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Unit-4

Balance of Payment

Record of all economic transactions b/w the resident of the country & the rest of the world.

Economic transactions include visibles (goods), invisibles (services), unilateral transfer (gift), and capital.

It keeps record of all imports and exports during a fiscal year (1st April - 31st March)

It is a flow concept and follow double entry system.

	Debit Items (-ve side)	Credit Items (+ve side)
	Outflow of cash	Inflow of cash
	Balance of Trade	
visibles	Import of goods	export of goods
invisibles	Import of services	export of services
unilateral	unilateral transfer to abroad	unilateral transfer from abroad
	Income paid to abroad (rent, Interest)	Income received from abroad (rent, interest)

current

Capital

Lending to abroad	borrowing from abroad
Investement to Abroad	Investment from Abroad
FDI: buying something completely i.e. property; FII: buying a certain portion i.e. shares	
Addition to Forex Reserve	Withdrawl from Forex Reserve

Balance of Trade

It is the difference between the import and the export of goods (~~item~~ visible)

There can be 3 situations

Surplus — Export > Import

Balance — Export = Import

Deficit — Export < Import

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Invisible, visibile, unilateral and income constitutes current account of the BOP account.

Balance of Current Account

- Current Account Surplus (CAS)
- Current Account Balance (CAB)
- Current Account Deficit (CAD)

Capital Account is used to balance current account if CAS then invest/lend abroad and if CAD then investment/borrow from abroad.

RBI is custodian of forex reserves.

Capital Account of BOP records all those transactions b/w the residents of a country and the rest of the world, which cause a change in the assets or liabilities of residents of the country or its government.

Errors and Omissions are the balancing items which reflects the inability to record all international transactions accurately in the BOP.

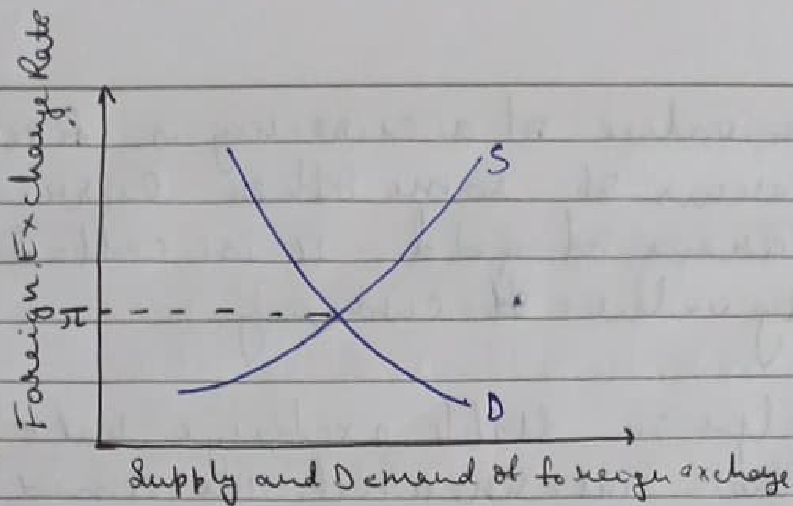
Market for Foreign Exchange and Exchange Rate

Foreign Exchange refers to all currencies other than the domestic currency of a given country.

Foreign Exchange Rate refers to the rate at which one currency is exchanged for the other. It represents the price of one currency in terms of another currency.

It is with respect to the domestic currency i.e. rupee.

Currency Depreciation	Currency Appreciation
When value of currency decline in comparison to the other currencies i.e. £80 = $1 ↓ £90 = $1	When value of currency increase in comparison to the other currencies i.e. £80 = $1 ↓ £70 = $1
It makes domestic goods cheaper which increases exports	It makes foreign goods cheaper which increases imports.
Increase in export will increase National Income.	



As the foreign exchange rate will increase imports will decline so demand for foreign ~~goods~~ currency will decline and exports will increase as domestic currency gets cheaper, so supply will increase so demand ↓, supply ↑, rate ↑

Types of Exchange Rate

1) Fixed

Refers to a system in which exchange rate is fixed by the government.

Used to ensure stability in foreign trade and capital movement

To achieve this government buys ~~all excess~~ foreign currency when excess supply and sells when excess demand, by maintaining large forex reserves.

When value of a currency is attached to another currency it is called Pegging

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When value of a currency is fixed in terms of some other currency or in terms of gold it is called Parity value of currency.

It helps in stable exchange rate, promote international investment and trade and prevent speculative activities.

Devaluation means ~~lower~~ increasing the foreign exchange rate by the govt in fixed exchange rate system and decreasing the foreign exchange rate is called revaluation

Whereas depreciation and ~~tr~~ appreciation takes place in flexible exchange rate system.

2) Flexible

System in which rate is determined by forces of demand and supply with no govt. intervention.

It is also known as floating exchange rate or free exchange rate.

It helps in maintaining equilibrium level no undervaluation or overvaluation, no need for huge resources and provides

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Optimum utilization of resources.

Also due to this rate is instable, speculative activities takes place and causes inflation

3) Managed Floating

System in which rate is determined by market forces and central bank of a country influences it to keep within a particular range.

It is hybrid of fixed and floating and also called dirty floating rate system

Mundell-Fleming Model: Perfect Capital Mobility, Imperfect Capital Mobility Under Fixed and Flexible Exchange Rate.

~~Also called IS-LM-BoP Model~~ (IS-LM → Domestic Sector; BoP → Foreign Sector)

Robert ~~Fleming~~ Mundell	Marcus Fleming
↓	↓
Perfect Capital Mobility	Imperfect Capital Mobility
Capital is allowed to move from one country to another without any restrictions	There are certain restrictions in respect to capital movement from one country to another

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Assumptions

- Small open economy which cannot affect interest ~~of~~ of rate of other countries but can be affected by others.

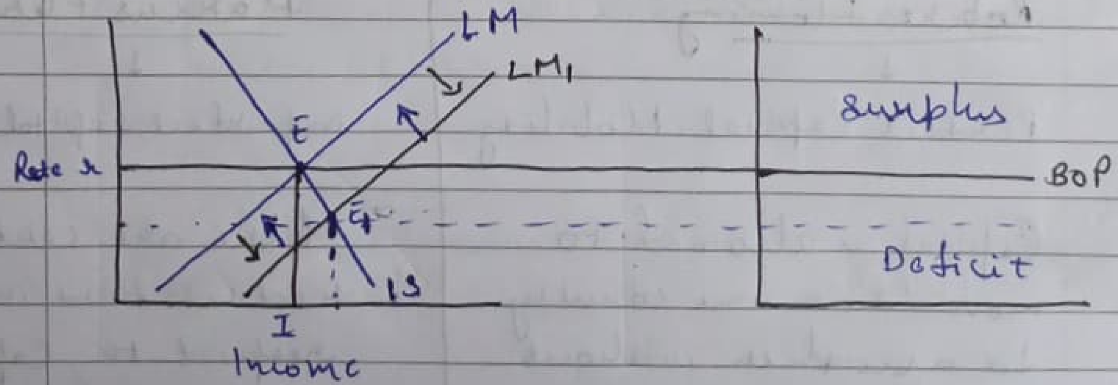
- IS-LM depicts equilibrium condition ~~with~~ in the domestic economy

Perfect Capital Mobility

1) Fixed Exchange Rate — effect of monetary policy / effect of fiscal policy

a) ~~Expansionary~~ Monetary Policy

~~downward~~ rightward shift in LM curve
BOP is in deficit
At E, Govt will start purchasing domestic and selling foreign currency, resulting in reduced money supply, which will send LM curve back to normal position



Monetary Policy in case of fixed exchange rate regime under the condition of perfect mobility is ineffective.

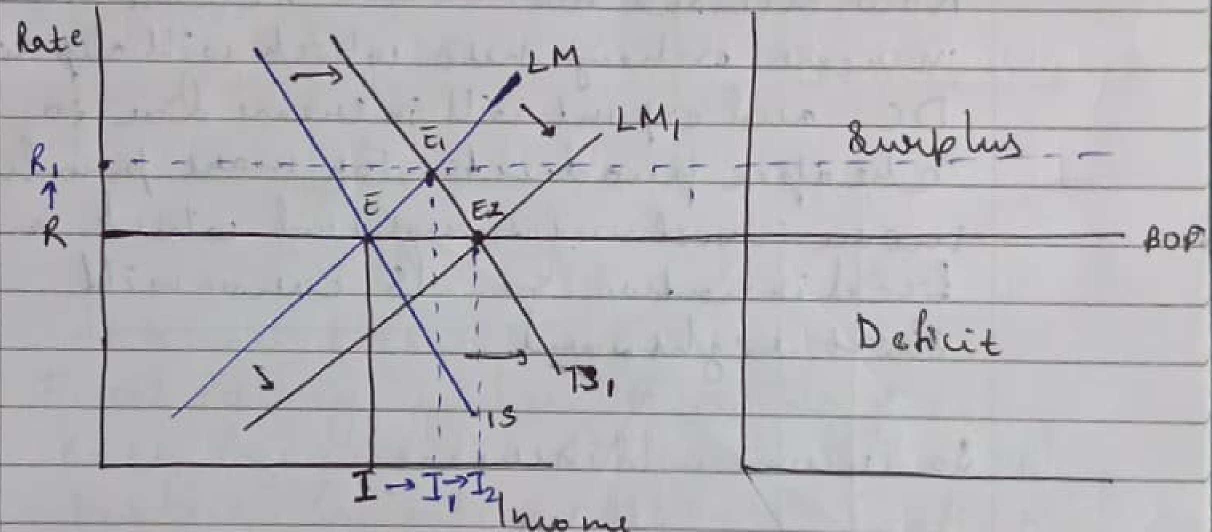
b) Fiscal Policy

rightward shift in IS curve

New equilibrium at ~~x, &~~ E_1 with higher income and rate

BOP is surplus (import < Export)

At E_1, Govt will purchase FC and sell DC resulting in increase money supply which will result in ~~down~~ downward shift of LM curve resulting in higher national income at same rate



~~Under~~ Fiscal Policy under fixed exchange rate regime under the condition of ~~fix~~-perfect mobility is effective.

2) Flexible Exchange Rate

a) Monetary Policy

BOP is straight line due to perfect capital mobility.

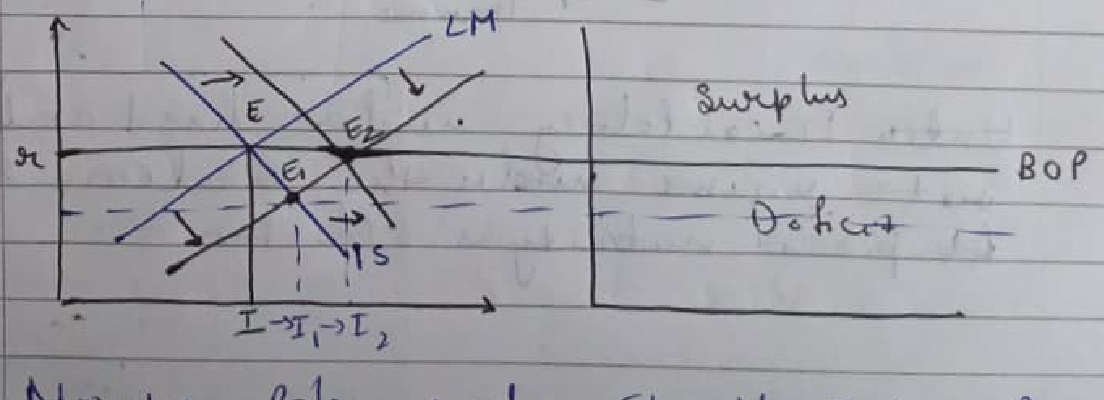
LM will shift to right

It will cause deficit in BOP as it is flexible govt won't intervene

Import > Export

Now demand for FC will increase and increase exchange rate which will depreciate DC and export will increase due to cheaper products. For more production more investment is required which is fiscal in nature so IS curve will shift rightward.

So income will increase.



Monetary Policy under Flexible Exchange Rate Regime with the condition of perfect capital mobility is effective.

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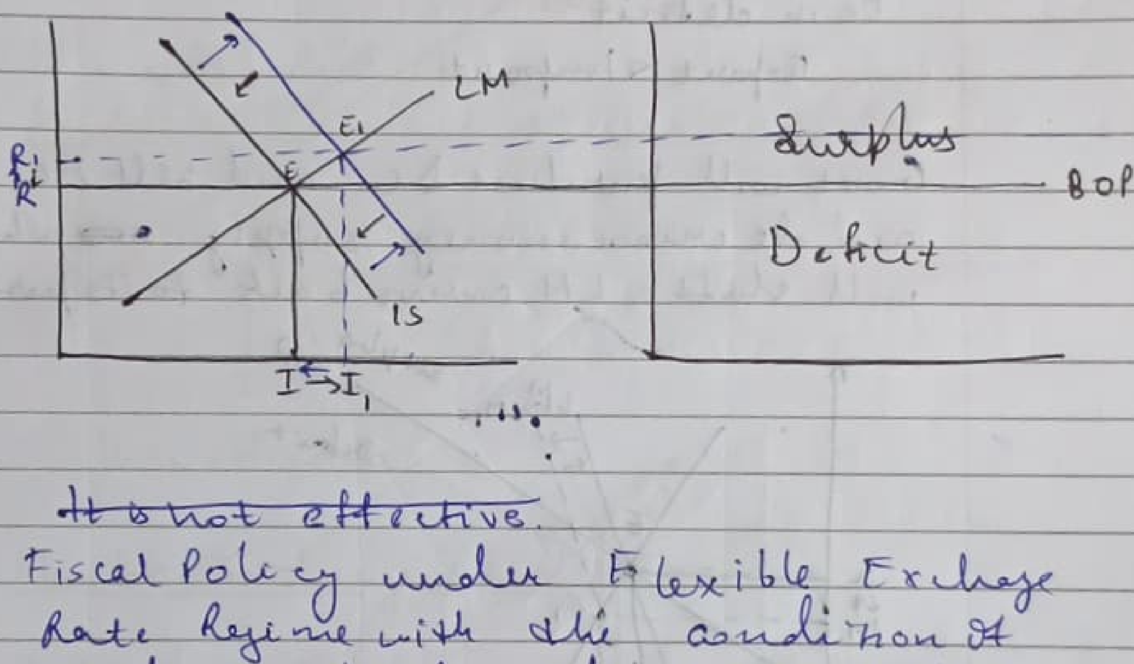
b) Fiscal Policy

IS curve will move rightward with new higher income and rate levels with BOP surplus

Export > Import

It will increase demand of DC and result in appreciation and ~~rate~~ decrease exports It will lower production and Investment So, IS curve will go back to normal position.



~~It is not effective.~~

Fiscal Policy under Flexible Exchange Rate Regime with the condition of perfect capital mobility is ineffective.

	FIXED	FLEXIBLE
MP	Ineffective	Effective
FP	Effective	Ineffective

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Imperfect Mobility Model

1) Fixed Exchange Rate

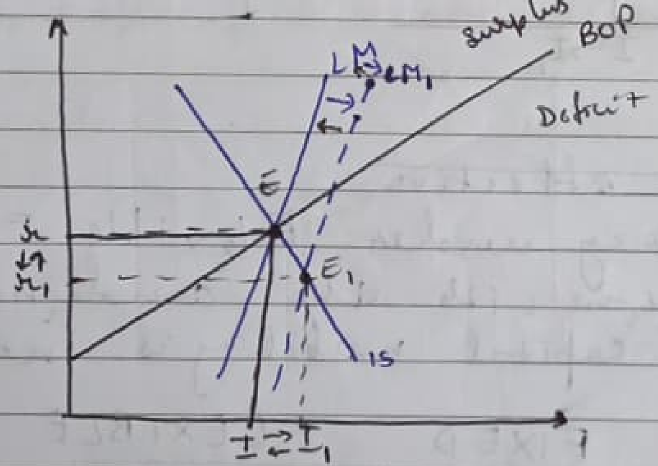
a) Monetary Policy

In this case BOP will be upward sloping and more the restrictions and steeper the slope.

LM will shift rightward and we will be in deficit

Export < Import

Govt will purchase DC and sell FC and decrease money supply which will shift LM curve back to its position



Monetary Policy under fixed exchange rate regime with the condition of imperfect mobility of capital is ineffective.

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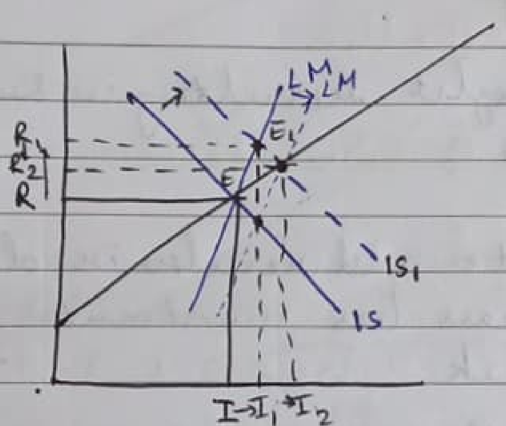
~~b) Fiscal~~

b) Fiscal Policy

rightward shift in IS curve and will be in surplus

Export > Import

Govt will by FC and sell DC and increase money supply and cause downward shift in LM curve with higher national income and ~~interest~~ rate.

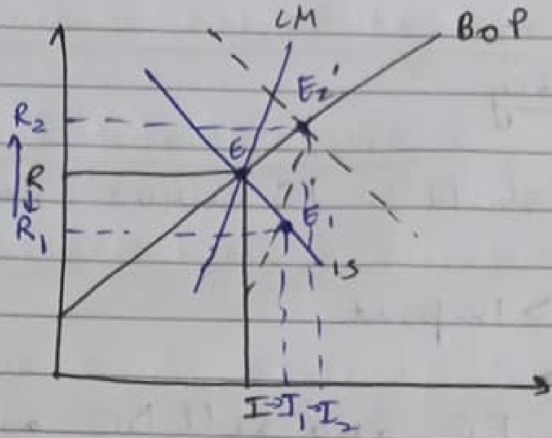


It is effective.

2) Flexible Exchange Rate

a) Monetary Policy

LM curve will shift right and we are in deficit. (export < import)
Demand for FC increase, DC depreciate and increase exports which require more investment for more product and IS curve shift right giving more income at higher rate

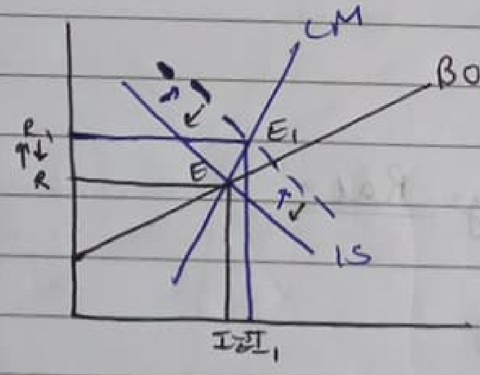


It is effective

b) Fiscal Policy

IS will shift right resulting in surplus
export > import

DC will appreciate and results in decrease
export which means less investment
and IS comes back



It is ineffective.