**CBSE Test Paper-04**

**Chapter 05 Balance of Payments**

1. Depreciation is a **(1)**
   a. Reduction in the price of foreign currency in terms of domestic currencies in the market
   b. Reduction in the price of domestic currency in terms of all foreign currencies by the govt
   c. Reduction in the price of domestic currency in the foreign exchange market by the govt
   d. Reduction in the price of foreign currency in terms of domestic currencies in the market
2. Exchange rate for currencies is determined by supply and demand in system of: **(1)**
   a. Flexible
   b. Govt. regulated
   c. Fixed exchange rate
   d. Constant
3. Point out a demerit of flexible exchange rate **(1)**
   a. promotes speculation in forex market
   b. Prevents speculation in forex market
   c. None
   d. Has no effect on speculation in forex market
4. Balance of current account includes **(1)**
   a. None of the above
   b. Balance of trade and balance of payment
   c. Balance of trade and balance of visibles
   d. Balance of trade and balance of invisibles
5. Define managed floating exchange rate. **(1)**

6. Name two invisible items of the Balance of Payments account. **(1)**
7. What is 'current account deficit' in the balance of payments? **(1)**
8. What is the meaning of deficit in Balance of Payments? **(1)**
9. Giving two examples, explain the relation between the rise in the price of a foreign currency and its demand. **(3)**
10. Distinguish between current account and capital account of the Balance of Payments account on the basis of its components. **(3)**
11. Describe the causes of disequilibrium in the balance of payments. **(4)**
12. Distinguish between autonomous transactions and the accommodating transactions in the balance of payments. What is the significance of this distinction? **(4)**
13. Distinguish between autonomous transactions and accommodating transaction of balance of payments accounts. **(4)**
14. Indian investors lend abroad. Answer the following questions. **(6)**
    i. In which sub-account and on which side of the Balance of Payments Accounts such lending is recorded? Give reasons.
    ii. Explain the impact of this lending on market exchange rate.
15. How is balance of trade different from balance of payments? State the items not included in balance of trade. **(6)**

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**Answers**

1. a. Reduction in the price of foreign currency in terms of domestic currencies in the market
   **Explanation:** Depreciation refers to flexible exchange regime where exchange rate is determined by market forces .
2. a. Flexible
   **Explanation:** Flexible
3. a. promotes speculation in forex market
   **Explanation:** System of flexible exchange rates has been opposed on the ground that under it there is widespread speculation regarding exchange rates of currencies which has a large destabilising effect on exchange rates.
4. d. Balance of trade and balance of invisibles
   **Explanation:** These items add to the current flow of goods and services and are included in national income.

5. 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.

6. Two invisible items of the Balance of Payments account are banking services and insurance services.

7. When receipts of the current account of BoP falls short of expenditure of current account, then it is referred to as 'current account deficit'.It is because the domestic economy has now low foreign currency to pay for foreign goods. So, there is a deficit.

8. Deficit in BOP refers to a situation when receipts of the country arising out of autonomous transactions are less than the corresponding payments to the rest of the world during the period of an accounting year. 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

9. The relation between the rise in price of foreign currency and its demand is explained by the following reasons:

    i. The imports become costlier when the price of a foreign currency rises. So, the value of imports will fall with time, hence the demand for foreign exchange will fall.
    ii. A resident of a country finds it costlier to travel abroad when the price of foreign currency rises. So, the number of foreign travellers decrease, and consequently, the demand for foreign currency also decreases.

10. Current account refers to an account which records all the transactions relating to export and import of goods and services and unilateral transfers during a given period of time. The components of the current account include:

    i. Export and imports of visible items, i.e. goods
    ii. Unilateral transfers to and from abroad.
    iii. Export and import of services.
    iv. Income receipts and payments to and from abroad.

    Capital account of BOP records all those transactions, between the residents of a country and the rest of the world, which cause a change in the assets or liabilities of the residents of the country or its government. The components of capital account include:

    i. Investment to and from abroad.
    ii. Borrowings and lendings to and from abroad.
    iii. Change in foreign exchange reserves.

11. Causes of disequilibrium in BOP can be classified as (a) Economic causes (b) Political causes (c) Social causes.

    a. Economic Causes:
        i. Huge development expenditure by the government of a developing country, implying large scale imports.
        ii. Business cycles in terms of recession, depression, recovery and boom.

iii. High rate of inflation in the domestic market compelling large scale imports of essential goods.
iv. Development of import substitute.
v. Change in the cost structure of the trading partners.

b. Political Causes: These causes mainly refers to political instability in the country owing to which inflow of foreign capital may get reduced.
c. Social Causes: These causes mainly refers to change in the tastes and preferences across different parts of the world owing to which the quantum of exports and imports may get affected.

12. 1) **Differences between autonomous and accommodating transactions:**

| **Basis** | **Autonomous Transactions** | **Accommodating Transactions** |
|---|---|---|
| **Meaning** | Autonomous transactions are the transactions between the residents of two countries which are undertaken for economic motive, i.e profit. | Accommodating transactions are those transactions which help to restore the identity of Balance of Payments. Such transactions are not undertaken for economic motive. For example- government financing. |
| **Also called** | These transactions are called Above the line items in BOP. | These transactions are called Below the line items in BOP. |
| **Recorded in** | These transactions can either be recorded in current account or capital account, depending on their nature. | These transactions are recorded only in the capital account. |
| **Example** | Exports and imports of goods and services, unilateral transactions etc are examples of autonomous transactions. | Borrowings from IMF, change in foreign exchange reserves etc are examples of accommodating transactions. |

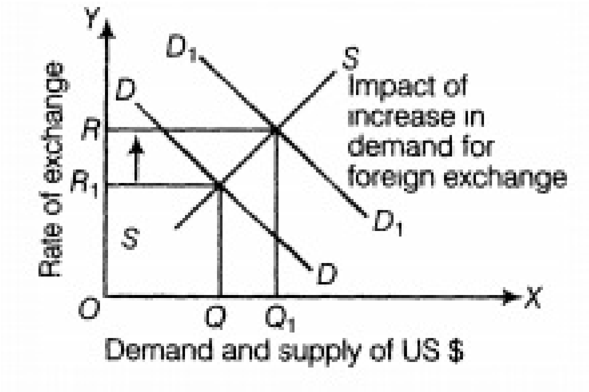
**2) The significance of this distinction:**

The distinction between these two transactions is important to understand the causes of disequilibrium and to restore the identity of Balance of Payments account.

13. **Autonomous Transactions:** A balance of payment transaction which is independent of all other BOP transactions is called an autonomous transaction. It is undertaken with a view to earn profit. Autonomous transactions are also called above the line transactions.
    **Accommodating Transactions:** A balance of payment transaction undertaken to cover deficit or surplus in autonomous transactions are called accommodating transaction. It is not undertaken with a view to earn profit. Accomodating transactions are also called below the line transactions.

14. i. **In the debit side of the capital accounts of the Balance of Payments Accounts:** Indian investors lending abroad will be recorded. Capital account records the capital transactions such as loans and investments between India and the rest of the world, which causes a change in the assets and liabilities status of the residents of the country or the government.
    One of the components of the capital account is 'Foreign Investment'. Foreign investment includes foreign direct investment (FDI) and foreign institutional investment (FII) or portfolio investment by the residents of a nation abroad or by the rest of the world in the domestic country. So, lending by Indian investors will be a part of this component and therefore will be recorded in the capital account. In the capital account, all transactions causing flow of foreign exchange out of the country are recorded in debit side. Indian investors lending abroad leads to an outward flow of foreign exchange and is hence treated as a negative item in the capital account of balance of payments and are recorded in debit side
    ii. **The impact of this lending on market exchange rate :** Due to this lending, the market exchange rate will tend to rise.
    The investors who want to lend abroad will demand a foreign exchange. In the graph given, as the demand for foreign exchange rises, with supply remaining the same, the market exchange rate will also rise, above. As the demand for foreign exchanges rises, the exchange rate rises from OR to $OR_1$. This is a situation of

depreciation of domestic currency.




15. The following are the major differences between the balance of trade and balance of payments:

    i. A statement recording the imports and exports done in goods by the country with the other countries, during a particular period is known as the Balance of Trade. The Balance of Payment captures all the monetary transaction performed internationally by the country during a course of time.
    ii. The Balance of Trade accounts for, only physical items, whereas Balance of Payment keeps track of physical as well as non-physical items.
    iii. The Balance of Payments records capital receipts or payments, but Balance of Trade does not include it.
    iv. The Balance of Trade can show a surplus, deficit or it can be balanced too. On the other hand, Balance of Payments is always balanced.
    v. The Balance of Trade provides the only half picture of the country's economic position. Conversely, Balance of Payment gives a complete view of the country's economic position.

    Therefore non-physical items, capital receipts and unilateral goods are not included in balance of trade.