## UNIT 10

# BALANCE OF PAYMENT

## POINTS TO REMEMBER

- The balance of payment is annual record of the transaction in goods, services and assets between residents of a country with the rest of the world.

**ACCOUNTS OF BALANCE OF PAYMENTS**

**Current Account**

The current account records exports and imports of goods and services and unilateral transfers.

**Capital Account**

The Capital account records all international purchases and sale of assets such as money-stocks. bond etc.

- ***Components of Current Account***

1. Visible items (import and export of goods)
2. Invisible items (import and export of services.)
3. Unilateral transfers.

***Components of Capital Account***

1. Foreign Direct investment.
2. Loans
3. Portfolio investment.
4. Banking capital transactions.

- The components of current account do not cause a change in assets or Liabilities status of the residents of a country or its Government.

- The components of capital accounts cause in change in assets or Liability status of the residents and the Government of a country.

- 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 item 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'.
- 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.

**SYSTEM OF EXCHANGE RATE**

Fixed exchange rate | Flexible exchange rate.

- The epitome of the fixed exchange rate system was the gold standard in which each participant country committed itself to convert freely its currency into gold at a Fixed Price.
- Merit of Fixed Exchange Rate
  - (i) Stability in exchange rate
  - (ii) Promotes capital movement and international trade.
  - (iii) No scope for speculation.
- Demerits of Fixed Exchange Rate
  - (i) Need to hold foreign exchange reserves.
  - (ii) No automatic adjustment in the 'Balance of payments.'
  - (iii) Enhance dependence on external sources.
- 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 supply of foreign exchange.

- The demand of foreign exchange have inverse relation with flexible exchange rate. If flexible exchange rate rise the demand of foreign exchange falls. Vice versa.

- Sources of Demand for Foreign Exchange
  - (a) To purchase goods and services from the rest of world.
  - (b) To purchase 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 rise the supply of foreign exchange rate also rise and vice versa.

- Sources of Supply of Foreign Exchange
  - (i) Direct purchase by foreigners in domestic market.
  - (ii) Direct investment by foreigners in domestic market.
  - (iii) Remittances by non-residents living abroad.
  - (iv) Flow of foreign exchange due to speculative purchases by N.R.I.
  - (v) Exports of goods and services.

- Merits of Flexible Exchange Rate
  - (i) No need to hold foreign exchange reserves
  - (ii) Leads to automatic adjustment in the 'balance of payments'.
  - (iii) To increase the efficiency in the economy by achieving optimum resources allocation.
  - (iv) To remove obstacles in the transfer of capital and trade.

- Demerits of Flexible Exchange Rate
  - (i) Fluctuations in foreign exchange rate.
  - (ii) Encourages speculation.
  - (iii) Discourages international trade and investment.

- In currency depreciation, there is a fall in the value of domestic currency in term of foreign currency. In currency appreciation, there is a rise in the value of domestic currency in term of foreign currency.
- In currency appreciation, there is a rise in the value of domestic currency in terms of foreign currency.
- Equilibrium flexible exchange rate is determined at a level where demand for and supply of foreign exchange are equal to each other.
- 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.

## VERY SHORT ANSWER TYPE QUESTIONS (1 MARK)

1. What is meant by balance of trade?
2. Define balance of payment.
3. When is there a deficit in the balance of trade.
4. The balance of trade shows a deficit of Rs. 300 crs. and the value of exports is Rs. 500 crs. What is the value of imports?
5. List two items included in the balance of trade account.
6. List two items of the capital accounts of balance of payment.
7. Give meaning of managed floating exchange rate.
8. What is meant by invisible items?
9. What is meant by unilateral transfer?
10. What is meant by Autonomous transactions?
11. Write the name of those economic transactions which are made by the government to make equilibrium in balance of payment.
12. What do you mean by Fixed Exchange Rate?
13. Define Flexible Exchange rate?
14. State two merits of Flexible Exchange Rate.
15. State two demerits of Flexible Exchange Rate.
16. State two merits of fixed exchange rate.

17. State two demerits of fixed exchange rate.
18. What is the slope of demand curve of foreign exchange?
19. What is the slope of supply curve of Foreign Exchange?
20. What will be the effect on exports, if foreign exchange rate increases?
21. What will be the effect on imports if foreign exchange rate increases.
22. Define Devaluation of Domestic Currency.
23. What is meant by Depreciation of Domestic Currency?
24. What is meant by Appreciation of Domestic Currency?

## HOTS (1 MARK)

26. In which circumstances, the devaluation of currency will be in favour of economy?
27. In which circumstances the appreciation of currency will be non favourable for the economy?
28. Under which circumstances, the purchasing power of foreign currency increases in comparison to domestic currency?
29. With the help of which item BOP gets balanced?
30. Does BOP always remain balanced?

## SHORT ANSWER TYPE QUESTIONS (3-4 MARKS)

1. Write any three points of difference between BOT and BOP.
2. Distinguish between current account and capital account of BOP.
3. How can deficit in BOP be financed?
4. What are the components of the current account of the balance of payment account.
5. Give difference between the autonomous and accommodating items included in BOP.
6. Distinguish between autonomous and accommodating transaction in the balance of payment account. Give an example each.

7. Give three reasons why people desire to have foreign exchange.
8. Give any three/four sources of supply of foreign exchange.
9. Explain the relationship between foreign exchange rate and demand for it.
10. Explain the relationship between foreign exchange rate and supply of foreign exchange.
11. Explain the terms ‘appreciation and depreciation of currency.’
12. Explain the merit and demerits of fixed exchange rate.
13. Explain the merits and demerits of flexible exchange rate.
14. How is flexible exchange rate determined in a free market economy? Explain with the help of diagram.
15. Higher the foreign exchange rate, lower the demand fore foreign exchange. Explain why?
16. Lower the foreign exchange rate, higher the demand for foreign exchange. Explain why?
17. Explain the impact of Devaluation of domestic currency on the export and imports of an economy.
18. Give the meaning of fixed flexible and managed floating exchange rate.
19. Why the demand for foreign exchange falls when the foreign exchange rate rise explain with the help of an example.



## 6 MARKS QUESTIONS

1. Explain the distinction between Autonomous and Accommodating transactions in balance of payments. Also explain the concept of balance of payments ‘defict’ in this context.
2. What is balance of payments accounts? Name three components each of its current account and capital account.
3. How is balance of trade different from balance of payments? State the items not included in balance of trade.

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## HOTS

20. What is the impact of appreciation of currency on the demand for foreign exchange?
21. What is the impact of appreciation of currency on the supply of foreign exchange?
22. What is the impact of depreciation of currency on the demand for foreign exchange?
23. What is the impact of depreciation of currency on the supply of foreign exchange?
24. Distinguish between devaluation and depreciation of domestic currency.
25. Giving reasons state whether the following statements are true or false :
    - (i) Excess of foreign exchange receipts over foreign exchange payments on account of accommodating transactions equals deficit in the balance of payments.
    - (ii) Export and import of machines are recorded in capital account of the balance of payments account.

## ANSWERS

### 1 MARK QUESTIONS

1. It is the difference between monetary value of exports and imports of material goods or visible items.
2. A balance of payment is a statement of double entry system of all economic transactions between residents of a country and the residents of foreign countries during a given period of time.
3. When the value of imports is more than value of exports.
4. 800 Crores.
5. Visible items Watch, Petrol, Electronic item.
6. (i) Direct Foreign Investment

   (ii) Loans

7. Exchange rate influenced by the intervention of the central bank in the foreign exchange market.

8. Invisible items are all those type of services which are exported and imported.

9. These refers to one sided transfers from one country to other. These are not trading transactions.

10. Autonomous transactions refer to international economic transactions in the current and capital account that are undertaken for profit.

11. Accommodating items.

12. Fixed exchange rate is the rate which is officially fixed in terms of Gold or any other currency by the govt. or adjusted only frequently.

13. Flexible exchange rate is determined by demand for and supply of a given currency in foreign exchange market.

14. (i) No need to hold foreign exchange reserve.

    (ii) Optimum resource allocation.

15. (i) Fluctuations in foreign exchange rate.

    (ii) Encourages speculation.

16. (i) Stability in Exchange rate.

    (ii) No scope for speculation.

17. (i) Need to hold foreign exchange reserves.

    (ii) No automatic adjustment in the 'Balance of Payments.'

18. Negative slope.

19. Positive slope.

20. Exports will increase because Indian goods have become cheaper for foreigners.

22. Import will decrease because foreign goods have become costlier for Indians.

23. Devaluations means to reduce parity rate of its currency with respect of gold or any other currency by the Government.

24. When the value of domestic currency reduce with respect to other currency by the demand and supply forces of foreign exchange in a free exchange market.

25. Appreciation of currency refer when the value of foreign currency reduce with respect to domestic currency. It occurs in a free exchange market by the forces of demand and supply of currency.

## 1 MARK HOTS QUESTIONS

26. When economy adopt the policy of Export Promotions.
27. When we adopt the policy of Import Substitution.
28. Capital account records capital transfer such as loans and investment between one country and the rest of the world which causes a change in the asset or liability status of the residents of a country or its government.
29. With the help of international loans.
30. Always in equilibruim in the sense of accounting.