NCERT Class 12 Indian Macro Economics Part 3/3 – G IST

This PDF contains summary of chapter 8-10 Macro-economics class 12

Government Budget and the Economy – Chapter 8

Introduction

This is a descriptive chapter on government budget of Indian economy, wherein its objectives, importance, types, components, budget deficits and its types (Revenue, Fiscal, Primary Deficit) and their implications are studied.
Chapter at a Glance

Government Budget and Its Related Concepts

1. A government budget is an annual financial statement showing item wise estimates of expected revenue and anticipated expenditure during a fiscal year.

2. Budget has two parts:
(a) Receipts; and (b) Expenditure.

3. Objectives of budget:
(a) Activities to secure a reallocation of resources:
(i) Private enterprises always desire to allocate resources to those areas of production where profits are high.
(ii) However, it is possible that such areas of production (like production of alcohol) may not promote social welfare.
(iii) Through its budgetary policy the government of a country directs the allocation of resources in a manner such that there is a balance between the goals of profit maximisation and social welfare.
(iv) Production of goods which are injurious to health (like cigarettes and whisky) is discouraged through heavy taxation.
(v) On the other hand, production of "socially useful goods" (like electricity, 'Khadi') is encouraged through subsidies.
(vi) So, finally government has to reallocate resources in accordance to social and economic considerations in case the free market fails to do or does so inefficiently.
(b) Redistributive activities:
(i) Budget of a government shows its comprehensive exercise on the taxation and subsidies.
(ii) A government uses fiscal instruments of taxation and subsidies with a view of improving the distribution of income and wealth in the economy.
(iii) A government reduces the inequality in the distribution of income and wealth by imposing taxes on the rich and giving subsidies to the poor, or spending more on welfare of the poor.
(iv) It reduces income of the rich and raises the living standard of the poor, thus, leads to equitable distribution of income.
(v) Expenditure on special anti poverty and employment schemes will be increased to bring more people above poverty line.
(vi) Public distribution system should be inferred so that only the poor could get foodgrains and

other essential items at subsidised prices.
(vii) So finally, Equitable distribution of income and wealth is a sign of social justice which is the principal objective of any welfare state in India.
(c) Stabilising activities:
(i) Free play of market forces (or the forces of supply and demand) are bound to generate trade cycles, also called business cycles.
(ii) These refer to the phases of recession, depression, recovery and boom in the economy. (Hi) The government of a country is always committed to save the economy from
business cycles. Budget is used as an important policy instrument to combat(solve) the situations of deflation and inflation.
(iv) By doing it the government tries to achieve the state of economic stability.
(v) Economic stability leads to more investment and increases the rate of growth and development.
(d) Management of public enterprises:
(i) A government undertakes commercial activities that are of the nature of natural monopolies; and which are established and managed for social welfare of the public.
(ii) A natural monopoly is a situation where there are economies of scale over a large range of output.
(iii) Industries which are potential natural monopolies are railways etc.

4. Importance of a budget:
(a) Today every country aims at its economic growth to improve living standard of its people. Besides, there are many other problems such as poverty, unemployment, inequalities in incomes and wealth etc. Government strives hard to solve these problems through budgetary measures.
(b) The budget shows the fiscal policy. Itemwise estimates of expenditure discloses how much and on what items, the government is going to spend. Similarly, itemwise details of government receipts indicate the sources from where the government intends to get money to finance the expenditure. In this way budget is the most important instrument in hands of governments to achieve their objectives and there lies the importance of the government budget. Note: Fiscal year is the year in which country's budgets are prepared. Its duration is from 1st April to 31st March.

5. Types of budget: It may be of two types:
(a) Balanced Budget (b) Unbalanced Budget
Let us discuss them in detail:
(a) Balanced Budget: If the government revenue is just equal to the government expenditure made by the general government, then it is known as balanced budget.

Balanced Budget = Estimated Govt. Receipts = Estimated Govt. Expenditure

(b) Unbalanced Budget: If the government expenditure is either more or less than a government receipts, the budget is known as Unbalanced budget.
It may be of two types:
(i) Surplus budget (ii) Deficit budget
Let us discuss them in detail:
(i) Surplus Budget: If the revenue received by the general government is more in comparison to expenditure, it is known as surplus budget.
In other words, surplus budget implies a situation where government income is in excess of

government expenditure.

Surplus Budget = Estimated Govt. Receipts > Estimated Govt. Expenditure

(ii) Deficit Budget: If the expenditure made by the general government is more than the revenue received, then it is known as deficit budget.
In other words, in deficit budget, government expenditure is in excess of government income.

Deficit Budget – Estimated Govt. Receipts < Estimated Govt. Expenditure

Components Of Government Budget, Budget Receipts Its Types

1. Components of a government budget: Government budget, comprises of two parts—
(a) Revenue Budget and (b) Capital Budget.

(a) Revenue Budget: Revenue Budget contains both types of the revenue receipts of the government, i.e., Tax revenue and Non tax revenue ; and the Revenue expenditure.
(i) Revenue Receipts: These are the receipts that neither create any liability nor reduction in assets of the government. It includes tax revenues like income tax, corporation tax and non-tax revenue like fines and penalties, special assessment, escheat etc.
(ii) Revenue Expenditure: An expenditure that neither creates any assets nor cause reduction of liability is called revenue expenditure.

(b) Capital Budget: Capital budget contains capital receipts and capital expenditure of the government.
(i) Capital Receipts: Government receipts that either creates liabilities (of payment of loan) or reduce assets (on disinvestment) are called capital receipts. Capital receipts include items, which are non-repetitive and non-routine in nature.
(ii) Capital Expenditure: This expenditure of the government either creates physical or financial assets or reduction of its liability. Acquisition of assets like land, machinery, equipment, its loans and advances to state governments etc. are its examples.
2. Budget receipts (government receipt): Budget receipt refers to the estimated receipts of the government from various sources during a fiscal year. It shows the sources from where the government intends to get money to finance the expenditure. Budget receipts are of two types:

Budget (Govt.) Receipts

Revenue Receipt

Capital Receipt
(Components)

Tax Revenue
(Components)

Non-Tax Revenue
(Components)

(1) Income tax
(2) Corporate tax
(3) Custom duty
(4) Excise duty
(5) Wealth tax
(6) Interest tax

(1) Commercial Revenue (Profit and dividends)
(2) Administrative Revenue,
(3) External grants-in-aid

(1) Borrowing
(2) Recovery of loans
(3) Disinvestment

(a) Revenue receipts

(i) Meaning:

• Government receipts, which
-> Neither create any liabilities for the government; and
-> Nor cause any reduction in assets of the government, are called revenue receipts.
In revenue receipts both the conditions should be satisfied.
• Revenue receipts include items which are Repetitive and routine in nature.

(ii) Revenue receipts are further classified into:

• **Tax Revenue:**
-> Tax revenue refers to receipts from all kinds of taxes such as income tax, corporate tax, excise duty etc.
-> A tax is a legally compulsory payment imposed by the government on income and profit of persons and companies without reference to any benefit. Taxes are of two types: Direct taxes and Indirect taxes.
• **Non-Tax Revenue:**
-> Non-tax revenue refers to government revenue from all sources other than taxes.
-> These are incomes, which the government gets by way of sale of goods and services rendered by different government departments.
-> **Components of Non-Tax Revenue:**
♦ Commercial Revenue (Profit and interest):
♦ It is the revenue received by the government by selling the goods and services produced by the government agencies.
♦ For example, profit of public sector undertakings like Railways, BHEL, LIC etc.
♦ Government gives loan to State Government, union territories, private enterprises and to general public and earns interest receipts from these loans.
♦ It also includes interest and dividends on investments made by the government.
♦ Administrative Revenue: The revenue that arises on account of the administrative function of the government. This includes:
♦ Fee: Fee refers to a payment made to the government for the services that it renders to the citizens. Such services are generally in public interest and fees are paid by those, who receive such services. For example, passport fees, court fees, school fees in government schools.
♦ License Fee: License fee is a payment to grant a permission by a government authority. For example, registration fee for an automobile.

♦ Fines and penalties for an infringement of a law, i.e., they are imposed on law breakers.
♦ **Special Assessment:** Sometimes government undertakes developmental activities by which value of nearby property appreciates, which leads to increase in wealth. So, it is the payment made by owners of those properties whose value has appreciated. For example, if value of a property near a metro station has increased, then a part of developmental expenditure made by government is recovered from owners of such property. This is the value of special assessment.
♦ Forfeitures are in the form of penalties imposed by courts that a person needs to pay in the court of law for failing to comply with court orders.
♦ Escheat refers to the claim of the government on the property of a person who dies without having any legal heir or without leaving a will.
♦ **External grants:** Government receives financial help in the form of grants, gifts from foreign governments and international organisations (IMF, World Bank). Such grants and gifts are received during national crisis such as earthquakes, flood, war etc.

(b) Capital receipts:
(i) Meaning:
• Government receipts, that either creates liabilities (of payment of loan) or reduce assets (on disinvestment) are called capital receipts.
In capital receipts any one of the conditions must be satisfied.
• Capital receipts include items which are non-repetitive and non-routine in nature,
(ii) Components:
• Borrowing (Domestic and External): Borrowings are made to meet the financial requirement of the country. A government may borrow money:
-> Domestically: General Public (By issuing government bonds in the open market). Reserve Bank of India.
-> Externally: Rest of the world (foreign government and international institutions)
• Recovery of Loans and Advances: Loans offered to others are assets of the government. It includes recovery of loans granted by the central government to state and union territory governments. It is a capital receipt because it reduces financial assets of the government. For example, The Government of India may give Rs. 1000 crore as a loan to The Government of Delhi. Here the value of asset is Rs. 1000 crore. When The Government of Delhi repaid Rs. 100 crore, the value of The Government of India assets reduces to Rs. 900 crore. Since, recovery of loan reduces the value of assets, it is termed as a capital receipts.
• **Disinvestment:** A government raises funds from disinvestment also. Disinvestment means selling whole or a part of the shares (i.e., equity) of selected public sector enterprises held by government. As a result, government assets are reduced.

Foreign Exchange Rate – Chapter 9

Introduction
This chapter defines the meaning of foreign exchange and related terms, how foreign exchange rate is determined, study of foreign exchange rate regimes (fixed and flexible exchange rate) and their differences; thereafter hybrid systems of exchange rate and operation of foreign exchange market.

Foreign Exchange and Its Related Concepts

1. Foreign exchange refers to all the currencies of the rest of the world other than the domestic currency of the country. For example, in India, US dollar is the foreign exchange.

2. The rate at which one currency is exchanged for another is called Foreign Exchange Rate. In other words, the foreign exchange rate is the price of one currency stated in terms of another currency. For example, if one U.S dollar exchanges for 60 Indian rupees, then the rate of exchange is 1$ = Rs. 60 or 1 Rs = 1/60 or 0.0166 U.S. dollar.

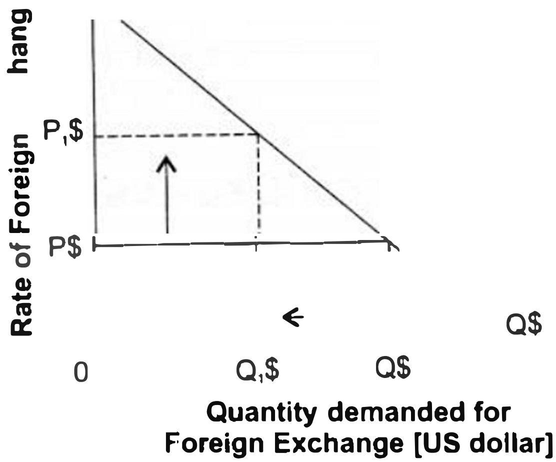
3. Foreign exchange market is the market where the national currencies are converted, exchanged or traded for one another.

4. Functions of a foreign exchange market
(a) Transfer Function: Transfer function refers to transferring of purchasing power among countries.
(b) Credit Function: It implies provision of credit in terms of foreign exchange for the export and import of goods and services across different countries of the world.
(c) Hedging Function: Hedging function pertains to protecting against foreign exchange risks. Where Hedging is an activity which is designed to minimize the risk of loss.

5. Sources of demand of foreign exchange:
The demand (or outflow) of foreign exchange comes from the people who need it to make payments in foreign currencies. It is demanded by the domestic residents for the following reasons:
(a) Imports of Goods and Services: When India imports goods and services, foreign exchange is demanded to make the payment for imports of goods and services.
(b) Tourism: Foreign exchange is demanded to meet expenditure incurred in foreign tours.
(c) Unilateral Transfers Sent Abroad: Foreign exchange is required for making unilateral transfers like sending gifts to other countries.
(d) Purchase of Assets in Foreign Countries: It is demanded to make payment for purchase of assets, like land, shares, bonds, etc. in foreign countries.
(e) Repayment of loans to Foreigners: As and when we have to pay interest and repay the loans to foreign lenders, we require foreign exchange.
(d) Speculation: Demand for foreign exchange arises when people want to make gains from appreciation of currency.

6. Reasons for 'Rise in Demand' for Foreign Currency:
The demand for foreign currency rises in the following situations:
(a) When price of a foreign currency falls, imports from that foreign country become cheaper. So, imports increase and hence, the demand for foreign currency rises. For example, if price of 1 US dollar falls from Rs. 60 to Rs. 55, then imports from the USA will increase as American goods will become relatively cheaper. It will raise the demand for US dollar.
(b) When a foreign currency becomes cheaper in terms of the domestic currency, it promotes tourism to that country. As a result, demand for foreign currency rises.
(c) When price of a foreign currency falls, its demand rises as more people want to make gains from speculative activities.

7. Demand curve of foreign exchange is downward sloping:



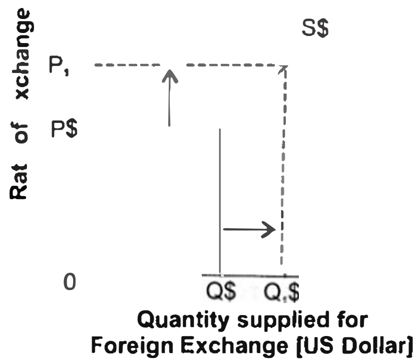
(a) Demand curve of foreign exchange slopes downwards due to inverse relationship between demand for foreign exchange and foreign exchange rate.
(b) In figure, demand for foreign exchange (US dollar) and rate of foreign exchange are shown on the horizontal axis and vertical axis respectively.
(c) The demand curve [US$] is downward sloping. It means that less foreign exchange is demanded as the exchange rate increase
(d) This is due to the fact that rise in the price of foreign exchange increases the rupee cost of foreign goods, which make them more expensive. As a result, imports decline. Thus, the demand for foreign exchange also decreases.

8. Sources of supply of foreign exchange: The supply (inflow) of foreign exchange comes from the people who receive it due to the following reasons.
(a) Exports of Goods and Services: Supply of foreign exchange comes through exports of goods and services.
(b) Tourism: The amount, which foreigners spend in the home country, increases the supply of foreign exchange.
(c) Remittances (unilateral transfers) from Abroad: Supply of foreign exchange increases in the form of gifts and other remittances from abroad.
(d) Loan from Rest of the world: It refers to borrowing from abroad. A loan from U.S. means flow of U.S. $ from U.S. to India, which will increase supply of Foreign exchange.
(e) Foreign Investment: The amount, which foreigners invest in our home country, increases the supply of foreign exchange.
(f) Speculation: Supply of foreign exchange comes from those who want to speculate on the value of foreign exchange.

9. Reasons of'rise in supply' of foreign currency: The supply of foreign currency rises in the following situations:
(a) When price of a foreign currency rises, domestic goods become relatively cheaper. It induces the foreign country to increase their imports from the domestic country. As a result, supply of foreign currency rises. For example, if price of 1 US dollar rises from Rs. 60 to Rs. 65, then exports to USA will

increase as Indian goods will become relatively cheaper. It will raise the supply of US dollars.
(b) When price of a foreign currency rises, foreign direct investment (FDI). from rest of the world increases, which will increase the supply for foreign exchange.
(c) When price of a foreign currency rises, supply of foreign currency also rises as people want to make gains from speculative activities.

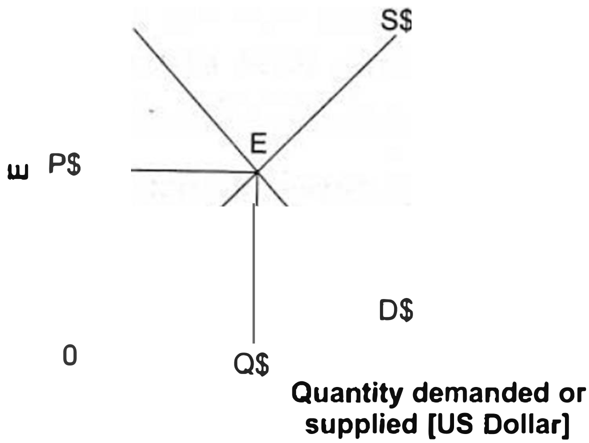
10. Supply curve of foreign exchange is upward sloping:



(a) Supply curve of foreign exchange slopes upwards due to positive relationship between supply for foreign exchange and foreign exchange rate, which means that supply of foreign exchange increases as the exchange rate increases.
(b) This makes home country's goods become cheaper to foreigners since rupee is depreciating in value. The demand for our exports should therefore increase as the exchange rate increases.
(c) The increased demand for our exports will translate into greater supply of foreign exchange. Thus, the supply of foreign exchange increases as the exchange rate increases.

How Foreign Exchange Is Determine, Disequilibrium Conditions Under Exchange Rate

1. Determination of foreign exchange rate:
(a) Exchange rate in a free exchange market is determined at a point, where demand for foreign exchange is equal to the supply of foreign exchange.
(b) Let us assume that there are two countries – India and U.S.A – and the exchange rate of their currencies i.e., rupee and dollar is to be determined. Presently, there is floating or flexible exchange regime in both India and U.S.A. Therefore, the value of currency of each country in terms of the other currency depends upon the demand for and supply of their currencies.
(c) In the above diagram, the price on the vertical axis is stated in terms of domestic currency (that is, how many rupees for one US dollar). The horizontal axis measures the quantity demanded or supplied.
(d) In the above diagram, the demand curve [D$] is downward sloping. This means that less foreign exchange is demanded as the exchange rate increases. This is due to the fact that the rise in price of foreign exchange increases the rupee cost of foreign goods, which make them more expensive. As a result, imports decline. Thus, the demand for foreign exchange also decreases.
(e) The supply curve [S$] is upward sloping which means that supply of foreign exchange increases as the exchange rate increases.

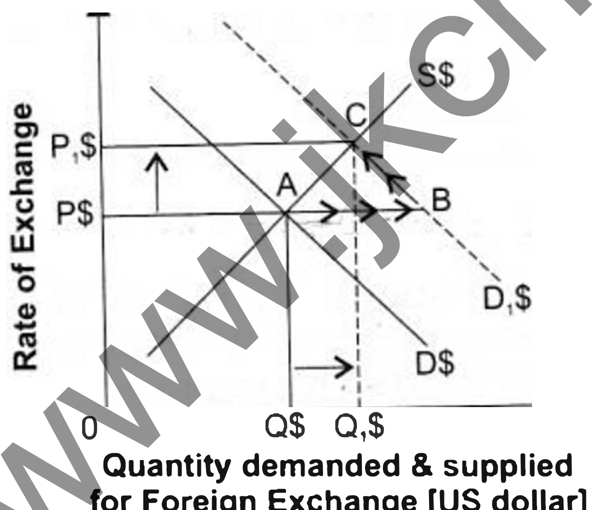


This makes home country's goods become cheaper to foreigners since rupee is depreciating in value. The demand for our exports should therefore increase as the exchange rate increases.
The increased demand for our exports translates into greater supply of foreign exchange. Thus, the supply of foreign exchange increases as the exchange rate increases.

2. Disequilibrium conditions under equilibrium exchange rate:

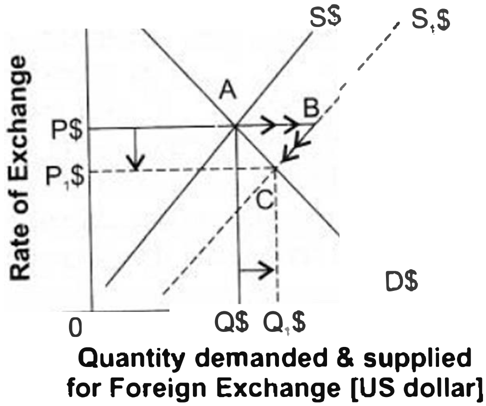
(a)Change in demand:

(i) Increase in demand for dollar: An increase in the demand for US dollar in India will cause the demand curve to shift to D_1\$ and the exchange rate rises to P_1\$. Note that increase in the exchange rate means that more rupees are required to buy one US dollar. When this occurs, Indian rupee is said to be depreciating.

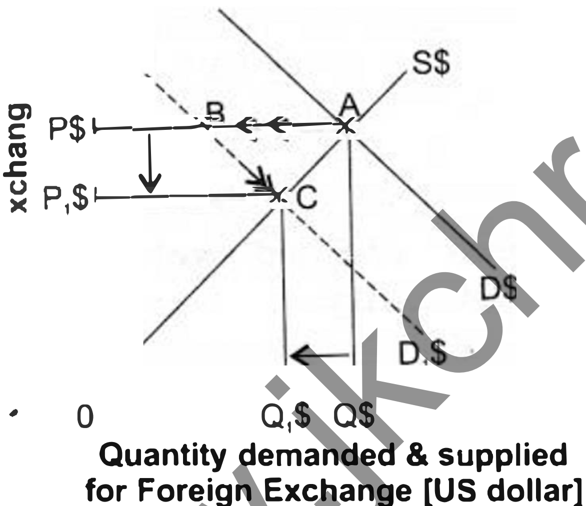


(b) Change in Supply

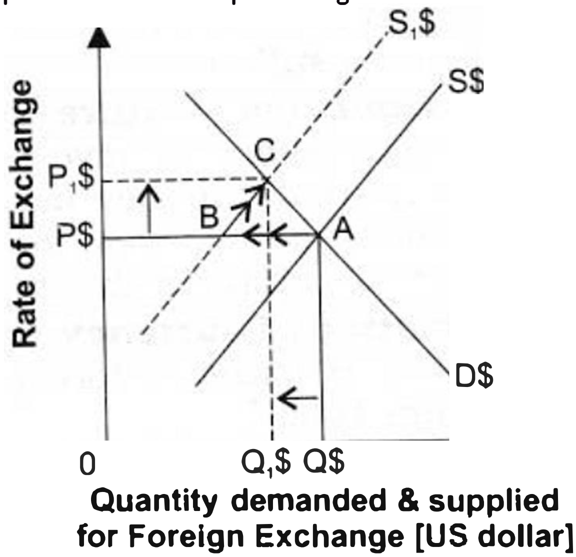
(i) Increase in supply for dollar: An increase in the supply of US dollar causes the supply curve to shift to S_1\$ and exchange rate falls to P_1\$. In this case, rupee cost of US dollar is decreasing and the Indian rupee is said to be appreciating.



(ii) Decrease in demand for dollar: A decrease in the demand for US dollar in India will cause the demand curve to shift to $D_1$$ and the exchange rate falls to $P_1$$. Note that decrease in the exchange rate means that less rupees are required to buy one US dollar. When this occurs, Indian rupee is said to be appreciating.



(ii) Decrease in supply of dollar: A decrease in the supply of US dollar causes the supply curve to shift to $S_1$$ and exchange rate rises to $P_1$$. In this case, rupee cost of US dollar is increasing and the Indian rupee is said to be depreciating.



Exchange Rate Regimes (Fixed, Flexible And Managed Floating Exchange Rate And Their Merits And Demerits)

Types of exchange rate regimes:
1. Fixed exchange rate system (Pegged exchange rate system):
(a) Meaning:
(i) The system of exchange rate in which exchange rate is officially declared and fixed by the government is called fixed exchange rate system.
(ii) When domestic currency is tied to the value of foreign currency, it is known as pegging.
(iii) To maintain stability in fixed exchange rate system, government buy foreign currency when exchange rate appreciates and sell foreign currency when exchange rate depreciate. This process is called Pegging operation, i.e., all efforts made by the central bank to keep the rate of exchange stable.

Note:
(i) Fixed exchange rate is not determined by the forces of demand and supply in the market. Such a rate of exchange has been associated with Gold Standard System during 1880-1914.
(ii) According to this system, value of every currency is determined in terms of gold. Accordingly, ratio between gold value of the two countries was fixed as exchange rate between those currencies.
(iii) For example, Value of one dollar = 100 gms of gold.
Value of a rupee = 5 gms of gold
Then, 1 dollar = 100/5 = Rs. 20
(b) Merits of fixed exchange rate system:
(i) Stability: It ensures stability, in the international money market/exchange market. Day to day fluctuations are avoided. It helps formulation of long term economic policies, particularly relating to exports and imports.
(ii) Encourages international trade: Fixed exchange rate system implies low risk and low uncertainty of future payments. It encourages international trade.
(iii) Co-ordination of macro policies: Fixed exchange rate helps co-ordination of macro policies across

different countries of the world. Long term economic policies can be drawn in the area of international trade and bilateral trade agreements.

(c) Demerits of fixed exchange rate system:

(i) Huge international reserves: Fixed exchange rate system is often supported with huge international reserves of gold. This is because different currencies are directly or indirectly convertible into gold.

(ii) Restricted movement of capital: Fixed exchange rate restricts the movement of capital across different parts of the world. Accordingly, international growth process suffers. .v

(iii) Discourages venture capital: Venture capital in the international money market refers to investments in the purchase of foreign exchange in the international money market with a view to earn profits. Fixed exchange rate system discourages such investments. Fixed exchange rate discourages venture capital in the international money market.

(d) Devaluation of currency: Devaluation refers to decrease in the value of domestic currency in terms of foreign currency by the government. It is a part of fixed exchange rate.

(e) Revaluation of currency: Revaluation refers to increase in the value of domestic currency by the central government. It is a part of fixed exchange rate.

2. Flexible exchange rate (floating exchange rate system):

(a) Meaning:

(i) The system of exchange rate in which value of a currency is allowed to float freely as determined by demand for and supply of foreign exchange is called flexible exchange rate system.

(ii) Under this system, the central banks, without intervention, allow the exchange rate to adjust to equate the supply and demand for foreign currency.

(iii) The foreign exchange market is busy at all times by changes in the exchange rates.

(b) Merits of flexible exchange rate system:

(i) No need for international reserves: Flexible exchange rate system is not to be supported with international reserves.

(ii) International capital movements: Flexible exchange rate system enhances movement of capital across different countries of the world. This is due to the fact that member countries are no longer required to keep huge international reserves.

(iii) Venture capital: Flexible exchange rate promotes venture capital in foreign exchange market. Trading in international currencies itself becomes an important economic activity.

(c) Demerits of flexible exchange rate system:

(i) Instability: It causes instability in the international money market. Exchange rate tends to fluctuate like price of goods in the commodity market.

(ii) International trade: Instability in foreign exchange market causes instability in the area of international trade. It becomes difficult to draw long period policies of exports and imports.

(iii) Macro policies: While fixed exchange rate helps coordination of macro policies, flexible exchange rate makes it a difficult proposition. Day to day fluctuations in exchange rate makes bilateral trade agreements a difficult exercise.

(d) Currency depreciation:
(i) Currency depreciation refers to decrease in the value of domestic currency in terms of foreign currency. It makes the domestic currency less valuable and more of it is required to buy a foreign currency. It is a part of flexible exchange rate.
(ii) For example, rupee is said to be depreciating if price of $1 rises from ? 60 to Rs. 65.
(iii) Effect of depreciation of domestic currency on exports: Depreciation of domestic currency means a fall in the price of domestic currency (say, rupee) in terms of a foreign currency (say, $). It means, with the same amount of dollars, more goods can be purchased from India, i.e., exports to USA will increase as they will become relatively cheaper.

(e) Currency appreciation:
(i) Currency appreciation refers to increase in the value of domestic currency in terms of foreign currency. The domestic currency becomes more valuable and less of it is required to buy a-foreign currency. It is a part of flexible exchange rate.
(ii) For example, Indian rupee appreciates when price of $1 falls from Rs. 60 to Rs. 55.
(iii) Effect of appreciation of domestic currency on imports: Appreciation of domestic currency means a rise in the price of domestic currency (say, rupee) in terms of a foreign currency (say, $). Now, one rupee can be exchanged for more $, i.e., with the same amount of money, more goods can be purchased from the USA. It leads to increase in imports from the USA as American goods will become relatively cheaper.

3. Managed floating rate system:
(a) Managed floating exchange rate is a mixture of a flexible exchange rate (the float part) and a fixed exchange rate (the Managed part).
(b) In other words, it refers to a system in which foreign exchange is determined by free market forces (demand and supply forces), which can be influenced by the intervention of the central bank in foreign exchange market.
(c) Under this system, also called Dirty floating, central banks intervene to buy or sell foreign currencies in an attempt to stabilize exchange rate movements in case of extreme appreciation or depreciation.

Kinds Of Foreign Exchange Rate (Spot And Forward Market)

1. Spot market for foreign exchange:
(a) If the operation is of daily nature, it is called spot market or current market.
(b) The exchange rate that prevails in the spots market for foreign exchange is called spot rate.
(c) In other words, spot rate of exchange refers to the rate at which foreign currency is available on the spot.
2. Forward market for foreign exchange:
(a) A market for foreign exchange for future delivery is known as forward market.
(b) Exchange rate that prevails in a forward contract for purchase or sale of foreign exchange is called forward rate.
(c) Thus, forward rate is the rate at which a future contract for foreign currency is bought and sold.

Other Types Of Exchange Rate System

1. Wider band System:
(a) It is a system that allows wider adjustment in the fixed exchange rate system.

(b) It allows adjustment upto 10% around the "parity" between any two currencies in the internationahmoney market.
(c) For example, if one US dollar is fixed as equal to fifty Indian rupees, 10% revision (upward or downward) is to be allowed in this exchange rate of 1: 50. Exchange rate may be revised as,
1: 60 + 10% = 1: 66 or as 1: 60 – 10% = 1 : 54

2. Crawling peg system:
(a) It allows "small" but regular adjustments in the exchange rate for different currencies.
(b) Not more than (+) 1% adjustment is allowed at a time. Indeed, it is a small adjustment.
(c) But it can crawl, i.e., it can be repeated at regular intervals.

Some Important Terms

1. Nominal exchange rate (NER): The number of units of domestic currency required to purchase a unit of foreign currency is called nominal exchange rate. Thus, $1 = Rs. 60. It may move to $1 = Rs. 65, and so on.

2. Nominal effective exchange rate (NEER):
(a) The concept is useful for an aggregative analysis. A nation has to deal with a number of countries, and hence a number of currencies.
(b) For example, during a period Indian rupee may be losing value against the American dollar, but it may be gaining value against Euro.
(c) Therefore, we would be interested in knowing what is happening in aggregate to our rupee i.e., is it gaining or losing.
(d) For this purpose, we prepare a basket of all the currencies which we are interested in, and find out the average of the changes in these currencies in a given period. This gives us the nominal effective exchange rate (NEER).
(e) So, finally NEER is the measure of average relative strength of a given currency with respect to other currencies without eliminating the effect of change in price.

3. Real exchange rate (RER): RER is the exchange rate which is calculated after eliminating the effects of price change. Therefore, RER is based on constant prices.

4. Real effective exchange rate (REER): REER is the measure of average relative strength of a given currency with respect to other currencies after eliminating the effects of price change.

5. Parity value: In the context of exchange rate in foreign exchange market, parity value refers to the value of one currency in terms of the other for a given basket of goods and services. If a U.S. dollar buys 50 times the goods and services in India, compared to a rupee, the parity value of a US dollar should be 50 : 1. Accordingly, the exchange rate between rupee and a US dollar ought to be Rs. 50 : 1$. Any change in the parity value would imply a corresponding change in exchange rate.

Words that Matter

1. Foreign exchange: It refers to all the currencies of the rest of the world other than the domestic currency of the country. For example, in India, US dollar is the foreign exchange.

2. Foreign Exchange Rate: The rate at which one currency is exchanged for another is called Foreign Exchange Rate.

3. Foreign exchange market: It is the market where the national currencies are converted, exchanged or traded for one another.

4. Hedging function: Hedging function pertains to protecting against foreign exchange risks, where Hedging is an activity which is designed to minimize the risk of loss.

5. Fixed exchange rate system: The system of exchange rate in which exchange rate is officially declared and fixed by the government is called fixed exchange rate system.

6. Pegging: When domestic currency is tied to the value of foreign currency, it is known as pegging.
7. Pegging operations: It refers to all efforts made by the central government to keep the rate of exchange stable.
8. Venture capital: Venture capital in the international money market refers to investments in the purchase of foreign exchange in the international money market with a view to earn profits.
9. Devaluation: It refers to decrease in the value of domestic currency in terms of foreign currency by the government. It is a part of fixed exchange rate.
10. Revaluation: It refers to increase in the value of domestic currency by the central government. It is a part of fixed exchange rate.
11. Flexible Exchange Rate: The system of exchange rate in which value of a currency is allowed to float freely as determined by demand for and supply of foreign exchange is called flexible exchange rate system.
12. Currency depreciation: It refers to decrease in the value of domestic currency in terms of foreign currency. It makes the domestic currency less valuable and more of it is required to buy a foreign currency. It is a part of flexible exchange rate.
13. Currency appreciation: It refers to increase in the value of domestic currency in terms of foreign currency. The domestic currency becomes more valuable and less of it is required to buy a foreign currency. It is a part of flexible exchange rate.
14. Managed floating exchange rate: It is a mixture of a flexible exchange rate (the float part) and a fixed exchange rate) the Managed part).
15.Spot Rate: If the operation is of daily nature, it is called spot market or current market.
16. Forward Rate: A market for foreign exchange for future delivery is known as forward market.
17. Nominal Exchange Rate (NER): The number of units of domestic currency required to purchase a unit of foreign currency is called nominal exchange rate.
18. Nominal Effective Exchange Rate (NEER): It is the measure of average relative strength of a given currency with respect to other currencies without eliminating the effect of change in price.
19. Real Exchange Rate (RER): It is the exchange rate which is calculated after eliminating the effects of price change. Therefore, RER is based on constant prices.
20. Real Effective Exchange Rate (REER): It is the measure of average relative strength of a given currency with respect to other currencies after eliminating the effects of price changes.
21. Parity value: It refers to the value of one currency in terms of the other for a given basket of goods and services.

Balance of Payment – Chapter 10

Introduction

This chapter gives a detailed account of balance of payment of an economy, it structure and categorisation into current and capital account. Thereafter explaining balance of trade and its differences with the balance of payment, autonomous items, accommodating items and their differences, disequilibrium in balance of payment.

Balance Of Payment, Its Structure And Components

1. The balance of payments of a country is a systematic record of all economic transactions between its residents and residents of the foreign countries during a given period of time.
Note: Economic transactions are the transactions which cause transfer of value. In the context of

foreign transactions value is transferred by the residents of one country to the residents of other country. Example: when exports of goods or services are made by country A to country B, value (= export receipts) is transferred by country B to country A. Between the countries, value is transferred in terms of foreign exchange (i.e. payments are received and made in terms of foreign exchange).

2. Structure of balance payment accounting

(a) Transactions are recorded in the balance of payments accounts in double-entry book keeping.
(b) Each international transaction undertaken by country will results in a credit entry and debit entry of equal size.
(c) As international transactions are recorded in double entry accounting, the BOP accounting must always balance i.e., total amount of debits must be equal to total amount of credits.
(d) The balancing item Errors and omissions must be added to "balance" the BOP accounts.
(e) By convension, debit items and credit items are entered with a minus sign and plus sign respectively.
(f) Transactions in BOP are classified into the following five major categories:
(i) Goods and services account (ii) Unilateral transfer account
(iii) Long-term capital account (iv) Short-term private capital account
(v) Short-term official capital account
For each of these given categories, specific types of transactions are shown as debits or credits. This is shown in below table:

Categories	Debits (–)	Credits (+)
Category-I	1. Imports of goods 2. Imports of services	1. Exports of goods 2. Exports of services
Category-II	Unilateral transfers (Gifts) made	Unilateral transfers (gifts) received
Category-III	1. Increase in long-term foreign assets owned by home country private citizens and government. 2. Decrease in long-term home country assets owned by foreign private citizens and governments.	1. Decrease in long-term foreign assets owned by home country citizens and government. 2. Increase in long-term home country assets owned by foreign private citizens and governments.
Category-IV	1. Increase in short-term foreign assets owned by home country private citizens. 2. Decrease in short-term home country assets owned by foreign private citizens.	1. Decrease in short-term foreign assets owned by home country private citizens. 2. Increase in short-term home country assets owned by foreign private citizens.
Category-V	1. Increase in short-term foreign assets owned by home country government (official monetary authorities). 2. Decrease in short-terms home country asset owned by foreign government (official monetary authorities).	1. Decrease in short-term foreign assets owned by home country government (official monetary authorities). 2. Increase in short-term home country asset owned by foreign governments, (official monetary authorities).

The above five categories are also divided into the following two major categories of accounts in the BOP account statement:

3. Current Account (Category-I, Category-II):

(a) Meaning: Current account records imports and exports of goods and services and unilateral transfers.

(b) Components of Current Account: The main components of Current Account are:

(i) Export and Import of Goods (Merchandise Transactions or Visible Trade):

A major part of transactions in foreign trade is in the form of export and import of goods (visible items). Payment for import of goods is written on the negative side (debit items) and receipt from exports is shown on the positive side (credit items). Balance of these visible exports and imports is known as balance of trade (or trade balance).

(ii) Export and Import of Services (Invisible Trade): It includes a large variety of non-factor services (known as invisible items) sold and purchased by the residents of a country, to and from the rest of the world. Payments are either received or made to the other countries for use of these services. Services are generally of three kinds: (a) Shipping, (b) Banking, and (c) Insurance. Payments for these services are recorded on the negative side and receipts on the positive side.

(iii) Unilateral or Unrequisted Transfers to and from abroad (One sided Trans–actions): Unilateral transfers include gifts, donations, personal remittances and other 'oneway' transactions. These refer to those receipts and payments, which take place without any service in return. Receipt of unilateral transfers from rest of the world is shown on the credit side and unilateral transfers to rest of the world on the debit side.

(iv) Income receipts and payments to and from abroad: It includes investment income in the form of interest, rent and profits.

4. Capital Account (Category-III, Category-IV, Category-V):

(a) Meaning: Capital account is that account which records all such transactions between residents of a country and rest of the world which cause a change in the asset or liability status of the residents of a country or its government.

(b) Components of Capital Account: The main components of capital account are:

(i) Loans: Borrowing and lending of funds are divided into two transactions:

• Private Transactions

-> These are transactions that are affecting assets or liabilities by individuals, businesses, etc. and other non-government entities. The bulk of foreign investment is private.

-> For example, all transactions relating to borrowings from abroad by private sector and similarly repayment of loans by foreigners are recorded on the positive (credit) side.

-> All transactions of lending to abroad by private sector and similarly repayment of loans to abroad by private sector is recorded as negative or debit item.

• Official Transactions

-> Transactions affecting assets and liabilities by the government and its agencies.

-> For example, all transactions relating to borrowings from abroad by government sector and similarly repayment of loans by foreign government are recorded on the positive (credit) side.

-> All transactions of lending to abroad by government sector and similarly repayment of loans to

abroad by government sector is recorded as negative or debit item.
Private and official transactions borrowing are of two components:
(i) Commercial borrowings, referring to borrowing by a country (including government and private sector) from international money market. This involves market rate of interest without considerations of any concession, (ii) Borrowings as External Assistance, referring to borrowing by a country with considerations of assistance. It involves lower rate of interest compared to that prevailing in open market.

(ii) Foreign Investment (Investments to and from abroad): It includes:
• Investments by rest of the world in shares of Indian companies, real estate in India, etc. Such investments from abroad are recorded on the positive (credit) side as they bring in foreign exchange.
• Investments by Indian residents in shares of foreign companies, real estate abroad, etc. Such investments to abroad are recorded on the negative (debit) side as they lead to outflow of foreign exchange.
'Investments to and from abroad' includes two types of investments:
-> Foreign Direct Investment (FDI)
It refers to purchase of an asset in rest of the world, such that it gives direct control to the purchaser over the asset.
For example, (i) acquisition of a firm in the domestic country by a foreign country's firm (ii) transfer of funds from the parent company abroad to the subsidiary company in the domestic country.
-> Portfolio Investment
Portfolio Investment refers to the purchase of financial asset by the foreigners that does not give the purchaser control over the asset. A foreign Institutional Investment (FII) is also a part of portfolio investment.
For instance, purchase of shares of a foreign company, purchase of foreign government's bonds, etc. are treated as portfolio investments.

(iii) Change in Foreign Exchange Reserves
• The foreign exchange reserves are the financial assets of the government held in
• central bank. A change in reserves serves as the financing item in India's BOP.
• So, any withdrawal from the reserves is recorded on the positive (credit) side and any addition to these reserves is recorded on the negative (debit) side.
• It must be noted that 'change in reserves' is recorded in the BOP account and not 'reserves'.

Balance Of Payments And Its Types

1. Balance: It means difference between the sum of credits and sum of debits. The BOP account records three balances:
(a) Balance of trade
(b) Balance on current account
(c) Balance on capital account
2. Balance of trade: The term "balance of trade" denotes the difference between the exports and imports of goods in a country. Balance of trade refers to the visible items only. It is the difference between the value of merchandise (goods) exports and imports.
Balance of Trade = Export of visible goods – Import of visible goods.
3. Balance on current account: It is the difference between sum of credits and sum of debits on current account.

Balance on Current Account = Sum of credits on current account – Sum of debits on current account

4. Balance on capital account: It is the difference between sum of credits and sum of debits on capital account.

Balance on capital account = Sum of credits on capital account – Sum of debits on capital account

Autonomous And Accommodating Items, Deficit In Balance Of Payment And Disequilibrium In Balance Of Payment

1. Autonomous items

(a) Autonomous items refer to those international economic transactions in the current account and capital account which take place due to some economic motive such as profit maximisation.

(b) These transactions are independent of the state of BOP account.

(c) These items are also known as 'above the line items'.

(d) For example, if a foreign company is making investments in India with the aim of earning profit, then such a transaction is independent of the country's BOP situation.

2. Accommodating items

(a) Accommodating items refer to the transactions that are undertaken to cover deficit or surplus in autonomous transactions, i.e., such transactions are determined by net consequences of autonomous transactions.

(h) These items are also known as 'below the line items'.

(c) For example, if there is a current account deficit in BOP, then this deficit is settled by capital inflow from abroad. The sources used to meet a deficit in BOP, are: (i) Foreign exchange reserves; (ii) Borrowings from IMF or foreign monetary authorities.

3. Deficit in BOP

(a) The balance of payments of a country is a systematic record of all economic transactions between the residents of foreign countries during a given period of time.

(b) The transaction in the balance of payment account can be categorized as autonomous transactions and accommodating transactions.

(c) Autonomous transactions are transactions done for some economic consideration such as profit.

(d) When the total inflows on account of autonomous transactions are less than total outflows on account of such transactions, there is a deficit in the balance of payments account.

(e) Suppose, the autonomous inflow of foreign exchange during the year is $500, while the total outflow is $600. It means that there is a deficit of $100.

4. Disequilibrium in Balance of Payments: There are a number of factors that cause disequilibrium in the balance of payments showing either a surplus or deficit. These causes are:

(a) Economic Factors

(i) Large scale development expenditure that may cause large imports.

(ii) Cyclical fluctuations in general business activity such as recession or depression.

(iii) High domestic prices may result in imports.

(b) Political Factors: Political factors instability may cause large capital outflows and hamper the inflows of foreign capital.

(c) Social Factors: Changes in tastes, preference and fashions of the people bring disequilibrium in BOP by inflowing imports and exports.

Words that Matter

1. Balance of payment: The balance of payments of a country is a systematic record of all economic transactions between its residents and residents of the foreign countries during a given period of time.
2. Current account: It records imports and exports of goods and services and unilateral transfers.
3. Capital account: Capital account is that account which records all such transactions between residents of a country and rest of the world which cause a change in the asset or liability status of the residents of a country or its government.
4. Foreign Direct Investment: It refers to purchase of an asset in rest of the world, such that it gives direct control to the purchaser over the asset.
5. Portfolio Investment: It refers to the purchase of financial asset by the foreigners that does not give the purchaser control over the asset.
6. Balance: It means difference between the sum of credits and sum of debits.
7. Balance of trade: The term "balance of trade" denotes the difference between the exports and imports of goods in a country. Balance of trade refers to the visible items only.
8. Balance on Current Account: It is the difference between sum of credits and sum of debits on current account.
Balance on Current Account = Sum of credits on current account – Sum of debits on current account
9. Balance on Capital Account: It is the difference between sum of credits and sum of debits on capital account.
Balance on capital account = Sum of credits on capital account – Sum of debits on capital account
10. Autonomous items: It refer to those international economic transactions in the current account and capital account which take place due to some economic motive such as profit maximisation.
11. Accommodating items: It refer to the transactions that are undertaken to cover deficit or surplus in autonomous transactions, i.e., such transactions are determined by net consequences of autonomous transactions.