

CUET · ECONOMICS · CLASS XII · CODE 309

Open Economy Macroeconomics

CUET unit: Balance of Payments

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Snapshot

- An open economy has three linkages with the rest of the world — output market, financial market and labour market.
- The Balance of Payments (BoP) framework has a current account (goods, services, transfers) and a capital account (assets); BoP can be in surplus, deficit or equilibrium.
- Autonomous (above-the-line) transactions differ from accommodating (below-the-line) ones; official reserve transactions are the accommodating item.
- In the foreign exchange market, demand and supply of foreign exchange determine the exchange rate under flexible, fixed and managed floating regimes.
- CUET tests this topic heavily for definitional clarity (BoT vs BoP, depreciation vs devaluation, autonomous vs accommodating) and small numerical BoP calculations using Table 6.1.

Detailed Notes

2.1 Core concepts

- An open economy interacts with other countries through three channels — output market (trade in goods and services), financial market (trade in financial assets) and labour market (movement of workers, restricted by immigration laws). (NCERT §intro, p. 85)
- Foreign trade influences Indian aggregate demand in two ways: imports are a leakage from the circular flow (decreasing aggregate demand) and exports are an injection (increasing aggregate demand for domestically produced goods). (NCERT §intro, p. 86)
- Because there is no single international currency issued by a single bank, foreign agents accept a national currency only if its purchasing power is stable; the international monetary system was set up to ensure this stability. (NCERT §intro, p. 86)
- The price of one currency in terms of another is the foreign exchange rate (or exchange rate). (NCERT §intro, p. 86)
- Balance of Payments (BoP) records the transactions in goods, services and assets between residents of a country and the rest of the world for a specified time period,

typically a year; it has two main accounts — the current account and the capital account. (NCERT §6.1, p. 86)

- Current Account is the record of trade in goods and services and transfer payments; trade in services covers factor income (labour, land, capital) and non-factor income (shipping, banking, tourism, software etc.); transfers are receipts got 'free' such as gifts, remittances and grants. (NCERT §6.1.1, p. 87)
- Current account is in balance when receipts equal payments; a surplus means the nation is a lender to other countries and a deficit means it is a borrower. (NCERT §6.1.1, p. 87)
- Balance of Current Account has two components — Balance of Trade (BoT) and Balance on Invisibles. BoT is the difference between value of exports and value of imports of goods; export of goods is a credit item and import of goods is a debit item. (NCERT §6.1.1, p. 87)
- Net Invisibles is the difference between value of exports and value of imports of invisibles — services (factor + non-factor income) and transfers and flows of income. (NCERT §6.1.1, p. 88)
- Capital Account records all international transactions of assets (money, stocks, bonds, government debt). Purchase of assets abroad is a debit item; sale of domestic assets to foreigners is a credit item. Items include FDIs, FII, external borrowings and external assistance. (NCERT §6.1.2, p. 88)
- BoP equilibrium: Current account + Capital account \equiv 0; a current account deficit must be financed by a capital account surplus, i.e. a net capital inflow. (NCERT §6.1.3, p. 89)
- Alternatively, the central bank uses its foreign exchange reserves to balance any deficit — selling foreign exchange when there is a deficit (official reserve sale). A decrease in official reserves is an overall BoP deficit; an increase is an overall BoP surplus. (NCERT §6.1.3, p. 89)
- Autonomous transactions are made for reasons other than to bridge the BoP gap (e.g. to earn profit) — these are 'above the line' items. BoP is in surplus (deficit) if autonomous receipts are greater (less) than autonomous payments. (NCERT §6.1.3, p. 89)
- Accommodating transactions ('below the line') are determined by the gap in the BoP; official reserve transactions are the accommodating item. (NCERT §6.1.3, p. 89)
- Errors and omissions form a third element of BoP, reflecting the difficulty of recording every international transaction accurately. (NCERT §6.1.3, p. 89)
- Foreign exchange market is the market in which national currencies are traded for one another; major participants are commercial banks, foreign exchange brokers, other authorised dealers and monetary authorities — the market is world-wide. (NCERT §6.2, p. 91)

- Demand for foreign exchange arises to purchase foreign goods and services, to send gifts abroad, and to purchase foreign financial assets; a rise in the price of foreign exchange reduces demand for imports, hence demand for foreign exchange falls. (NCERT §6.2.1, p. 91)
- Supply of foreign exchange arises from exports (foreigners buying domestic goods/ services), foreign transfers/gifts received, and foreigners buying home-country assets; a rise in price of foreign exchange tends to increase exports and hence supply (subject to elasticities). (NCERT §6.2.1, pp. 91–92)
- Flexible (floating) exchange rate is determined by market forces of demand and supply; in a completely flexible system, central banks do not intervene. A rise in exchange rate means rupee depreciation; a fall means rupee appreciation. (NCERT §6.2.2, p. 92)
- Speculation, interest rate differentials and income changes are short-run determinants — higher home interest rates appreciate the domestic currency; faster growth in domestic aggregate demand than the world's tends to depreciate the domestic currency. (NCERT §6.2.2, p. 93)
- In the long run, the Purchasing Power Parity (PPP) theory predicts that exchange rates adjust so the same product costs the same across countries, reflecting differences in price levels. (NCERT §6.2.2, p. 93)
- Fixed exchange rate is set by the government. If the fixed rate is above the market rate, supply of dollars exceeds demand and RBI absorbs the excess by buying dollars (accumulating reserves); if it is below, the government withdraws from past dollar holdings to meet excess demand. (NCERT §6.2.2, p. 94)
- Devaluation: in a fixed exchange rate system, a government action that increases the exchange rate (makes domestic currency cheaper). Revaluation: a government action that decreases the exchange rate (makes domestic currency costlier). (NCERT §6.2.2, p. 94)
- Fixed exchange rate systems require credibility and large reserves and are prone to speculative attacks; flexible systems automatically take care of BoP surpluses/ deficits and give countries independence in monetary policy. (NCERT §6.2.3, p. 95)
- Managed floating ("dirty floating") is a mixture of flexible and fixed systems — central banks intervene to moderate exchange rate movements when appropriate; official reserve transactions are therefore not equal to zero. (NCERT §6.2.4, p. 95)

2.2 Definitions to memorise

Term	Definition	Page
Open economy	Economy that trades with other nations in goods and services and most often also in financial assets	85
Balance of Payments (BoP)		86

Term	Definition	Page
	Record of transactions in goods, services and assets between residents of a country and the rest of the world for a specified period, usually a year	
Current Account	Record of trade in goods and services and transfer payments	87
Balance of Trade (BoT)	Difference between the value of exports and value of imports of goods in a given period	87
Net Invisibles	Difference between value of exports and value of imports of invisibles (services, transfers, income flows)	87–88
Transfer payments	Receipts that residents get 'free' without providing goods/ services in return — gifts, remittances, grants	87
Capital Account	Record of all international transactions of assets (money, stocks, bonds, government debt)	88
BoP equilibrium	Current account + Capital account \equiv 0	89
Autonomous transactions	International transactions made for reasons other than to bridge the BoP gap; 'above the line' items	89
Accommodating transactions	Transactions determined by the BoP gap; 'below the line' items — official reserve transactions	89
Errors and omissions	Third element of BoP that reflects inaccuracies in recording international transactions	89
Foreign exchange rate	Price of one currency in terms of another	91
Foreign exchange market	Market in which national currencies are traded for one another	91
Flexible / Floating exchange rate	Exchange rate determined by market forces of demand and supply, without central bank intervention	92
Depreciation	In a flexible system, a rise in the price of foreign currency in terms of domestic currency	92
Appreciation	In a flexible system, a rise in the price of domestic currency in terms of foreign currency	92
Purchasing Power Parity (PPP)	Theory that exchange rates adjust so identical goods cost the same across countries (long-run)	93
Fixed exchange rate	Exchange rate fixed at a particular level by the government	94
Devaluation	Government action in a fixed-rate system that increases the exchange rate (cheapens domestic currency)	94
Revaluation	Government action in a fixed-rate system that decreases the exchange rate (costlier domestic currency)	94
Managed floating ("dirty floating")	Mixture of flexible and fixed — central bank intervenes to moderate exchange rate movements	95

Term	Definition	Page
Speculative attack	Aggressive buying of a currency forcing the government to devalue	95
Marginal propensity to import (m)	Fraction of an extra rupee of income spent on imports	98

2.3 Diagrams / processes to remember

- Fig. 6.1, p. 87 — Components of Current Account: trade in goods (exports/imports) + trade in services (factor income, non-factor income) + transfers (gifts, remittances, grants).
- Fig. 6.2, p. 88 — Components of Capital Account: FDIs, FII, external borrowings, external assistance.
- Table 6.1, p. 90 — Sample BoP for India in million USD; shows trade deficit (−90), invisibles (+52), current account deficit (−38), capital account surplus (+41.15), errors and omissions (+3.15), overall balance = 0, reserves change = 0.
- Equilibrium under Flexible Exchange Rates, p. 92 — D and S curves intersect at exchange rate e and quantity q of dollars.
- Fig. 6.2, p. 92 — Effect of an increase in demand for imports: demand curve shifts right; equilibrium exchange rate rises from $e_0 = 50$ to $e_1 = 70$ (rupee depreciates).
- Fig. 6.3, p. 94 — Foreign exchange market with fixed exchange rates; at $e_1 > e$ there is excess supply of dollars (AB) absorbed by RBI.

2.5 Key formulas

Formula	Meaning	NCERT page
$\text{BoP} = \text{Current Account} + \text{Capital Account} + \text{Errors \& Omissions}$	Identity of total BoP	89
$\text{Current Account} = \text{Balance of Trade} + \text{Net Invisibles}$	Two-component decomposition	87
$\text{Balance of Trade} = \text{Exports of goods} - \text{Imports of goods}$	Merchandise balance only	87
$\text{Net Invisibles} = \text{Exports of services} + \text{Transfers} + \text{Income flows} - \text{Imports of services}$	Non-merchandise balance	87–88
$\text{BoP equilibrium: Current account} + \text{Capital account} \equiv 0$	When there are no reserve movements	89
$\text{Overall BoP deficit} = \text{Decrease in official foreign-exchange reserves}$	Below-the-line accounting	89
$\text{Overall BoP surplus} = \text{Increase in official foreign-exchange reserves}$	Below-the-line accounting	89

Formula	Meaning	NCERT page
Depreciation: $e \uparrow$ (price of foreign currency rises)	Flexible regime, market-driven	92
Appreciation: $e \downarrow$ (price of domestic currency rises)	Flexible regime, market-driven	92
Devaluation = government raises e (fixed regime)	Cheapens domestic currency	94
Revaluation = government lowers e (fixed regime)	Costlier domestic currency	94
Marginal propensity to import $m = \Delta M \div \Delta Y$	Sensitivity of imports to income	98
Open-economy multiplier $\approx 1 \div (1 - c + m)$	Multiplier with imports as a leakage	98

2.4 Common confusions / NTA trap points

- Balance of Trade vs Balance on Current Account: BoT is only goods; current account = BoT + Net Invisibles (services, transfers, income). (p. 87)
- Depreciation/Appreciation (flexible system, market-driven) vs Devaluation/Revaluation (fixed system, government-driven). (pp. 92, 94)
- Autonomous (above-the-line, independent of BoP) vs Accommodating (below-the-line, official reserve transactions to bridge the gap). (p. 89)
- Sign convention in BoP: imports of goods, purchase of foreign assets and decrease in receipts are debit items; exports, sale of domestic assets to foreigners are credit items. (pp. 87–88)
- Official reserves and BoP: decrease in official reserves indicates overall BoP deficit; increase indicates surplus — the sign reverses from intuition. (p. 89)

Practice MCQs

PYQ Alignment

This chapter is consistently one of the highest-weight chapters of the CUET 309 Economics paper: roughly a dozen MCQs each year. Past papers reliably test definitional pairs (depreciation vs devaluation, autonomous vs accommodating, BoT vs current account balance), Table 6.1-style numerical sums on current account balance and overall BoP, and identification of items as current-account/capital-account/debit/credit.

Statement-based and assertion–reason items on flexible vs fixed vs managed floating regimes are also common.

CUET 2024 — Actual PYQs from this chapter

Q.22 (CUET 2024) Arrange chronologically: (A) Smithsonian Agreement (B) Bretton Woods Conference (C) Establishment of WTO (D) Gold Standard Options:

- A) A, B, C, D B) D, B, A, C C) D, A, B, C D) C, B, D, A **Tests:** International monetary system chronology - Gold Standard, Bretton Woods, Smithsonian, WTO **Answer:** Not in extracted key

Q.23 (CUET 2024) Under flexible exchange rate, rise in value of domestic currency is:

- A) Depreciation B) Appreciation C) Devaluation D) Revaluation **Tests:** Flexible exchange rate - appreciation of domestic currency **Answer:** Not in extracted key

Q.24 (CUET 2024) Match List-I with List-II List-I List-II Pegged exchange rate Fixed exchange rate Managed floating Dirty floating Bretton Woods Conference IMF & World Bank Third element in BOP Errors & omissions Options:

- A) A-II, B-I, C-III, D-IV B) A-II, B-III, C-I, D-IV C) A-I, B-II, C-IV, D-III D) A-III, B-IV, C-I, D-II **Tests:** Exchange rate regimes - pegged, managed floating, Bretton Woods **Answer:** Not in extracted key

Q.37 (CUET 2024) European Monetary Union was created in:

- A) 1996 B) 1994 C) 1999 D) 2002 **Tests:** European Monetary Union **Answer:** Not in extracted key

Q.41 (CUET 2024) Which of the following is a component of Current Account?

- A) Capital transfer B) Export of goods C) Foreign investment D) External borrowing **Tests:** Components of Current Account (BoP) **Answer:** Not in extracted key

Q.42 (CUET 2024) Which organisation provides long-term loans for development projects?

- A) IMF B) World Bank C) WTO D) ADB **Tests:** International institutions - long-term development loans (World Bank) **Answer:** Not in extracted key