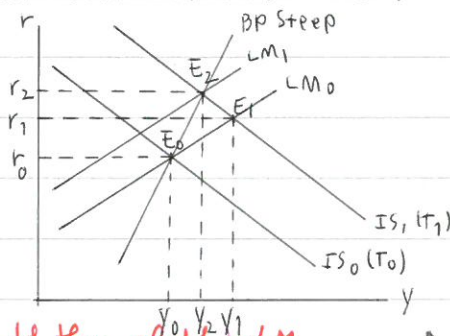


ASSIGNMENT 2

Keep doing good jobs!

- ④ (1) Firstly, when pay-roll income tax is cut, people have more money in their hand to spend, invest, or save. This would result in a rightward shift of IS curve from IS_0 to IS_1 . The equilibrium moves to point E_1 which the level of output rises from Y_0 to Y_1 , and the interest rate also increases from r_0 to r_1 . This higher interest rate attracts investors to invest more in domestic country which will drive the economy to a balance of payment surplus at point E_1 . The rise in output drives the current account to deficit, but the rise in interest rate drives the capital account to surplus since we have more capital inflow. The net result depends on the slope of BP line. *✓ v. good! Very effective way of writing, so few concise and clear!*

If LM is flatter than BP curve (under fixed exchange rates) ①



In this case, BP is steeper because there is low capital mobility.

The higher income stimulates a greater import, while the higher interest rate creates a little capital inflow. Hence, the net result is a balance of payment deficit. As we can see

from the graph, BP is deficit at Point E_1 because net capital inflow is worse than the level needed to ensure (r is too low). Then,

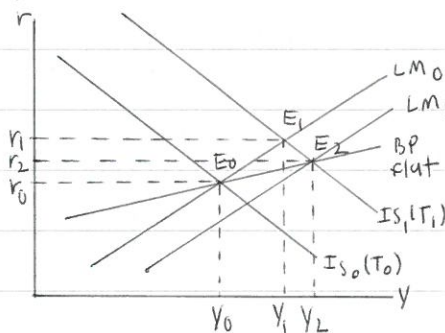
how would the shift in LM

can help "gradually" bring Economy to General equilibrium.

there is excess demand in dollars. To maintain fixed exchange rate, central bank sells more dollars which leads to a lower money supply and LM curve shifts to the left from LM_0 to LM_1 . The new equilibrium is at Point E_2 which the output level decreases to Y_2 , but the interest rate rises further to r_2 .

It would have been even better if

If LM is steeper than BP curve (under fixed exchange rates) ②.



In this case, BP is flatter. An increase in interest rate creates

a high capital inflow, while the higher output generates higher imports. So, capital inflows dominate imports resulting in a

balance of payment surplus. From the graph, BP is surplus at point E_1 . This case we have very high interest rate, a high capital flow come to Thailand. Hence, there is an excess supply of dollars.

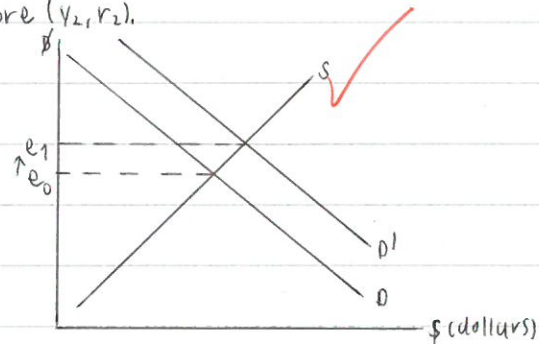
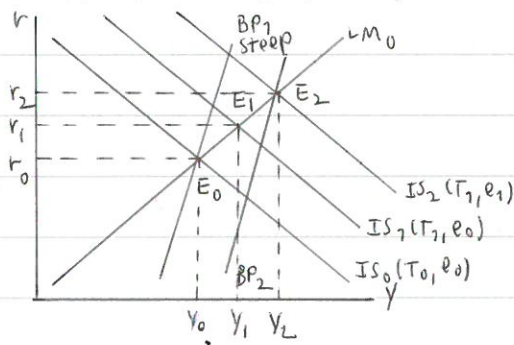
To maintain the fixed exchange rate, central bank buys excess supply in US dollars, so the supply of money rises.

A rise in money supply results in a shift in LM to the right from LM_0 to LM_1 . At new equilibrium E_2 , the interest rate is lower, but higher than initial rate, and level of output increase to Y_2 . Capital inflow seems to be lower. *✓ v. good*

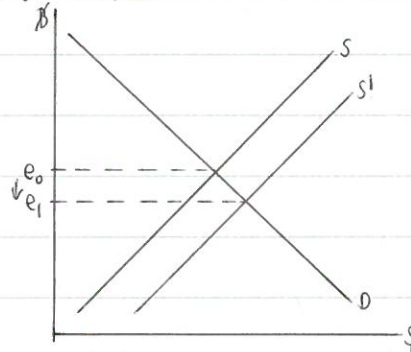
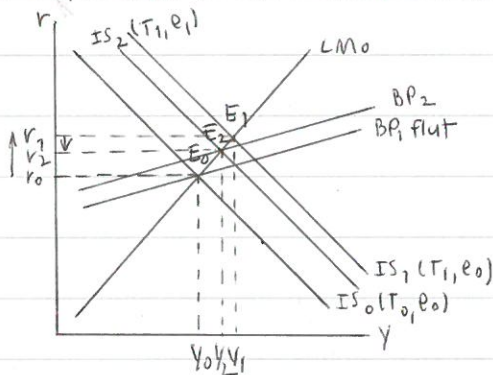
If LM is flatter than BP Curve (under flexible exchange rates) ③

In this case, BP is steeper. After cutting tax, IS curve shifts to the right at new equilibrium E_1 which interest rate rises and output also rises. The higher income and interest rate under steep BP causes a balance of payment deficit since a large amount of imports offset the capital flow. At point E_1 , BP is deficit, so there is an excess demand for USD. Without any interventions, exchange rate will rise from

e_0 to e_1 (depreciate in $\text{Thal } \text{B}$). A rise in exchange rate causes a right shift in the BP line and IS curve also shifts to the right. This is because we can sell more to the rest of the world implied that the domestic country exports is more than imports. Therefore, the new equilibrium is at point E_2 which both output level and interest rate level are higher than before (y_2, r_2).



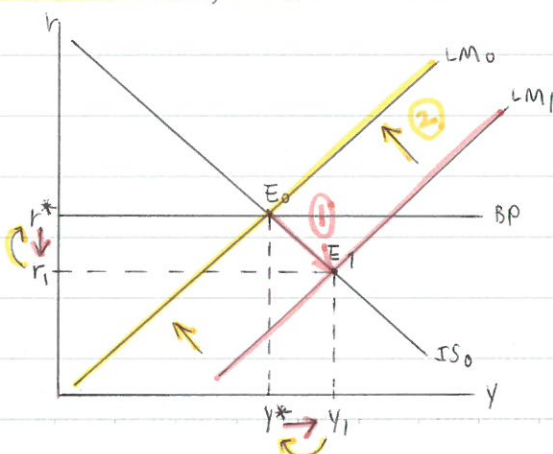
If LM is steeper than BP curve (under flexible exchange rates) ④



In this case, BP is flatter than LM curve. When government lowers the tax, IS curve shifts to the right to IS_1 at new equilibrium E_1 with higher interest rate and higher output. The higher level of interest rate make a huge capital inflow come into domestic country because interest rate is higher than required. Then, we have BOP surplus at point E_1 , those cause domestic currency to be stronger (appreciate), so the net exports decreases as we already have surplus. It implies that the current account lowers. In order to cancel out the effect, the capital account have to increase a lot. From the graph, exchange rate falls from e_0 to e_1 , and BP falls which shifts to the left. The new equilibrium is at point E_2 which interest rate falls to r_2 and output falls to y_2 .

I think your country is the most effective that I've read so far.

(2.) Under fixed exchange rate



Assume that this is a perfect capital mobility, no transaction or other costs in moving capital from one country to another. In this case, suppose we have a positive innovation in financial technology; so people hold just a bit amount of money as we have technology to make a payment without holding cash in our hands (cashless society). Hence, people will demand less for money. A decrease in money