Unit 12

I. Choose the correct answer (each question carries 1 mark)

1. The consumers and producers can choose between domestic and foreign goods, this market linkage is called

a) Financial Market linkage
b) Output Market linkage
c) Labour Market linkage
d) None of the above

2. The exchange rate is determined by the market forces of demand and supply is called as

a) Fixed exchange rate
b) Dirty floating exchange rate
c) Flexible exchange rate
d) None of the above

3. The balance of payments (BOP) record these transactions between residents and with the rest of the world

a) Goods
b) Services
c) Assets
d) All the above

4. The rate at which the price of one currency in terms of Foreign Currency is called

a) Exchange Control
b) Interest Rate
c) Foreign Exchange Rate
d) None of the above

5. In this standard all currencies were defined in terms of gold

a) Metal standard
b) Silver standard
c) Gold standard
d) None of the above

II. Fill in the blanks (each question carries 1 mark)

1. __Current Account____________is the record of trade in goods and services and transfer payments.
2. ____Capital Account_______ account records all international transactions of assets.
3. The price of foreign currency in terms of Domestic currency has increased and this is called ______Nominal Exchange Rate ________of domestic currency.
4. __Managed_____________is a mixture of a flexible and fixed exchange rate system.
5. The Bretton Woods conference held in the year __1944__

III. Match the following (Carries 5 marks)

1. SDR	a) Dirty floating
2. Balance of Payment	b) Flexible exchange rate
3. Balance of Trade	c) Paper gold
4. Floating exchange rate	d) Trade in goods
5. Managed floating	e) Trade in goods and services

SDR	Paper gold
Balance of Payment	Trade in goods and services
Balance of Trade	Trade in goods
Floating exchange rate	Flexible exchange rate
Managed floating	Dirty floating

IV. Answer the following questions in a sentence/word. (each question carries 1 mark)

1. What do you mean by open economy?

An open economy is one that trades with other nations in goods and services and, most often, also in financial assets.

2. What is Balance of payment?

The balance of payments (BoP) record the transactions in goods, services and assets between residents of a country with the rest of the world.

3. What is balance of trade?

The balance of trade record the transactions in imports and exports of goods.

4. What do you mean by fixed exchange rate?

Most countries had fixed or what is called pegged exchange rate system, in which the exchange rate is pegged at a level.

5. Give the meaning of official reserve sale.

The country could engage in official reserve transactions, running down its reserves of foreign exchange, in the case of a deficit by selling foreign currency in the foreign exchange market.

6. Give the meaning of managed floating.

In a system of flexible exchange rates (also known as floating exchange rates), the exchange rate is determined by the forces of market demand and supply.

V. Answer the following questions in 4 sentences. (each question carries 2 marks)

1. Mention the three linkages of open economy.

a) Product Linkage
b) Financial Market Linkage
c) Factor Linkage.

2. What is the difference between current account and capital account?

The current account records exports and imports in goods and services and transfer payments.

The capital account records all international purchases and sales of assets such as money, stocks, bonds, etc

3. When do surplus and deficit arises in Capital Account?

The country could engage in official reserve transactions, running down its reserves of foreign exchange, in the case of a deficit by selling foreign currency in the foreign exchange market. The decrease (increase) in official reserves is called the overall balance of payments deficit (surplus).

4. Write the meaning of balanced, surplus and deficit BOT.

A balanced BOT is when total imports equals total exports

It is surplus when total exports exceed total imports

It is deficit when total imports exceed exports

5. Why do people demand foreign exchange?

Let us assume that an Indian resident wants to visit London on a vacation (an import of tourist services). She will have to pay in pounds for her stay there. She will need to know where to obtain the pounds and at what price. Her demand for pounds would constitute a demand for foreign exchange which would be supplied in the foreign exchange market

6. What is foreign exchange rate.

It is the total amount of foreign currency one can obtain for one unit of domestic currency.

7. Differentiate between depreciation and devaluation.

A devaluation is said to occur when the exchange rate is increased by social action under a pegged exchange rate system.

A depreciation is the rise in exchange rate caused causing the import demand to fall since rupee price rises with the exchange rate.

VI. Answer the following questions in 12 sentences. (each question carries 4 marks)

1. Write a note on balance of trade.

Balance of payments should be distinguished from balance of trade. Balance of trade refers to the export and import of visible items, i.e., material goods. It is the difference between the value of visible exports and imports.

Visible items are those items which are recorded in the customs returns; for example, material goods exported and imported. If the value of visible exports is greater than that of visible imports, the balance of trade is favourable.

If the value of visible imports is greater than that of visible exports the balance of trade is unfavourable; if the value of visible exports is equal to that of visible imports, the balance of trade is in equilibrium. Balance of trade is also known as merchandise account of exports and imports.

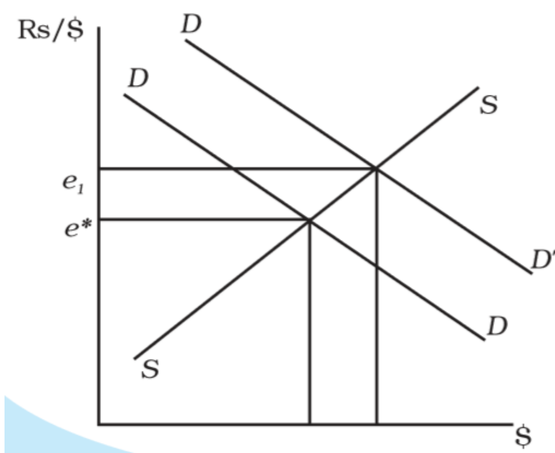
2. Write the chart of components of Current account.

Credit (Receipts)	Debit (Payments)
Current Transactions	
Items	Items
Merchandise trade	Merchandise trade
Service exported	Service imported
Unilateral receipts	Unilateral payments

3. Write the chart of components of capital account.

Capital Transactions	
Credit (Receipts) Items	Debit payment Items
Borrowing from foreign countries and FDI	Lending to foreign countries and direct investment in foreign countries
Repayment of loans from foreign countries	Repayment of loans to foreign countries
Sale of gold / assets	Purchase of gold / assets

4. Briefly explain the effect of an increase in demand for imports in the foreign exchange market with the help of a diagram.



If the demand for foreign exchange goes up due to Indians travelling abroad more often, or increasingly showing a preference for imported goods, the DD curve will shift upward and rightward. The resulting intersection would be at a higher exchange rate.

Changes in the price of foreign exchange under flexible exchange rates are referred to as currency depreciation or appreciation. In the above case, the domestic currency (rupee) has depreciated since it has become less expensive in terms of foreign currency.

For instance, if the equilibrium rupeedollar exchange rate was Rs 45 and now it has become Rs 50 per dollar, the rupee has depreciated against the dollar. By contrast, the currency appreciates when it becomes more expensive in terms of foreign currency. At the initial equilibrium exchange rate e*, there is now an excess demand for foreign exchange. To clear the market, the exchange rate must rise to the equilibrium value e1 as shown. The rise in exchange rate (depreciation) will cause the quantity of import demand to fall since the rupee price of imported goods rises with the exchange rate. Also, the quantity of exports demanded will increase since the rise in the exchange rate makes exports less expensive to foreigners. At the new equilibrium with e1, the supply and demand for foreign exchange is again equal.

5. Explain the merits and demerits of Flexible and fixed exchange rate system.

Merits of Fixed Exchange Rate System

a) Minimise exchange rate fluctuations
b) Reduces volatility and fluctuations in prices
c) (iii)Imposes discipline on the monetary authority
d) Encourages international trade and investment flows
e) Less speculation in the currency market

Demerits of Fixed Exchange Rate System

a) Central Bank needs to hold huge stocks of either Gold or USD.
b) Do not allow for automatic stabilisation of exchange rate.
c) Diverts Central Banks focus from economic problems to exchange rate
d) It discourages venture capital.
e) These exist the possibility of policy delay.

Merits of Flexible Exchange Rate System

a) Independent monetary policy
b) Encourages international mobility of capital and trade
c) Encourages venture capital
d) No need to maintain huge stock of gold or other currency

Demerits of Flexible Exchange Rate System

a) Creates the condition of instability in the international trade
b) Adverse effect on economic structure
c) Unnecessary capital movements
d) Inflationary problems
e) Difficulty in policy formation

VII. Answer the following questions in 20 sentences. (each question carries 6 marks)

1. Write a note on balance of payment.

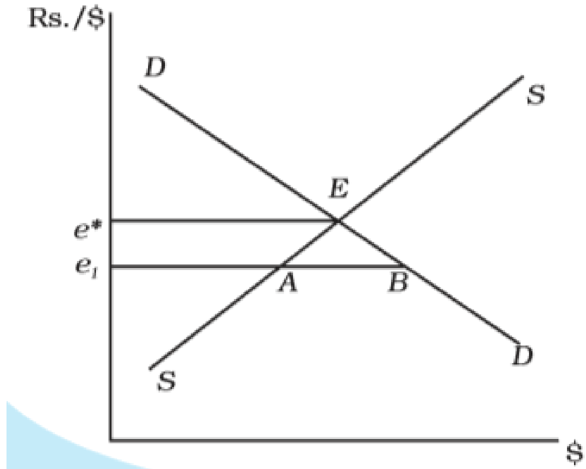
The balance of payments (BoP) record the transactions in goods, services and assets between residents of a country with the rest of the world. There are two main accounts in the BoP – the current account and the capital account. The current account records exports and imports in goods and services and transfer payments.

Trade in services denoted as invisible trade (because they are not seen to cross national borders) includes both factor income (payment for inputs-investment income, that is, the interest, profits and dividends on our assets abroad minus the income foreigners earn on assets they own in India) and non-factor income (shipping, banking, insurance, tourism, software services, etc.). Transfer payments are receipts which the residents of a country receive 'for free', without having to make any present or future payments in return.

They consist of remittances, gifts and grants. They could be official or private. The balance of exports and imports of goods is referred to as the trade balance. Adding trade in services and net transfers to the trade balance, we get the current account balance.

The capital account records all international purchases and sales of assets such as money, stocks, bonds, etc. We note that any transaction resulting in a payment to foreigners is entered as a debit and is given a negative sign. Any transaction resulting in a receipt from foreigners is entered as a credit and is given a positive sign.

2. Briefly explain the foreign exchange market with fixed exchange rates with the help of a diagram



We examine the way in which a country can 'peg' or fix the level of its exchange rate. We assume that Reserve bank of India (RBI) wishes to fix an exact par value for the rupee at Rs 45 per dollar (e1 in Fig. 6.3). Assuming that this official exchange rate is below the equilibrium exchange rate (here e* = Rs 50) of the flexible exchange rate system, the rupee will be overvalued and the dollar undervalued. This means that if the exchange rate were market determined, the price of dollars in terms of rupees would have to rise to clear the market.

At Rs 45 to a dollar, the rupee is more expensive than it would be at Rs 50 to a dollar (thinking of the rate in dollar-rupee terms, now each rupee costs 2.22 cents instead of 2 cents). At this rate, the demand for dollars is higher than the supply of dollars. Since the demand and supply schedules were constructed from the BoP accounts (measuring only autonomous transactions), this excess demand implies a deficit in the BoP. The deficit is bridged by central bank intervention. In this case, the RBI would sell dollars for rupees in the foreign exchange market to meet this excess demand AB, thus neutralising the upward pressure on the exchange rate.

The RBI stands ready to buy and sell dollars at that rate to prevent the exchange rate from rising (since no one would buy at more) or falling (since no one would sell for less). Now the RBI might decide to fix the exchange rate at a higher level – Rs 47 per dollar – to bridge part of the deficit in BoP. This devaluation of the domestic currency would make imports expensive and our exports cheaper, leading to a narrowing of the trade deficit.

It is important to note that repeated central bank intervention to finance deficits and keep the exchange rate fixed will eventually exhaust the official reserves. This is the main flaw in the system of fixed exchange rates. Once speculators believe that the exchange rate cannot be held for long they would buy foreign exchange (say, dollars) in massive amounts.

The demand for dollars will rise sharply causing a BoP deficit. Without sufficient reserves, the central bank will have to allow the exchange rate to reach its equilibrium level. This might amount to an even larger devaluation than would have been required before the speculative 'attack' on the domestic currency began.

3. Write a short note on the gold standard

The Gold Standard: From around 1870 to the outbreak of the First World War in 1914, the prevailing system was the gold standard which was the epitome of the fixed exchange rate system. All currencies were defined in terms of gold; indeed, some were actually made of gold.

Each participant country committed to guarantee the free convertibility of its currency into gold at a fixed price. This meant that residents had, at their disposal, a domestic currency which was freely convertible at a fixed price into another asset (gold) acceptable in international payments. This also made it possible for each currency to be convertible into all others at a fixed price.

Exchange rates were determined by its worth in terms of gold (where the currency was made of gold, its actual gold content). For example, if one unit of say currency A was worth one gram of gold, one unit of currency B was worth two grams of gold, currency B would be worth twice as much as currency A.

Economic agents could directly convert one unit of currency B into two units of currency A, without having to first buy gold and then sell it. The rates would fluctuate between an upper and a lower limit, these limits being set by the costs of melting, shipping and recoining between the two Currencies. To maintain the official parity each country needed an adequate stock of gold reserves. All countries on the gold standard had stable exchange rates.