Revision Notes

Class 12 Macroeconomics

Chapter 6 – Open Economy Macroeconomics

Open Economy: It is one that conducts business with other countries in a range of methods. The majority of modern economies are open.

Balance of Payment (BOP): It is a record of all transactions that occurred between firms in a particular country and the rest of the world over a certain time period, such as a quarter or a year.

Accounts of Balance of payment:
1. Current Account: It is the record of goods and services traded as well as transfer payments. It encompasses a country's most important activities, such as capital markets and services.

Two components of the Current Account:

- **Balance of Trade (BOT):** It is the difference between the value of a country’s exports and imports of goods over a specified timeframe. The export of products is recorded as a credit in the BOT, whereas the import of goods is recorded as a debit. It is also referred to as the Trade Balance.

- **Balance of Invisibles:** The difference between a country’s exports and imports of invisible over a certain time frame is known as the balance of invisible. Services, transfers, and income movements between countries are all examples of invisible.

2. Capital Account: All overseas asset transactions are recorded in the Capital Account. An asset is any type of wealth that may be held, such as money, stocks, bonds, government debt, and so on. The purchase of assets is recorded as a debit item on the capital account.

Components of Capital Account:

- **Investments:**

a. Direct Investment: Equity Capital, FDI, Reinvested Earning, and other Direct Capital Flows.
b. Portfolio Investment: Offshore Funds, FII.

- **External Borrowings:** Includes Short-term Debt, External Commercial Borrowings.
- **External Assistance:** Multilateral and Bilateral Loans, Government Aid, Inter-governmental Aid.

Deficit of Balance of Payment Account:
- When a country has a balance of payments deficit, it imports more goods, capital, and services than it exports. It must take from other countries in order to pay for its imports.
- A deficit in the balance of payment happens when total payment surpasses total receipts; ergo BOP = Credit < Debit.
- A deficit of the balance of payment can be amended through an official reserve deal which signifies the sale of foreign exchange by the Reserve Bank.

Autonomous Transactions:
- When international economic transactions are made for reasons other than bridging the balance of payments gap, they are referred to as autonomous transactions.
- One reason might be to make money. In the balance of payment, these items are referred to as “above the line” items.
- This type of transactions are free of the condition of the balance of payment account.
- Autonomous items allude to those international economic exchanges, which happen because of some economic intention, for example, profit maximisation.

Accommodating Transactions:
- The gap in the balance of payments, or whether there is a deficit or surplus in the balance of payments, determines accommodating transactions, also known as “below the line” items. In other words, the net consequences of autonomous transactions determine them.
- Accommodating transactions are repaying capital exchanges that are intended to address the disequilibrium in the balance of payments, i.e., the autonomous items.
- If the balance of payment has a surplus or deficit, accommodating transactions are carried out on purpose to balance the balance of payment's surplus or deficit.

Errors and Omissions:
- It is difficult to keep accurate records of all international transactions. As a result, in addition to the current and capital accounts, there is a third element of the balance of payment called errors and omissions, which reflects this.
- The entries made under this head relate for the most part to leads and lags in the detailing of exchanges.

- It is a balancing entry that is expected to counterbalance the exaggerated or underestimated components.

Foreign Exchange Market:
- The foreign exchange market is the market where national currencies are exchanged for one another.
- Commercial banks, foreign exchange brokers, other authorised dealers, and monetary authorities are the main participants in the foreign exchange market.
- The foreign exchange markets are the first and most established financial markets and remain the premise whereupon the remainder of the financial edifice is built. It provides global liquidity, ideally with reasonable stability.

Foreign Exchange rate: An exchange rate is the worth of a country's currency versus that of another nation or an economic zone, also termed as Forex rate. Most of the trade rates are free-floating and will rise or fall based on market interest on the lookout. A few monetary forms are not free-floating and have limitations. It connects different countries' currencies and allows for cost and price comparisons across territorial boundaries.

1. Demand for Foreign Exchange: People require foreign exchange because they want to buy goods and services from other countries, send gifts abroad, and buy financial assets from a specific country. The demand for foreign exchange falls as the flexible exchange rate rises and vice versa.

2. Supply of Foreign Exchange: Foreign currency flows into the home country for the following reasons - a country's exports lead to foreigners purchasing its domestic goods and services; foreigners send gifts or make transfers, and foreigners purchase a home country’s assets. The foreign exchange supply has a positive relationship with the foreign exchange rate. When the foreign exchange rate rises, so does the supply of foreign exchange, and vice versa.

Flexible Exchange Rate: The market forces of demand and supply determine this exchange rate. It is also referred to as a floating exchange rate.
- An increase in the exchange rate indicates that the price of foreign currency (dollar) in terms of domestic currency (rupees) has risen. This is referred to as **depreciation** of the domestic currency (rupees) in terms of foreign currency (dollars).
- **Appreciation** of the domestic currency (rupees) in terms of foreign currency (dollars) occurs when the price of domestic currency (rupees) increases in relation to foreign currency (dollars) (dollars).

Merits of Flexible Exchange Rate:
a. There is no need to keep foreign exchange reserves.
b. As a result, the 'balances of payments' are automatically adjusted.
c. To remove impediments to capital and trade transfers.
d. Improves resource allocation efficiency.
e. It eliminates the issue of currency undervaluation or overvaluation.
f. It encourages foreign exchange-based venture capital.

Demerits of Flexible Exchange Rate:
a. Future exchange rate fluctuations.
b. Is a deterrent to international trade and investment.
c. Promotes speculation.
d. It contributes to market uncertainty.

Fixed Exchange Rate: The government fixes the exchange rate at a specific level in this exchange rate system. The goal of a fixed exchange rate system is to maintain the value of a currency within a narrow spectrum.

- **Devaluation** occurs in a fixed exchange rate system when a government action raises the exchange rate, causing the domestic currency to become cheaper.
- In a fixed exchange rate system, a **revaluation** occurs when the government lowers the exchange rate, making the domestic currency more expensive.

Merits of Fixed Exchange Rate:
a. Exchange rate stability.
b. There is no room for speculation.
c. Encourages capital mobility and international trade.
d. Attracts foreign investment.
e. It forces the government to keep inflation under control.

Demerits of Fixed Exchange Rate:
a. In relation to the balance of payments, there are no automatic adjustments i.e., it forestalls changes for monetary standards that become under-or over-esteemed.
b. Requiring a huge pool of reserves to help the currency of a country in the event that it goes under pressure.
c. It could lead to currency undervaluation or overvaluation.
d. It undercuts the goal of free markets.

Determination of Equilibrium Foreign Exchange Rate: The equilibrium foreign exchange rate is the rate at which demand and supply of foreign exchange are equitable. It is determined by market forces, i.e., demand for and supply of foreign exchange, in a free market situation. The demand for foreign exchange and the exchange rate has an inverse relationship. There is a direct relationship between foreign exchange supply and exchange rate. Because of the aforementioned reasons, the demand curve is sloped downward, and the supply curve is sloped upward. The equilibrium foreign exchange rate is determined graphically by the intersection of the demand and supply curves.

Managed Floating: It is a hybrid of a flexible exchange rate system, known as the float, and a fixed rate system, known as the managed part. This exchange rate system enables a country's central bank to intervene on a regular basis in foreign exchange markets to moderate exchange rate movements whenever such actions are deemed appropriate.