

Chapter 5 · Balance of Payments

CBSE Class 12 Economics (030) · Part A Macroeconomics · Unit 5 = 6 marks · Ultimate Revision Sheet

60-SECOND RECALL

BoP	Record of all economic transactions between residents of a country and the rest of the world in a year
Two accounts	Current Account (goods, services, income, transfers) · Capital Account (assets, loans, investment)
Balance of Trade	Exports of GOODS – Imports of GOODS — visible items only
BoT vs Current A/c	BoT is a part of the current account
Accounting sense	BoP always balances (autonomous + accommodating)
Currency terms	Depreciation = market forces · Devaluation = government decision

1. Meaning and Structure

DEFINITION The *Balance of Payments* is a systematic record of all economic transactions between the residents of a country and the rest of the world during a given period, usually one year.

THE TWO ACCOUNTS

Account	Contains
CURRENT ACCOUNT	1. Export and import of goods (visible items) → Balance of Trade 2. Export and import of services (invisible: shipping, banking, insurance, tourism, software) 3. Income — interest, profit, dividend received and paid 4. Unilateral transfers — gifts, remittances, donations, grants
CAPITAL ACCOUNT	1. Borrowings and lendings to and from abroad 2. Investment — FDI and FII/portfolio investment 3. Change in foreign exchange reserves

Rule of thumb: current account items do not create a claim or liability; capital account items do.

THE CLASSIFICATION TRAP • Software exports → Current account (a service)

- Remittances from an NRI relative → Current account (unilateral transfer)
- FDI by a foreign company → Capital account
- Interest paid on foreign loan → Current account (income)
- Repayment of the loan itself → Capital account

Ask: does this create or settle a claim? If yes, capital. If it is a payment for something, current.

2. Balance of Trade vs Balance on Current Account

Basis	BALANCE OF TRADE	CURRENT ACCOUNT BALANCE
Covers	Only visible items (goods)	Visible + invisible + income + transfers
Formula	Export of goods – Import of goods	BoT + net services + net income + net transfers
Scope	Narrow — a part of the current account	Wider

Deficit meaning

Imports of goods exceed exports

Country is a **net borrower** from the world

3. Autonomous vs Accommodating Transactions

THE DISTINCTION THAT EXPLAINS "BoP ALWAYS BALANCES"

Basis	AUTONOMOUS	ACCOMMODATING
Motive	Undertaken for profit or economic motive, independent of the BoP position	Undertaken to cover the gap in the BoP
Also called	Above the line items	Below the line items
Who does it	Any economic agent	Government / monetary authority

A BoP deficit or surplus is measured on **AUTONOMOUS** transactions only. The accommodating items then fill the gap, which is why the BoP always balances in the accounting sense but may be in *disequilibrium* in the economic sense.

4. Foreign Exchange Rate

DEFINITION The foreign exchange rate is the price of one currency in terms of another. It is determined in the foreign exchange market by the *demand for and supply of* foreign exchange.

DEMAND AND SUPPLY OF FOREIGN EXCHANGE**DEMAND** for foreign exchange rises when...

Imports of goods and services increase
 Indians travel or study abroad
 Indians invest abroad
 Sending gifts/remittances abroad
 Repaying foreign loans

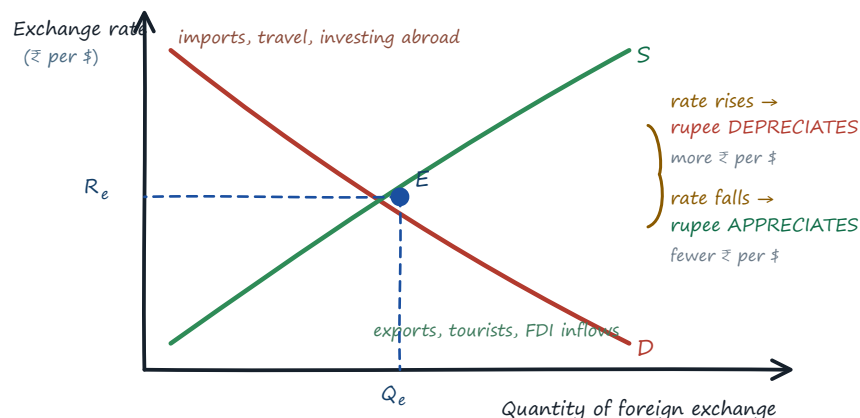
SUPPLY of foreign exchange rises when...

Exports of goods and services increase
 Foreign tourists visit India
 FDI and FII inflows
 Remittances received from abroad
 Foreign loans received

Demand curve slopes DOWNWARD (a cheaper foreign currency makes imports cheaper, so more is demanded).

Supply curve slopes UPWARD (a costlier foreign currency makes exports more attractive, so more is supplied).

Equilibrium is where the two curves intersect.



D slopes down, S slopes up, and the rate settles where they cross. A **higher** number on the vertical axis means a **weaker** rupee.

5. The Four Currency Terms

Term	Meaning	Caused by
Depreciation	Domestic currency loses value against a foreign currency ₹70 → ₹75 per \$	Market forces
Appreciation	Domestic currency gains value ₹75 → ₹70 per \$	Market forces
Devaluation	Domestic currency's value reduced officially	Government decision (fixed regime)
Revaluation	Domestic currency's value raised officially	Government decision (fixed regime)

THE MOST-ASKED 1-MARKER *Depreciation vs Devaluation: both mean the currency falls in value.*

The difference is *who causes it* — depreciation happens through **market forces** in a flexible exchange rate system; devaluation is a **deliberate government decision** in a fixed exchange rate system.

Effect of depreciation: exports become cheaper for foreigners → exports rise. Imports become costlier → imports fall.

6. Exchange Rate Systems

System	How the rate is set
Fixed	Officially fixed by the government or central bank; changed only by devaluation or revaluation
Flexible / Floating	Determined entirely by demand and supply in the foreign exchange market
Managed floating	Basically market-determined, but the central bank intervenes to reduce volatility. India follows this.

7. Question Triggers current or capital account?

Transaction	Account
Export of tea / import of crude oil	Current (visible)
Software services exported to the USA	Current (invisible)
Money sent home by an Indian working abroad	Current (unilateral transfer)
Interest paid on a foreign loan	Current (income)
Foreign tourist spending in India	Current (invisible)
FDI by a foreign firm in India	Capital
Purchase of shares of a foreign company	Capital
Loan taken from the IMF	Capital
Repayment of a foreign loan	Capital
Change in foreign exchange reserves	Capital (accommodating)
"₹ moved from 74 to 78 per \$"	Depreciation of the rupee
"government lowered the official value of the ₹"	Devaluation

MOST-ASKED BOARD QUESTIONS

1. [3-4M] Distinguish between the current account and the capital account of BoP.
2. [3-4M] Distinguish between devaluation and depreciation / BoT and current account balance.
3. [4-6M] Explain how the exchange rate is determined by demand and supply, with a diagram.
4. [3M] Explain the effect of a depreciation of the rupee on exports and imports.
5. [3M] Distinguish between autonomous and accommodating transactions.
6. [1M] Which account records FDI? → **Capital account**

THE HABIT THAT SCORES — For the exchange-rate question, **draw the diagram** — demand sloping down, supply sloping up, equilibrium at the intersection, axes labelled "Rate of exchange" and "Quantity of foreign exchange". A labelled diagram carries a mark on its own and takes twenty seconds.