

Unit 7

Balance of Payments

Key answers for the questions:

1. b) The government pegs the currency value to a basket of foreign currencies or gold.
2. b) The supply and demand for foreign currencies in the market.
3. b) Greater stability in international trade.
4. b) It can lead to currency volatility and instability.
5. b) Intervenes to maintain the currency's peg to a stable asset.
6. b) Potential loss of monetary policy independence.
7. d) The number of goods imported by the country.
8. c) No need for foreign exchange reserves.
9. b) Exports and imports of goods and services.
10. c) Investments and loans made by foreigners in the country.
11. b) Foreign direct investment (FDI) and foreign portfolio investment (FPI).
12. a) Any discrepancy between the total debit and credit entries in the accounts.
13. b) Export of software services to another country.
14. a) All economic transactions between a country and the rest of the world.
15. a) Borrow from abroad to cover the deficit.
16. d) All of the above.
17. d) All of the above.
18. b) Risk of currency devaluation or overvaluation.
19. b) A country's currency depreciates rapidly, causing economic instability.
20. b) Intervene by buying or selling the currency in the market.
21. c) The demand for its currency rises in the foreign exchange market.
22. b) Large foreign exchange reserves to maintain the peg.
23. c) It automatically adjusts to changes in the economy.
24. a) The central bank has to use its reserves to maintain the rate.
25. c) Flexible exchange rate.
26. c) Higher inflation in India compared to trading partners.
27. c) The record of all economic transactions between the country and the rest of the world.
28. b) Exports and imports of goods and services.
29. b) The inflow and outflow of financial assets.
30. a) A foreign loan taken by the government.
31. b) Foreign direct investment.
32. b) The value of the domestic currency depreciates.
33. d) Changes in weather patterns.
34. a) The Indian Rupee will appreciate.
35. b) Currency depreciation.
36. b) High inflation and widening current account deficit.
37. b) Selling dollars in the forex market.
38. b) It will increase foreign direct investment and improve the current account.
39. b) Growth in foreign exchange reserves.
40. a) COVID-19 pandemic recovery.
41. b) Depreciation of its currency.
42. c) Foreign direct investment (FDI).
43. a) Increase in India's foreign exchange reserves.

44. b) Lead to an appreciation of the Indian Rupee.
45. b) Buying or selling US dollars to manage Rupee fluctuations.
46. c) Exchange rates are largely determined by market forces, with some intervention by the government.
47. b) Increase in the capital account surplus.
48. c) Finance trade deficits in the short term.
49. c) A decline in foreign investments.
50. b) Decrease in imports of crude oil.

Explanations

1. **b) The government pegs the currency value to a basket of foreign currencies or gold.**
A fixed exchange rate involves the government setting a specific value for its currency, often pegged to another currency or a basket of currencies or commodities, to maintain stability.
2. **b) The supply and demand for foreign currencies in the market.**
A flexible exchange rate system is determined by the market forces of supply and demand, where currencies fluctuate freely based on economic conditions.
3. **b) Greater stability in international trade.**
The fixed exchange rate provides stability as it prevents large fluctuations, allowing businesses to plan international trade with less risk.
4. **b) It can lead to currency volatility and instability.**
In a flexible exchange rate system, currencies are subject to fluctuations based on market conditions, which may result in increased volatility.
5. **b) Intervenes to maintain the currency's peg to a stable asset.**
Governments using a fixed exchange rate intervene in the currency market, buying or selling their currency to maintain the set value against another asset.
6. **b) Potential loss of monetary policy independence.**
In a fixed exchange rate system, the government may lose the ability to control interest rates and money supply to meet domestic economic goals due to the need to maintain the currency peg.
7. **d) The number of goods imported by the country.**
Currency demand is influenced by factors like interest rates and political stability, but the amount of imports alone does not directly determine the demand for a currency.
8. **c) No need for foreign exchange reserves.**
In a flexible exchange rate system, the value of the currency is determined by the market, and the government does not need to hold large reserves to stabilize the currency.
9. **b) Exports and imports of goods and services.**
The current account records a country's trade in goods and services, including exports and imports, along with income flows and transfers.
10. **c) Investments and loans made by foreigners in the country.**
The capital account reflects the inflow and outflow of capital through foreign investments and loans, such as FDI and portfolio investments.
11. **b) Foreign direct investment (FDI) and foreign portfolio investment (FPI).**
The financial account captures foreign investment inflows and outflows, including direct investments in businesses and purchases of financial assets.

12. **a) Any discrepancy between the total debit and credit entries in the accounts.**
The errors and omissions account adjusts for discrepancies between recorded debits and credits in the balance of payments, ensuring the accounts balance.
13. **b) Export of software services to another country.**
Current account transactions involve the exchange of goods and services, such as the export of software services, which brings in foreign currency.
14. **a) All economic transactions between a country and the rest of the world.**
The balance of payments records every financial transaction between a country and foreign entities, covering trade, investments, and loans.
15. **a) Borrow from abroad to cover the deficit.**
A current account deficit means the country is importing more than it exports, and it often needs to borrow from foreign sources to cover the shortfall.
16. **d) All of the above.**
Global events such as trade tensions, fluctuating oil prices, and central bank actions during COVID-19 have contributed to exchange rate volatility, affecting currencies globally.
17. **d) All of the above.**
Digital currencies like Bitcoin can influence the balance of payments by affecting traditional currency demand, changing investment flows, and potentially impacting inflation and monetary policy.
18. **b) Risk of currency devaluation or overvaluation.**
Exchange rate volatility increases the risk that a currency could become overvalued or undervalued, creating instability in trade and investment.
19. **b) A country's currency depreciates rapidly, causing economic instability.**
A currency crisis occurs when a nation's currency rapidly loses value, leading to inflation, reduced investor confidence, and economic turmoil.
20. **b) Intervene by buying or selling the currency in the market.**
To stabilize exchange rates, central banks intervene by either buying or selling their currency in the foreign exchange market, to adjust supply and demand.
21. **c) The demand for its currency rises in the foreign exchange market.**
If demand for a country's currency increases, typically through rising exports or investments, the currency appreciates as foreign entities need more of it.
22. **b) Large foreign exchange reserves to maintain the peg.**
In a fixed exchange rate system, the government needs substantial reserves of foreign currency to buy or sell its currency and keep it pegged to another asset.
23. **c) It automatically adjusts to changes in the economy.**
A flexible exchange rate automatically adjusts based on economic conditions like inflation and interest rates, allowing the currency to reflect changes in the domestic economy.
24. **a) The central bank has to use its reserves to maintain the rate.**
In a fixed exchange rate system, the central bank must use its foreign currency reserves to defend the peg, which can be costly and unsustainable.
25. **c) Flexible exchange rate**
A flexible exchange rate allows the currency value to fluctuate freely according to the forces of supply and demand, with no government intervention.
26. **c) Higher inflation in India compared to trading partners**
Higher inflation in India relative to trading partners erodes the competitiveness of Indian goods, leading to reduced demand for the currency, causing depreciation.
27. **c) The record of all economic transactions between the country and the rest of the world.**

The Balance of Payments records the flow of goods, services, income, and financial transactions between a country and the global economy.

28. **b) Exports and imports of goods and services**
India's current account records trade in goods and services, including exports and imports, which impact the currency value and balance of payments.
29. **b) The inflow and outflow of financial assets.**
The capital account captures financial transactions such as foreign direct investments and loans, reflecting the movement of financial assets in and out of the country.
30. **a) A foreign loan taken by the government.**
A foreign loan taken by the government is recorded in the financial account of the Balance of Payments, reflecting capital inflows.
31. **b) Foreign direct investment**
Foreign direct investment is recorded in the capital account, not the current account, as it involves long-term investment in physical assets, rather than trade in goods or services.
32. **b) The value of the domestic currency depreciates.**
If the demand for foreign currency exceeds supply, the domestic currency loses value (depreciates) as more is needed to meet foreign currency demand.
33. **d) Changes in weather patterns.**
Weather patterns do not directly influence currency demand. Factors such as interest rates, government policies, and speculation have a stronger impact on demand.
34. **a) The Indian Rupee will appreciate.**
A rapid growth in exports increases demand for the domestic currency, as foreign buyers need the local currency to pay for the goods, leading to appreciation.
35. **b) Currency depreciation**
If supply of a currency exceeds demand, it leads to depreciation as the market corrects for the imbalance by lowering the currency's value.
36. **b) High inflation and widening current account deficit**
The Indian Rupee depreciated due to inflationary pressures and a growing current account deficit, which weakened investor confidence in the currency.
37. **b) Selling dollars in the forex market**
During the 2013 crisis, the Reserve Bank of India sold US dollars in the forex market to stabilize the Rupee by increasing its supply and reducing depreciation pressures.
38. **b) It will increase foreign direct investment and improve the current account.**
The "Make in India" campaign encourages foreign investment, improving the capital account and reducing the current account deficit by boosting exports and production.
39. **b) Growth in foreign exchange reserves**
The Indian Rupee strengthened in 2024 due to an increase in foreign exchange reserves, improving the country's ability to support its currency and absorb external shocks.
40. **a) COVID-19 pandemic recovery**
The recovery from the COVID-19 pandemic led to strong capital inflows, particularly from foreign investors looking for growth opportunities in India, thus strengthening the Rupee.
41. **b) Depreciation of its currency**
A consistent trade deficit means that a country is importing more than it is exporting, leading to higher demand for foreign currency, which causes the domestic currency to depreciate.

42. **c) Foreign direct investment (FDI)**

FDI is part of the capital account in India's Balance of Payments, reflecting foreign investments in the country, which help finance deficits and support the economy.

43. **a) Increase in India's foreign exchange reserves**

An increase in foreign exchange reserves indicates more stable currency management and less likelihood of depreciation, as it gives the government the tools to stabilize the Rupee.

44. **b) Lead to an appreciation of the Indian Rupee.**

Policies that promote exports increase foreign demand for a country's goods, raising demand for its currency and leading to its appreciation.

45. **b) Buying or selling US dollars to manage Rupee fluctuations**

Foreign exchange interventions by the RBI include buying or selling US dollars to stabilize the Rupee and manage currency fluctuations in the market.

46. **c) Exchange rates are largely determined by market forces, with some intervention by the government.**

A managed floating exchange rate is mostly determined by market forces but includes occasional interventions by the government or central bank to stabilize the currency.

47. **b) Increase in the capital account surplus**

An increase in foreign direct investment boosts the capital account surplus, reflecting greater foreign investment in the country.

48. **c) Finance trade deficits in the short term**

A country with high foreign exchange reserves can use them to finance trade deficits temporarily, helping stabilize the currency and maintain import levels.

49. **c) A decline in foreign investments**

A decline in foreign investments reduces demand for the currency, leading to depreciation as the outflow of capital causes a loss in value.

50. **b) Decrease in imports of crude oil**

A reduction in crude oil imports would reduce foreign exchange outflows, improving India's current account balance and strengthening the Rupee by lowering demand for foreign currency.