CBSE Test Paper-03
Chapter 05 Balance of Payments

1. Balance of invisibles is the **(1)**
   a. Value of invisibles exported less value of visibles imported
   b. Value of visibles exported less value of invisibles imported
   c. Value of invisibles exported less value of invisibles imported
   d. None of the above
2. Accommodating Items are also called **(1)**
   a. None of the above
   b. On the line items
   c. Above the line items
   d. Below the line items
3. Point out a demerit of flexible exchange rate **(1)**
   a. None
   b. Wide fluctuations do not affect foreign trade
   c. Wide fluctuations promotes foreign trade
   d. Wide fluctuations hamper foreign trade
4. A deficit in balance of trade indicates **(1)**
   a. That the imports of good are equal to the exports
   b. None of the above
   c. That the imports of good are greater than the exports
   d. That the imports of good are less than the exports
5. State two sources of demand of foreign exchange. **(1)**
6. Which two transactions determine Balance of Trade? **(1)**
7. State two sources of supply of foreign exchange. **(1)**
8. Where are ‘borrowings from abroad’ recorded in BOP account and why? **(1)**
9. How will the following be affected due to a fall in rupee against dollar ?

a. A student who wanted to go to USA for higher studies.
b. An exporter
c. An importer
d. A foreign tourist from USA.

10. Explain the effect of rise in price of foreign currency on exports. **(3)**

11. Indian investors lend abroad. Answer the following questions: **(4)**

    a. In which sub-account and on which side of the Balance of Payments Account such lending is recorded? Give reasons.
    b. Explain the impact of this leanding on market exchange rate.

12. What will be the effect of the following on the Balance of Payments? **(4)**

    i. Make in India Programme.
    ii. Import of pulses.

13. How does balance of payments reflect supply, demand status of foreign exchange for a country? **(4)**

14. Why does the demand for foreign currency fall and supply rises when its price rises? Explain. **(6)**

15. Explain the distinction between autonomous and accommodating transactions in Balance of Payments. Also explain the concept of Balance of Payments deficit in this context. **(6)**

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Answers

1. c. Value of invisibles exported less value of invisibles imported
   Explanation: We know Net exports =exports -imports. Same is the case with invisibles .
2. d. Below the line items
   Explanation: These are those transactions that occur because of other activities like government financing.
3. d. Wide fluctuations hamper foreign trade
   Explanation: Fluctuating exchange rates cause changes in the price of imported and exported goods which, in turn, destabilise the economy of the country. Due to fluctuation it becomes unable to take proper decisions regarding exports and imports of goods. Obviously, this has a dampening effect on the volume and growth of foreign trade.
4. c. That the imports of good are greater than the exports
   Explanation: A trade deficit represents outflow of domestic currency that takes place when value of imports exceed value of exports.
5. i. Gifts and grants to rest of the world.
   ii. Foreign investment across the world.
6. (i) Export of goods (or visible items) (ii) Import of goods (or visible items).
7. Exports of goods and services from domestic country and Foreign Tourism are the two sources of supply of foreign exchange.
8. Borrowings are a part of Capital Account as it is foreign liability. Borrowings can be external commercial borrowing and external assistance
9. a. The cost of education will increase.
   b. Exports will increase as purchasing power of dollar has increased in the Indian market.

c. Imports will decrease because purchasing power of Indian rupee has fallen.
d. USA tourist will be a gainer because purchasing power of dollar has increased and he can buy more.

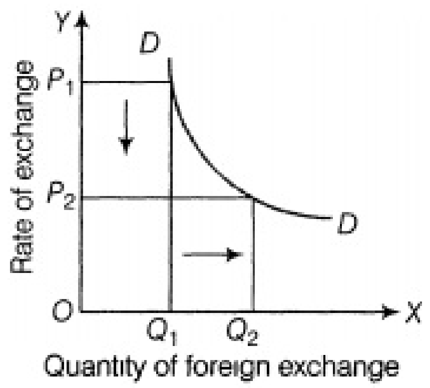
10. When the price of a foreign currency rises, the domestic goods become relatively cheaper. It induces the foreign country to increase their imports from the domestic country(say India), i.e. the exports of India rises. As a result of the supply of foreign currency increases. For example, if the price of 1 US dollar rises from Rs. 45 to Rs. 50, then exports to the USA will increase as Indian goods will become relatively cheaper. This will increase the supply of US dollars.

11. a. Indians lending abroad is recorded in capital account of BOP account because it leads to creation of foreign exchange assets. It is recorded on the debit side because it leads to outflow of foreign exchange.
    b. Lending abroad reduces the Supply of foreign exchange as a result of which exchange rate may rise.
12. i. **Make in India Programme:** The aim of 'Make in India' programme is to attract foreign investment. This will increase the flow of foreign exchange in the country leading to an improvement in the Balance of Payments account.
    ii. **Import of pulses:** It would result in the outflow of foreign exchange. Due to this, there will be an adverse effect on Balance of Payments account.

13. Unfavourable BOP of a country like India shows our greater financial obligations to rest of the world than our financial claims against rest of the world. It also reflects a situation of low forex reserves of the country. Together these facts imply that (i) Availability of forex reserves is low and (ii) Demand for forex reserves is high. This pushes up our demand for forex in the international market. Accordingly, the price of ‘forex’ or the rate at which we can buy (say) a dollar or a pound tends to rise. More rupees are to be paid for a dollar or a pound. Thus, exchange rate becomes unfavourable for India in the international forex market.

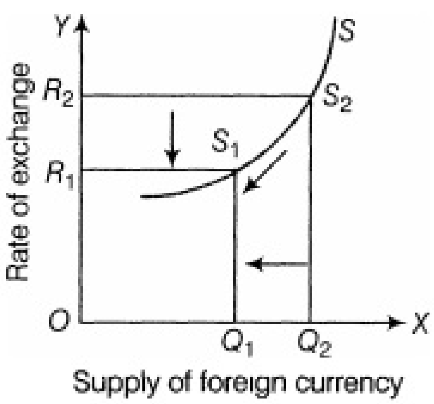
14. Foreign exchange rate shares an inverse relationship with the demand for the currency. Here, the currency itself is taken as a commodity which follows the law of demand. Thus, with the increase in the price of foreign currency, it's demand falls and vice versa. Thus, with less of foreign goods are purchased. With a fall in the price of

foreign exchange, the value of domestic currency increases (i.e. appreciation of domestic currency) and that means foreign goods become cheaper and their domestic demand (i.e. imports) increases. The rising domestic demand for foreign goods implies higher demand for foreign exchanges which increases from OQ_1 to OQ_2 as shown in the figure



Demand Curve of Foreign Exchange

The supply of foreign currency is directly proportional to the price of foreign exchanges. Here, foreign currency is taken as a commodity that follows the law of supply. Thus, the higher the price of foreign currency in terms of domestic currency, higher the quantity of foreign exchange supplied in the foreign exchange market. When the price of a foreign currency falls, it leads to cheaper imports and exports because it leads to an appreciation of domestic currency. The exporters are discouraged due to costlier exports. This results in lesser inflow or supply of foreign currency in the economy. As a result the supply of foreign exchange decreases from OQ2 to OQ as shown in the figure.



Supply Curve of Foreign Exchange

15. Following are some differences between autonomous and accommodating transactions:

Autonomous transactions	**Accommodating transactions**
These are the international transactions which are undertaken for economic motive, i.e profit.	These are the international transactions which are not undertaken for economic motive. for example- government financing.
These transactions are called Above the line items in BOP.	These transactions are called Below the line items in BOP.
The balance of these transactions governs the overall BOP balance.	These transactions are compensating in nature. These transactions correct the disequilibrium in autonomous items.
If autonomous receipts are less than payments then it shows deficit balance in BOP and vice versa.	If there is deficit balance in BOP, then government run down its reserve in form of accommodating transaction to cover a deficit in an autonomous transaction.

When the payments of a country on account of autonomous transactions exceed the receipts of the country on account of autonomous transactions, this difference is termed as BoP deficit Suppose, the receipts of the domestic country is Rs. 200 crore, whereas payments are Rs. 220 crore Then BoP deficit will be = 220 - 200 crore = Rs. 20 crore.