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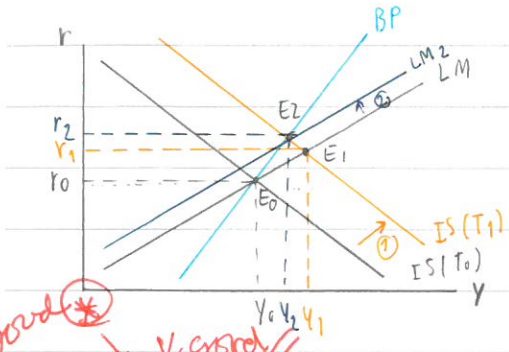
EE312 Assignment 2. (AJ)

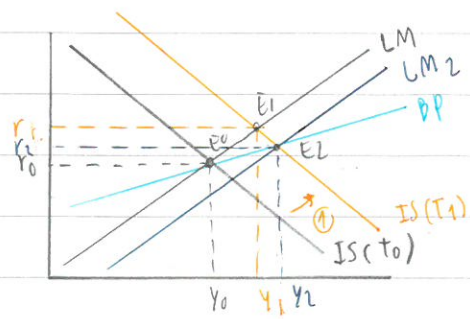
Q4.1 : Analyze the impact of cut in pay-roll income tax under the imperfect capital mobility

① Fixed exchange rate regime ⇒ BP is steeper than LM



we assume that we have the imperfected capital mobility for this one we focus on situation than slope of BP is steeper than LM. The effect on a cut in pay-roll income tax is T_0 to T_1, so IS curve shift to the right from $IS(T_0)$ $IS(T_1)$, that change the equilibrium from point E_0 to E_1, also income will increase from Y_0 to Y_1 and interest rate is increase from r_0 to r_1, from this situation we have higher interest rate that make it attractive foreign investor, so we will have BOP surplus (BOP>0), as we assume that BP is steeper than LM. It will steeper when it have less responsive capital flow are to interest rate. The smaller increase in capital flow for a given rising in interest rate. The BP will also steeper the larger marginal propensity to import ($\frac{\partial IM}{\partial Y}$). In this figure, there is BOP deficit at point E_1 because interest rate in domestic country is lower than the interest rate of global rate. Therefore, there is excess demand for dollar (USD) that make central bank have to sell more dollar from the foreign reserve that they accumulate in the past, to fix the exchange rate back to the same level as before causing MS to be lower and then LM shift to the left. As a result, it will lead to the new equilibrium (E_2), which have higher output than Y_0, but lower output from Y_1. This is an equilibrium for ~~open-market~~ open-economy.

② Fixed exchange rate regime ⇒ LM is steeper than BP



This case is same as the previous case, but change in shifting IS curve, BOP > 0 ; surplus instead. Thus, global investor will try to invest in domestic country with huge amount of money, so they try to convert money into domestic currency causing the excess supply for USD. The BOT have to buy those excess by using foreign reserve. This will increase money supply in money market and LM will shift to the right obtain the new open-market eqm. at $E_2(Y_2, r_2)$

See the above comment and apply them to this part.

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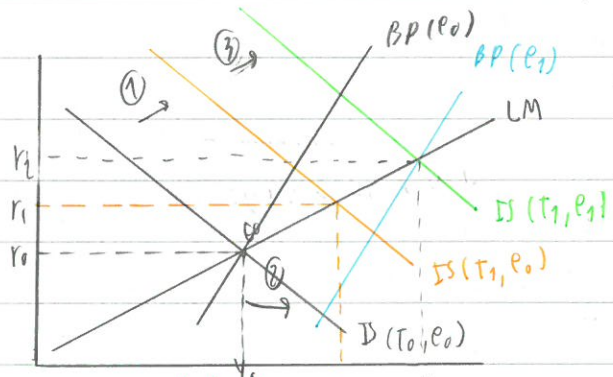
① flexible exchang rate ⇒ BP is steeper than LM



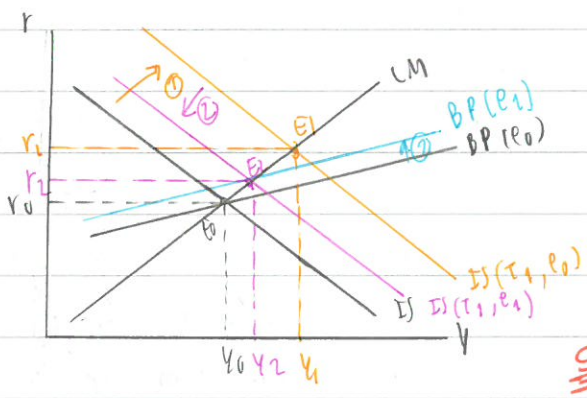
The initial effect after lowering the tax is IS will shift right as the economy was stimulated by gov. collecting lower tax. The equilibrium will be at point E_2, this point, there is a BOP<0 resulting from the expansionary fiscal policy action. As a result, there is an excess demand for USD causing the increasing in domestic currency from e_0 to e_1 to clear foreign exchange market. An increase in ex. will shift BP to the right because when the exchange rate increase, then domestic country will export more, import less causing current account to be higher. The MA will be reduce to compensate the charge of CA by decreasing the interest rate, further more, IS will also shift to right because higher net export from currency depreciation will lead to increase in AE, so the output in good market will be higher. The first out come will be E_2, the expansionary fiscal policy is very effective because it can increase a lot of output.

good → to help reader understand that the change in e mean- ce↑/depreciate)

✓ good

✓ V. good

④ flexible exchange rate ⇒ LM is steeper than BP.



In this case, we will focus on the situation whe we have BP flatter than LM. After conducting expansionary monetary policy, IS curve will shift to the right and then we will get the new equilibrium at E_1, At this point, we will have the interest rate higher than the global investor require, so it will have a huge amount of capital inflow into domestic country causing the excess supply in USD (TH baht appreciate) As a result, net export is lower than before and capital account have to rise to compensate the reducing in CA by increasing the exchange rate to e_1 (BP ↑) the depreciation in domestic currency also make output level get worse and IS will shift to left to the equilibrium in open-market (E_2)

ok

→ should explain how the problem (the equilibrium) gets resolved?? V. good

~~See the comm~~ ok.

flow of writing is good, effective not too many repetitive parts. would This is a good writing!

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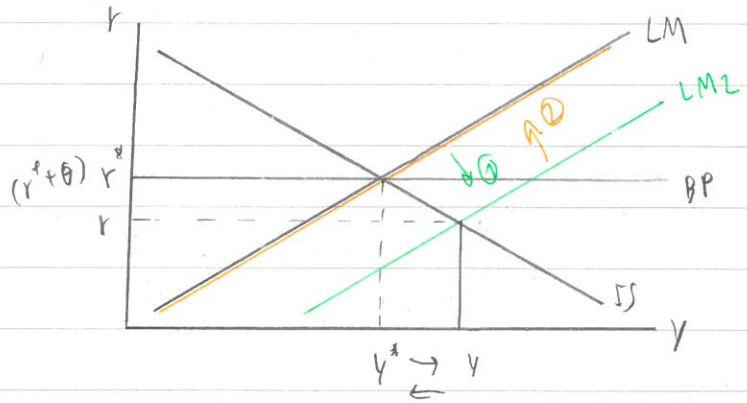
4.2) ⇒ Fixed exchange rate regime.

We assume that there is a perfect capital mobility which is the situation when we have fully integrated economy. There is no transaction cost when we move money to aboard. For this situation, that we will have a positive innovation in financial technology, so that people will hold less cash on their hand and use electronic payment instead ie paypal, net bank, As a result, we will have less money demand in the money market (Md↓, r↓) causing interest rate going to drop and LM curve will shift to the right for representing new eqm. in money market, After that, we will get the new equilibrium at point E_1. At this point, the interest rate required by global investor ($r^f + \theta$) is higher than the interest rate in domestic market this will lead to have more capital outflow from domestic country causing the BOP (BOP<0) deficit because global investor can get more return from investing in other countries, therefore, there demand for USD. will higher than before under fixed exchange rate, BOT have to sell USD. for eliminate excess demand for USD. and fixed exchange rate at the same level as before, but it will decrease MS↓ in money market, so the LM curve will shift back to the old LM. to be back in opend-market eqm. again.



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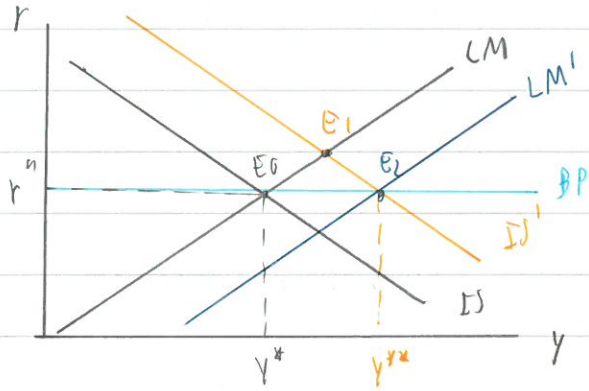
4.2) Flexible exchange rate regime.



From given information that we will have a positive innovation in financial technology, so that people will hold less cash on hand b/c they can use electronic payment instead.. the money demand will be lower causing LM curve to shift to the right, After that, we will face with BOP deficit as I mention in previously causing excess demand for USD. the difference between fixed exchange rate regime and flexible exchange rate is here. IF we are analyzing under fix exchange rate CB will have to sell USD to manage the exchange rate, on the other hand, for flexible exchange rate regime, CB will do nothing and let the domestic currency to depreciate, After depreciation, it will stimulate the economy to have more competitiveness (for domestic country) in term of exporting. The domestic country will export more ($X\uparrow, M\downarrow$) and import less causing net export $(X-M)\uparrow$ to be higher. As a result, IS will shift to the right because of increasing in AE putting output to be higher in good market. Finally, it will lead to opened-market equilibrium where IS-LM-BP intersect with each other, At this point, output will be at E2 (y^{**}, r^n), which higher than before.