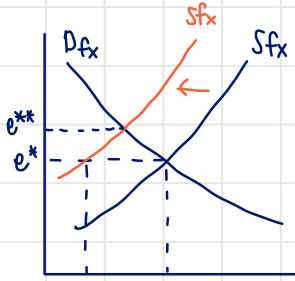


Assignment 4

Group 1

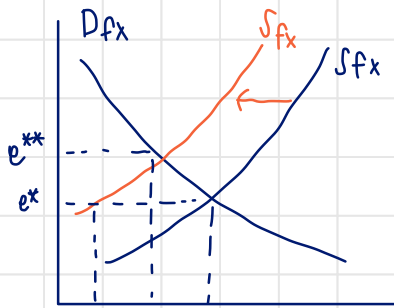
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1.1 The bank of Thailand cuts its policy rate



As bank of Thailand cuts the rate, interest rate decreases. This cause the change in demand for domestic asset. As interest rate decreases, people wouldn't want to invest in Thai market, causing less financial inflow. The supply of US dollars shift to the left. Now, there is an excess demand for US dollars and the exchange rate is now at e^{**} . Therefore, a cut in interest causes exchange rate to increase.

1.3 The US government has imposed a trade sanction on Thai's agricultural product exported to the US market.

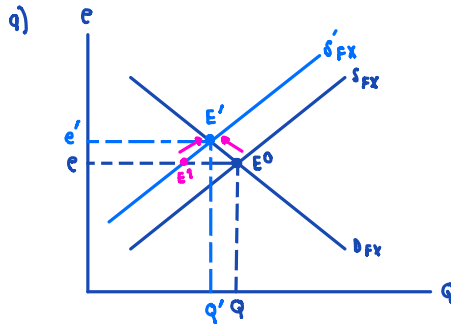


The trade sanction causes a drop in export. Since we cannot export goods to foreign countries, The supply of US dollars decreases. As the supply shift left, there is an excess demand for US dollars and the exchange rate is now increased from e^* to e^{**} . Therefore, the trade sanction on exported products causes exchange rate to increase.

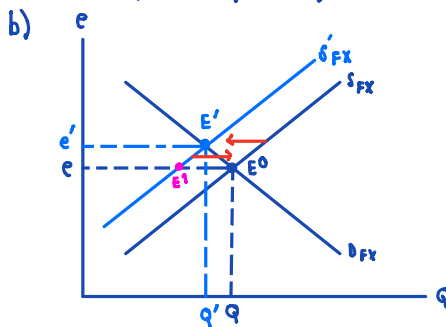
2

Question 2 Suppose that S&P, an international credit-rating agency, has decided to *downgrade* the credit rating of Thai economy. Answer the following problems.

- Under the flexible exchange rate, how does the ~~upgrade~~ **downgrade** of credit rating affect the value of Thai currency?
- If the authority wishes to resist the movement of the exchange rate (baht/USD), what does the authority need to do? Explain about the implementation process under the forex market intervention.
- Discuss about the unintended impact of the forex market intervention on the domestic financial system. If the authority wishes to limit the sided effect of the forex market intervention, what does the authority need to do?



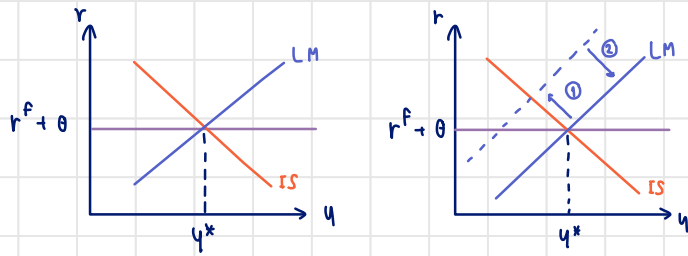
under the flexible exchange rate, when S & P (an international credit-rating agency) has decided to downgrade the credit rating of Thai economy, It will cause Thai creditability to invest falling down which leads to hesitation of foreigners to exchange US currency into THB currency. Therefore, supply curve will shift to the left. We can see that at fixed e , there is excess demand. In order to clear up excess demand, we have to rise exchange rate must be adjusted from E^0 to E' . This tells us that, when exchange rate increases, foreigners will supply USD because Thai products are cheaper relative to others, However, in demand for forex curve, domestic people will demand to hold less USD because it is more expensive since in the case of THB depreciation, foreign goods become more expensive.



As the result from the previous question (2a), we knew that THB depreciates. To solve this issue, central bank must supply the forex reserve because the market faced excess demand and when it is already occurred, supply for forex will shift back to the equilibrium (at E_0) which is at the original exchange rate

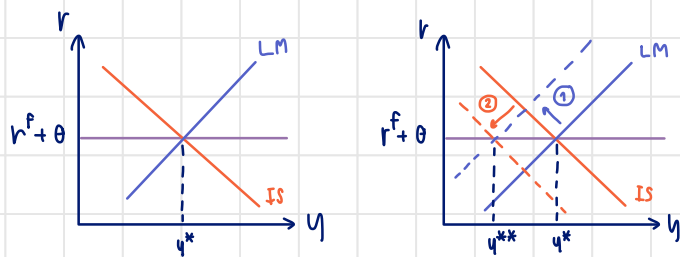
c) When central bank sold forex reserve, it causes a drop in forex reserve in Thailand, currency in the circulation and commercial bank reserve finally, it causes an increase in interest rate. To solve these, central bank must encourage people to buy government bond.

3.1 A reduction of money supply / fixed exchange rate



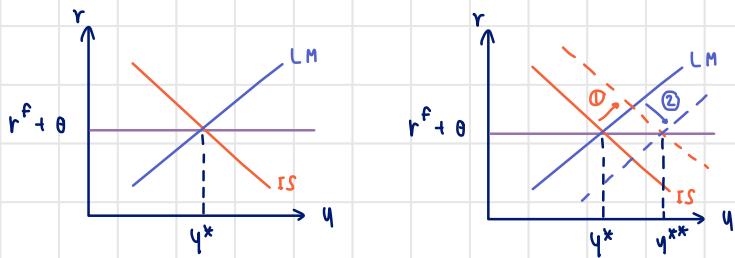
A reduction in Money supply causes LM curve to shift to the left. This causes interest rate to rise and increases capital inflow. As capital account increases, there is a surplus in the Balance of Payment. Under fixed exchange rate, the forex intervention is to buy more of US dollars in order to reduce Current Account to compensate with the increase in Capital Account. Central Bank has to print more Thai-baht, which resulted in an increase in domestic Money supply. LM shift back to the right and back to the original situation where Balance of Payment is equal to zero.

A reduction of money supply / flexible exchange rate



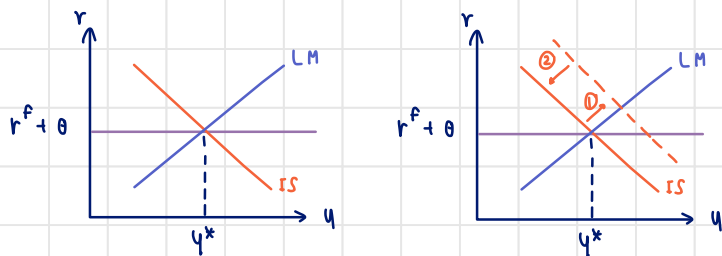
Reduction in money supply causes LM curve to shift to the right, and interest rate to increase. Under the flexible exchange rate, high interest rate causes exchange rate to appreciate. Thai baht is now appreciated, which causes the decrease in export and increase in import. This is because foreign products are now relatively cheaper than domestic product. High interest rate also affect the production by reducing Aggregated expenditure. Firms invest less and consumers borrow less, causing interest rate to be pushed down and shift IS curve to the left. In open economy, we end up having a deeper recession because exchange rate damaged the export sector. Effect of LM shock is amplified, reducing y^* to y^{**} .

3.3 Thai government has imposed a tariff on imported products / fixed exchange rate



Imposing tariff on imported products shift IS curve to the right, since import will be decreased, because people would turn to buy more of domestic products, causing an increase in net export and total aggregated expenditure. There is a Balance of Payment surplus because of the higher Current Account. Under the fixed exchange rate, Central Bank needs to buy more of US dollars to fix the Balance of Payment. Converting US dollars to Thai baht causes domestic money supply to increase, shifting LM curve to the left. This also create an expansionary impact because it stimulates people to consume and invest more. Aggregated expenditure increases even more and the new output level is at y^{**} , while the Balance of Payment is back at zero.

Thai government has imposed a tariff on imported products / flexible exchange rate



Imposing tariff on imported products shifts IS curve to the left. There is a Balance of payment surplus because of an increasing in Current Account, due to an increase in net export as people buy more of domestic product, because it is relatively cheaper than foreign product. As the demand for US dollars to drops, Thai baht appreciates, causing a decrease in export and increase in import. This causes the net export to decrease, resulted in a drop in aggregated expenditure IS curve shifts back to the original situation and the Balance of payment is equal to zero.