HOTS & Applications

Q.1. Is a rise in reserves of India's foreign exchange a sign of our rising exports?

Ans. 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.

Q.2. How does 'export/import' component affect the circular flow of income in a country?

Ans. Exports reflect expenditure on the domestic product by the rest of the world. It leads to increase in AD and works as an 'injection' into the circular flow of income. It stimulates the flow of income by way of 'multiplier effect'. Imports, on the other hand, is a 'withdrawal' from the circular flow of income. It depresses the flow of income by way of negative multiplier effect.

Q.3. Balance of payments always balances. Does it mean a situation of zero net financial obligation for a country?

Ans. It is only in the accounting sense that balance of payment always balances. From the practical point of view, it should not be interpreted as a situation of zero net financial obligation for a country. A negative balance on the current account is equated with positive balance in the capital account. But the positive balance in capital account may have been achieved through loans from rest of the world. All loans are financial obligations to rest of the world.

Q.4. How does balance of payments reflect supply, demand status of foreign exchange for a country?

Ans. Unfavourable balance of payments of a country (like India) shows that our financial obligations vis-a-vis rest of the world are greater than our financial claims. It reflects that:

- **a.** availability (supply) of forex reserves is low, and
- **b.** demand for forex reserves is high. Implying a net rise in the demand for foreign exchange.

This leads to a rise in the price of 'forex' (the rate at which we can buy a dollar or a pound). Thus, exchange rate becomes unfavourable.

Q.5. How is the rising demand for the Indian goods in the US market likely to impact the exchange rate between the Indian rupee and US dollar?

Ans. Rising demand for the Indian goods in the US market imply that our exports are tending to rise. Consequently, supply of foreign exchange (US dollar) tends to rise. Other things remaining constant, it would lead to a fall in foreign exchange rate. Implying that the domestic currency (Indian rupee) will start appreciating in relation to the US dollar.