisible items between two nations is a part of current account of Balance of Payment. (0.80)
3. (c) : A is true but R is false. It leads to inflow of foreign exchanges from the domestic economy. (0.80)
4. (b) : i and iii (0.80)
5. (d) : D-iv (0.80)
6. (a) : Credit, current (1)
7. Autonomous transactions are those international economic transactions which are independent of the state of Balance of Payments (BOP). These transactions generally take place with 'economic motive'. These transactions are called 'above the line' transactions in the Balance of Payments account whereas; (1.5)
Accommodating transactions are those international economic transactions which are undertaken (by competent authorities) to cover the surplus or deficit in Balance of Payments. These transactions are independent of any economic motive and are called 'below the line' transactions in the Balance of Payments account. (1.5)

8. (a) The given statement is false as Gross Domestic product is the result of sum of Gross Value Added by all the producing units/firms in an economy, during an accounting year. (1.5)
- (b) The given statement is false as the borrowings from abroad are recorded in the Capital Account of Balance of Payments on the credit side as it result in an inflow of foreign currency in the economy. (1.5)
9. (b) : 40,000 (0.80)
10. (d) : A is false but R is true. If the receipts and payments on the current account are equal to each other, it depicts a situation of balanced Current Account. (0.80)
11. (b) : Current Account Surplus = Receipts > Payments (1)
12. The given statement is refuted as the Current Account Deficit (CAD) is a broader concept. CAD occurs when the foreign exchange payments on account of visible, invisibles and current transfer are in excess over the receipts of visible, invisibles and current transfer. A country may face a situation of CAD, even if the country has trade surplus, with greater negative balances on account of services and unilateral transfer. (3)
13. (d) : Outflow of US Dollars from India will rise. (1)
14. (c) : In the Managed floating exchange rate system, the central bank intervenes to moderate exchange rate fluctuations. (1)
15. Equilibrium rate of exchange is established at a point where the quantity demanded and quantity supplied of foreign exchange are equal. In the foreign exchange market, if disequilibrium occurs, it may lead to a situation of excess demand or excess supply. The market mechanism will drive the exchange rate back to the equilibrium level. This implies that the free market forces of demand and supply will operate in such a manner that the equilibrium rate of exchange is automatically restored. (3)
16. (c) : Managed Floating Exchange Rate (0.80)