CBSE Test Paper-02
Chapter 05 Balance of Payments

1. Point out a merit of flexible exchange rate **(1)**
   a. None
   b. Inefficient resource allocation
   c. Optimum resource allocation
   d. Resource underutilisation
2. What would cause a country's exchange rate to fall: **(1)**
   a. An increased demand for its imports
   b. An increased in flow of capital
   c. An increased demand for its exports
   d. None of these
3. If exchange rate increases, this will make **(1)**
   a. Can’t say
   b. The demand for our exports will rise
   c. The demand for our exports will not change
   d. The demand for our exports will fall
4. A disequilibrium in Balance of payment can also be corrected by (**1)**
   a. Devaluation
   b. Depreciation
   c. Appreciation
   d. Revaluation
5. When will balance of trade show surplus? **(1)**
6. Is a rising reserve of India’s foreign exchange a sign of our rising exports? **(1)**
7. The balance of trade shows a deficit of Rs. 5,000 crore and the value of imports are Rs.9,000 crore. What is the value of exports? **(1)**

8. What is meant by depreciation of domestic currency? **(1)**
9. What is Balance of Payments Account? Where are borrowings from abroad recorded in it and why? **(3)**
10. Visits to foreign countries for sightseeing etc by the people of India is on the rise. What will be its likely impact on foreign exchange rate and how? **(3)**
11. Distinguish between devaluation and depreciation of domestic currency. **(4)**
12. Give the structure of balance of payments account in India. **(4)**
13. State the items of capital account of India's BOP. **(4)**
14. Distinguish between balance of trade and balance of payments. **(6)**
15. Give the meaning of foreign exchange and foreign exchange rate. Give the example. Explain the relation between foreign exchange rate and demand for foreign exchange. **(6)**

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Answers

1. c. Optimum resource allocation
   Explanation: The foreign exchange rate always fluctuates under flexible exchange rate and a domestic economy exports more when it's currency depreciates in the forex market and vice versa. Such adjustments are not possible under fixed regime .
2. a. An increased demand for its imports
   Explanation: An increased demand for its imports
3. b. The demand for our exports will rise
   Explanation: Because goods of exporting country now become cheaper for the foreign country.
4. a. Devaluation
   Explanation: Devaluation would lead to increase in net exports.

5. Surplus in the balance of trade occurs when Export of goods > Import of goods.

6. Not necessarily. In case of India, it is certainly not. Our forex reserves have tended to rise largely because of remittances from abroad by the NRIs..

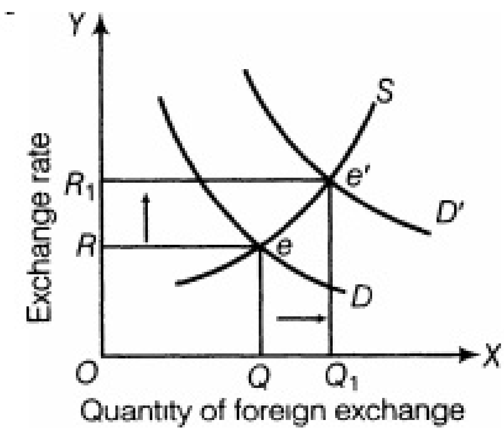
7. Balance of Trade = Rs. 5,000 crore
   Value of Imports = Rs. 9,000 crore
   BOT = Exports - Import.
   Value of Exports = BOT (Deficit) + (Imports)
   = -5000 + 9000 = Rs. 4,000 crore.

8. Depreciation of domestic currency means that the value of domestic currency decreases in relation to the value of foreign currency typically in a floating exchange rate system in which no official currency value is maintained.

9. The Balance of Payments (BoP) account of a country is a systematic record of all economic transactions between its residents and residents of foreign countries during

an accounting year. Balance of payments accounting uses the Double Entry System for recording the transactions with the rest of the world. The BOP account has two sides, credit and debit. Credit side shows all inflows or sources of foreign exchange whereas the debit side shows all the outflows or uses of foreign exchange. BOP can be balanced, surplus or deficit BOP. Balance of Payments account is classified into Current Account and Capital Account. Borrowing from abroad are recorded in the Capital Account (credit side) of Balance of Payments as it is a foreign liability on the country and it is to be repaid with interest.

10. The given graph clearly shows that when the demand for foreign exchange increases, then its price also increases.



- The demand for foreign currency increases when there is a rise in the number of visits to foreign countries by the residents of India.
- With the supply of foreign currency remaining the same, the foreign exchange rate rises, implying a depreciation of rupee.

11. Depreciation of a currency means a decrease in the price of the domestic currency in terms of the foregin currency. It corresponds to an increase in the exchange rate. For eg. if the value of a rupee in terms of US dollar falls from Rs. 60 to Rs. 65, more rupees, i.e. 65 rupees will be required to buy one US dollar. Depreciation of currency encourages exports and discourages imports.

    Like depreciation, devalauation means fall in the external value of the domestic currency in terms of the foreign currency. Both devaluation and depreciation make domestic goods cheapter for the foreigners .

However, devaluation is done when a country has adopted fixed exchange rate system while depreciation is done when a country has adopted a floating exchange rate system.

12. Balance of payments accounts are broadly split as

    i. current account - Under this we have export and import of goods and invisible.
    ii. capital account - Under this we have foreign investment and borrowings.
    iii. official reserves account.

13. Following are the items of capital account of India’s BOP: Items of Capital Account

Receipts Or Credit	Payments Or Debit
Foreign Private Loans.	Repayment of private loans from foreigners.
In Low of banking capital.	Out flow of banking capital
Loans received by the govt.	Repayment of loans by Govt. Sector.
Reserves and monetary gold inflow.	Reserves monetary gold transfer payment.
International sale of gold.	Purchase of gold in international market.
Total Capital Receipts.	Total Capital Payments.

14.

Basis	Balance of Trade (BOT)	Balance of payment
(i) Definition	Balance of trade refers to difference between amount of exports and imports of visible items. It may be favourable,unfavourable or in equilibrium.	It records all the actual transactions of goods and services which affect the income, output and employment of a country. It is always in balnce because receipt side is always made equal to payment side.
(ii) Components	Balance of trade includes only visible items.	Current Account records both visible and invisible items.

(iii) Scope	It is a narrow concept as it is only a part of balance of payment.	It is a wider concept and it includes BOT.
(iv) Deficit	Its deficit cannot be met by balance of payments.	Its deficit can be met through balance of trade.
(v) Indicator	It is not a true indicator of economic performance of an economy.	It is a true indicator of economic performance of an economy.

15. i. **Foreign exchange:**
It refers to all currencies other than the domestic currency of a given country, e.g. currency of US and UK are the foreign exchanges for India.

ii. **Foreign exchange rate:**
The rate at which one unit of currency of a country can be exchanged for the number of units of currency of another country. In simple words, we can say that the price of one currency in terms of other currency is known as the foreign exchange rate or exchange rate. For eg. , if Rs. 58 is paid, to buy one US dollar, then per $ exchange rate will be 58 ie. Rs. 58 per dollar.

iii. **Relation between foreign exchange rate and demand for foreign exchange:**
Exchange rate of foreign currency is inversely related to the demand. When the price of a foreign currency rises, it results in costlier imports for the country. As imports become costlier, the demand for foreign products also reduce. This leads to a reduction in demand for that foreign currency and vice-versa.