INDIAN SCHOOL AL WADI AL KABIR

Class: XII	**Department: Commerce**
Worksheet No: 1	**Topic: Open Economy**

1. **Which of the following statements about the increase in the value of foreign commodities is true?**
   a. The increase in the value of foreign commodities is known as revaluation
   b. The increase in the value of foreign commodities is known as devaluation
   c. The increase in the value of foreign commodities is known as inflation
   d. The increase in the value of foreign commodities is known as deflation
   A: b

2. **The foreign exchange is determined by _______.**
   a. The demand for foreign currency
   b. The supply of foreign currency
   c. Supply and demand in the foreign exchange market
   d. None of the above
   A: c

3. **One of the advantages of a fixed exchange rate is ______.**
   a. It helps to induce capital from abroad
   b. It helps to increase capital formation
   c. It helps to promote foreign trade
   d. All of the above
   A: d

4. **One of the demerits of a flexible exchange rate is ______.**
   e. Uncertainty
   f. Instability of foreign exchange
   g. Adverse results due to the low rate
   h. All of the above
   A: d

5. **The foreign exchange transactions that are dependent on other transactions are known as _________.**
   a. Autonomous transactions
   b. Accommodating transactions
   c. Current account transactions
   d. None of the above
   A: b

6. **The structure of the balance of payment accounts includes the _______.**

e. Capital account
f. Current account
g. Both a and b are correct
h. Both a and b are incorrect
A: c

7. **Which among the following could be said to be an 'Open Economy'?**
a) A nation that follows the doctrine of Free-market and Laissez-faire economics
b) A nation that trades with other nations in goods and services and financial assets
c) An economy that operates without government intervention
d) None of the above
A: b

8. **The records of exports and imports in goods and services and transfer payments is known as:**
a) Current account
b) Budget surplus
c) Economic leakage
d) degree of openness
A: a

9. What records a country's transactions (made by individuals, firms and government bodies.) with the rest of the world?
a) Trade deficit
b) Capital Budget
c) Foreign imports
d) Balance of Payments or BoP
A: d

10. Price of one currency in relation to other currencies in the international exchange market is known as:
a. Equilibrium rate
b. Fixed exchange rate
c. Exchange rate
d. Flexible exchange rate

11. The rate which is determined by the government is known as:
a. Flexible exchange rate
b. Fixed exchange rate
c. Floating exchange rate
d. None of these

12. What is the relationship between demand for foreign exchange and exchange rate?
a. Inverse
b. Direct

c. One to one
d. No relationship

13. Direct foreign investment of an individual of the domestic country is a source of:
    a. Demand for foreign exchange
    b. Supply of foreign exchange
    c. Both(a) and (b)
    d. None of these

14. Due to depreciation of foreign currency, the supply of foreign currency in domestic economy will:
    a. Increase
    b. Not change
    c. Either increase or decrease
    d. Decrease

15. Dirty floating is related to:
    a. Fixed system of exchange rate
    b. Flexible system of exchange rate
    c. Both of these
    d. None of these

16. Current account records transactions relate to:
    a. Export and import of goods
    b. Non-factor and factor income
    c. Current transfers
    d. All of these

17. Which of the following items relate to bop on capital account?
    a. Foreign investment
    b. Loans
    c. NRI remittances
    d. All of these

18. Unilateral transfers are:
    a. One-sided payments
    b. Reciprocal payments
    c. Factor incomes
    d. All of these

19. Balance of trade is a part of:

a. **Current account bop**
b. Capital account bop
c. Official reserves account
d. None of these

1. Why does demand for foreign exchange rise when its price falls?

The demand for foreign currency rises in the following situations:

1. When price of a foreign currency falls, imports from that, foreign, country become cheaper. So, imports increase and hence, the demand for foreign currency rises.
   For example, if price of 1 US dollar falls from Rs 60 to T 55, then imports from The USA will increase as American goods will become relatively cheaper. It will raise the demand for US dollar.
2. When a foreign currency becomes cheaper in terms of the domestic currency, it promotes tourism to that country. As a result, demand for foreign currency rises.
3. When price of a foreign currency falls, its demand rises as more people want to make gains from speculative activities.

2. What are the reasons of 'rise in supply' of foreign currency?

The supply of foreign currency rises in the following situations:

1. When price of a foreign currency rises, domestic goods become relatively cheaper. It induces the foreign country to increase their imports from the domestic country. As a result, supply of foreign currency rises. For example, if price of 1 US dollar rises from Rs 60 to Rs 65, then exports to USA will increase as Indian goods will become relatively cheaper. It will raise the supply of US dollars.
2. When price of a foreign currency rises, foreign direct investment (FDI) from rest of the world increases, which will increase the supply for foreign exchange.
3. When price of a foreign currency rises, also supply of foreign currency rises as people want to make gains from speculative activities.

3. Explain the effect of depreciation of domestic currency on exports.

Depreciation of domestic currency means a fall in the price of domestic currency (say, rupee) in terms of a foreign currency (say, $). It means, with the same amount of dollars, more goods can be purchased from India, i.e., exports to USA will increase as they will become relatively cheaper.

4. Explain the effect of appreciation of domestic currency on imports.

Appreciation of domestic currency means a rise in the price of domestic currency (say, rupee) in terms of a foreign currency (say, $). Now, one rupee can be exchanged for more $, i.e., with the same amount of money, more goods can be purchased from the USA. It leads to increase in imports from the USA as American goods will become relatively cheaper.

5. **‘Devaluation and Depreciation of currency are one and the same thing’. Do you agree? How do they affect the exports of a country?**

1. Devaluation refers to reduction in price of domestic currency in terms of all foreign currencies under fixed exchange rate regime, i.e., (It takes place due to government).
2. Depreciation refers to fall in market price of domestic currency in terms of a foreign currency under flexible exchange rate regime, i.e., (It takes place due to market forces of demand and supply)

Currency Depreciation and Currency Devaluation may result into increase in exports of the goods and services from the country since it would increase the global competiveness of the goods.

6. **Explain the distinction between autonomous and accommodating transactions in balance of payments. Also explain the concept of balance of payments deficit in this context.**

Ans: The distinction between autonomous and accommodating transactions in balance of payments are as follows:

Basis	**Autonomous Transactions**	**Accommodating Transactions**
Meaning	Autonomous items are international economic transactions that take place for some economic reason, such as profit maximization.	Accommodating Items refers to transactions which are those that are undertaken to cover a deficit or surplus in autonomous transactions.
Effects on BOP account	Autonomous transactions are unaffected by the state of the payment account's balance.	To keep the balance in the BOP account, accommodating transactions are carried out.
Current/capital account	Autonomous transactions occur on both the current and capital accounts.	Only capital accounts are subject to accommodating transactions.

Alternate Name	These are also called "above the line items."	These are also called "below the line items."

BOP deficit:

- When a country's payments for autonomous transactions exceed its receipts, the gap is referred to as the BOP deficit. It can be calculated as follows:
- Deficits in BOP occur when the receipts on account of autonomous transactions are fewer than payments on account of autonomous transactions.
- If the home country's receipts are Rs. 500 crore and payments are Rs. 600 crores, the BOP deficit will be calculated 600-500= 100 Crore.
- When a country has a balance of payments deficit, it imports more products, services, and capital than it exports.
- The country has to borrow from other countries in order to pay for its imports..
- In the short run, this contributes to the country's economic growth. It's analogous to taking out a student loan to pay for college, as ultimately college will help in shaping the future of the student.

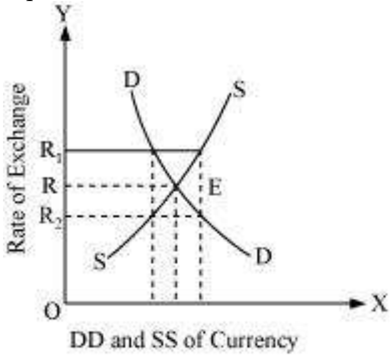
7. What determines the flow of foreign exchange into the country?

The following variables contribute to the flow of foreign exchange into the country:

- Foreigners purchasing domestic goods, in terms of exports.
- Foreigners buying the assets of the home country.
- In-country foreign direct investment and portfolio investment.
- Foreign exchange speculative buying, that will lead to inflow of the foreign exchange.
- Foreign tourists visiting various locations in India.

8. **How is the exchange rate determined under a flexible exchange rate regime?**

Under flexible exchange rate regime, the rate of exchange is determined by the forces of demand and supply. In other words, the equilibrium rate of exchange occurs where demand and supply are equal to each other. This can be illustrated with the help of the given figure:



In the figure, *x*−axis represents demand for and supply of foreign currency and *y*−axis represents the exchange rate. DD is the demand curve that is downward slopping, showing an inverse relationship between the rate of exchange and demand for foreign currency. Whereas, the supply curve is upward sloping, showing positive relationship between the rate of exchange and the supply of foreign currency. E is the equilibrium rate of exchange, where the demand equates the supply of foreign exchange (OR). Now, if the exchange rate rises to OR_1, then the supply exceeds the demand, forcing the exchange rate to fall back to OR. On the contrary, if the exchange rate falls to OR_2, there is excess demand over supply. Hence, the rate of exchange rises from R_2 to R.
Hence, the equilibrium exchange rate (OR) is determined by demand and supply of foreign currency.

9. **Distinguish between current account and capital account of Balance of Payments account Mention; any two transactions of capital account.**
   The Balance of Payments on capital account includes capital transactions relating to borrowing and; lending of capital, sale and purchase of assets, interest payment, etc.
   The Balance of Payments on current account is the sum of balance of merchandise trade, services; and net transfers received from rest of the world.
   The two transactions of capital account are:

- Direct investment
- Private transactions

10. **State any four items each of current account and capital account of the Balance of Payments account.**

Items of Current Account
(i) Export and Import of Goods: Current account shows exports and imports of visible items i.e., goods like machinery, wheat, steel, etc.
(ii) Export and Import of Services: Current account shows exports and imports of invisible items i.e., services like banking, tourism, insurance, etc.
(iii) Unilateral Transfers: These are those receipts which residents of a country receive or payments that the residents of a country make without getting anything in return. Receipts from abroad are entered as positive items and payments abroad are entered as negative items.
(iv) Private Transfers: These are gifts that domestic residents receive from or make to foreign residents.
Items of Capital Account

- Private Transactions: These are transactions that affect the assets or liabilities of individuals, business, etc. and other non-government entities.
- Official Transactions: These are the transactions that affect the assets and liabilities by the government and its agencies.
- Direct Investment: Direct investment means the act of purchasing an asset and at the same time acquiring control of it.
- Portfolio Investment: It is the acquisition of an asset that does not give the purchase control over the asset.

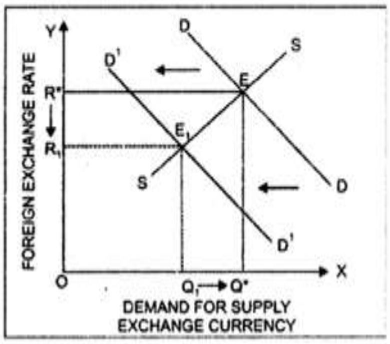
11. **Define "Trade surplus". How is it different from "Current account surplus"?**
Trade surplus refers to excess of value of export of visible items over value of import of visible items in the balance of payment account of a country. In other words, it only includes trade of goods. Current account surplus refers to excess of receipts from value of exports of visible items and invisible items; and unilateral transfers over payment for value of imports of visible items and invisible items; and unilateral transfer. It is a relatively broader concept as compared to trade surplus.

12. **Where will sale of machinery to abroad be recorded in the Balance of Payments Accounts? Give reasons.**
Machinery is a visible item and its sale to abroad will be an export. This will result in inflow of foreign exchange in the country. Thus, sale of machinery to abroad will be recorded as a credit item under visible items in the current account.

13. **Where is 'borrowings from abroad' recorded in the Balance of Payments Accounts? Give reasons.**
Borrowings from abroad would lead to an inflow of foreign exchange into the country. Thus, borrowings from abroad will be recorded as positive items in the capital account of Balance of Payments.

14. **"Indian Rupee (₹) plunged to all time low of ₹ 74.48 against the US Dollar ($)". In the light of the above report, discuss the impact of the situation on Indian Imports.**
Indian rupee plunged to all time low of rupees ₹ 74.4 8 against US Dollar. This is called as depreciation in the value of Indian rupee. It might lead to fall in imports as foreign goods will become more expensive for domestic consumers.

15. **Recently Government of India has doubled the import duty on gold. What impact is it likely to have on foreign exchange rate and how?**
When the import duty on gold rises, the import of gold would become costlier. This would reduce the demand for foreign currency. Since the supply of foreign currency remains the same, the foreign exchange rate would fall. This implies appreciation of rupees.



In the diagram, point E determines the equilibrium exchange rate in the foreign market (R*) and equilibrium quantity (Q*) of the foreign currency, where demand (DD) and supply (SS) curves intersect. A fall in the demand for foreign currency will cause the demand curve to shift-to the left from DD to D_1D_1, and the exchange rate falls to R_1 New equilibrium is established at E_1.

16**. How does giving incentives for exports influence foreign exchange rate? Explain.**

The incentives for exports boost exports of the country. An increase in exports causes the supply of foreign currency to increase in the domestic country while the demand remains unchanged. Consequently, the exchange rate falls and the domestic currency appreciates.

in the diagram, point E determines the equilibrium exchange rate in the foreign market (R*) and equilibrium quantity (0*) of the foreign currency, where demand (DD) and supply (SS) curves intersect. A rise in the supply for foreign currency will cause the supply curve to shift to the right from SS to S_1 S_1 and the exchange rate falls to R_1.