CBSE Class–12 economics

Important Questions - Macro Economics 06

Open Economy Macroeconomics

VERY SHORT ANSWER QUESTIONS (1 Mark)

Q1. Foreign exchange rate of a country is the

a) price of a foreign good in terms of the domestic good
b) price of a foreign trade in terms of the domestic trade
c) price of a foreign factor in terms of the domestic factor
d) price of a foreign good in terms of the domestic currency

Ans. (d)

Q2. A source of supply of foreign exchange is

a) Donations given
b) Imports
c) Exports
d) Gifts

Ans. (c)

Q3. Balance of payment Accounts is a

a) Systematic record of all receipts between the residents of a country and abroad
b) Systematic record of all expenditures between the residents of a country and abroad
c) Systematic record of all economic transactions between the residents of a country
d) Systematic record of all economic transactions between the residents of a country & abroad

Ans. (d)

Q4. A source of demand for foreign exchange is

a) **Brokerage of goods & services**
b) **Smuggle of goods & services**
c) **Export of goods & services**
d) **Import of goods & services**

Ans. (d)

Q5. A deficit in balance of trade indicates

a) **That the imports of good are equal to the exports**
b) **None of the above**
c) **That the imports of good are less than the exports**
d) **That the imports of good are greater than the exports**

Ans. (d)

Q6. What do you mean by Foreign exchange market?

Ans. The foreign exchange marekt is the market where international currencies are traded for one another.

Q7. Define flexible exchange rate.

Ans. Flexible exchange rate is the rate which is determined by the demand and supply of different currencies in the foreign market.

Q8. What is meant by appreciation of currencies?

Ans. Appreciation of currency means increase in exchange value of the currency when it is compared with other country.

Q9. What is the balance of visible times in the balance of payments account called?

Ans. Balance of trade

Q10. What is meant by managed floating?

Ans. It is a system that allows adjustments in exchange rate according to a set of rules and regulations which are offciailly declared in the foreign exchange market.

Q11. When a situation of deficit in BOP does arises?

Ans. A situation of deficit in BOP arise when autonomous receipts are less than autonomous payments.

Q12. Fixed exchange rate is

a) is fixed by the foreign exchange market
b) is fixed by the businesses in an economy
c) is fixed by the anybody in an economy
d) is fixed by the government in an economy

Ans. (d)

Q13. Flexible exchange rate is

a) Fixed

b) Ordered
c) Can't say
d) Determined

Ans. (d)

Q14. Point out a merit of fixed exchange rate

a) None
b) Ensures supply of the fixed exchange rate
c) Ensures demand for the fixed exchange rate

d) Ensures stability of the fixed exchange rate

Ans. (d)

Q15. Point out a demerit of fixed exchange rate

a) Promotes the objectives of free markets

b) Ensures supply of the fixed exchange rate

c) None

d) Contradicts the objectives of free markets

Ans. (d)

SHORT ANSWER QUESTIONS (3/4 Marks)

Q16. Why does demand for foreign exchange rises when price falls?

Ans. With a fall in price of foreign exchange, the exchange value of domestic currency increase and that of foreign currency falls. This implies that foreign goods becomes cheaper and their domestic demand increases. The rising domestic demand for foreign goods implies higher demand for foreign exchange. So there is relationship between price and demand for foreign exchange.

Q17. Give two examples and explain why there is a rise in demand for a foreign currency when its price falls.

Ans. When price of foreign currency falls, imports get cheaper. So, more demand for foreign exchange by importers. Toursim abroad is promoted as it becomes cheaper. So demand for foreign currency rises.

Q18. Distinguish between fixed and flexible foreign exchange rate.

Ans. When foreign exchange rate is fixed by central bank or government, it is called fixed exchange rate. When foreign exchange rate is determined by market forces/mechanism, it is flexible exchange rate.

Q19. Distinguish between autonomous and accommodating transaction of balance of payment account.

Ans. Autonomous transactions are done for some economic consideration such as profit, such transactions are independent of the state of balance of payment. Accomodating transactions are under taken to cover the deifcit or surplus in balance of payments.

Q20. What determines the flow of foreign exchange in to the country?

Ans. Below mentioned factors contribute the flow of foreign exchange into the country:-

1. **Purchase of domestic goods by the foreigners**
2. **Foreign direct investment and portfolio investment in the home country**
3. **Speculative purchase of foreign exchange**
4. **Foreign tourists visits different places in India.**

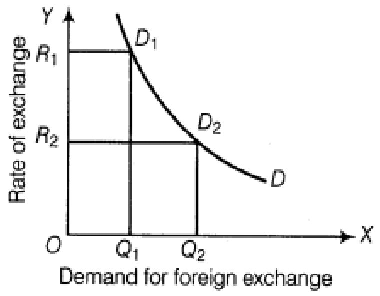
LONG ANSWER QUESTIONS (6 Marks)

Q21. Give the meaning of foreign exchange and foreign exchange rate. Giving reason, explain the relation between foreign exchange rate and demand for foreign exchange.

Ans. A foreign exchange rate is the rate at which one currency is exchanged for another. Thus, an exchange rate can be regarded as the price of one currency in terms of another. Ex-change rate is usually quoted in terms of ru-pees per unit of foreign currencies. Thus, an exchange rate indicates external purchasing power of money.

A foreign exchange rate is the rate at which one currency will be exchanged for another. It is also regarded as the value of one country's currency in relation to another currency. There are two methods of foreign exchange rate determination. One method falls under the classical gold standard mechanism and another method falls under the classical pa-per currency system. Today, gold standard mechanism does not operate since no stand-ard monetary unit is now exchanged for gold. Demand for foreign exchange is generated When Indian people and business firms want to make payments to the US nationals for buy-ing US goods and services or to make gifts to the US citizens or to buy assets there. The larger the volume of imports the greater is the demand for foreign exchange.

Relation between foreign exchange rate and demand for foreign exchange There is an inverse relationship between the foreign exchange rate and demand for foreign exchange, with the rise in foreign exchange rate, demand for foreign exchange falls and vice-versa.



In the above figure, D curve represent the demand for foreign currency. When exchange rate is high (R1), demand for the foreign currency falls (Q1,). On the other hand, when exchange rate is low (R_2), demand for the foreign currency rises Q_2. The demand curve for the foreign currency is always downward sloped and signifies an inverse relationship between demand and exchange rate i.e. price of foreign exchange.

Q22. Explain the distinction between autonomous and accomodating transactions in balance of payments. Also explain the concept of balance of payments deficit in this context.

Ans. The basic difference between the two is that whereas deficit or surplus in BOP occurs due to autonomous items, the accommodating items are taken to cover deficit (or surplus) in autonomous transactions. Autonomous items are generally called 'above the line items' in BOP Again, it is autonomous transactions which make deficit or surplus in BOP. BOP is in deficit if the autonomous receipts are less than autonomous payments. BOP is in surplus if the autonomous receipts are greater than former one. In other words, deficit or surplus in BOP depends upon the balance of autonomous items. Accomodating items refer to transactions that take place to cover deficit arising from autonomous transactions. These items are also called ‘below the line items’. Because of government financing, official settlements are seen as accommodating items to keep the BOP identity.

BOP deficit:-

When the payments of a country on account of autonomous transactions exceed the receipt of the country, this difference is termed as BOP deficit. It can be calculated as:

Deficit in BOP = Receipts on account of autonomous transactions is less than payment on account of autonomous transactions.

Suppose, receipts of the domestic country is Rs. 500 crore and payments were Rs. 600 crore, then BOP deficit will be

= 600 -500 = Rs. 100 crore.

A balance of payments deficit means the country imports more goods, services and capital than it exports. It must borrow from other countries to pay for its imports. In the short-term, that fuels the country's economic growth. It's like taking out a school loan to pay for education.

Q23. Distinguish between balance of trade account and current account balance of BOP account.

Ans. Following are the differences between the balance of trade and current account balance:-

Basis of difference	Balance of Trade	Balance on Current Account
Meaning	It includes only visible items. It is the difference between exports and imports of the country	It is the difference between sum of credit items and sum of debit items on current account

Coverage	**It does not record any transactions of invisible items and transfers**	**It includes balance of visible items, invisible items and balance of unilateral transfer**
Concept	**It is a narrow concept and it is only a part of the balance of payment account**	**It is a very wide concept. Balance of current account includes the balance of trade**
Financing of deficit	**A deficit in balance of trade can be meet out by surplus of current account**	**Deficit of current account cannot be meet out by using surplus of balance of trade**