5 Balance of Payment

Fastrack Revision

Balance of Payment

- **Balance of Payment:** The Balance of Payment (BoP) of a country is a systematic record of all economic transactions between its residents and residents of foreign countries. It records transactions related to:
  - Visible items (physical goods)
  - Invisible items (services)
  - Capital transfers (capital receipts and payments)
  - Unilateral transactions

Knowledge BOOSTER

Balance of Payment is a statement which records the monetary transactions made between residents of a country and the rest of the world.

- **Components of BoP Account**
  - **Current Account:** Current account is a statement of actual receipts and payments relating to export and import of goods and services and unilateral transfers during a given period of time.
  - **Capital Account:** It records capital transfer such as loans and investments between one country and the rest of the world, which causes a change in the assets or liability status of the residents of the domestic country or its government.
  - **Official International Reserve Account:** Official international reserve account includes the foreign exchange reserves, gold reserves and Special Depository Receipts (SDRs).

Difference between Current Account and Capital Account in BoP

S. No.	Basis of Difference	Current Account (BoP)	Capital Account (BoP)
(i)	Meaning	It is that account which records export and import of goods and services and unilateral transfers during a given period of time.	Capital account of BoP records all those transactions, which cause a change in the assets or liabilities status of the residents or government of the country.
(ii)	Concept	It is a flow concept.	It is a stock concept.
(iii)	Formula	BoP Current Account = Visible Trade + Invisible Trade + Unilateral Transfers + Investment Income	BoP Capital Account = Private Transaction + Official Transaction + Banking Capital + Foreign Direct Investment + Portfolio Investment

- **Autonomous Items in BoP:** Autonomous items, also termed as 'above the line items', are those items which relate to transactions which are done by consideration of profit (economic motive). Hence, these transactions have nothing to do with the state of BoP.
- **Accommodating Items of BoP:** Accommodating items, also termed as 'below the line items,' are those items of BoP that are not undertaken for profit but to restore identity of BoP *i.e.*, to balance the BoP.

Knowledge BOOSTER

Devaluation refers to decrease in the value of domestic currency in terms of foreign currency by the government.

Difference between Autonomous Items and Accommodating Items

S. No.	Basis of Difference	Autonomous Items	Accommodating Items
(i)	Meaning	These are those international economic transactions which are done to earn profit.	These are those international economic transactions, which are done to bring the balance in the BoP account.
(ii)	Take place	Take place in both accounts (capital as well as current).	Take place only in capital account.
(iii)	Relationship with BoP	Independent	Dependent
(iv)	Other Name	Above the line items.	Below the line items.

(v)	Undertaken by	Private as well as government sector.	Only government sector.
(vi)	Example	Exports and imports.	Use of foreign exchange reserve, borrowing.

- **Balance of Payments Identity**

  Current Account + Capital Account + Official Reserve = 0.

- **Disequilibrium in BoP:** BoP is said to be in state of disequilibrium when there is either surplus or deficit in BoP.
  - **BoP Surplus:** When the receipts of the country on account of autonomous transactions exceed the payments of a country on account of autonomous transactions, this difference is termed as BoP surplus.

    BoP Surplus = Receipts on account of autonomous transaction > Payments on account of autonomous transactions
  - **BoP Deficit:** When the payments of a country on account of autonomous transactions exceed the receipts of a 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
- **Causes of Disequilibrium in BoP**
  - **Economic Factors:** The main economic factors are development activities, high rate of inflation, cyclical fluctuations, change in demand, import of services.
  - **Social Factors:** When the people of developing countries (like India) come in contact with the people of developed countries (America), they start adopting the foreign pattern of consumption such as Nike shoes, Apple iPhone, Swatch watch, etc. Due to this reason, the imports of the country increases. As a result of this, there is a deficit in BoP.
  - **Political Factors:** The main political factors are:
    - **Political Instability:** When there is a political instability in the country then foreign investors may withdraw their investments which leads to large capital outflows and reduce the inflows of foreign investments. As a result of this, there is a deficit in BoP.
    - **Political Disturbances:** When there is a frequent changes in the government, in adequate support to the government in parliament then this discourage inflows of foreign investments in the country. This leads to more outflows than inflows. As a result of this, there is a deficit in BoP.
- **Balance of Trade (BoT):** It refers to difference between visible exports and visible imports. BoT is also known as 'Balance of Visible Trade' or 'Trade Balance' or Merchandise.

  Balance of Trade = Export of Goods – Import of Goods

Difference between Balance of Payment and Balance of Trade

S. No.	Basis of Difference	Balance of Payment	Balance of Trade
(i)	Meaning	The balance of payment of a country is systematic record of all economic transactions between its residents and residents of foreign countries.	Balance of trade refers to the difference between export of merchandise and import of merchandise of a country.
(ii)	Records	It records all transactions (visible as well as invisible).	It records only visible transactions.
(iii)	Comprehensiveness	It is a wider concept.	It is a narrow concept.
(iv)	Nature of transactions	It records transactions of capital nature.	It does not record transactions of capital nature.

Practice Exercise

Multiple Choice Questions

Q 1. 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

Q 2. Foreign exchange transactions which are independent on other foreign exchange transactions in the BoP are called:

a. Current Account Transactions
b. Capital Account Transactions
c. Autonomous Transactions
d. Accommodating Transactions

Q 3. Balance of payments deficit is the excess of:

a. current account payments over current account receipts
b. capital account payments over capital account receipts
c. autonomous payments over autonomous receipts
d. accommodating payments over accommodating receipts

Q 4. A company located in India receives a loan from a company located abroad. How is his transaction recorded in India's balance of payments account?

a. Credit side of current account
b. Debit side of current account
c. Credit side of capital account
d. Debit side of capital account

Q 5. An Indian company located in India invests in a company located abroad. This transaction is entered in India's balance of payments account on:

a. credit side of current account
b. debit side of current account
c. credit side of capital account
d. debit side of capital account

Q 6. A systematic record of all economic transactions between residents of a country and the rest of the world during a year is called:

a. Balance of Payments b. Foreign Trade
c. Balance of Trade d. X – M

Q 7. Identify the correct reason(s) that may affect the demand for foreign exchange in an economy.

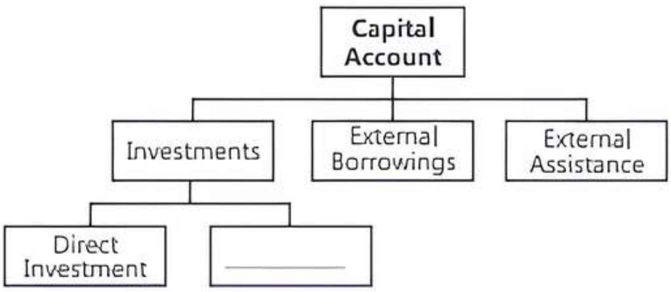
(CBSE SQP 2023-24)

(i) Imports of visibles
(ii) Exports of invisibles
(iii) Remittances by residents working abroad
(iv) Purchase of assets abroad

Alternatives:

a. (i) and (ii) b. (ii) and (iii)
c. (iii) and (iv) d. (i) and (iv)

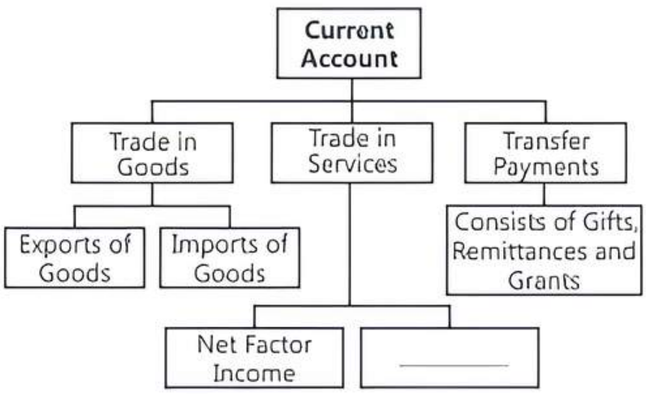
Q 8. Read the following chart carefully and choose the correct alternative:



Alternatives: *(CBSE SQP 2023-24)*

a. Interest Received on Loans
b. Multilateral Loans
c. Portfolio Investment
d. Government Aid

Q 9. Read the following chart carefully and choose the correct alternative:



Alternatives:

a. Net Non-factor Income
b. Compensation of Employees
c. Net Investment Income
d. Shipping Services

Q 10. Balance of Trade (BoT) may be:

a. surplus b. deficit
c. balanced d. All of these

Q 11. The difference between value of visible exports and value of visible imports is called:

a. BoP
b. BoT
c. Balance of current account
d. Balance of capital account

Q 12. 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 ....

(Choose the correct alternative) *(CBSE 2023)*

a. appreciated b. depreciated
c. revalued d. devalued

Q 13. In current account, BoP items include:

a. export and import of goods
b. export and import of services
c. receipts and payments of unilateral transfer
d. All of the above

Q 14. Capital account of BoP items include:

a. foreign investment
b. loans
c. NRI deposits with Indian banks
d. All of the above

Q 15. If Balance of Trade is (–) ₹ 500 crore and value of exports is ₹ 400 crore, then the value of imports will be:

a. ₹ 1,300 crore b. ₹ 300 crore
c. ₹ 900 crore d. ₹ 1,200 crore

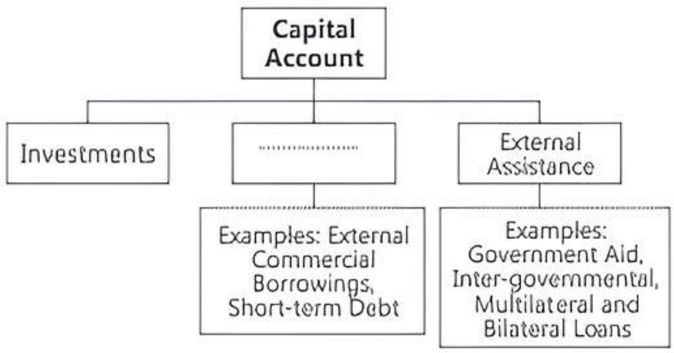
Q 16. If BoT is (–) ₹ 700 crore and value of exports is ₹ 500 crore, then the value of imports will be:

a. ₹ 1,200 crore b. ₹ 200 crore
c. ₹ 1,100 crore d. ₹ 1,300 crore

Q 17. If Balance of Trade (BoT) deficit is (–) ₹ 6,000 crore and the value of imports is ₹ 8,000 crore, then the value of exports will be:

a. ₹ 2,000 crore b. ₹ 14,000 crore
c. ₹ 9,000 crore d. None of these

Q 18. Read the following chart carefully and choose the correct alternative:



Alternatives:

a. Internal Borrowings b. External Borrowings
c. Direct Investment d. Portfolio Investment

Q 19. A country's BoT is ₹ 400 crore. Value of exports of goods is ₹ 550 crore, then the value of imports will be:

a. ₹ 1,150 crore
b. ₹ 500 crore
c. ₹ 150 crore
d. None of these

Q 20. BoP is measured as:

a. difference between visible items of exports and imports.
b. difference between invisible items of exports and imports.
c. difference between external and internal flow of gold.
d. difference between all receipts of foreign exchange and payments of foreign exchange.

Q 21. As per the Reserve Bank of India (RBI) press report, dated 22nd June, 2022:
"Net Foreign Portfolio Investment (FPI) recorded an outflow of US $ 15.2 billion mainly from the equity market."
The above transaction will be recorded in the .... account on .... side of Balance of Payments account of India.
(Choose the correct alternative) *(CBSE 2023)*

a. current, credit
b. current, debit
c. capital, credit
d. capital, debit

Q 22. Deficit in Balance of Payment (BoP) refers to the excess of ....
(Choose the correct alternative) *(CBSE 2023)*

a. Current account payments over Current account receipts
b. Capital account payments over Capital account receipts
c. Autonomous payments over Autonomous receipts
d. Accommodating payments over Accommodating receipts

Q 23. Accommodating items are those items of BoP which:

a. are not determined by profit motive
b. are conditioned by the positive or negative BoP status
c. Both a. and b.
d. deal with capital transfers only

Q 24. Balance of Payments of an economy records .... for a fiscal year. *(CBSE SQP 2021, Term-1)*

a. Income and expenditure of the government
b. Inflow and outflow of funds of the government
c. Inflow and outflow of foreign exchange to/from the economy
d. Inflow and outflow of loans to/from the rest of the world

Q 25. Identify which of the following is not an example of 'invisible item' under Current Account of the Balance of Payments transactions? *(CBSE SQP 2021, Term-1)*

a. Air and sea transport
b. Postal and courier services
c. Education related travel
d. Merchandise linked transactions

Q 26. Under the Balance of Payments structure of a nation, the two main categories of accounts for the classification of the transactions are .... and .... *(CBSE SQP 2021, Term-1)*

(i) Current Account
(ii) Unilateral Transfer Account
(iii) Capital Account
(iv) Loan Account

Identify the correct alternatives from the following:

a. (i) and (ii)
b. (i) and (iii)
c. (iii) and (iv)
d. (iv) and (i)

Q 27. 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 world. *(CBSE SQP 2021, Term-1)*
The value of exports would be ₹ .... crores.

a. 30,000
b. 40,000
c. 24,000
d. 35,000

Q 28. Export and imports of which of the following will be a component of 'Balance of Trade? *(CBSE 2021, Term-1)*

a. Banking
b. Shipping
c. Merchandise
d. Insurance

Q 29. From the following statements, choose the correct statement: *(CBSE 2021, Term-1)*

a. Trade deficit refers to the excess of 'total value of exports' over the 'total value of imports' of goods and services.
b. Trade surplus refers to the excess of 'total value of imports' over the 'total value of exports' of goods and services.
c. Current account deficit in a nation occurs when the foreign exchange receipts in current account fall short of foreign exchange payments in current account.
d. Current account surplus in a nation occurs when the credit items of Balance of Payments are less than the debit items of Balance of Payments.

Q 30. From the following which of the item would appear on the credit side of capital account of the balance of payment in India? *(CBSE 2021, Term-1)*

a. Education consultation from a firm in New York.
b. Borrowings from rest of the world.
c. Earthquake relief aid received from France.
d. Imports of edible oils.

Q 31. Identify the incorrect statement with reference to Balance of Payments: *(CBSE 2021, Term-1)*

a. Current account records exports and imports transactions of a nation.
b. Export of machinery is recorded in capital account.
c. Transfer of funds to the relatives abroad, entered on debit side to current account.
d. Current account records all such transactions, which do not impact asset or liability status of a country.

Q 32. '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 Payment situation of the Indian economy from the following: *(CBSE SQP 2022-23)*

a. Production of cars in Indian 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.

Q 33. **Suppose, following data is presented, for an imaginary economy: (all figures in ₹ '000 crore)**

Year	Visible Exports	Visible Imports
2010	280	240
2020	580	460

Identify, which of the statement about the period 2010 to 2020 is correct? *(CBSE SQP 2022-23)*

a. Improvement in balance of trade.
b. Increase in trade deficit.
c. Improvement in balance in invisible items.
d. Deterioration of balance of trade.

Q 34. **The following information is given for an imaginary country:**

Current Account	Amount (in ₹ ' 000 Crore)
Visible Exports	100
Visible Imports	150
Invisible Exports	70
Invisible Imports	30
Net Current Transfer Balance	15

Balance on current account will be .... of ₹ ...... thousand crore. *(CBSE SQP 2022-23)*

a. deficit, 10 b. surplus, 5
c. deficit, 5 d. surplus, 10

Statement Based Questions

Q 35. **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 Investments in India will be recorded on credit side of capital account.

In the light of the given statements, choose the correct alternative: *(CBSE SQP 2022-23)*

a. Statement I is true and statement II is false.
b. Statement I is false and statement II is true.
c. Both statements are true.
d. Both statements are false.

Q 36. **Read the following statements carefully:**

Statement I: External assistance is recorded in the capital account of the Balance of Payments.

Statement II: External assistance is recorded in the current account of the Balance of Payments.

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 are true.
d. Both statements are false.

Fill in the Blank Type Questions

Q 37. **"Considering the depreciation of Indian Currency (₹) in the international market, the Reserve Bank of India (RBI) has decided to purchase Indian Currency (₹) in the open market."**

This represents .... exchange rate system.

(Choose the correct alternative to fill up the blank) *(CBSE 2023)*

a. fixed b. flexible
c. managed floating d. manipulated

Q 38. **Accommodating items are called .... the line items.**

(Choose the correct alternative to fill up the blank)

a. above b. below
c. parallel d. zero

Q 39. **Autonomous items are called .... the line items.**

(Choose the correct alternative to fill up the blank)

a. above b. below
c. parallel d. zero

Q 40. **................ account deficit, when current account receipts are less than current account payments.**

(Choose the correct alternative to fill up the blank)

a. Capital b. Current
c. Revenue d. Fiscal

Q 41. **..................... account deficit, when capital account receipts are less than capital account payments.**

(Choose the correct alternative to fill up the blank)

a. Current b. Fiscal
c. Capital d. Revenue

Q 42. **Decrease in foreign exchange reserve is recorded in ....items.**

(Choose the correct alternative to fill up the blank)

a. debit b. credit
c. assets d. transfer

Q 43. **Investments to abroad is recorded in .... items.**

(Choose the correct alternative to fill up the blank)

a. assets b. transfer
c. credit d. debit

Q 44. **As per the Reserve Bank of India (RBI) press report, dated 29th December, 2022: "Net external commercial borrowings to India recorded an outflow of US $ 0.4 billion in the second quarter (2022-23)."**

The above transaction will be recorded in the ..... account on ...... side of Balance of Payments account of India.

(Choose the correct alternative to fill up the blanks) *(CBSE SQP 2023-24)*

a. current, credit b. current, debit
c. capital, credit d. capital, debit

True/False Type Questions

Q 45. Excess of foreign exchange receipts over foreign exchange payments on account of accommodating transactions equal deficit in balance of payments.

Q 46. Export and import of machines are recorded in capital account on balance of payments account.

Q 47. Current account of BoP records only exports and imports of goods and services.

Q 48. Foreign investments are recorded in the capital account of BoP.

Q 49. Profits received from investments abroad is recorded in capital account. *(CBSE 2015)*

Q 50. Import of machines is recorded in current account. *(CBSE 2015)*

Q 51. Balance of trade is the difference between invisible exports and invisible imports.

Q 52. Increase in foreign exchange reserve is a credit item.

Match the Column Type Questions

Q 53. From the following statements given in Column I and Column II, choose the correct pair of statements:

Column I	Column II
A. Visible Exports > Visible Imports	1. Balance of trade
B. Visible Exports = Visible Imports	2. Surplus in balance of trade
C. Visible Exports < Visible Imports	3. Balance in balance of trade
D. Visible Exports – Visible Imports	4. Deficit in balance of trade

	A	B	C	D		A	B	C	D
a.	2	3	4	1	b.	1	2	3	4
c.	3	4	1	2	d.	4	2	1	3

Q 54. From the following statements given in Column I and Column II, choose the correct pair of statements:

Column I	Column II
A. Make in India Policy	1. Accommodating items
B. Import of iPhone	2. Autonomous items
C. Above the line items	3. Inflow of foreign exchange
D. Below the line items	4. Outflow of foreign exchange

	A	B	C	D
a.	4	3	1	2
b.	3	2	1	4
c.	3	4	2	1
d.	1	4	2	3

Q 55. From the following statements given in Column I and Column II, choose the correct pair of statements:

Column I	Column II
A. Records only visible items	1. Balance of payments current account
B. Records both visible and invisible items	2. Balance of payments capital account
C. Records change in asset and liability status	3. Balance of trade

	A	B	C		A	B	C
a.	3	1	2	b.	1	2	3
c.	2	3	1	d.	2	1	3

Q 56. From the following statements given in Column I and Column II, choose the correct pair of statements:

Column I	Column II
A. Investments made by Indians abroad	1. Supply of foreign exchange
B. Rise in exports, fall in imports	2. Decrease in national income
C. Fall in exports, rise in imports	3. Increase in national income
D. Remittances from abroad	4. Demand for foreign exchange

	A	B	C	D		A	B	C	D
a.	1	4	3	2	b.	4	2	1	3
c.	4	3	2	1	d.	1	2	3	4

Q 57. From the following statements given in Column I and Column II, choose the correct pair of statements:

Column I	Column II
A. These items can take place on both current and capital accounts.	1. Stock concept
B. These items can take place only on capital accounts.	2. Flow concept
C. BoP current account	3. Autonomous items
D. BoP capital account	4. Accommodating items

	A	B	C	D		A	B	C	D
a.	2	3	1	4	b.	4	1	3	2
c.	3	4	2	1	d.	1	2	4	3

Q 58. From the following statements given in Column I and Column II, choose the correct pair of statements:

Column I	Column II
A. Demand for foreign exchange	1. Inflow of foreign exchange
B. Supply of foreign exchange	2. Outflow of foreign exchange
C. Foreign currencies are bought and sold	3. Revaluation
D. Rise in price of domestic currency with respect to foreign currencies by government	4. Foreign exchange market

	A	B	C	D		A	B	C	D
a.	1	2	3	4	b.	2	1	4	3
c.	3	1	4	2	d.	4	3	2	1

Q 59. **From the following statements given in Column I and Column II, choose the correct pair of statements:**

Column I	Column II
A. Investments by large MNCs in India	1. Depreciation of currency
B. Selling of securities by FIIs in Indian Capital Market	2. Appreciation of currency
C. More risk and uncertainty	3. Fixed exchange rate
D. Depends upon gold price	4. Flexible exchange rate

	A	B	C	D		A	B	C	D
a.	2	1	4	3	b.	1	4	3	2
c.	4	2	3	1	d.	1	2	3	4

Q 60. **From the following statements given in Column I and Column II, choose the correct pair of statements:**

Column I	Column II
A. Visits to foreign countries for sightseeing.	1. Appreciation of currency
B. Incentives for exports.	2. Spot market
C. Market in which receipts and payments take place at the same time.	3. Forward market
D. Market in which sale and purchase of foreign currency is fixed on a specified future date at a rate decided today.	4. Depreciation of currency

	A	B	C	D		A	B	C	D
a.	4	3	2	1	b.	3	1	4	2
c.	4	1	2	3	d.	1	2	3	4

Q 61. **From the following statements given in Column I and Column II, choose the correct pair of statements:**

Column I	Column II
A. Incredible India or Atulya Bharat	1. Outflow of foreign currency
B. Indians going to Japan to visit Mario Kingdom	2. Inflow of foreign currency
C. Related to fixed exchange rate system	3. Depreciation of currency
D. Related to flexible exchange rate system	4. Devaluation of currency

	A	B	C	D
a.	1	3	4	2
b.	2	1	4	3
c.	2	4	3	1
d.	4	3	2	1

Q 62. **From the following statements given in Column I and Column II, choose the correct pair of statements:**

Column I	Column II
A. All currencies other than home currency	1. Flexible exchange rate
B. Rate at which currencies are exchanged	2. Foreign exchange
C. Hybrid of fixed and flexible exchange rate	3. Foreign exchange rate
D. Free exchange rate	4. Managed floating exchange rate

	A	B	C	D
a.	1	2	3	4
b.	3	1	4	2
c.	4	1	2	3
d.	2	3	4	1

Assertion & Reason Type Questions

Directions (Q.Nos. 63-74): *There are two statements marked as Assertion (A) and Reason (R). Read the statements and choose the appropriate option from the options given below:*

a. Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).

b. Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).

c. Assertion (A) is true, but Reason (R) is false.

d. Assertion (A) is false, but Reason (R) is true.

Q 63. **Assertion (A): Fixed exchange rate is a stable exchange rate so uncertainty in the international market is prevented which promotes international trade.**

Reason (R): Because it is the exchange rate which is officially fixed and declared by the government.

Q 64. **Assertion (A): Flexible exchange rate is also known as floating or free exchange rate.**

Reason (R): Because it is determined by the market forces of demand and supply of foreign exchange without government intervention.

Q 65. **Assertion (A): Managed floating exchange rate is a hybrid of fixed and flexible exchange rate.**

Reason (R): Because exchange rate is determined by the market forces however Central Bank intervenes to reduce fluctuations in the foreign exchange rate.

Q 66. **Assertion (A): Rupee is said to be depreciating if price of $1 falls from ₹ 75 to ₹ 70.**

Reason (R): Rupee depreciates when more Indian rupees are needed to buy a dollar.

Q 67. **Assertion (A): Rupee is said to be appreciating if price of $ 1 falls from ₹ 75 to ₹ 70.**

Reason (R): Rupee appreciates when less Indian rupees are needed to buy a dollar.

Q 68. **Assertion (A): When the exchange rate is too high, Central Bank intervenes to reduce fluctuations in the foreign exchange rate.**

Reason (R): Central Bank start selling foreign currency from its reserves.

Q 69. Assertion (A): When the exchange rate is too low, Central Bank intervenes to reduce fluctuations in the foreign exchange rate.

Reason (R): Central Bank start buying foreign currency from the market.

Q 70. Assertion (A): Currency depreciation increases exports and decreases imports.

Reason (R): Because foreigners have to pay less for buying goods of that country whose currency has been depreciated. On the other hand, to buy a good from foreign country will become expensive.

Q 71. Assertion (A): Currency appreciation decreases exports and increases imports.

Reason (R): Because foreigners have to pay more for buying goods of that country whose currency has been appreciated. On the other hand, to buy a good from foreign country will become less expensive.

Q 72. Assertion (A): Revaluation is the opposite of devaluation.

Reason (R): Both are done by government. Revaluation means increase in the value of domestic currency with respect to foreign currency. Devaluation means decrease in the value of domestic currency with respect to foreign currency.

Q 73. Assertion (A): Trade of invisible items between two nations is a part of capital account of BoP.

Reason (R): Transactions that affect the asset liability status of a country in relation to the rest of the world are known as Capital Account transaction.

(CBSE SQP 2021, Term-1)

Q 74. Assertion (A): The Balance of Payments is in surplus, if autonomous receipts are greater than autonomous payments.

Reason (R): Autonomous transactions are determined by the difference in the Balance of Payments.

(CBSE 2023)

Answers

1. (d) Accommodating Transactions
2. (c) Autonomous Transactions
3. (c) autonomous payments over autonomous receipts
4. (c) Credit side of capital account
5. (d) debit side of capital account
6. (a) Balance of Payments
7. (d) (i) and (iv)
8. (c) Portfolio Investment
9. (a) Net Non-factor Income
10. (d) All of these
11. (b) BoT
12. (b) depreciated
13. (d) All of the above
14. (a) foreign investment
15. (c) ₹ 900 crore
16. (a) ₹ 1,200 crore
17. (a) ₹ 2,000 crore
18. (b) External Borrowings
19. (c) ₹ 150 crore
20. (d) difference between all receipts of foreign exchange and payments of foreign exchange.
21. (d) capital. debit
22. (c) Autonomous payments over Autonomous receipts
23. (c) Both a. and b.
24. (c) inflow and outflow of foreign exchange to/from the economy
25. (d) Merchandise linked transactions
26. (b) (i) and (iii)
27. (b) ₹ 40,000
28. (c) Merchandise
29. (c) Current account deficit in a nation occurs when the foreign exchange receipts in current account fall short of foreign exchange payments in current account.
30. (b) Borrowings from rest of the world.
31. (b) Export of machinery is recorded in capital account.
32. (d) Outflow of US Dollars from India will rise.
33. (a) Improvement in balance of trade.
34. (b) surplus, 5
35. (c) Both statements are true.
36. (a) Statement I is true and statement II is false.
37. (b) flexible
38. (b) below
39. (a) above
40. (b) Current
41. (c) Capital
42. (b) credit
43. (d) debit
44. (d) capital. debit
45. False: It is autonomous transactions and not accommodating transactions.
46. False: They are recorded in current account of BoP.
47. False: It records export and import of goods and services and unilateral transfers.
48. True: As they cause a change in the assets of the country.
49. False: It is recorded in BoP current account.
50. True: All imports and exports of goods are recorded in current account of BoP.
51. False: It is the difference between visible exports and visible imports.
52. False: It is a debit item.

	A	B	C	D
53. (a)	2	3	4	1
54. (c)	3	4	2	1
55. (a)	3	1	2	
56. (c)	4	3	2	1
57. (c)	3	4	2	1
58. (b)	2	1	4	3
59. (a)	2	1	4	3
60. (c)	4	1	2	3

61. (b) 2 1 4 3
62. (d) 2 3 4 1
63. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).
64. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).
65. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).
66. (d) Assertion (A) is false, but Reason (R) is true.
67. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).
68. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).
69. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).
70. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).
71. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).
72. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).
73. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).
74. (c) Assertion (A) is true, but Reason (R) is false.

Case Study Based Questions

Case Study 1

Read the extract given below and answer the questions on the basis of the same:

India's balance of payment this year is going to be 'very very strong' on the back of significant improvement in exports and a fall in imports, as stated by Commerce and Industry Minister Piyush Goyal.

'We are in July at about 91% export level of July 2019 figures. Imports are still at about 70-71% level of July 2019. So, broadly, our balance of payments this year is going to be very, very strong, which is why we feel confident that Indian industry will see opportunities of themselves, will see opportunities of growth', he said.

Country's trade turned surplus for the first time in 18 years as imports dropped by a steeper 47.59%. The country posted a trade surplus of $ 0.79 billion in June. It is because of government's efforts to support and promote domestic manufacturing and industry. **Source:** *The Hindu, August 10, 2020*

Q 1. When inflow of foreign currency is greater than the outflow of foreign currency then there is a .... in balance of payment.

a. surplus b. deficit
c. reduction d. None of these

Q 2. Autonomous items are known as .... the line items.

a. below b. above
c. consumption d. None of these

Q 3. Import of PS 5 leads to an .... of foreign currency.

a. inflow b. flow
c. outflow d. None of these

Q 4. India posted a trade surplus of $ 0.79 billion in June because ....of foreign currency is greater than ....of foreign currency.

a. outflow, inflow b. stock, outflow
c. stock inflow d. inflow, outflow

Answers

1. (a) 2. (b) 3. (c) 4. (d)

Case Study 2

Read the extract given below and answer the questions on the basis of the same:

New Delhi: India's Foreign Direct Investment (FDI) saw a significant jump in November 2020. FDI date released by the Commerce Ministry shows that total FDI in the month of November 2020 grew by a whopping 81% to $ 10.15 billion against $ 5.6 billion in November 2019. FDI equity has also jumped to $ 8.5 billion as against $ 2.8 billion in November 2019, registering a growth of 70%.

India has attracted total FDI inflow of $ 58.37 billion during April to November 2020. It is the highest ever for the first eight months of a financial year (F.Y.) and 22% higher as compared to the first eight months of 2019-20 ($ 47.67 billion).

FDI equity inflow received during F.Y. 2020-21 (April to November 2020) is $ 43.85 billion. It is also the highest ever for the first eight months of a financial year and 37% more compared to the first eight months of 2019-20 ($ 32.11 billion), the data revealed.

FDI is a major driver of economic growth and an important source of non-debt finance for the economic development of India. It has been the endeavour of the government to put in place an enabling and investor-friendly FDI policy, the Commerce Ministry said.

The intent all this while has been to make the FDI policy more investor-friendly and remove the policy bottlenecks that have been hindering the investment inflows into the country. The steps taken in this direction have borne fruit, as is evident from the ever-increasing volumes of FDI inflows being received into the country, it said.

Measures taken by the Government on the FDI policy reforms, investment facilitation and ease of doing business have resulted in increased FDI inflows into the country. The following trends in India's Foreign Direct Investment are an endorsement of its status as a preferred investment destination amongst global investors. "India's foreign direct investment inflows few by 81% in November 2020 to $10 billion."

The Economic Times- January 28, 2021

Q 1. What effect will the increase in foreign direct investment will have on the economy?

a. Increase in the forex reserve
b. Increase in the supply of foreign currency
c. Decrease in Exchange Rate
d. All of the above

Q 2. Why does the country foster for a higher Foreign Direct Investment?

a. FDI is a major driver of the economic growth.
b. FDI helps in getting better foreign exchange return.
c. FDI helps the government to control foreign exchange rate.
d. All of the above

Q 3. There has been an increase in the FDI. How has the government helped it?

a. FDI Policy Reforms
b. Ease of doing business
c. Both a. and b.
d. Neither a. nor b.

Q 4. When the FDI increases, the .... of foreign currency increases.

a. demand
b. supply
c. production
d. None of these

Answers

1. (d) **2.** (d) **3.** (c) **4.** (b)

Case Study 3

Read the extract given below and answer the questions on the basis of the same:

The rupee rose by 3 paise to settle at 72.94 (provisional) against the US dollar on Monday, extending its gains for the fifth straight session despite heavy selling in the domestic equity market.

At the interbank Forex market, the rupee opened at 72.95 against the American currency and hit an intra-day high of 72.89 and a low of 72.96 in day trade.

It finally finished at 72.94, higher by 3 paise over its last close. On Friday, the rupee had settled at 72.97 against the American currency.

Meanwhile, the dollar index, which gauges the greenback's strength against a basket of six currencies, advanced 0.10 % to 90.32.

"The rupee has managed to hold its fort around the 72.90 to 73 levels, but given the sell-off in equities and the likelihood of a rebound in the dollar index, we see the trend tilting slightly towards depreciation going forward," said Sugandha Sachdeva VP-Metal, Energy and Currency Research, Religare NSE 0.52% Broking.

"Rupee rises for 5th straight session, settles 3 paise higher at 72.94."

The Economic Times- January 25, 2021

Q 1. In the above given report which foreign exchange system does India follow?

Ans. Flexible Exchange Rate.

Q 2. What is the benefit for the appreciation of the Indian Rupees?

Ans. There will be an increase in the Foreign Direct Investment.

Case Study 4

Read the extract given below and answer the questions on the basis of the same:

A lower trade deficit along with strong FDI and portfolio flows in F/Y 19 January-March quarter may help the external sector balance sheet and prop up both current account as well as the overall balance of payments numbers. This could reflect in a lower current account deficit in the balance of payments for the quarter ended March. Trade balance, an important component of the current account, is estimated at a deficit of $ 35.6 billion for Q4 compared to $ 40.6 billion in the same period a year ago, thanks to lower crude prices and slowdown in gold and other imports, Other factors influencing the current account are software services, income and remittances by overseas Indians. Market estimates for F/Y 19 March quarter current account deficit is at $ 8.1 billion versus $13.2 billion for March 18 quarter.

In the capital account, thanks to some bidding for defaulting companies by ArcelorMittal which are expected to have bought in some funds, FDI inflows in March is projected to be almost double the amount in the previous comparable period of March 18. Also, external commercial borrowing flows in the latest quarter are almost double the amount of previous comparable quarter ending March 18. In addition, Forex resources raised through the swap agreements with the commercial banks are expected to add another $ 5 billion through the foreign investment route. The overall balance of payments surplus is estimated higher at \$17 billion for the latest March quarter compared to \$ 13 billion surplus in the March 18 quarter. "Fall in trade deficit, strong flows boost balance of payments no's in Q4."

The Economic Times- May 15, 2019

Q 1. Explain any two benefits of lower trade deficit.

Ans. (i) Help the external sector balance sheet.

(ii) Increase the Balance of Payment numbers.

Q 2. What do you mean by Foreign Direct Investments?

Ans. Foreign Direct Investments are autonomous transactions of long-term capital movements, motivated by economic interests, with profit at the first place.

Very Short Answer Type Questions

Q 1. What is balance of payment?

OR

What does balance of payment account of a country record?

Ans. Balance of payment of a country is a systematic record of all economic transactions, between its and residents of foreign countries during an accounting year.

Q 2. What is balance of trade?

Ans. It refers to difference between visible exports and visible imports:

Balance of Trade = Exports of Goods – Imports of Goods

BoT is also known as 'Balance of Visible Trade' or 'Trade Balance' or Merchandise.

Q 3. Name the items included in balance of trade account .

Ans. Balance of trade includes visible exports and visible imports.

Q 4. What is meant by devaluation?

Ans. Devaluation refers to decrease in the value of domestic currency in terms of foreign currency by the government.

Q 5. What are visible items?

Ans. It includes export and import of physical goods. These are called 'visible items' as they can be seen, touched and measured.

Q 6. What are invisible items?

Ans. It includes all types of services like shipping, banking, insurance, etc., which are given and received. These are called invisible items as they cannot be seen and touched.

Q 7. What are unilateral transfers?

Ans. It includes gifts, donations, charity, remittances, etc.

Q 8. What is current account of balance of payment?

Ans. It is that account of balance of payment which records export and import of goods, export and import of services and unilateral transfers during a given period of time.

Q 9. What is capital account of balance and payment?

Ans. It is that account of BoP, which records all those transactions, between the residents of a country and the rest of the world, that brings a change in the assets or liabilities status of the residents of the country or its government.

Q 10. What are autonomous items?

Ans. These are those international economic transactions, which are done to earn profit.

Q 11. What are accommodating items?

Ans. These are those international economic transactions, which are done to bring the 'balance' in the BoP account.

Q 12. What do you mean by disequilibrium and deficit in the balance of payment?

Ans. Disequilibrium in BoP means either deficit or a surplus in balance of payment. Deficit in balance of payment refers to a situation when outflow of foreign exchange is more than its inflow.

Q 13. What is meant by surplus in BoP?

Ans. BoP account is in surplus when autonomous receipts are more than the autonomous payments.

Q 14. What is meant by deficit in BoP?

OR

Explain the meaning of BoP deficit?

Ans. BoP is in deficit when autonomous receipts are less than autonomous payments.

Q 15. What is revaluation of currency?

Ans. Revaluation of currency means official rise of the value of domestic currency in relation to foreign currency. It is the opposite of devaluation of currency.

Short Answer Type-I Questions

Q 1. Distinguish between current and capital account of balance of payment.

Ans. Difference between current account and capital account of balance of payment are as follows:

S. No.	Basis of Difference	Current Account (BoP)	Capital Account (BoP)
(i)	Meaning	It is that account which records export and import of goods and services and unilateral transfers during a given period of time.	Capital account of BoP records all those transactions, which cause a change in the assets or liabilities status of the residents or government of the country.
(ii)	Concept	It is a flow concept.	It is a stock concept.
(iii)	Formula	BoP Current Account = Visible Trade + Invisible Trade + Unilateral Transfers + Investment Income	BoP Capital Account = Private Transaction + Official Transaction + Banking Capital + Foreign Direct Investment + Portfolio Investment

Q 2. Mention three credit items and debit items each of BoP account.

Ans. Three credit items and debit items each of BoP account are as follows:

S. No.	Credit Items	Debit Items
(i)	Borrowing from abroad	Lending to abroad
(ii)	Investments from abroad	Investments to abroad
(iii)	Decrease in foreign exchange reserves	Increase in foreign exchange reserves

Q 3. Distinguish between autonomous items and accommodating items of Balance of Payment.

OR

Distinguish between autonomous and accommodating transactions in Balance of Payment Accounts. *(CBSE SQP 2022-23, CBSE 2023)*

Ans. Difference between autonomous items and accommodating items are as follows:

S.No.	Autonomous Items	Accommodating Items
(i)	These are those international economic transactions, which are related to profit maximisation.	These are those international economic transactions that are done to clear deficit or surplus in autonomous transactions.
(ii)	They are also known as above the line items.	They are also known as below the line items.
(iii)	They are independent of the state of BoP account.	They took place to maintain the balance in BoP account.

TiP

Students should clear the effect of these transactions on the Balance of Payment.

Q 4. Should a current account deficit be a cause for alarm? *(NCERT)*

Ans. A current account deficit means that the value of imports for goods and services are greater than the value of exports.

It leads to several-ill-effects which are:

(i) Inflation and borrowings become major problems.

(ii) It increases dependence on foreign country for borrowing, creating dept trap.

Thus, we can say that current account deficit is a cause for alarm because of the above stated ill-effects on the country.

Q 5. What is the difference between Balance of Trade and Current Account balance? *(NCERT)*

Ans. Balance of trade refers to the balance occurring on account of export and import of visible items.

Current account balance includes the following:

(i) Export and import of goods.

(ii) Export and import of services.

(iii) Unilateral transfers from one country to other country.

Thus, Balance of Trade is only a component of current account.

Q 6. 'Current account deficit in an economy must be financed by a corresponding capital account surplus'. Do you agree with the given statement? Give valid reason(s) in support of your answer. *(CBSE SQP 2023-24)*

Ans. Yes, the statement can be agreed upon.

Since, in accounting sense: Current Account + Capital Account = 0.

If an economy is facing the situation of current account deficit. A current account deficit is financed through a surplus on the capital account, showing that the additional investment funds support the imports that are in excess of exports. Most sovereign states run a current account deficit which is backed by a positive capital account. Developing nations typically run very large current account deficits in proportion to their GDP, which are financed by loans and grants on the capital account.

Short Answer Type-II Questions

Q 1. Distinguish between balance of trade and balance of payment.

Ans. Difference between balance of trade and balance of payment are as follows:

S. No.	Basis of Difference	Balance of Trade (BoT)	Balance of Payment (BoP)
(i)	Meaning	Balance of trade refers to difference between export and import of visible items.	It is a systematic record of all economic transactions, between residents of a country and rest of the world during an accounting year.
(ii)	Items	BoT includes only visible items.	BoP includes both visible items as well as invisible items.
(iii)	Record	It is an incomplete or partial record of all economic transactions with the rest of the world.	It is a complete record of all economic transactions with the rest of the world.
(iv)	Scope	It has a narrow concept because it is only a part of BoP	It has a wider concept because it includes BoT.

Q 2. What is current account of Balance of Payment? Explain its components.

Ans. Current Account of BoP: It is that account which records export and import of goods and services and unilateral transfers during a given period of time.

Components of Current Account

The main components of current account are:

(i) Export and Import of Goods (Merchandise Transactions or Visible Trade): Payments for import of goods is written on the negative side (debit items) and receipt from exports is shown on the positive side (credit items).

Balance of these visible exports and imports is known as Balance of Trade (or trade balance).

(ii) **Export and Import of Services (Invisible Trade):** All the receipts of invisible trade from rest of the world are shown on the positive side and all invisible trade payments to rest of the world are shown on the negative side of BoP current account.

(iii) **Unilateral or Unrequited Transfers (One Sided Transaction):** Unilateral transfers include charity, donation, gifts and other 'one-way' transactions. All the receipts of unilateral transfers from rest of the world are shown on the positive side and unilateral transfers paid to rest of the world are shown on the negative side of BoP current account.

(iv) **Investment Income:** It includes investment income in the form of interest, rent and profits. All the receipts of investment income from rest of the world are shown on the positive side and all investment income paid to rest of the world are shown on the negative side of BoP current account.

Q 3. What is capital account of balance of payment? Explain its components.

Ans. Capital Account of BoP: Capital account of BoP records all those transactions, which cause a change in the assets or liabilities status of the residents or government of the country.

Components of Capital Account: The main components of capital account are:

(i) **Private Transaction:** Private sector of the country receives short-term and long-term foreign loans. Receipts of such loans are recorded as positive or credit items and their repayment as negative or debit item.

(ii) **Official Transactions:** It includes the transaction undertaken by the government with the rest of the world. For example, government borrows loans from international organisation like IMF, World Bank, etc., to finance the deficit of BoP.

Receipts of such loans are recorded on the positive (credit) side and repayment on the negative (debit) side.

(iii) **Banking Capital:** It refers to capital movements in the form of foreign exchange transactions and investments in foreign currency and securities by foreign branches of Indian commercial and cooperative bank (which are authorised to deal in foreign exchange). It also includes deposits of non-residents.

(iv) **Foreign Direct Investment:** It refers to purchase of an asset in the rest of the world such that, it gives direct control to the purchaser over the asset. For example, acquisition of foreign firm by an Indian firm.

(v) **Portfolio Investment:** It refers to purchase of an asset in the rest of the world such that, it does not give any direct control over the asset to the purchaser. For example, purchase of share of a foreign firm by an Indian firm. Foreign institutional investment is also a part of portfolio investment.

Long Answer Type Questions

Q 1. What is disequilibrium or deficit in the balance of payment?

Ans. Disequilibrium in balance of payment means either a deficit or a surplus in balance of payment. Deficit in balance of payment refer to a situation when outflow of foreign exchange is more than the inflow of foreign exchange. On the other hand, surplus in balance of payment refers to a situation in which inflow of foreign exchange is more than the outflow of foreign exchange.

Deficit in the balance of payments is caused due to the following factors:

(i) **Economic Factors**

(a) **Developmental Activities:** Developing countries like India, purchase advanced machines, technology and other equipments from developed countries of the world. This increases imports and thus leads to a deficit in the BoP account.

(b) **High Rate of Inflation:** When there is inflation in the domestic economy, foreign goods become relatively cheaper as compared to domestic goods. This increases imports and thus leads to a deficit in the BoP.

(c) **Cyclical Fluctuations:** When the domestic economy is going through a phase of recession or depression, then domestic production may be unable to satisfy the domestic demand. This increases imports and thus leads to a deficit in the BoP.

(d) **Change in Demand:** When the demand for domestically produced goods fall in the foreign markets then it leads to a fall in exports. This adversely affects the balance of payment. As a result of this, there is a deficit in BoP.

(e) **Import of Services:** When developing countries like India, import services from developed countries of the world then it has to pay huge amount of money. As a result of this, there is a deficit in BoP.

(ii) **Political Factors**

(a) **Political Instability:** When there is a political instability in the country then foreign investors may withdraw their investments which leads to large capital outflows and reduce the inflows of foreign investments. As a result of this, there is a deficit in BoP.

(b) **Political Disturbances:** When there is a frequent changes in the government, in adequate support to the government in parliament then this discourage inflows of foreign investments in the country. This leads to more outflows than inflows. As a result of this, there is a deficit in BoP.

(iii) **Social Factor**

Demonstration Effect\Change in Tastes, Preferences, Fashion and Trends: When the people of developing countries (like India) come in contact with the people of developed countries (America), they start adopting the foreign pattern of consumption such as Nike shoes, Apple iPhone, Swatch watch, etc. Due to this reason, the imports of the country increases. As a result of this, there is a deficit in BoP.

Q 2. Arrange the following as inflow/outflow of foreign exchange, debit/credit transaction in BoP, current/capital account of BoP and effect on demand and supply of foreign exchange.

(i) Lending to abroad | **(ii) Making in India policy**
(iii) Import of metro rail engine | **(iv) Investments by McDonald's in India**
(v) Import of iPhones/ PS5 | **(vi) Export of wheat**
(vii) Sending gifts/funds to relatives abroad | **(viii) Borrowings from America (USA).**

Ans.

S. No.	Economic Transactions	Inflow/Outflow of Foreign Exchange	Debit/Credit Transaction in BoP	Current/ Capital Account of BoP	Effect on Demand and Supply of Foreign Exchange
(i)	Lending to Abroad	Outflow	Debit	Capital	Increase in Demand
(ii)	Make in India Policy	Inflow	Credit	Capital	Increase in Supply
(iii)	Import of Metro Rail Engine	Outflow	Debit	Current	Increase in Demand
(iv)	Investments by McDonald's in India	Inflow	Credit	Capital	Increase in Supply
(v)	Import of iPhones/PS5	Outflow	Debit	Current	Increase in Demand
(vi)	Sending Gifts to Relatives Abroad	Outflow	Debit	Current	Increase in Demand
(vii)	Exports of Wheat	Inflow	Credit	Current	Increase in Supply
(viii)	Borrowings from USA	Inflow	Credit	Capital	Increase in Supply

Foreign Exchange Rate

- **Foreign Exchange Rate:** It is the rate at which one currency can be exchanged for the other currency. If in the foreign exchange market, ₹ 58 are to be paid to buy one dollar, then the ₹/$ (Rupees per dollar) exchange rate is ₹ 58 *i.e.*, ₹ 58 per $.

Knowledge BOOSTER

Foreign exchange refers to the reserve of foreign currencies e.g., currency of US and UK are foreign exchange for India.

- **Exchange Rate System:** There are two exchange rate systems, *viz.*, fixed exchange rate and flexible exchange rate.
  - **Fixed Exchange Rate:** It is a system in which the central authority or government maintains their exchange rate fixed either against gold or some other currency.
  - **Types of Fixed Exchange Rate**
    - **Gold Standard:** Under this system, a country's Central Bank fixes its currency against certain quantity of gold. Accordingly, value of one currency in terms of the other currency was fixed, considering gold value of each currency.
    - **Bretton Woods System:** The Bretton Woods conference held in 1944, established a system of fixed exchange rate. Under this system, Central Bank ties its currency with US Dollar, as the official reserve asset.
  - **Merits of Fixed Exchange Rate**
    - It helps the government to check inflation.
    - It stops speculation in Foreign exchange market.
    - It prevents capital outflow.
    - It ensures stability in exchange rate.
    - It promotes capital movements because it does not involve any uncertainties about exchange rate that may cause capital outflow.
  - **Demerits of Fixed Exchange Rate**
    - Central Bank needs to hold huge stocks of either gold or US Dollar.
    - Automatic stabilisation of exchange rate does not allow.
    - Diverts Central Bank focus from economic problems to determination of exchange rate.
    - It discourages venture capital.
    - There exists the possibility of delay in policy making.

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- ***Overvaluation:*** *It is a situation in which the exchange rate of a currency exceeds what the open market willing to pay.*
- ***Undervaluation:*** *It is a situation in which the value of currency is lower than what is expected in the exchange market.*

➤ **Flexible Exchange Rate System:** 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. It is a combination of flexible exchange rate system and a fixed exchange rate system.

➤ **Managed Floating System:** Under this system, exchange rate is determined by the market forces of demand and supply of foreign exchange and the excessive fluctuation is checked by the central authority. It is also termed as dirty floating. It is a combination of flexible exchange rate system and a fixed exchange rate system.

➤ **Merits of Flexible Exchange Rate System**
- It is independent monetary policy. There is no need for the government to hold any reserve.
- It encourages international mobility of capital and trade.
- It encourages venture capital.
- There is no need to maintain huge stock of gold or other currencies.

➤ **Demerits of Flexible Exchange Rate System**
- Creates the condition of instability in the international trade.
- Adverse effect on economic structure.
- Unnecessary capital movements.
- Inflationary problems.
- Difficulty in policy formation.

▶ **Different Types of Foreign Exchange Rate**

➤ **Nominal Exchange Rate (NER):** It refers to the number of units of domestic currency, one must give up to get a unit of foreign currency. In simple term, it refers to the price of foreign currency in terms of domestic currency.

➤ **Real Exchange Rate (RER):** It is the ratio of foreign to domestic prices, measured in the same currency. It is defined as:

$$\text{Real Exchange Rate} = \frac{eP_f}{P}$$

where, P and P_f are the price levels in home country and abroad, respectively, and e is the rupee price of foreign exchange *i.e.*, exchange rate.

➤ **Nominal Effective Exchange Rate (NEER):** It is that type of effective exchange rate which does not accounts for changes in price level while measuring average strength of one currency in relation to the other.

➤ **Real Effective Exchange Rate (REER):** It is that type of effective exchange rate which accounts for changes in the price level across different countries of the world.

▶ **Sources of Demand for Foreign Exchange**

➤ Payment of loans and interests to international organisations.

➤ Gifts and grants to rest of the world.

➤ Foreign investments across the world.

➤ Foreign trade *i.e.*, import.

➤ Foreign exchange trade for speculation.

➤ Foreign tourism to abroad.

▶ **Sources of the Supply of Foreign Exchange**

➤ Exports of goods and services from domestic country.

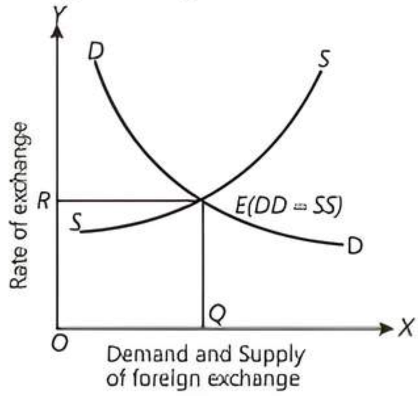
➤ Foreign investment:
- Foreign direct investment.
- Portfolio investment.

➤ Foreign tourism from abroad.

➤ Purchases by non-residents in the domestic country.

➤ Remittances from abroad.

▶ **Determination of Equilibrium Rate of Foreign Exchange:** The equilibrium foreign exchange rate is obtained at the point where supply of foreign exchange equals to the demand for foreign exchange.



In the above figure, the line *SS* shows the supply of foreign currency which is positively related to the rate of exchange. The line *DD* shows the demand for foreign currency which is negatively related to the rate of exchange. The point *E*, at which *DD* equals to *SS*, represents the equilibrium rate of exchange.

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- ***Spot Market:*** *The market which handles only spot or current transactions of foreign exchange are termed as spot market or current market.*
- ***Forward Market:*** *The market of foreign exchange which deals with the purchase and sale of foreign exchange which are contracted today, but are implemented in future is called forward market.*

▶ **Some Extra Knowledge Points**

Difference between Appreciation of Domestic Currency and Depreciation of Domestic Currency

S. No.	Basis of Difference	Appreciation of Domestic Currency	Depreciation of Domestic Currency
(i)	Rise or Fall	Fall in the exchange rate.	Rise in the exchange rate.
(ii)	Effect	Less rupees are required to buy a Dollar.	More rupees are required to buy a Dollar.

(iii)	Causes	Decrease in demand for foreign exchange and increase in supply of foreign exchange.	Increase in demand for foreign exchange and decrease in supply of foreign exchange.
(iv)	Example	Exchange rate falls from ₹ 70 to ₹ 65.	Exchange rate rises from ₹ 70 to ₹ 75.

Difference between Devaluation of Currency and Depreciation of Currency

S. No.	Basis of Difference	Devaluation of Currency	Depreciation of Currency
(i)	Meaning	Fall in the value of domestic currency by the government.	Fall in the value of domestic currency by the forces of demand and supply.
(ii)	Take place	Take place due to government order.	Take place due to market forces of demand and supply.
(iii)	Related to	Fixed exchange rate system.	Flexible exchange rate system.

COMMON ERROR

Many times students get confused between depreciation and devaluation.

TiP

Students should learn devaluation and depreciation separately. Devaluation is done by government as fixed exchange rate and depreciation by demand and supply forces as flexible exchange rate.

Practice Exercise

Multiple Choice Questions

Q 1. All currencies other than domestic currency:
a. foreign currency
b. foreign exchange
c. Both a. and b.
d. None of the above

Q 2. That exchange rate which is officially fixed by the government.
a. Fixed exchange rate
b. Flexible exchange rate
c. Managed floating exchange rate
d. None of the above

Q 3. That exchange rate which is determined by the market forces of demand and supply.
a. Fixed exchange rate
b. Flexible exchange rate
c. Managed floating exchange rate
d. None of the above

Q 4. That exchange rate which is a mixture of both fixed and flexible exchange rate.
a. Fixed exchange rate
b. Flexible exchange rate
c. Managed floating exchange rate
d. None of the above

Q 5. Other things remaining the same, when in a country the price of foreign currency rises, national income is:
a. likely to rise
b. likely to fall
c. Both a. and b.
d. not affected

Q 6. Other things remaining the same, when in a country the price of foreign currency falls, national income is:
a. likely to rise
b. likely to fall
c. Both a. and b.
d. not affected

Q 7. Foreign exchange is demanded:
a. by domestic residents to purchase goods from other countries
b. for sending gifts to foreign countries
c. to visit foreign countries
d. All of the above

Q 8. What is the relationship between foreign exchange rate and demand for foreign exchange?
a. Inverse
b. Direct
c. One-to-one
d. None of these

Q 9. Supply of foreign exchange comes from:
a. exports of goods and services
b. investment by foreigners in the country
c. currency dealers and speculators
d. All of the above

Q 10. What is the relationship between exchange rate and supply of foreign exchange?
a. Inverse
b. Direct
c. One-to-one
d. No relationship

Q 11. Depreciation in currency means:
a. fall in the value of domestic currency in terms of foreign currency.
b. rise in the value of domestic currency in terms of foreign currency.
c. no change in the value of domestic currency.
d. None of the above

Q 12. Depreciation in domestic currency leads to:
a. increase in exports
b. increase in imports
c. Both a. and b.
d. Neither a. nor b.

Q 13. Indian Rupee has depreciated in terms of US Dollar due to:
a. rising demand of dollars
b. shortage of US dollar
c. more supply of Indian currency
d. less demand of Indian rupees

Q 14. Flexible exchange rate is also known as:
a. Pegged exchange rate
b. Floating exchange rate
c. Both a. and b.
d. None of the above

Q 15. Devaluation of currency means:
a. reduction in the value of foreign currency by the government.
b. reduction in the value of domestic currency in terms of foreign currency.
c. reduction in the value of domestic currency by force.
d. None of the above

Q 16. Two friends Mira and Sindhu were discussing the exchange rate systems. "Under this system, the exchange rates are determined by the 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 was she talking about? *(CBSE SQP 2021, Term-1)*
a. Fixed Exchange Rate
b. Floating Exchange Rate
c. Managed Floating Exchange Rate
d. Managed Fixed Exchange Rate

Statement Based Questions

Q 17. Read the following statements carefully:
Statement I: Current account transactions bring a change in the capital stock of a country.
Statement II: 'Make in India' will increase the inflow of foreign exchange.
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 are true.
d. Both statements are false.

Q 18. Read the following statements carefully:
Statement I: The export of sugar is recorded in the capital account.
Statement II: Atmanirbhar Bharat' will decrease the outflow of foreign exchange.
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 are true.
d. Both statements are false.

Fill in the Blanks Type Questions

Q 19. All currencies other than the domestic currency of a country are called as .... *(CBSE 2021, Term-1)*
(Fill up the blank with correct alternative)
(i) Foreign exchange rate
(ii) Foreign exchange
(iii) Foreign aid
Identify the correct alternatives from the following.
Alternatives:
a. (i) and (ii) b. (i) and (iii)
c. Only (ii) d. All of these

Q 20. .... exchange rate is fixed by the government.
(Choose the correct alternative to fill up the blank)
a. Fixed b. Flexible
c. Constant d. Reserve

Q 21. .... exchange rate is determined by the market forces.
(Choose the correct alternative to fill up the blank)
a. Fixed b. Flexible
c. Constant d. Reserve

Q 22. .... is a mixture of both fixed and flexible exchange rates.
(Choose the correct alternative to fill up the blank)
a. Balance of Payment b. Balance of Trade
c. Managed Floating d. Trade Deficit

Q 23. .... is the decrease in value of domestic currency in terms of foreign currency by the government.
(Choose the correct alternative to fill up the blank)
a. Depreciation b. Devaluation
c. Appreciation d. Revaluation

Q 24. .... is the increase in value of domestic currency in terms of foreign currency by the government.
(Choose the correct alternative to fill up the blank)
a. Depreciation b. Devaluation
c. Appreciation d. Revaluation

Q 25. .... is the decrease in the value of domestic currency in terms of foreign currency by the market forces.
(Choose the correct alternative to fill up the blank)
a. Appreciation b. Revaluation
c. Depreciation d. Devaluation

Q 26. .... is the increase in the value of domestic currency in terms of foreign currency by the market forces.
(Choose the correct alternative to fill up the blank)
a. Depreciation b. Devaluation
c. Appreciation d. Revaluation

True/False Type Questions

Q 27. Under fixed exchange rate system, the exchange rate is determined by the market forces.

Q 28. Decrease in demand for imported goods raises the demand for foreign exchange.

Q 29. Devaluation of currency means decrease in the value of domestic currency.

Q 30. A change from \$1 = ₹70 to \$1 = ₹75 implies appreciation of currency.

Q 31. A rise in supply of foreign exchange would lead to appreciation of currency.

Q 32. Managed floating exchange rate is decided by market forces and the Central Bank influences the exchange rate through intervention. *(CBSE SQP 2020)*

Q 33. Flexible exchange rate is determined by the market forces.

Q 34. Supply curve of foreign exchange is left to right upward sloping curve.

Q 35. Demand for foreign exchange curve is negatively sloped curve.

Q 36. Other things being equal, when foreign currency becomes cheaper, National Income will decrease.

Match the Column Type Questions

Q 37. From the following statements given in Column I and Column II, choose the correct pair of statements:

Column I	Column II
A. Fixed exchange rate	1. Foreign exchange rate
B. Flexible exchange rate	2. Fixed by the government
C. Managed floating exchange rate	3. Determined by market forces
D. \$1 = ₹ 75	4. Hybrid of fixed and floating

	A	B	C	D
a.	1	2	3	4
b.	2	3	4	1
c.	4	3	2	1
d.	3	4	1	2

Q 38. From the following statements given in Column I and Column II, choose the correct pair of statements:

Column I	Column II
A. Depreciation of currency	1. Positively related to exchange rate
B. Appreciation of currency	2. Inversely related to exchange rate
C. Demand for foreign currency	3. Rise in exports, fall in imports
D. Supply of foreign currency	4. Fall in exports, rise in imports

	A	B	C	D
a.	3	4	2	1
b.	1	2	3	4
c.	4	3	2	1
d.	1	4	2	3

Q 39. From the following statements given in Column I and Column II, choose the correct pair of statements:

Column I	Column II
A. A change from \$1 = ₹ 70 to \$1 = ₹ 75	1. Demand for foreign exchange
B. A change from \$1= ₹ 75 to \$1 = ₹ 70	2. Supply of foreign exchange
C. Import of iPhone	3. Appreciation of currency
D. Foreigners coming to India to visit Taj Mahal	4. Depreciation of currency

	A	B	C	D
a.	1	2	3	4
b.	4	3	2	1
c.	4	3	1	2
d.	3	4	2	1

Q 40. From the following statements given in Column I and Column II, choose the correct pair of statements:

Column I	Column II
A. Demand for foreign exchange	1. Inflow of foreign exchange
B. Supply of foreign exchange	2. Outflow of foreign exchange
C. Foreign currencies are bought and sold	3. Revaluation
D. Rise in price of domestic currency with respect to foreign currencies by government	4. Foreign exchange market

	A	B	C	D
a.	2	1	4	3
b.	1	2	3	4
c.	4	3	2	1
d.	2	4	1	3

Q 41. From the following statements given in Column I and Column II, choose the correct pair of statements:

Column I	Column II
A. Investments by large MNCs in India	1. Depreciation of currency
B. Selling of Securities by FIIS in Indian Capital Market	2. Appreciation of currency
C. More risk and uncertainty	3. Fixed exchange rate
D. Depends upon Gold price	4. Flexible exchange rate

	A	B	C	D
a.	1	2	3	4
b.	3	4	1	2
c.	2	1	4	3
d.	4	3	2	1

Q 42. From the following statements given in Column I and Column II, choose the correct pair of statements:

Column I	Column II
A. Visits to foreign countries for sightseeing	1. Appreciation of currency
B. Incentives for exports	2. Spot market
C. Market in which receipts and payments take place at the same time	3. Forward market
D. Market in which sale and purchase of foreign currency is fixed on a specified future date at a rate decided today	4. Depreciation of currency

	A	B	C	D		A	B	C	D
a.	4	1	2	3	b.	1	2	3	4
c.	3	1	2	4	d.	4	3	2	1

Q 43. From the following statements given in Column I and Column II, choose the correct pair of statements:

Column I	Column II
A. Incredible India or Atulya Bharat	1. Outflow of foreign currency
B. Indians going to Japan to visit Mario Kingdom	2. Inflow of foreign currency
C. Related to fixed exchange rate system	3. Depreciation of currency
D. Related to flexible exchange rate system	4. Devaluation of currency

	A	B	C	D		A	B	C	D
a.	1	2	3	4	b.	4	3	2	1
c.	2	1	4	3	d.	3	4	1	2

Q 44. From the following statements given in Column I and Column II, choose the correct pair of statements:

Column I	Column II
A. All currencies other than home currency	1. Flexible exchange rate
B. Rate at which currencies are exchanged	2. Foreign exchange
C. Hybrid of fixed and Flexible exchange rate	3. Foreign exchange rate
D. Free exchange rate	4. Managed floating exchange rate

	A	B	C	D		A	B	C	D
a.	1	2	3	4	b.	4	3	2	1
c.	3	4	1	2	d.	2	3	4	1

Q 45. From the following statements given in Column I and Column II, choose the correct pair of statements:

Column I	Column II
A. Investments made by Indians abroad	1. Supply of foreign exchange
B. Rise in exports, fall in imports	2. Decrease in National Income
C. Fall in exports, rise in imports	3. Increase in National Income
D. Remittances from abroad	4. Demand for foreign exchange

	A	B	C	D		A	B	C	D
a.	1	2	3	4	b.	4	3	2	1
c.	4	2	1	3	d.	3	1	4	2

Q 46. From the following statements given in Column I and Column II, choose the correct pair of statements:

Column I	Column II
A. Purchase of Metro rail engine from Korea	1. Supply of foreign exchange
B. McDonald's opening new outlets in India	2. Demand for foreign exchange
C. RBI sells foreign exchange	3. Related to protection
D. Hedging function	4. Bring down foreign exchange rate

	A	B	C	D		A	B	C	D
a.	2	1	4	3	b.	1	4	2	3
c.	1	2	3	4	d.	4	3	2	1

Assertion & Reason Type Questions

Directions (Q. Nos. 47-57): *There are two statements marked as Assertion (A) and Reason (R). Read the statements and choose the appropriate option from the options given below:*

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

Q 47. Assertion (A): Fixed exchange rate is a stable exchange rate so uncertainty in the international market is prevented which promotes international trade.

Reason (R): Because it is the exchange rate which is officially fixed and declared by the government.

Q 48. Assertion (A): Flexible exchange rate is also known as floating or free exchange rate.

Reason (R): Because it is determined by the market forces of demand and supply of foreign exchange without government intervention.

Q 49. Assertion (A): Managed floating exchange rate is a hybrid of fixed and flexible exchange rate.

Reason (R): Because exchange rate is determined by the market forces however Central Bank intervenes to reduce fluctuations in the foreign exchange rate .

Q 50. Assertion (A): Rupee is said to be depreciating if price of $ 1 falls from ₹ 75 to ₹ 70.

Reason (R): Rupee depreciates when more Indian rupees are needed to buy a dollar.

Q 51. Assertion (A): Rupee is said to be appreciating if price of $ 1 falls from ₹ 75 to ₹ 70 .

Reason (R): Rupee appreciates when less Indian rupees are needed to buy a dollar.

Q 52. Assertion (A): When the exchange rate is too high, Central Bank intervenes to reduce fluctuations in the foreign exchange rate.

Reason (R): Central Bank start selling foreign currency from its reserves.

Q 53. Assertion (A): When the exchange rate is too low, Central Bank intervenes to reduce fluctuations in the foreign exchange rate.

Reason (R): Central Bank start buying foreign currency from the market.

Q 54. Assertion (A): Currency depreciation increases exports and decreases imports.

Reason (R): Because foreigners have to pay less for buying goods of that country whose currency has been depreciated. On the other hand, to buy a good from foreign country will become expensive.

Q 55. Assertion (A): Currency appreciation decreases exports and increases imports.

Reason (R): Because foreigners have to pay more for buying goods of that country whose currency has been appreciated. On the other hand, to buy a good from foreign country will become less expensive.

Q 56. Assertion (A): Revaluation is the opposite of devaluation.

Reason (R): Both are done by government. Revaluation means increase in the value of domestic currency with respect to foreign currency. Devaluation means decrease in the value of domestic currency with respect to foreign currency.

Q 57. Assertion (A): Managed floating exchange rate system is also known as 'hybrid system'.

Reason (R): Managed floating exchange rate system is a combination of a flexible and fixed exchange rate system. *(CBSE 2021, Term-1)*

Answers

1. (c) Both a. and b.
2. (a) Fixed exchange rate
3. (b) Flexible exchange rate
4. (c) Managed floating exchange rate
5. (b) likely to fall
6. (a) likely to rise
7. (d) All of the above
8. (a) Inverse
9. (d) All of the above
10. (b) Direct
11. (a) fall in the value of domestic currency in terms of foreign currency.
12. (a) increase in exports
13. (a) rising demand of dollars
14. (b) Floating exchange rate
15. (b) reduction in the value of domestic currency in terms of foreign currency.
16. (c) Managed Floating Exchange Rate
17. (b) Statement I is false and statement II is true.
18. (b) Statement I is false and statement II is true.
19. (c) Only (ii)
20. (a) Fixed
21. (b) Flexible
22. (c) Managed Floating
23. (b) Devaluation
24. (d) Revaluation
25. (c) Depreciation
26. (c) Appreciation
27. False: Exchange rate is officially fixed and declared by the government.
28. False: It decreases the demand for foreign exchange.
29. True: Devaluation is the decrease in value of domestic currency in terms of foreign currencies. It is done by government.
30. False: It implies depreciation of currency because more Indian rupees are needed to buy a dollar.
31. True: It increases the inflow of foreign currency. demand remains same. supply increases. Thus, appreciation of Indian rupee.
32. True: Central Bank may increase or decrease the supply of foreign exchange in order to keep the price stable.
33. True: It is determined by the intersection of demand and supply of foreign exchange curves.
34. True: It shows positive relationship between foreign exchange rate and supply of foreign exchange.
35. True: It shows inverse relationship between foreign exchange rate and supply of foreign exchange.
36. True: It will decrease Indian exports and thus National income is likely to fall.

		A	B	C	D
37.	(b)	2	3	4	1
38.	(a)	3	4	2	1
39.	(c)	4	3	1	2
40.	(a)	2	1	4	3
41.	(c)	2	1	4	3
42.	(a)	4	1	2	3
43.	(c)	2	1	4	3
44.	(d)	2	3	4	1
45.	(b)	4	3	2	1
46.	(a)	2	1	4	3

47. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).
48. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).
49. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).
50. (d) Assertion (A) is false, but Reason (R) is true.
51. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).
52. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).
53. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).
54. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).
55. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).
56. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).
57. (b) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).

Case Study Based Questions

Case Study 1

Read the extract given below and answer the questions on the basis of the same:

Economists say that rise in foreign exchange reserves in combination with benign oil prices and tepid imports, leading to a current account surplus, has helped the Indian rupee to remain broadly stable since mid-March 2020, despite deterioration in some of the other macro parameters such as retail inflation, fiscal deficits and negative GDP growth.

Experts say that in times of dwindling economic activity and growth, the rising forex reserves provide a lot of strength as they now cover one-year of import expenditure.

It is important to note that gold, which was a big import component for India, witnessed a sharp decline in the quarter ended June 2020 following the skyrocketing prices and the lockdown induced by the pandemic. As per World Gold Council, gold imports fell by 95% to 11.6 tonnes in the quarter, compared to 247.4 tonnes in the year-ago period due to logistical issues and poor demand.

***Source:** Indian Express, October 18, 2020*

Q 1. When export of goods and services are less than the imports of goods and services, then there is a .... in current account.

a. deficit　　b. fixed
c. sell　　d. appreciation

Q 2. Foreign exchange rate determined on the basis of gold price is known as .... exchange rate.

a. deficit　　b. fixed
c. sell　　d. appreciation

Q 3. Rising foreign exchange reserves will help the Central Bank to .... foreign exchange at the time of high foreign exchange rate.

a. deficit　　b. fixed
c. sell　　d. appreciation

Q 4. Fall in demand and a rise in supply of foreign exchange would lead to .... of currency.

a. deficit　　b. fixed
c. sell　　d. appreciation

Answers

1. (a)　**2.** (b)　**3.** (d)　**4.** (c)

Case Study 2

Read the extract given below and answer the questions on the basis of the same:

The rupee depreciated by 6 paise to close at 73.02 (provisional) against the US dollar on Monday, tracking a rebound in the American currency overseas.

At the interbank forex market, the domestic unit opened at 72.89 against the US dollar and witnessed an intra-day high of 72.84 and a low of 73.15. The local unit finally settled at 73.02, registering a fall of 6 paise over its previous close, even as the domestic equity market settled with significant gains on budget day. On Friday, the rupee had closed at 72.96 against the American currency.

Meanwhile, the dollar index which gauges the green backs strength against a basket of six currencies, rose 0.21% to 90.78.

On the domestic equity market front, the BSE sensex ended 2,314.84 points or 5% higher at 48,600.61 while the broader NSE Nifty advanced 646.60 points or 4.74% to 14,281.20.

Foreign institutional investors were net sellers in the capital market as they off loaded shares in the capital worth ₹ 5,930.66 crore on Friday, according to exchange data.

Brent crude futures, the global oil benchmark, advanced 0.84% to USD 55.50 per barrel.

"Rupee tumbles 6 paise to close at 73.02 against US dollar"

The Economic Times- February 01, 2021

Q 1. **How will the devaluation of Indian Rupee affect the imports?**
a. Imports will fall
b. Imports will rise
c. Imports will have no effect
d. None of the above

Q 2. **How will the devaluation of Indian Rupee affect the exports?**
a. Exports will fall
b. Exports will rise
c. Exports will remain same
d. Exports will fall first and then rise

Q 3. **With the devaluation of the Indian Rupee, foreign reserve of the country will ....** (fall/rise)

Q 4. **How is the exchange rate determined?**
a. By the government.
b. By the demand and supply of foreign currency.
c. Both a. and b.
d. Neither a. nor b.

Answers

1. (a) 2. (b) 3. fall 4. (c)

Case Study 3

Read the extract given below and answer the questions on the basis of the same:

Now a days Barter system has been converted into money system. Now people can import their required commodities and can export their excess or surplus quantity of produced goods to abroad. Here, one problem also arose, as earlier pointed out that currency of a country is not generally accepted in other countries. From this it originates the problem of converting one currency into the other and fixing the rate at which the two currencies are to be exchanged. This rate is named as foreign exchange rate.

Conversion of one currency into other currency at the determined exchange rate facilitated the foreign trade.

Q 1. **What do you mean by foreign exchange rate?**
Ans. Foreign exchange rate is the price of one currency in terms of another one.

Q 2. **What do you mean by foreign trade?**
Ans. Foreign Trade is the exchange of goods and services between two countries in the international market.

Very Short Answer Type Questions

Q 1. **What is foreign exchange?**
Ans. Foreign exchange refers to foreign currency. All currencies other than the Home (domestic) currency of the country are called foreign exchange.

Q 2. **What is foreign exchange rate?**
Ans. The rate at which currency of one country can be exchanged for the currency of the other country is called the foreign exchange rate.

Q 3. **What are the main types of foreign exchange rates?**
Ans. There are three types of exchange rate systems which are as follows:
(i) Fixed Exchange Rate System (or Mint Par Value of Exchange)
(ii) Flexible Exchange Rate System (or Floating Exchange Rate System)
(iii) Managed Floating Exchange Rate System.

Q 4. **Define fixed exchange rate system.**
Ans. Fixed exchange rate is defined as a system in which exchange rate is officially fixed and declared by the government.

Q 5. **Define flexible exchange rate system.**
Ans. Flexible exchange rate system is defined as a system in which exchange rate is determined by forces of demand and supply of different currencies in the foreign exchange market.

Q 6. **Define managed floating exchange rate system.**
Ans. A managed floating rate system is defined as a combination of fixed exchange rate and flexible exchange rate system.

Q 7. **What is the relationship between foreign exchange rate and its demand?**
Ans. There is an inverse relationship between price of foreign exchange (exchange rate) and demand for foreign exchange.

Q 8. **What is the relationship between foreign exchange rate and its supply?**
Ans. There is a positive relationship between price of foreign exchange (exchange rate) and supply of foreign exchange.

Q 9. **How is foreign exchange rate determined?**
Ans. Flexible exchange rate is determined where demand for foreign exchange curve and supply of foreign exchange curve intersect each other.

Q 10. **What is depreciation of currency?**
Ans. Depreciation of currency refers to decrease in the value of domestic currency in terms of foreign currency.
For example: Rupee is said to be depreciated if the price of $1 rises from ₹ 75 to ₹ 80.

Q 11. **What is appreciation of currency?**
Ans. Currency appreciation refers to increase in the value of domestic currency in terms of foreign currency.
For example, Indian rupee appreciates when price of $1 falls from ₹ 80 to ₹ 75.

Q 12. **The price of US $ has fallen from ₹ 50 to ₹ 48. Has the Indian currency appreciated or depreciated?**
Ans. Indian currency has appreciated as less INR are needed to buy a dollar.

Q 13. **The price of US $ has risen from ₹ 50 to ₹ 55. Has the Indian currency appreciated or depreciated?**
Ans. Indian currency has depreciated as more INR are needed to buy a dollar.

Q 14. **How can Reserve Bank of India help in bringing down the foreign exchange rate which is very high?**
Ans. Reserve Bank of India will start selling foreign exchange from its reserves in order to bring down the foreign exchange rate. RBI will increase the supply of foreign exchange.

Q 15. Name the exchange rate system in which RBI can actively intervene.

Ans. Managed Floating Exchange Rate System.

Short Answer Type-I Questions

Q 1. Distinguish between fixed and flexible exchange rate system.

Ans. Difference between fixed and flexible exchange rate are:

S.No.	Basis of Difference	Fixed Exchange Rate System	Flexible Exchange Rate System
(i)	Meaning	It is officially fixed and declared by the government.	It is determined by forces of demand and supply of foreign exchange.
(ii)	Exchange rate	In this system, the exchange rate is determined by the Gold price.	In this system, the exchange rate is determined by the market forces.
(iii)	Stability	In this system, the exchange rate is more stable and less risky.	In this system, the exchange rate is less stable and more risky.

Q 2. Explain any three merits and demerits of Fixed Exchange Rate.

Ans. Merits of Fixed Exchange Rate

The merits of fixed exchange rate are:

(i) It helps the government to check inflation.

(ii) It stops speculation in foreign exchange market.

(iii) It prevents capital outflow.

Demerits of Fixed Exchange Rate

The demerits of fixed exchange rate are:

(i) Central Bank needs to hold huge stocks of either gold or US Dollar.

(ii) Automatic stabilisation of exchange rate does not allow.

(iii) Diverts Central Bank's focus from economic problems to determination of exchange rate.

Q 3. What do you mean by managed floating system?

Ans. Managed Floating System: Under this system, exchange rate is determined by the market forces of demand and supply of foreign exchange and the excessive fluctuation is checked by the central authority. It is also termed as dirty floating. It is a combination of flexible exchange rate system and a fixed exchange rate system.

Merits of Flexible Exchange Rate System

(i) Independent monetary policy. There is no need for the government to hold any reserve.

(ii) It encourages international mobility of capital and trade.

(iii) It encourages venture capital.

(iv) There is no need to maintain huge stock of gold or other currencies.

Demerits of Flexible Exchange Rate System

(i) Creates the condition of instability in the international trade.

(ii) Adverse effect on economic structure.

(iii) Unnecessary capital movements.

(iv) Inflationary problems.

(v) Difficulty in policy formation.

Q 4. Why there is an inverse relation between foreign exchange rate and demand for foreign exchange?

Ans. There is an inverse relation between foreign exchange rate and demand for foreign exchange.

When price of a foreign currency falls, imports from that foreign country become cheaper. So, imports system increase and hence, the demand for foreign currency rises. For example, fall in the price of US dollar from \$1 = ₹ 75 to \$1 = ₹ 70 will make American goods cheaper and demand for dollar will rise and *vice-versa*.

When a foreign currency becomes cheaper in terms of the domestic currency. It promotes tourism to that country. As a result, demand for foreign currency rises and *vice-versa*.

When prices of foreign currency falls, demand for foreign currency rises as more people want to make gains from speculative activities and *vice-versa*.

Q 5. Why there is a direct relation between foreign exchange rate and supply of foreign exchange?

OR

Why are foreign exchange rate and demand for foreign exchange inversely related? Explain.

(CBSE 2016)

OR

"When dollar price increases or price of foreign currency rises, domestic goods become relatively cheaper."

Do you agree with the given statement? Give valid reason in support of your answer.

Ans. There is a direct relation between foreign exchange rate and supply of foreign exchange.

When dollar price increases or price of a foreign currency rises, domestic goods become relatively cheaper. It induces the foreign country to increase their imports from the domestic country. As a result, supply of foreign currency rises.

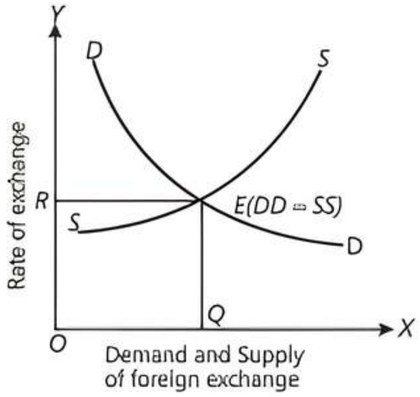
For example, rise in price of US dollar from \$1 = ₹ 70 to \$1 = ₹ 75 will make Indian goods cheaper. It will induce the Americans to increase their imports from India, which will raise the supply of foreign currency and *vice-versa*.

When dollar price increases. It promotes tourism to India. As a result, supply of foreign currency rises and *vice-versa*.

When price of a foreign currency rises, supply of foreign currency rises as people want to make gains from speculative activities and *vice-versa*.

Q 6. Explain, how exchange rate is determined under a free market exchange rate system? *(CBSE SQP 2022-23)*

Ans. Determination of Equilibrium Rate of Foreign Exchange: The equilibrium foreign exchange rate is obtained at the point where supply of foreign exchange equals to the demand for foreign exchange.



In the above figure, the line *SS* shows the supply of foreign currency which is positively related to the rate of exchange. The line *DD* shows the demand for foreign currency which is negatively related to the rate of exchange. The point *E*, at which *DD* equals to *SS*, represents the equilibrium rate of exchange.

Q 7. "Under the flexible exchange rate system, the Central Bank does not intervene in the foreign exchange market."

Justify the statement, giving valid arguments. *(CBSE 2023)*

Ans. A flexible exchange rate is determined by supply and demand on the open market. A flexible exchange rate does not mean countries don't try to intervene and manipulate their currency's price, since governments and Central Banks regularly attempts to keep their currency price favourable for international trade.

Q 8. Giving valid reasons, state whether the following statements are true or false:

(i) Dividend received from investment abroad is recorded on the credit side of the capital account.

(ii) Depreciation of the Indian Currency will lead to promotion of Indian exports. *(CBSE 2023)*

Ans. (i) False. Dividend received from investment abroad is recorded in the current account of the balance of payment, not in the capital account. The capital account records capital transfers and acquisition and disposal of non-produced and non-financial assets.

(ii) True. Depreciation of the Indian currency means that the value of the Indian rupee has decreased in relation to other currencies, making Indian goods relatively cheaper for foreign buyers. This makes Indian exports more competitive in international markets and can lead to an increase in exports.

Short Answer Type-II Questions

Q 1. What is depreciation of currency? Explain its effect on exports.

OR

Explain the impact of home currency depreciation on the exports of a nation. *(CBSE 2023)*

Ans. Depreciation of Currency: Depreciation of currency refers to decrease in the value of domestic currency in terms of foreign currency.

Depreciation of currency makes the domestic currency less valuable and more of it is required to buy the foreign currency.

For example, Rupee is said to be depreciating if price of $1 rises from ₹ 70 to ₹ 75.

Effect of Depreciation of Domestic (Home) Currency on Exports: Depreciation of domestic (home) currency means a fall in the price of domestic (home) currency (Say, rupee) in terms of a foreign currency (Say, $). It means that one $ can be exchanged for more rupees, *i.e.*, with the same amount of dollars, more goods can be purchased from India. Thus, exports to USA will become relatively cheaper. It leads to increase of exports to USA.

Q 2. What is appreciation of currency? Explain its effect on imports.

OR

Explain the effect of appreciation of domestic currency on exports. *(CBSE 2015)*

Ans. Appreciation of Currency: It refers to increase in the value of domestic currency in terms of foreign currency.

The domestic currency becomes more valuable and less of it is required to buy the foreign currency.

For example, Indian rupee appreciates when price of $1 falls from ₹ 75 to ₹ 70.

Effect of Appreciation of Domestic Currency on Imports: Appreciation of domestic currency means a rise in the price of domestic currency, (say, rupee) in terms of a foreign currency (say, $). Now, one rupee can be exchanged for more $, *i.e.*, with same amount of money, more goods can be purchased from USA. Thus, imports from USA will become relatively cheaper. It leads to increase of imports from USA.

Q 3. Distinguish between devaluation and depreciation of currency. *(CBSE 2019)*

Ans. Difference between devaluation and depreciation of currency are as follows:

S.No.	Basis of Difference	Devaluation of Currency	Depreciation of Currency
(i)	Meaning	Devaluation of currency refers to decrease in the value of domestic currency in terms of foreign currency by the government.	Depreciation of currency refers to decrease in the value of domestic currency in terms of foreign currency due to market forces.
(ii)	Causes	Devaluation is done by the government to clear the deficit in BoP.	Depreciation of the currency takes place due to market forces, *i.e.*, increase in demand and decrease in supply of foreign currency.
(iii)	Relation	Devaluation is related to fixed exchange rate system.	Depreciation is related to flexible exchange rate system.

Q 4. Explain the NEER and REER as type of Foreign Exchange.

Ans. **(i) Nominal Effective Exchange Rate (NEER):** It is that type of effective exchange rate which does not accounts for changes in price level while measuring average strength of one currency in relation to the other.

(ii) Real Effective Exchange Rate (REER): It is that type of effective exchange rate which accounts for changes in the price level across different countries of the world.

Q 5. Describe sources of demand and supply of foreign exchange.

Ans. **Sources of the Demand for Foreign Exchange:**

(i) Payment of loans and interests to international organisations.
(ii) Gifts and grants to rest of the world.
(iii) Foreign investments across the world.
(iv) Foreign trade *i.e.*, import.
(v) Foreign exchange trade, for speculation.
(vi) Foreign tourism to abroad.

Sources of the Supply of Foreign Exchange:

(i) Exports of goods and services from domestic country.
(ii) Foreign investment:
  (a) Foreign direct investment.
  (b) Portfolio investment.
(iii) Foreign tourism from abroad.
(iv) Purchases by non-residents in the domestic country.
(v) Remittances from abroad.

Long Answer Type Questions

Q 1. Distinguish between appreciation of domestic currency and depreciation of domestic currency.

Ans. Difference between appreciation of domestic currency and depreciation of domestic currency are as follows:

S. No.	Basis of Difference	Appreciation of Domestic Currency	Depreciation of Domestic Currency
(i)	Rise or Fall	Fall in the exchange rate.	Rise in the exchange rate.
(ii)	Effect	Less rupees are required to buy a Dollar.	More rupees are required to buy a Dollar.
(iii)	Causes	Decrease in demand for foreign exchange and increase in supply for foreign exchange.	Increase in demand for foreign exchange and decrease in supply for foreign exchange.
(iv)	Example	Exchange rate falls from ₹ 70 to ₹ 65.	Exchange rate rises from ₹ 70 to ₹ 75.

Q 2. Distinguish between devaluation of currency and depreciation of currency.

Ans. Difference between devaluation of currency and depreciation of currency are as follows:

S. No.	Basis of Difference	Devaluation of Currency	Depreciation of Currency
(i)	Meaning	Fall in the value of domestic currency by the government.	Fall in the value of domestic currency by the forces of demand and supply.
(ii)	Take place	Take place due to government order.	Take place due to market forces of demand and supply.
(iii)	Related to	Fixed exchange rate system.	Flexible exchange rate system.

Q 3. Explain the determination of equilibrium exchange rate in foreign exchange market.

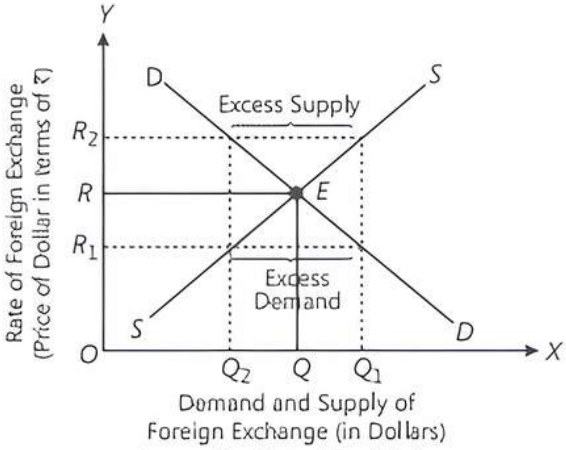
Ans. **Determination of Equilibrium Exchange Rate:** Foreign Exchange Rate is determined where demand for foreign exchange curve and supply of foreign exchange curve intersect each other.

In other words, the flexible exchange rate is determined at a level where demand for foreign exchange is equal to supply of foreign exchange.

In brief, Flexible Foreign Exchange Rate : Demand for Foreign Exchange = Supply of Foreign Exchange

This has been explained with the help of following schedule and diagram:

Dollar Price (In Rupees)	Demand for Foreign Exchange (In Million)	Supply of Foreign Exchange (In Million)	Cause	Effect
68	500	100	DFE > SFE	Excess demand for Dollars
69	400	200	DFE > SFE	Excess demand for Dollars
70	300	300	DFE = SFE	Equilibrium
71	200	400	DFE < SFE	Excess supply of Dollars
72	100	500	DFE < SFE	Excess supply of Dollars



Determination of Equilibrium Exchange Rate

In the given graph, on X-axis we have demand and supply of foreign exchange. On Y-axis, we have foreign exchange rate. DD is the downward slopping demand curve of foreign exchange. SS is the upward sloping supply curve of foreign exchange. Both the curves intersect each other at point 'E'. The foreign exchange rate is determined at OR (₹ 70) and the equilibrium quantity is determined at OQ (300 million).

Chapter Test

Multiple Choice Questions

Q 1. Managed Floating exchange rate is called 'managed' because it is influenced by the steps taken by:

a. Government b. Central Bank
c. World Bank d. IMF

Q 2. Which of the following is not a component of the balance of payment?

a. Real account b. Current account
c. Capital account d. None of these

Fill in the Blank Type Questions

Q 3. Trade deficit occurs when ....
(Choose the correct alternative to fill up the blank)

a. X < M b. X > M
c. X = M d. None of these

Q 4. The transactions undertaken to cover the deficit or surplus of autonomous transactions are called ....
(Choose the correct alternative to fill up the blank)

a. Autonomous transaction
b. induced transaction
c. balanced transaction
d. accommodating transaction

True/False Type Questions

Q 5. Difference between value of exports and imports of goods and services is called Trade Balance.

Q 6. External assistance is not recorded in Balance of Payment Account.

Match the Column Type Question

Q 7. From the following statements given in Column I and Column II, choose the correct pair of statements:

Column I	Column II
A. Purchase of land in England	1. Current account
B. Shipping services	2. Export of visibles
C. Export of tea	3. Demand of forex
D. Import of LCD screen from Malaysia	4. Export of invisibles

	A	B	C	D
a.	1	2	4	3
b.	2	4	1	3
c.	3	4	2	1
d.	1	2	4	3

Assertion and Reason Type Questions

Directions (Q.Nos. 8-9): *There are two statements marked as Assertion (A) and Reason (R). Read the statements and choose the appropriate option from the options given below:*

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

Q 8. Assertion (A): Demand for foreign exchange and exchange rate moves in the same direction.
Reason (R): When the exchange rate rises domestic goods become cheaper in the international market.

Q 9. Assertion (A): Appreciation of domestic currency means a rise in the price of the domestic currency with respect to foreign currency.
Reason (R): Appreciation leads to an increase in Exports.

Case Study Based Questions

Q 10. Read the extract given below and answer the questions on the basis of the same:

India's balance of payments this year is going to be "very very strong" on the back of significant improvement in exports and a fall in imports, Commerce and Industry; Minister Piyush Goyal said on Monday.

He said that 'good' green shoots are visible in the economy and exports have shown a 'good' turnaround.

"We are in July at about 91% export level of July 2019 figures. Imports are still at about 70-71% level of July 2019. So, broadly our balance of payments this year is going to be very strong, which is why we feel confident that Indian industry will see opportunities for themselves, will see opportunities of growth, "he said at a FICCI webinar."

India's exports fell for the fourth straight month in June as shipments of key segments like petroleum and textiles declined but the country's trade turned surplus for the first time in 18 years as imports dropped by a steeper 47.59 %.

The country posted a trade surplus of USD 0.79 billion in June.

"Balance of payments to be 'very, very strong' this year, green shoots visible in economy: Piyush Goyal"

The Economic Times- August 10, 2020

(i) Why is India having a very strong Balance of Payment?

a. Increase in exports b. Decrease in imports
c. Both a. and b. d. None of these

(ii) India's export fell for the fourth straight month resulting in ....

a. Trade surplus b. Trade deficit
c. BoP d. BoT

(iii) Consider the following statements:

(i) It will get a lot of investments.
(ii) The government can achieve its development.
(iii) Increase the GDP of the economy.
(iv) It is more profitable for the domestic manufacturers.

Which of the following is the true benefit of having a strong Balance of Payment?

a. (i) and (iii) b. (iii) and (iv)
c. (i), (iii) and (iv) d. (i), (ii), (iii) and (iv)

(iv) .... is the situation when the imports of goods are more than the export of goods.

a. BoP b. BoT
c. Trade deficit d. None of these

Q 11. Read the extract given below and answer the questions on the basis of the same:

The rupee depreciated by 5 paise to close at 74.02 (provisional) against the US dollar on Monday, tracking a rebound in the American currency overseas.

At the interbank Forex market, the domestic unit opened at 73.89 against the US dollar and witnessed an intra-day high of 73.84 and a low of 74.15.

The local unit finally settled at 74.02, registering a fall of 6 paise over its previous close, even as the domestic equity market settled with significant gains on Budget day.

On Friday, the rupee had closed at 73.96 against the American currency.

Meanwhile, the dollar index, which gauges the greenback's strength against a basket of six currencies, rose 0.21% to 90.78.

On the domestic equity market front, the BSE Sensex ended 2,314.89 points or 5 % higher at 48,600.61, while the broader NSE Nifty advanced 646.60 points or 4.74% to 14,281.20.

Foreign institutional investors were net sellers in the capital market as they offloaded shares worth ₹ 5,930.66 crore on Friday, according to exchange data.

Brent Crude Futures, the global oil benchmark, advanced 0.84% to USD 55.50 per barrel.

"Rupee tumbles 5 paise to close at 74.02 against US dollar."

(i) How will the devaluation of Indian Rupee affect the imports?

(ii) How will the devaluation of Indian Rupee affect the exports?

Very Short Answer Type Questions

Q 12. Should a current account deficit be a cause for alarm? Explain.

Q 13. Why are imports entered as negative items in the balance of payments account?

Short Answer Type Questions

Q 14. What does deficit in capital accounts indicate?

Q 15. Why is the Balance of Payment vital for a country?

Long Answer Type Question

Q 16. How does giving incentives for exports influence foreign exchange rate?