Q14. In the above example, if exports change to X = 100, find the change in equilibrium income and the net export balance.

Ans: C = 40 + 0.8 YD

T = 50

I = 60

G = 40

X = 100

M = 50 + 0.05Y

Equilibrium income (Y) = $\frac{A}{1-c+m}$

$= \frac{C - cT + I + G + X - M}{1-c+m}$

$= \frac{40 - 0.8\times 50 + 40 + 60 + 100 - 50}{1-0.8+0.05}$

$= \frac{40 - 40 + 40 + 60 + 100 - 50}{0.25}$

$= \frac{150}{0.25}$

$= \frac{150\times 100}{25}$

=600

Net export balance NX = X – M – 0.05Y

$= 100 - 50 - 0.05\times 600$

$= 50 - 0.05\times 60$

= 50 – 30 = 20

Q15. Explain why $G - T = (S_g - I) - (X - M)$.

Ans: In a closed economy, savings and investments are equal at equilibrium level of income. However, in an open economy savings and investments differ.

$Y = C + I + G + X - M$

Or, $Y = C + I + G + NX$ [As $NX = X - M$]

Or, $Y - C - G = I + NX$

Or, $S = I + NX$

Savings in an economy include private savings (S^P) and government savings (S_g).

So, $S_P + S_g = I + NX$

Or, $NX = S_P + S_g - I$

Or, $NX = (Y - C - T) + (T - G) - I$

$$\begin{bmatrix} S^P = Y - C - T \\ S^g = T - G \end{bmatrix}$$

Or, $NX = Y - C - T + T - G - I$

Or, $NX = Y - C - G - I$

Or, $G = Y - C - I - NX$

Or, $G - T = Y - C - I - NX - T$ [Subtracting T from both sides]

Or, $G - T = Y - C - T - I - NX$

Or, $G - T = (S_P - I) - NX$

Or, $G - T = (S_g - I) - (X - M)$ [$NX = X - M$]

Q16. If inflation is higher in country A than in Country B, and the exchange rate between the two countries is fixed, what is likely to happen to the trade balance between the two countries?

Ans:Country A has a higher inflation than country B. Since, the exchange rate is fixed, it is advantageous for country B to export goods to country A. Similarly, it is advantageous for country A to import goods from country B. On the other hand, it would be expensive for country A to export goods to country B. Thus, country A will have trade deficit as it will import more goods as compared to exports, from country B. Country B will import less goods as compared to exports, from country A. Hence, there is a trade surplus in country B.

Q17. Should a current account deficit be a cause for alarm? Explain.

Ans: Current account deficit is the excess of total imports of goods, services and transfers over total exports of goods, services and transfers. This situation makes a country debtor to the rest of the world. But, this cannot be always treated as a cause for alarm because countries might be running in deficits (current account) to increase productivity and exports in future. Also, more investment will help in building capital stock, which in future will lead to rise in output.

*********** END **********