Q8

Consider the following statements: The effect of devaluation of a currency is that it necessarily 1. improves the competitiveness of the domestic exports in the foreign markets. 2. increases the foreign value of domestic currency 3. improves the trade balance Which of the above statements is/are correct? (a) 1 only (b) 1 and 2 (c) 3 only (d) 2 and 3 Official key: A.

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Explanation

(a) Official key

1 only. Devaluation cheapens exports in foreign-currency terms. It does not raise the foreign value of the home currency, and the trade balance need not improve (J-curve, elasticities).

(b)

1 and 2. Statement 2 is the opposite of devaluation.

(c)

3 only. Trade balance is not a necessary result.

(d)

2 and 3. Both fail.

Summary

Official key is (a) 1 only. A cheaper rupee makes exports more competitive abroad. The rupee's foreign value falls, not rises. Whether the trade balance improves depends on elasticities - it is not necessary.

Related possible facts

These can be asked in a future Prelims paper.

Devaluation
A discrete official cut in the peg; depreciation is a float.

Marshall-Lerner
Trade balance improves only if demand elasticities sum above one.

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