

Important Questions for CBSE Class 12 Macro-Economics Chapter 6 Open Economy Macroeconomics

Very Short Answer Questions (1 Mark)

1. 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) price of a foreign good in terms of the domestic currency

2. A source of supply of foreign exchange is

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

Ans: (c) Exports

3. 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) Systematic record of all economic transactions between the residents of a country & abroad

4. 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) Import of goods & services

5. 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) That the imports of good are greater than the exports

6. What do you mean by Foreign exchange market?

Ans: The foreign exchange market is the marketplace where international currencies are exchanged for one another.

7. Define a flexible exchange rate.

Ans: The flexible exchange rate, also known as free exchange rate is a rate which is governed by the free play of demand and supply forces in a foreign exchange market.

8. What is meant by appreciation of currencies?

Ans: Currency appreciation refers to an increase in the exchange value of a currency as compared to the currency of another country. For example, if earlier 1 was equal to Rs 75, but later, the value of 1 was equal to Rs 72, but later, the value of 1 moves from Rs 75 to Rs 72, In such a situation, we can say that the value of rupee is appreciating.

9. What is the balance of visible items in the balance of payments account called?

Ans: Balance of trade

10. What is meant by managed floating?

Ans: It is a system that allows exchange rate modifications based on a set of rules and regulations that are publicly published in the foreign exchange market. It is an effort to keep the exchange rate within a specific limit.

11. When does a situation of deficit in BOP arise?

Ans: When the payments in respect to the economic transactions of a country with the rest of the world surpasses its receipts, it is called a BOP deficit.

Hence, a BOP shortfall occurs when autonomous receipts are fewer than autonomous payments.

12. 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) is fixed by the government in an economy

13. Flexible exchange rate is

- a) Fixed
- b) Ordered
- c) Can't say
- d) Determined

Ans: (d) Determined

14. 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) Ensures stability of the fixed exchange rate.

15. 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) Contradicts the objectives of free markets

Short answer Questions (3 or 4 Marks)

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

Ans: When the price of foreign exchange falls, the exchange value of domestic currency rises while the value of foreign currency declines. This indicates that foreign goods become less expensive and domestic demand increases. Rising domestic demand for international goods indicates increased need for foreign currency. As a result, there is a link between foreign exchange pricing and demand.

For example, When the price of 1 US Dollar falls from Rs 75 to Rs 70, It means that the imports will rise, and domestic demand for US goods will increase as the US products will be cheaper to purchase. Hence, a demand for the US dollar will also rise.

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

Ans: The two examples are:

1. When the price of foreign exchange falls, the exchange value of domestic currency rises while the value of foreign currency falls, and foreign goods become cheaper in comparison to domestic goods. Rising domestic demand for foreign goods implies increased demand for foreign currency.
2. As the value of the foreign currency falls, tourists from the home country find it less expensive to travel abroad. As a result, demand for foreign currency rises.

18. Distinguish between fixed and flexible exchange rate.

Ans: The differences between between fixed and flexible exchange rate are as follows:

Basis	Fixed Exchange Rate	Flexible Exchange Rate
Meaning	A fixed exchange rate is one that is set and maintained by the central government.	A market-determined exchange rate is referred to as a flexible exchange rate.
Controlled by	An apex bank or monetary authority controls a fixed exchange rate.	The demand and supply forces govern a flexible exchange rate.

How it affects currency	A fixed exchange rate devalues and evaluates a currency.	A flexible exchange rate allows a currency's value to depreciate and appreciate.
Hedging	If the country uses a fixed exchange rate, there is no need for hedging.	Hedging is used to reduce currency risks in a flexible exchange rate environment.

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

Ans: The difference between autonomous and accommodating transaction of balance of payment account is as follows:

Basis	Autonomous Items	Accommodating Items
Meaning	Autonomous items are international economic transactions that take place for some economic reason, such as profit maximization.	Transactions that are done to cover a deficit or surplus in autonomous transactions are referred to as accommodating items.
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,"

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

Ans: 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.

Long Answer Questions (6 Marks)

21. 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: Foreign Exchange: It refers to the amount of foreign currency held in relation to the amount of domestic currency. Foreign exchange is important in international transactions. All currencies other than the Indian rupee are considered as foreign exchange in India.

Foreign Exchange Rate: The rate at which one currency is exchanged for another is referred to as the foreign exchange rate. As a result, an exchange rate can be defined as the cost of one currency in terms of another. The exchange rate is often expressed in terms of rupees per unit of foreign currency. As a result, an exchange rate represents the external purchasing power of money.

There are two approaches for determining foreign exchange rates- one technique is based on the conventional gold standard mechanism, while the other is based on the classical paper currency system. Because no standard monetary unit is currently exchanged for gold, the gold standard mechanism no longer operates. Foreign exchange demand is created when Indians and commercial firms desire to make payments to US nationals for purchasing US goods and services, make gifts to US individuals, or buy assets in the US. The greater the amount of imports, the greater the demand for foreign currency.

Relation between foreign exchange rate and demand for foreign exchange:

- An inverse relationship exists between the foreign exchange rate and the demand for foreign exchange.
- The foreign currency demand curve is always downward sloping, indicating an inverse relationship between demand and exchange rate.
- When the exchange rate rises, more units of domestic currency are required to be paid for the same unit of foreign money. This raises the cost of import. As a result, imports reduce, causing a drop in demand for foreign exchange.
- In the figure given below, the demand for foreign currency is represented by the DD curve. When the exchange rate reaches R1, the demand for foreign money decreases to Q1. And, when the exchange rate falls to R2, the demand for foreign currency rises to Q2

(Image will be uploaded soon)

22. 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 crore, 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.

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

Ans: The following are the differences between the trade balance and the current account balance:

Basis of differences	Balance of Trade	Balance on current amount
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Meaning	It only covers objects that are visible. It is the gap between the country's exports and imports.	It is the difference between the sum of credit and debit items on the current account.
Coverage	It does not keep track of any transactions involving invisible items or transfers.	It contains the balance of visible objects, the balance of invisible items, and the balance of unilateral transfer.
Concept	It is a limited concept that accounts for only a portion of the payment account balance.	It is a broad idea. The current account balance includes the trade balance.
Financing of deficit	A trade deficit can be compensated for by a current account surplus.	Current-account deficits cannot be offset by balance-of-trade surpluses.
