CBSE Test Paper 01

Chapter 05 Balance of Payments

1. The demand curve for foreign exchange is **(1)**
    a. Downward sloping
    b. Upward sloping
    c. Horizontal
    d. Vertical
2. Point out a demerit of fixed exchange rate **(1)**
    a. BOP surplus countries face inflation
    b. Has no effect on the stock of gold in BOP surplus countries
    c. BOP surplus countries face inflation
    d. None
3. Point out a demerit of fixed exchange rate **(1)**
    a. BOP deficit countries run down the stock of gold
    b. None
    c. BOP surplus countries run down the stock of gold
    d. Has no effect on the stock of gold
4. If CDA (Capital Development Authority, Islamabad) gets a loan from World Bank for roads, it will be recorded in the balance of payments in section: **(1)**
    a. Capital account
    b. Invisible balance
    c. Visible balance
    d. Official financing
5. What is balance of payment accounts? **(1)**
6. What is a fixed exchange rate? **(1)**
7. Give the meaning of managed floating exchange rate. **(1)**

8. What is fixed exchange rate? (**1**
9. Give the meanings of devaluation and depreciation of domestic currency. **(3)**
10. Describe any three sources of supply of foreign exchange. **(3)**
11. Explain the impact of Devaluation of domestic currency on the export and imports of an economy. **(4)**
12. Give the meaning of favourable balance of payments. **(4)**
13. The Central Bank takes steps to control rise in the price of foreign exchange. Explain the economic values it involves as far as the common man is concerned. **(4)**
14. Discuss the components of capital account. **(6)**
15. Distinguish between autonomous and accommodating transactions of balance of payments account. **(6)**

Answers

1. a. Downward sloping
   Explanation: At lower exchange rate more foreign currency is demanded and at higher exchange rate less foreign currency is demanded.
2. c. BOP surplus countries face inflation
   Explanation: As countries can't implement autonomous monetary policies under a metallic standard, they many import their trade partner's inflation and unemployment rates. For example, if the inflation rate is increasing in a country, at the given exchange rate, its consumers may increase their demand for foreign goods, thus increasing the prices in other countries.
3. a. BOP deficit countries run down the stock of gold
   Explanation: Fixed exchange rate had however a great flaw in that the countries with a large and persistent balance of payments deficits were losing gold and other foreign assets. This could not go on forever as evidently stock of gold and foreign currencies would have run out.
   Countries with deficit bop found their international reserves dwindling which forced them to devalue their currency. The devaluation has an inflationary potential.
   Due to depletion of reserves of gold and foreign currencies, the countries with deficit balance of payments are forced to devalue their currency to overcome the deficit
4. a. Capital account
   Explanation: Capital account
5. It is a systematic record of all economic transactions between the residents of a country and the rest of the world in a given period (one year) of time. It has two components which are, current account and capital account.
6. Fixed exchange rate is the system under which the monetary authority of a country fixes the value of its currency against other foreign currencies.
7. Managed floating system is a system in which the central bank allows the exchange

rate to be determined by market forces but intervenes at times to influence the rate. When central bank finds the rate is too high, it starts selling foreign exchange from its reserve to bring down it. When it finds the rate is too low. It starts buying to raise the rate.

8. It is a system in which the central authority or government maintains their exchange rate, fixed either against gold or some other currency.
9. The differences between devaluation and depreciation of domestic currency are as follows : -

Basis	Devaluation	Depreciation
Meaning	Devaluation is the fall in the value of the domestic currency in relation to foreign currency under the fixed exchange rate regime. It is planned by the Government in a situation when the exchange rate is not determined by the forces of demand and supply.	It occurs when the value of domestic currency decreases in relation to the value of foreign currency in the foreign exchange market under the flexible exchange rate regime. It takes place due to market forces of demand and supply.
Example	The government has changed the exchange rate of $1 from Rs. 40 to Rs. 45. This is an example of the devaluation of currency made by the government.	The increase in demand or decrease in supply for the foreign exchange causes depreciation of domestic currency, e.g. $1 exchanges rate is Rs. 45 instead of Rs. 40 due to the market forces of demand and supply. Here there is no government intervention. The depreciation is happening solely due to the effect of changes in demand and supply for the foreign exchange.

10. The supply of foreign exchange comes from those people who receive it due to the following reasons. Three sources of supply of foreign exchange are given below:
    i. **Exports of goods and services:** When goods and services are exported to other

countries then the foreign exchange earned through exports is a source of supply of foreign exchange.

ii. **Gifts and remittances from abroad:** Gifts and remittances from abroad are also a source of supply of foreign exchange.
iii. **Foreign Direct Investments (FDI):** The amount which foreigners invest in India increases the supply of foreign exchange.

11. Devaluation means a fall in the value of the domestic currency. A devaluation of the exchange rate will make exports more competitive and appear cheaper to foreigners. This will increase demand for exports. Devaluation also means that imports, such as petrol, food and raw materials will become more expensive. This will reduce demand for imports.
12. When there is an excess of receipts over payments made by a country, it is called favourable balance of payment. This situation is favourable because there is more money coming into the country than what is going out of the country.
    Favourable balance is when R>P. or R - P > O.
13. The Central Bank's steps to control rise in the price of foreign exchange involves the following economic values as far as the common man is concerned.
    i. Exports will reduce. This will ensure an adequate supply of goods in the domestic markets.
    ii. It will increase imports in the country and help to check the inflation of necessary items.
14. Capital account is that account which records all such transactions between residents of a country and rest of the world which cause a change in the asset or lability status of residents of a country as its government. Components of capital account:
    1. Foreign investment: It has two sub components:
        i. Foreign Direct Investment (FDI) refers to ownership of enterprises by the non residents in the domestic economy like walmart stores in India.
        ii. Portfolio investment refers to FII(Foreign Institutional investment) which is invested by the non residents in shares and bonds of the domestic companies.
    2. Borrowings: It has two sub components:
        i. External commercial borrowings: It refers to borrowing by a country (including govt, and private sector) from the international money market. This involves market rate of interest compared to that prevailing in the open

market.

ii. External assistance - External assistance are borrowings which are available at concessional rate of interest.

3. NRI deposits is another important component of the capital account, particularly in emerging economies like India where interest rates are high.
4. Banking Capital is another important compontent of the capital account. It refers to the foriegn asset holding of commercial banks.
5. Capital account BoP also includes the flow of capital on account of short term debt.

15.

Basis	Autonomous	Accommodating Items
Meaning	Autonomous items refer to those international balance of payments transactions, which take place due to some economic motive such as profit maximisation.	Accommodating items refer to the transactions that are undertaken to cover deficit or surplus in autonomous
Effect on BOP account	Autonomous transactions are independent of the state of BOP account, They are the cause of BoP imbalance. (BoP surplus or BoP deficit).	Accommodating transactions are undertaken to restore the BoP balance.
Current/Capital Account	Autonomous transactions take place on both current and capital accounts. They may involve the movement of goods across the border(like export and import of consumer goods or capital goods)	Accommodating transactions take place only on capital account. They do not involve the movement of goods across the borders. These items only involve the movement of official reserves with the RBI.
Alternate Name	These items are also known as ‘above the line items’.	These items are also known as ‘below the line items’.