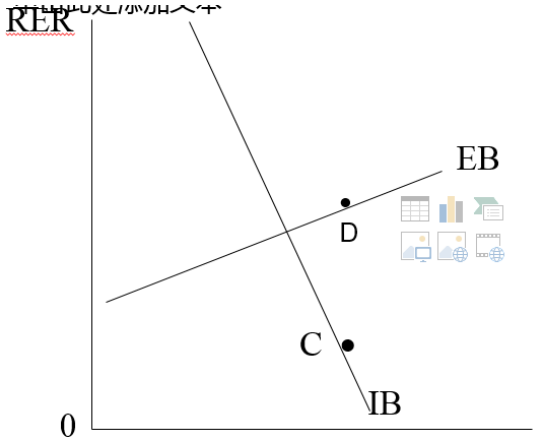
SECTION B COMPLETE ANY 3 QUESTIONS OUT OF GIVEN 5

Question 1

(a) Assume an economy is in internal balance but not external balance. Externally, it is experiencing a current account deficit. Also assume that the IB schedule is steeper than the EB schedule. **Explain how and why** an attempt to restore external balance will disrupt internal balance and what policy would be used to restore external balance. **(10 marks)**

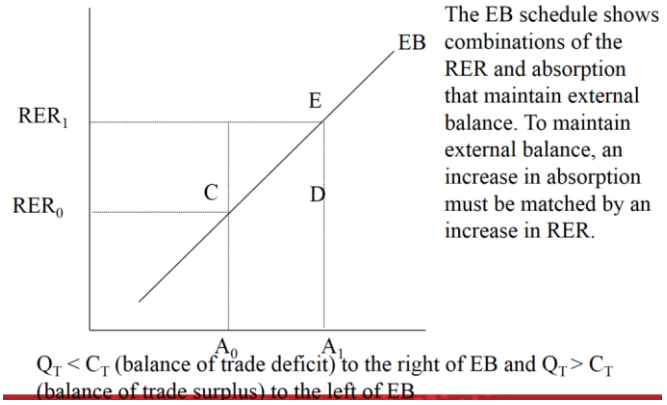


- As the EB schedule is relatively flat, policy makers will increase the nominal exchange rate to increase the RER in order to restore external balance. An increase in the RER will increase the relative price of tradeable goods, which will increase the production of tradeables and reduce the consumption of tradeables. The current account deficit will be eliminated, and external balance restored at point D.
- What has happened in the market for non-tradeables? As the relative price of non-tradeables has fallen, the consumption of non-tradeables has increased and the production of non-tradeables has fallen. This has led to excess demand in the market for nontradeables, and therefore inflation at point D.
- *If the authorities maintained a fixed exchange rate and attempted to eliminate the excess demand for tradeables by reducing government expenditure (reducing absorption, which reduces the demand for tradeables), this would worsen unemployment.*
- *On the other hand, an increase in the nominal exchange rate (increasing the real exchange rate, which increases the production of tradeables and reduces spending on tradeables) sufficient to restore external balance would generate an excess demand for non-tradeables, and therefore inflation.*

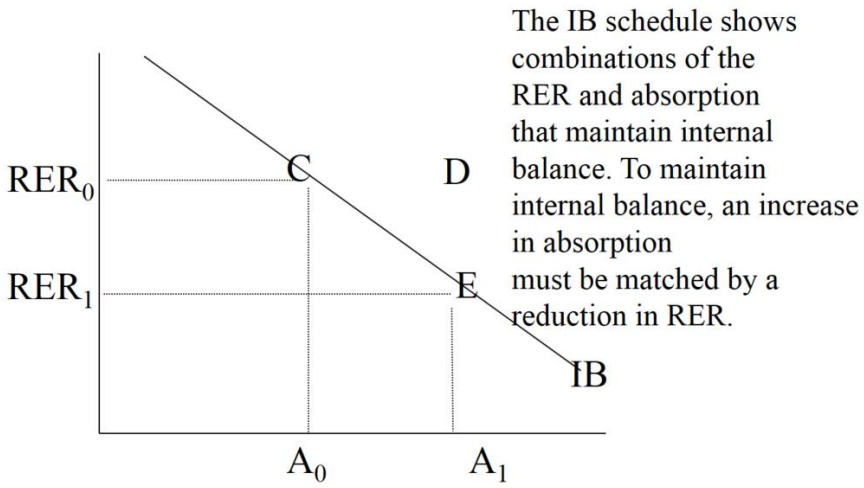
(b) Assume an economy is in external balance but not internal balance. Internally, it is experiencing unemployment. Also assume that the IB schedule is steeper than the EB schedule. **Explain how and why** an attempt to restore internal balance will disrupt external balance and what policy would be used to restore internal balance. **(10 marks)**

(c) Critically comment on the following statement.

"The external balance schedule is upward sloping as an increase in the real exchange rate **causes** an increase in the level of government expenditure."



"The internal balance schedule is downward sloping as an increase in the real exchange rate **causes** a decrease in the level of government expenditure."



Starting at internal balance point E

The internal balance curve II has a negative slope

since monetary restraint must be met by greater fiscal expansion to preserve internal balance. The external balance curve XX has a positive slope since monetary expansion, which depreciates the exchange rate and improves the current account, must be matched by fiscal expansion to preserve external balance