MAYANG ANCHALIK COLLEGE

HOME ASSIGNMENT

2nd SEMESTER, I PAPER

ECONOMICS HONOURS

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MACRO ECONOMICS

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Question: 1. What is Balance of payments? What are the different accaunts of a Balance of payment?

Ans:- The balance of payments of a caunty is a systematic record of all its economic transactions with the autside world in a given year. It is a statistical record of the character and dimensions of the country's economic relationship with the rest of the world. According to Bo Sodersten," The balance of payments is merely a way of listing receipts and payments in international transactions for a caunty."[1] B.J cohen says "It shows the country's trading position, change in its net position as foregin lender or borrower, and changes in its official reserve holding."[2]

Structure of balance of payments accaunts

The balance of payments accaunt of a country is constructed on the principle of double-entry book-keeping. Each transaction is entered on the credit and debit side of the balance sheet. But balance of payments accaunting differs from business accaunting in one respect. In business accaunting, debits (-) are shown on the left side and credits (+) on the right side ~~and~~ of the balance sheet. But in balance of payments accaunting, the practice is to show credits on the left side ~~of the balance~~ and debits on the right side of the balance sheet.

when a payment is received from a foreign country, it is a credit transaction while payment to a foreign country is a debit transaction. The Principle items

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Shown on the credit ~~transaction~~ side (+) are exports of goods and services, unrequited (or transfer) receipts in form of gifts etc. from foreigners, borrowings from abroad, investment by foreigners in the country, and official sale of reserve assets including gold to foreign countries and international agencies. The principle items on the debit side (-) include imports of goods and services, transfer (or unrequited) payments to foreigners as gifts, grants, etc., lending to forign countries, investment by residents to foreign countries, and purchase of reserve assets or gold from foreign countries and international agencies.

These credit and debit items are shown vertically in the balance of payments account of a country according to the priciple of double-entry book-keeping. Horizontally, they are divided into three categories the current account, the capital account, and the ~~official account or the~~ official settlements account or the official reserve assets account

The balance of payment account of a country is constructed in table 1

Table 1. Balance of payment account

Credit (+) (Receipts)		Dedits (-) (payments)
Exports	1 current account	
(a) Goods		(a) Goods
(b) Services		(b) Services
(c) Transfer payment		(c) Transfer payments
	2 capital account	
(a) Borrowings from foreign countries		(a) Lending to foreign countries

2 capital account

(b) Direct investment by
(a) Foreign countries

(b) Direct investment in
foreign countries

3. official settlements account

(a) Increase in foreign
official holdings

(a) Increase in official
Reserve of gold and
foreign currencies

Errors and omission

1. current account :- The current account of a country consists of all transaction relating to trade in goods and services and unilateral (or unrequited) transfers. Services transactions include costs of travel and transportation, insurance, income and payments of foreign investments, etc. Transfer payments relate to gifts, foreign aid, pensions, private remittances, charitable donations etc. Received from foreign individuals and governments to foreigners.

In the current account, merchandise exports and imports are the most important items. Exports are shown as a positive item and are calculated f.o.b. (free on board) which means that costs of transportation, insurance, etc. are exclued. on the other side, imports are shown as negative item and are calculated c.i.f. which means that costs, insurance and freight are included. The difference between exports and imports of a country is its balance of visible trade or merchandise trade or simply balance of trade. If visible exports exceed visible imports, the

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Balance of trade is favaurable. In the opposite case
when imports exceed exports, it is unfavaurable.
It is however, services and transfer payments or
invisible items of the current account that reflect
the true picture of the balance of payments account.
The balance of exports and imports of services and transfer
payments is called the balance of invisible trade.
The invisible items alongwith the visible items determina-
nt the actual current account position. If exports of
goods and services exceed imports of goods and services
the balance of payments is said to be favaurable. In
the opposite case, it is unfavaurable.
In the current account, the exports of goods and services
and the receipts of transfer payments (unrequited
receipts) are entered as credits (+) because they
represent receipts from foriegners. on the other hand
the imports of goods and services and grant of transfer
payments to foreigners are entered as debits (-) because
they represent payments to foreigners. The net value of
these visible and invisible trade balance is the balance
on current account.
2. capital account :- The capital account of a country
consists of its transactions in financial assets in the
form of short-term and long-term lendings and borrowings
and private and official investment. In other words,
the capital account shows international flow of loans
and investments, and represents a change in the
country's foreign assets and liabilities. Long-term
capital transaction like ~~building of a~~ foregin relate

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to international capital movements with maturity of
one year or more and include direct investments like
building of a foregin plant, portfolio investment like
the purchese of foriegn bonds and stocks, and interna-
~~at~~ tional loans. on the other hand short-term internatio-
nal capital transactions are for a period ranging
between three months and less.
There are two types of transaction in the capital account-
private and government, private transactions include
all types of investment: direct, portfolio and short-
term, Government ~~transal~~ transactions consist of loans
to and from forEign official agencies.
In the capital accaunt, borrowings from foreign direct
investment by foreign countries represent capital
inflows. They are positive items or credits because the
other hand, lending to foreign countries and direct
investments in foreign countries represent capital
autflows. They are negative items or debits because
they are payments to foreigners. The net value of the
balance of short-term and long-term direct and
portfolio investment is the balance on capital accaunt.
Sodersten and reed refer to the external wealth
accaunt of a cauntry which shows the stocks of
foreign assets held by the caunty (positive item)
and of domestic assets held by foreign investors
(liabilities or negative item). The net value of a caunty's
assets and liabilities is its balance of indebtedness.
If its assets ~~during the year~~ the are than its
liabilities, then it is a net creditor. If its liabilities
are more than its assets, then it is a net debtor.[3]

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Basic Balance. The sum of current account and capital account is known as the basic balance.

3. The official settlements account :- The official Settlement account or official ~~se~~ reserve assets account is, in fact, a part of the capital account. But the U.K. and U.S. balance of payments accounts show it as a separate account. "The official settlements account measures the change in nation's liquidity and non-liquid liabilities to foreign official holders and the change in a nationes official reserve assets during the year. "The official reserve assets of a country inclde its gold stock, holdings of its convertible foreign currencies and SDRs, and its net position in the IMF." It shows transactions in a country's net official reserve assets.

Errors and omissions. Erros and ommissions is a balancing item so that total credits and debits of the three accounts must equal in accordance with the principles of double entry book-keeping so that the balance of payments of a country always balance in the accounting sense.

Question : 2 Explain the fishers cash transaction approch to the quantity theory of money.

Ans:- The quantity theory of money states that the quantity of money is the main determinant of the price level or the value of money. Any change in the quantity of money ~~d~~ produces an exactly proportionate change in the price level. In the wards of Irving fisher,

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"other things remaining unchange, as the quantity of money in circulation increases, the price level also increases, in direct proportion and the value of money decreases and vice versa." If the quantity of money is doubled, the price level will also double and the value of money will be one half. on the other hand, if the quantity of mmey is reduced by one half, the price level will also be reduced by one half and the value of money will be twise.

Fisher has explained his theory in terms of his equation of exchange.

$PT = MV + M'V'$

where P = price level, or $1/P$ = the value of money,
M = the total quantity of legal tender money,
V = the velocity of circulation of M;
M' = the total quantity of credit money,
V' = the velocity of circulation of M';
T = the total amaunt of goods and services exchanged for money or transaction performed by money.

The eauation equates the demand for money (PT) to supply of money ($MV = M'V'$). The total volume of transactions multiplied by the price level (PT) represent the demand for money. According to fisher, PT is ΣPQ. In other wards, price level (P) multiplied by quantity baught (Q) by the community (Σ) gives the total demand for money. This equals the total supply of money in the community consisting of the quantity of demand for money, ~~This equals the total supply of money in the~~ M and its velocity of circulation V plus the total quantity of credit money M' and its velocity of circulation V'.

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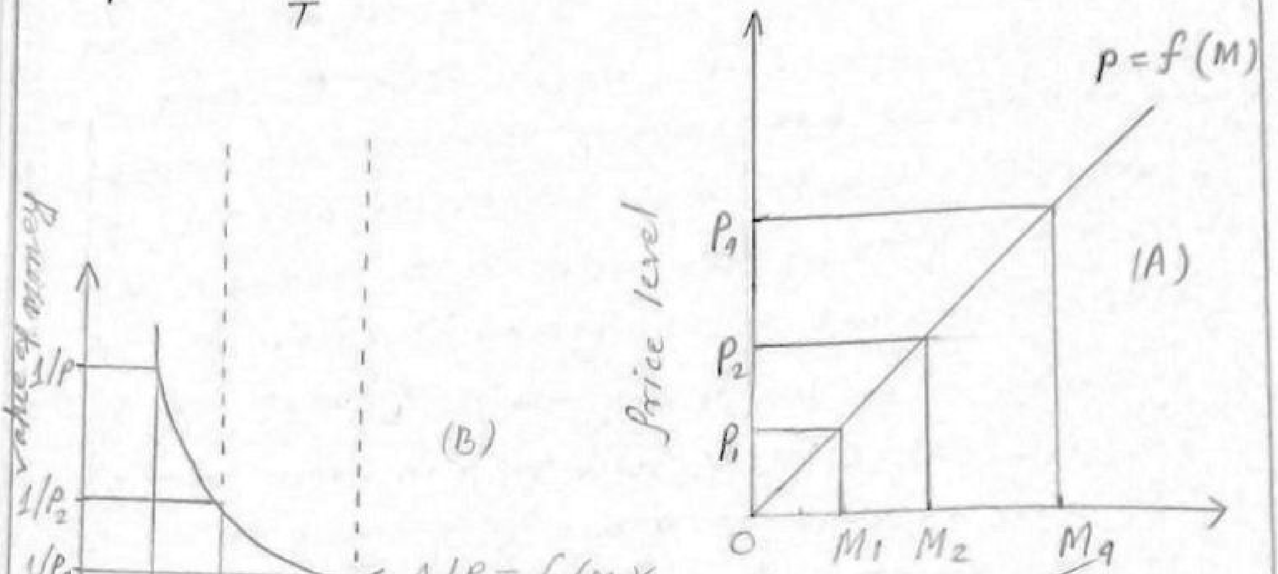
Thus the total value of purchases (PT) in a year is measured by MV + M'V'. Thus the equation of exchange is PI = MV + M'V'. In ~~other~~ order to find out the effect of the quantity of money on the price level or the value of money. we write the equation as

$$P = \frac{MV + M'V'}{T}$$



Fisher points out that the price level (P) varies directly as the quantity of money (M+M') provided the volume of trade (T) and velocity of circulation (V,V') remain unchanged. The truth of this proposition is evident from the fact that if M and M' are doubled while V, V' and T remain constant, P is also doubled but the value of money (1/P) is reduced to half. Fisher quantity theory of money is explained with the help of figure 1(A) and (B). Panel A of the figure shows the ~~direct~~ effect of changes in the quantity of money on the price ons the price level. ~~is~~ B1.

To began with, when the quantity of money is M_1 the price level is P_1. when the quantity of money is daubled to M_2 the price level is also daubled to P_2. Further, when the quantity of money is increased faur-fold to M_4 the price also increases by faur times to P_4. this relationship is expressed by the curve $P=f(M)$ from the origin at 45°.

In panel B of the figure, the inverse relation between the quantity of money and the value of money is depicted where the value of money is taken on the vertical axis. when the quantity of money is M_1 the value of money is $1/P$. But with the daubling of the quantity of money to M_2, the value of money becomes one-half of what it was before, $1/P_2$. And with the quantity of money increasing by faur-fold to M_4 the value of money is reduced by $1/P_4$. This inverse relationship between the quantity of money and the value of money is shown by downward sloping curve $1/P = f(M)$.

Question : 3 What is Inflation? what are the cause of demand - pull inflation?

Ans:- Inflation is the decline of purchasing power of a given crrency over time. A quantitative estimate of the rate at which the decline in purchasing power occurs can be reflected in the increase of an average price level of a basket of selected goods and services in an economy over some period of time.

Factors affecting Demand

Both keyesians and monetaries belive that inflation is cused by increase in aggregate demand they point toward the following factors which raise it.

1. Increase in money supply :- Inflation is cused by an increase in the supply of money which leads to increase in aggregate demand. The higher the growth rate of the nominal money supply, the higher is the rate of inflation. Modern quantity theorists do not believe that true inflation starts after the full employment ~~and high~~ level. This view is realistic because all advanced countries are faced with high levels of unemplayment and rates of inflation.

2. Increase in diposable income : when the disposable income of the people increases, it raise their demand for goods and services. Diposable income may increase with the rise in national income or reduction in taxes or reduction in the saving of the people.

3. Increase in public expenditure : Government activities have been expending much with the result that government expenditure has also been increasing at a phenomenal rate, thereby raising aggregate demand for goods and services. Government of both developed and developing countries are providing more facilities under public utilities and social services,

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and also nationalising industries and starting public enterprises with the result that they help in increasing aggregate demand.

4. Increase in Consumer spending :- The demand for goods and services increases when consumer expenditure increases. Consumers may spend more due to conspicuous consumption effect. They may also spend more when they are given credit facilities to buy goods on hire-purchase and instalment basis.

5. cheap monetary policy :- cheap monetary policy or the policy of credit expansion also leads to increase in the money supply which raises the demand for goods and services in the economy. when credit expands it raises the money income of the borrowers which, in turn, rises aggregate demand relative to supply, there by leading to inflation. This is also known as credit-induced inflation.

6. Deficit financing :- In order to meet its mounting expenses, the government resorts to deficit financing by borrowing from the public and even by printing more notes. This raises aggregate demand in relation to aggregate supply, thereby leading to inflationary rise in prices. This is also known as deficit induced inflation.

7. Expansion of the private sector :- The expansion of the private sector also tends to rise

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the aggregate demand. For huge investments increase employment and income, thereby creating more demand for goods and services. But it takes time for the output to enter the market. This leads to rise in prices.

8. <u>Black money</u> :- The existence of black money in all countries due to corruption, tax evasion etc. increases the aggregate demand. people spend such unearned money extravagantly, thereby creating unnecessary demand for commodities. This tends to raise the price level further.

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