CBSE Class–12 Economics

Macro Economics

Chapter 6 – Open Economy Macroeconomics

Revision Notes

The balance of payment is a comprehensive and systematic records of all economic transaction between normal residents of a country and rest of the world during an accounting year.

Accounts of Balance of Payments:

1. **Current Account:** The current account records export and import of goods and services and unilateral transfers.

2. **Capital Account:** It records of all such transactions between normal residents of a country and rest of the world which relates to sale and purchase of foreign assets and liabilities during an accounting year.

Components of Current Account	Components of Capital Account
1. Visible items (import and export of goods)	1. Foreign Direct investment.
2. Invisible items (import and export of services).	2. Loans
3. Unillateral transfers.	3. Portfolio investment.
4. Income receipts and payments from and to abroad.	4. Banking capital transactions.
5. These are the transactions which do not affect the assets or liabilities position of the country.	5. These are the transactions which affect the assets or liabilities position of the country.
6. It is a flow concept.	6. It is a stock concept.

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 is 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 recorded as a first items before calculating deficit or surplus in balance of payment a/c.

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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’.

Deficit of Bop Account: When total inflows of foreign exchange on account of autonomous transactions are less than total outflows on account such transaction then there is a deficit in Bop.

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. In simple words, we can say that the price of one currency in terms of other currency is known as foreign exchange rate or exchange rate.

SYSTEM OF EXCHANGE RATE:

1. Fixed exchange rate
2. Flexible exchange rate.

In fixed exchange rate system, the rate of exchange is officially fixed or determined by Government or Monetary Authority of the country.

Merits of Fixed Exchange Rate

(i) Stability in exchange rate
(ii) Promotes capital movement and international trade.
(iii) No scope for speculation
(iv) It forces the govt. to keep inflation in check.
(v) Attracts foreign capital.

Demerits of Fixed Exchange Rate

(i) Need to hold foreign exchange reserves.
(ii) No automatic adjustment in the ‘Balance of payments.’
(iii) It may result in undervaluation or overvaluation of currency.
(iv) It discourages the objective of having free markets.

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 the inverse relation with flexible exchange rate. If flexible

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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 the positive relation with foreign exchange rate. If foreign exchange rate rises the supply of foreign exchange also rises 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.

(vi) Foreign direct investment as well as portfolio investment from rest of the world.

Merits of Flexible Exchange Rate

(i) No need to hold foreign exchange reserves

(ii) Leads to automatic adjustment in the 'balances of payments'.

(iii) To enhances efficiency in resources allocation.

(iv) To remove obstacles in the transfer of capital and trade.

(v) It eliminates the problem of undervaluation or overvaluation of currency.

(vi) It promotes venture capital in the form of foreign exchange.

Demerits of Flexible Exchange Rate

(i) Fluctuations in future exchange rate.

(ii) Encourages speculation.

(iii) Discourages international trade and investment.

(iv) It creates a situation of market instability.

Determination of Equilibrium Foreign Exchange Rate: Equilibrium FER is the rate at which

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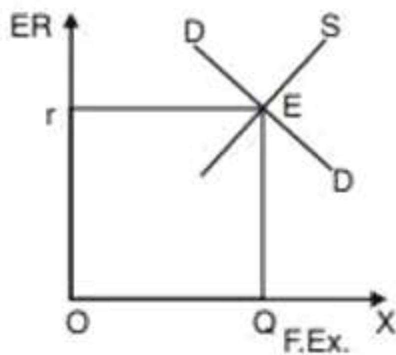
demand for and supply of foreign exchange is equal. Under free market situation, it is determined by market forces i.e., demand for and supply of foreign exchange. There is inverse relation between demand for foreign exchange and exchange rate. There is direct relationship b/w supply of foreign exchange and exchange rate. Due to above reasons demand curve downward sloping and supply curve is upward sloping curve graphically intersection of demand Curve and supply curve determines the equilibrium foreign exchange rate.



Devaluation of a currency: When government or monetary authority of a country officially lowers the external value of its domestic currency (in respect of all other foreign currency) is called devaluation of a currency. It takes place by government order under fixed exchange rate system.

Revaluation of a currency: When government or monetary authority of a country officially raises the external value of its domestic currency is called revaluation. It takes place by government order under fixed exchange rates system.

In currency depreciation there is a fall in the value of domestic currency, in term of foreign currency due to change in demand and supply of the currency under flexible exchange rate system.

In currency appreciation, there is a rise in the value of domestic currency in terms of foreign currency due to change in demand and supply of the currency under flexible exchange rate system.

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. When central bank finds the rate is too high, it starts selling foreign exchange from its reserve to bring down it. When it finds the rate is too low. It starts buying to raise the rate.

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