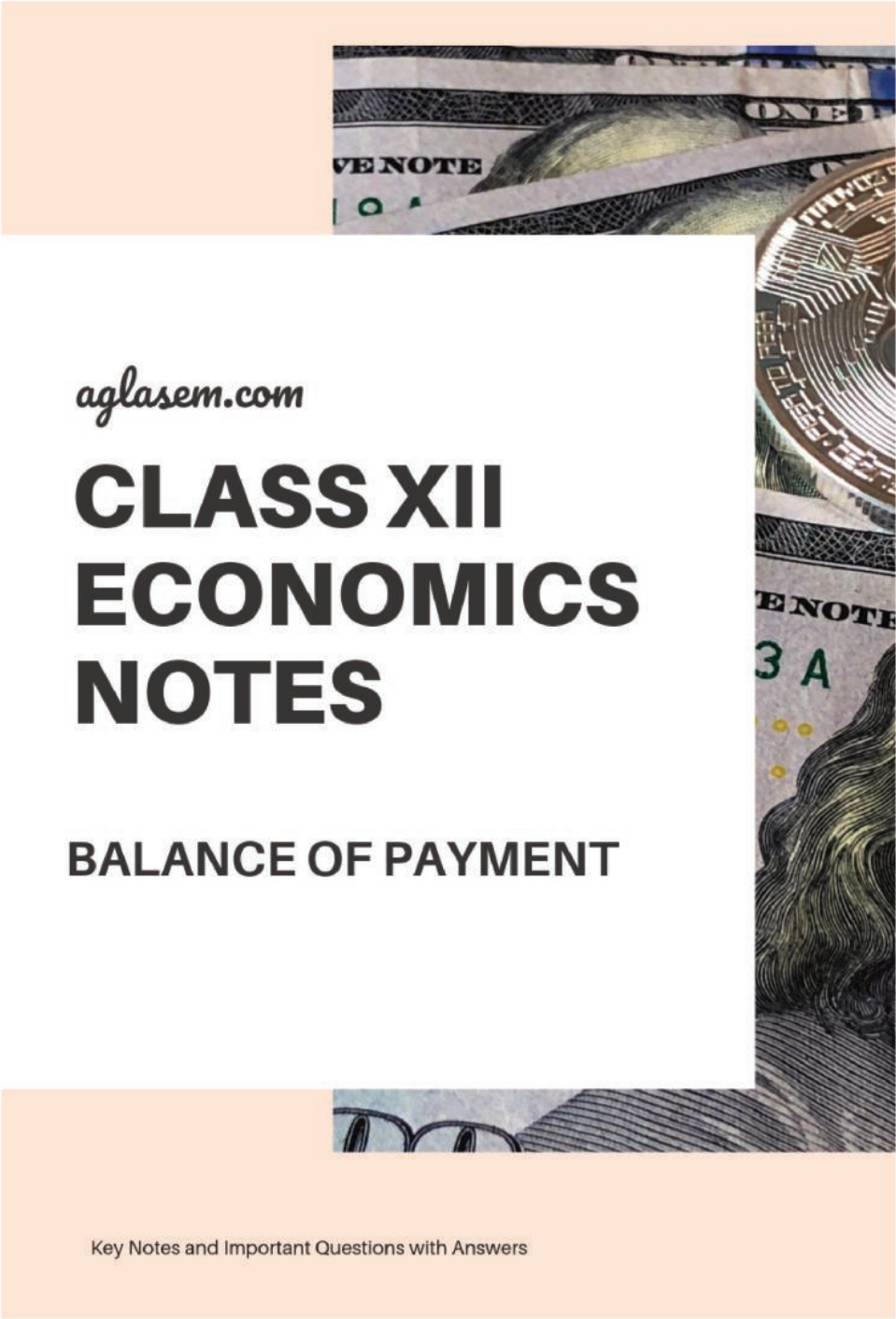


The background of the page features a collage of US currency. On the right side, there is a vertical strip showing a close-up of a dollar bill with the text 'ONE DOLLAR' and 'FEDERAL RESERVE NOTE' visible. Below this, another section shows a '3 A' serial number. At the bottom right, a portion of a coin is visible. The left and bottom edges of the page are framed by solid orange blocks.

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CLASS XII ECONOMICS NOTES

BALANCE OF PAYMENT

Key Notes and Important Questions with Answers

UNIT IX

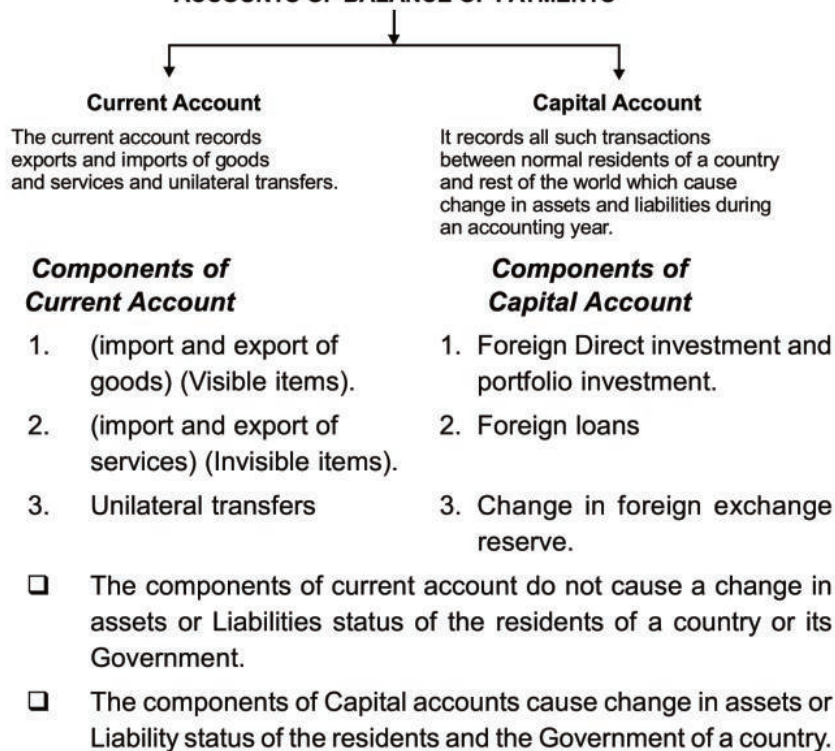
BALANCE OF PAYMENT

Points to Remember

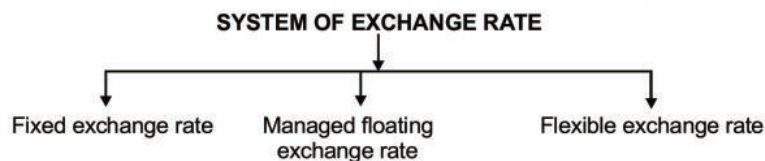
- ❑ The balance of payment is a comprehensive and systematic record of all economic transaction between normal residents of a country and rest of the world during an accounting year.

In other words BOP is a record of inflows and outflows of foreign exchange.

ACCOUNTS OF BALANCE OF PAYMENTS

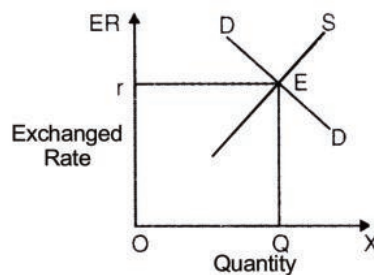


- ❑ **Balance of trade** is the net difference of import and export of all visible items between the normal residents of a country and rest of the world.
- ❑ **Autonomous items** are those items of balance of payment which are related to such transaction as are determined by the motive of profit maximisation and not to maintain equilibrium in balance of payments. These items are generally called 'Above the Line items' in balance of payment.
- ❑ **Accommodating items** refers to transactions that take place because of other activity in Balance of Payment. These transactions are meant to restore the Balance of Payment identity. These items are generally called 'Below the Line items'.
- ❑ **Deficit of BOP Account** : When total inflows of foreign exchange on account of autonomous transactions are less than total outflows on account of such transaction then there is a deficit in BoP.
- ❑ **Foreign Exchange Rate** : Foreign exchange rate refers to the rate at which one unit of currency of a country can be exchanged for the number of units of currency of another country.



- ❑ **Fixed Exchange Rate** : In fixed exchange rate system, the rate of exchange is officially fixed or determined by Government or Monetary Authority of the country.
- ❑ **Flexible or Floating Exchange Rate** : In a system of flexible exchange rate (also known as floating exchange rates), the exchange rate is determined by the forces of market demand and market supply of foreign exchange.
- ❑ The demand of foreign exchange have inverse relation with flexible exchange rate. If flexible exchange rate rises the demand of foreign exchange falls and Vice versa.

- ❑ **The Sources of Demand for Foreign Exchange**
 - (a) To purchase goods and services from the rest of world.
 - (b) To purchases financial assets (i.e., to invest in bonds and equity shares) in a foreign country.
 - (c) To invest directly in shops, factories, buildings in foreign countries.
 - (d) To send gifts and grants to abroad.
 - (e) To speculate on the value of foreign currency.
 - (f) To undertake foreign tours.
- ❑ The supply of foreign exchange have positive relation with foreign exchange rate. If foreign exchange rate rises the supply of foreign exchange rate also rises and vice versa.
- ❑ **The Source of Supply of Foreign Exchange**
 - (i) Direct purchase by foreigners in domestic market.
 - (ii) Direct investment by foreigners in domestic market.
 - (iii) Remittance by non-residents living abroad.
 - (iv) Flow of foreign exchange due to speculative purchases by N.R.I.
 - (v) Exports of goods and services.
- ❑ **Determination of Equilibrium Foreign Exchange Rate :**
 Equilibrium foreign exchange rate is the rate at which demand and supply of foreign exchange are equal. Under free market situation, it is determined by market forces i.e., demand for and supply of foreign exchange. There is inverse relation between demand for foreign exchange and exchange rate. There is direct relationship b/w supply of foreign exchange and exchange rate. Due to above reasons demand curve downward sloping and supply curve is upward sloping curve Graphically, intersection of demand curve and supply curve determine the equilibrium foreign exchange rate (i.e., or).



- ❑ **Devaluation of a Currency** : When government or monetary authority of a country officially lowers the external value of its domestic currency (in respect of all other foreign currency) is called devaluation of a currency. It takes place by government order under fixed exchange rate system.
- ❑ **Revaluation of a currency** : When government or monetary authority of a country officially raises the external value of its domestic currency (in respect of all other foreign currency) is called revaluation. It takes place by government order under fixed exchange rates system.
- ❑ **In currency depreciation** there is a fall in the value of domestic currency, in term of foreign currency due to change in demand and supply of the currency under flexible exchange rate system.
- ❑ **In currency appreciation**, there is a rise in the value of domestic currency in terms of foreign currency due to change in demand and supply of the currency under flexible exchange rate system.
- ❑ **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.

Exam. Oriented Questions with Answers

VERY SHORT ANSWER QUESTION (1 MARK)
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- Q. 1.** Define foreign exchange rate.
Ans. Foreign exchange rate is the price of a foreign currency in terms of domestic currency.
- Q. 2.** What is foreign exchange?
Ans. Any currency other than the domestic currency.
- Q. 3.** What is balance of payment accounts?
Ans. 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.
- Q. 4.** State two sources of supply of foreign exchange.
Ans. Exports and Foreign Tourism.
- Q. 5.** State two sources of demand of foreign exchange.
Ans. Import of goods and services and to get education in abroad.
- Q. 6.** What does a deficit in balance of trade indicate.
Ans. Deficit in balance of trade indicates that the imports of goods are greater than the exports.
- Q. 7.** What is fixed exchange rate?
Ans. When rate of exchange is fixed by the government in an economy.
- Q. 8.** Define flexible exchange rate.
Ans. The rate of exchange in terms of other currencies are determined by market forces of demand and supply.
- Q. 9.** Define managed floating exchange rate.
Ans. It is a system in which the Central Bank or government allows the exchange rate to be determined by market forces but they take decisions to intervene whenever they feel it appropriate.

SHORT ANSWER TYPE QUESTIONS 3-4 MARK

Q. 1. State the components of capital account of balance of payment.

Ans.

1. Borrowing and lending to and from abroad.
2. Investment to and from abroad.
3. Change in foreign exchange reserves.

Q. 2. What are the components of current account of the BOP account?

Ans.

1. Exports and imports of goods
2. Exports and imports of services
3. Unilateral transfers

Q. 3. Explain the meaning of deficit in BOP.

Ans. When autonomous foreign exchange payments exceeds autonomous foreign exchange receipts, the difference is called balance of payments deficit.

Q. 4. Distinguish between devaluation and depreciation of domestic currency.

Ans. When government or authorities reduce the price of domestic currency in terms of all foreign currencies is called devaluation. The fall in market price of domestic currency (due to demand and supply in the market) in terms of a foreign currency is called depreciation.

Q. 5. When price of a foreign currency rises its supply also rises. Explain? Why?

Ans. If exchange rate increases, this will make domestic country's goods cheaper to foreigners. The demand for our exports will rise. It implies more supply of foreign exchange.

Q. 6. Indian investors lend abroad. Answer the following questions:

- (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 lending on market exchange rate.

- Ans.** (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 increases demand for foreign exchange. Supply of foreign exchange remains unchanged, exchange rate may rise.

Q. 7. Distinguish between autonomous transactions and accommodating transaction of balance of payments accounts.

Ans. **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.

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.

Q.8. What do you mean by official reserve transaction? How it is treated in BoP account.

Ans. Official reserve transaction is the change in the forex reserve with RBI. It is recorded in capital account of BoP. Any decrease in reserve is recorded in credit side and increase in forex recorded in debit side of capital account of BoP. (Student must be noted only change is recorded)