Unit V: Open Economy

🔹 Textual Questions & Answers (NCERT-Based)

1. **What is the Balance of Payments (BoP)?**
   → The BoP is a systematic record of all economic transactions—goods, services, income transfers, and assets—between residents of a country and the rest of the world during a year.
2. **What are the two main components of the BoP?**
   → The two main accounts are the **Current Account** and the **Capital Account**.
3. **Define Current Account Deficit.**
   → When total payments for imports, services, and transfers exceed receipts from exports and transfers, it is called a current account deficit.
4. **What is the foreign exchange rate?**
   → The foreign exchange rate is the price of one unit of foreign currency expressed in terms of domestic currency.
5. **What is managed floating exchange rate?**
   → A system in which exchange rates fluctuate but the central bank occasionally intervenes to moderate excessive volatility.

🔹 Short Answer Questions (2–3 Marks)

6. **Distinguish between trade deficit and current account deficit.**

→ Trade deficit refers only to the excess of imports over exports of goods, while current account deficit includes goods, services, and transfers.

7. **What are official reserve transactions?**
   → These involve a country's central bank buying or selling foreign currency to address balance of payments imbalances.
8. **What is marginal propensity to import (m)?**
   → It is the fraction of additional income spent on imports. It is the coefficient of Y in the import function $M = M_0 + mY$.
9. **Why is the multiplier in an open economy smaller than in a closed one?**
   → Because part of the additional income is spent on imports, reducing the overall impact on domestic output.
10. **Differentiate between fixed and flexible exchange rate systems.**
    → A fixed exchange rate is maintained by the central bank, while a flexible exchange rate is determined by market forces.

📝 Long Answer Questions (4–6 Marks)

11. **Explain the composition and significance of the Capital Account in BoP.**
    → The Capital Account records financial inflows and outflows like foreign investments, loans, and banking capital. It is crucial for balancing the current account and maintaining foreign exchange reserves.

12. **How do central banks intervene under managed float?**
→ They buy or sell foreign currency in the market to moderate large fluctuations in exchange rates.

13. **Show national income identity for an open economy.**
→ $Y = C + I + G + (X - M)$, where X = exports and M = imports. The term $(X - M)$ represents net exports.

14. **Analyse advantages and disadvantages of a flexible exchange rate regime.**
→
Advantages:

- Automatic adjustment
- Monetary policy autonomy
Disadvantages:
- Exchange rate volatility
- Uncertainty for trade and investment

15. **Discuss policy measures to correct a BoP deficit.**
→ These include currency devaluation, import restrictions, promotion of exports, capital controls, and use of foreign reserves.

⭐ 20 Additional Q&A — Short & Long Type

🟢 Short Answer (2–3 Marks)

1. **Which goods determine the balance of trade?**
→ Exports and imports of physical goods.

2. **Define ‘Balance on Current Account’.**
   → The net value of current receipts and payments including goods, services, and transfers.
3. **Explain nominal vs real exchange rate.**
   → Nominal exchange rate is the actual quoted rate; real exchange rate adjusts nominal rate for price levels.
4. **What is purchasing power parity (PPP)?**
   → The theory that currencies should have equal purchasing power in different countries when prices are adjusted.
5. **What happens if a country imports more goods as income rises?**
   → The import leakage increases, reducing the multiplier effect on domestic output.
6. **Mention three items in the Current Account.**
   → Trade in goods, trade in services, and unilateral transfers.
7. **What is an exchange rate realignment?**
   → A government-initiated adjustment of the official exchange rate.
8. **Give one merit of fixed exchange rates.**
   → It ensures stability in foreign trade by avoiding sudden currency fluctuations.
9. **What is a currency appreciation?**
   → An increase in the value of domestic currency in terms of foreign currency.

10. **What is a currency depreciation?**
→ A fall in the value of domestic currency relative to foreign currency.

🔵 Long Answer (4–6 Marks)

11. **Derive the open economy multiplier formula.**
→ $Y = C + I + G + X - M$
→ $Y = a + cY + I + G + X - mY$
→ $Y(1 - c + m) = a + I + G + X$
→ Multiplier $(k) = 1 / (1 - c + m)$
Since $m > 0$, the open economy multiplier is smaller than in a closed economy.

12. **Compare fixed vs managed floating exchange rate systems.**
→ In a fixed system, the rate is pegged and stable. In a managed float, rates are flexible but central bank intervenes when needed.

13. **Explain the role of capital account in stabilizing BoP.**
→ Capital inflows can offset current account deficits, helping maintain overall BoP equilibrium.

14. **How does exchange rate change affect exports and imports?**
→ A depreciation makes exports cheaper and imports costlier, boosting net exports. Appreciation has the opposite effect.

15. **Why is the BoP statement important for policymakers?**
→ It helps in understanding the country's external

economic position and shaping foreign trade, exchange rate, and reserve policies.

16. **How do official reserve transactions correct BoP imbalances?**
→ Central banks buy or sell foreign exchange reserves to settle imbalances in the BoP.

17. **Discuss effects of sustained current account deficit.**
→ Leads to debt accumulation, pressure on currency, fall in reserves, and lower investor confidence.

18. **Evaluate benefits of free-floating exchange rates.**
→ They allow automatic adjustment and flexible policies but can be unstable and unpredictable.

19. **Why might a country impose capital controls?**
→ To prevent speculative capital flight, stabilize the economy, and retain control over monetary policy.

20. **What strategies can a country follow to encourage export promotion?**
→ Subsidies, tax incentives, exchange rate management, quality improvement, and trade agreements.