Q18. Suppose $C = 100 + 0.75Y_D$, $I = 500$, $G = 750$, taxes are 20 per cent of income, $X = 150$, $M = 100 + 0.2Y$. Calculate equilibrium income, the budget deficit or surplus and the trade deficit or surplus.

Ans:C = 100 + 0.75YD
I = 500
G = 750
X = 150
M = 100 + 0.2Y
Equilibrium income (Y) = C + c (Y – T) + I + G + X – M – mY

Or, $Y = 100 + .75\left(Y - \frac{20}{100}Y\right) + 500 + 750 + 150 - 100 - 0.2Y$

Or, $1400 + \frac{75}{100} \times \frac{4Y}{5} - 0.2Y$

Or, $Y = 1400 + \frac{3}{5}Y - 0.2Y$

Or, $\frac{6Y}{10} = 1400$

Or, $Y = \frac{1400 \times 10}{6} = \frac{7000}{3}$

Government expenditure = 750

Government receipts (taxes) = $\frac{20}{100} \times \frac{7000}{3} = \frac{1400}{3}$

=466.6
Since, government expenditure > government receipts
It shows the government is running budget deficit

NX = X – M – MY

$= 150 - 100 - \frac{0.2}{10} \times \frac{7000}{3}$

$= 150 - 100 - \frac{1400}{3}$

= 150 – 100 – 466.66
= 150 – 566.66
= – 416.66
Since NX is negative, it implies trade deficit.

Q19. Discuss some of the exchange rate arrangements that countries have entered into to bring about stability in their external accounts.
Ans:To combine the two extreme positions, `fixed' and 'flexible', the following exchange rate arrangements are used by governments to bring stability in external accounts:
i. Wider Bands:A system that allows adjustment in fixed exchange rate is referred to as wider bands. It permits only 10% variation between the currencies of any two countries. For example, a country can improve its balance of payments (BoP) deficit by depreciating its currency, which leads to increase in demand for domestic goods due to increase in purchasing power of other

currencies. This further leads to the increase in exports, hence improving the BoP.

ii. Crawling Peg:Crawling peg system allows continuous and regular adjustments in the exchange rate. Only 1% of variation is allowed at a time.

iii. Managed floating:Managed floating is a scheme under which government can intervene to vary the exchange rate when the situation demands so. There is no specific limit of variation as in crawling peg and wider bands.

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