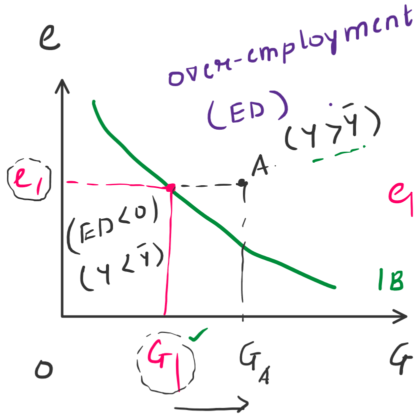
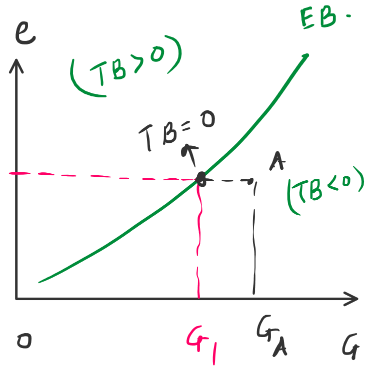
EB: Maintain TB.

Locus of (e, G) s.t $TB = 0$.

IB: Maintain $Y = \bar{Y}$.

Locus of (e, G) s.t $Y = \bar{Y}$





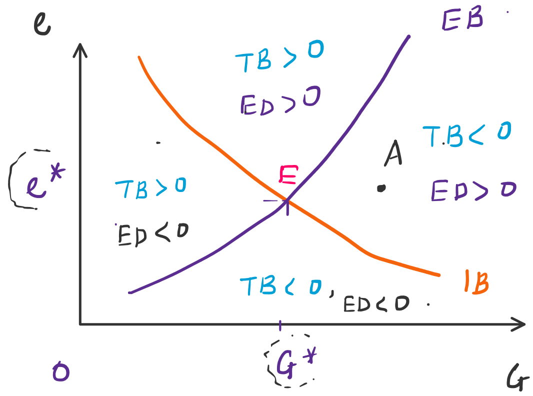
$G\uparrow \Rightarrow AD\uparrow \Rightarrow Y\uparrow$

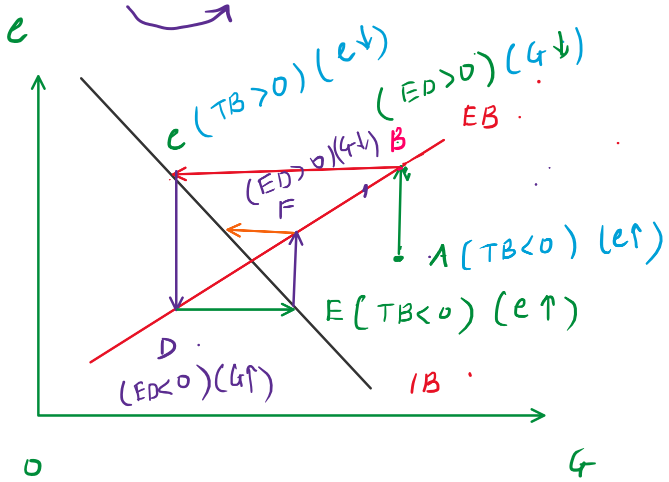
$G\uparrow \Rightarrow AD\uparrow \Rightarrow Y\uparrow \Rightarrow M\uparrow \Rightarrow TB<0$

Policy variables: e, G → Which policy variable to assign to which target [Assignment problem]

Policy → e, G

Case I: $e \rightarrow EB$, $G \rightarrow IB$ } Correct Assignment.





Path

First address EB, then IB.

Starting from pt. A.

(i) At pt A, $TB<0 \Rightarrow$ Do: $e\uparrow$. We Reach pt B.

(ii) B is above IB, $ED>0$. $\Rightarrow$ Do: $G\downarrow \Rightarrow$ We reach pt c

(iii)

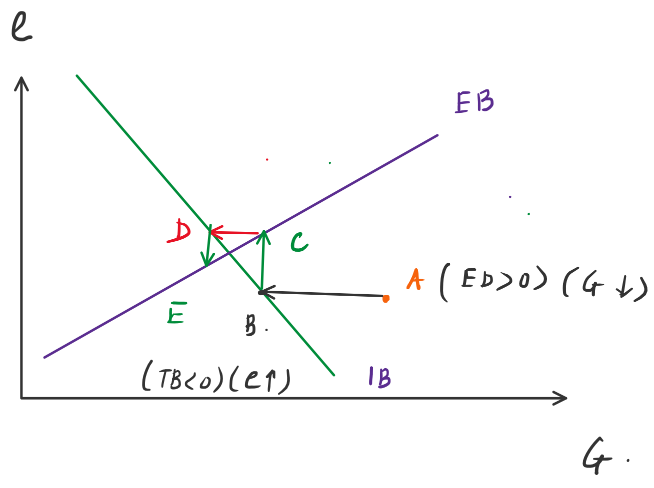
Case II: $e \rightarrow EB$. $G \rightarrow IB$.

[IB is steeper than EB]

Path

First address IB.

Then address EB.



Start from pt A.

Compare Govt Exp multiplier under Fixed exchange Rate & Flexible Exchange Rate.

Consider SMOPEC: $C = \bar{C} + c'(Y-T)$, $\bar{C} > 0$, $0 < c' < 1$.

$I = \bar{I}$, $G = \bar{G}$

$X = \bar{X}$, $M = \bar{M} + m \cdot Y$, $\bar{M} > 0$, $m > 0$.

Case I: Fixed exchange Rate ($e = \bar{e}$)

i.e exchange rate does not respond to change in trade balance.

$\therefore \quad Y = C + I + G + X - M.$

$Y = \bar{C} + c'(Y-T) + \bar{I} + \bar{G} + \bar{X} - \bar{M} - m \cdot Y.$

Diff: $dY = c' \cdot dY + dG - m \cdot dY.$

$[1 - c' + m] \cdot dY = dG$

$$\frac{dY}{dG} = \frac{1}{1 - c' + m} = \frac{1}{s' + m}.$$

Case II: Flexible exchange rate

e is mkt determined.

If $TB < 0 \Rightarrow e \uparrow$.
If $TB > 0 \Rightarrow e \downarrow$.
$\Rightarrow$ under flexible exchange, 'e' will adjust so that $TB = 0$ always.

$TB = X - M$.

under flexible exchange rate $TB = 0 \Rightarrow X = M$.

i.e $\bar{X} = \bar{M} + m.Y$ --- (i)

$\therefore \quad Y = C + I + G + \underbrace{(X - M)}_{= 0 \ [\text{from (i)}]}$.

$Y = \bar{C} + c'(Y - T) + \bar{I} + \bar{G}$

Diff: $dY = c'.dY + dG \Rightarrow \frac{dY}{dG} = \frac{1}{1-c'} = \frac{1}{s}$.

$\underset{(₹)}{P} = \underset{(₹/\$)}{e} \, \underset{(\$)}{P_f}$