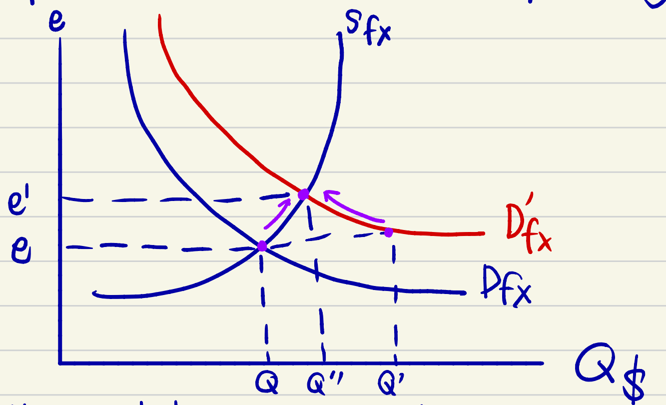
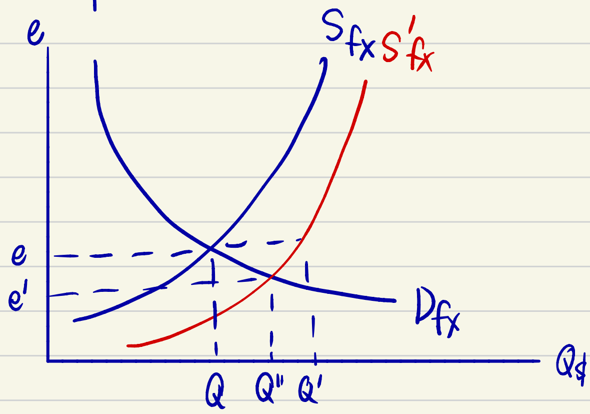
Group 4

2 Market expects that USD will be appreciating in the future



Since the market expects that USD will appreciate in the near future, domestic demand for US products will increase now since US products are expected to be more expensive. This would increase demand for USD, causing our imports to increase. As shown on the graph, D_{fx} shifts to the right. The initial excess demand will be eliminated by having USD appreciated from e to e'.

4 A positive improvement in production technology of Thailand causes a decrease in domestic price



If the domestic price for our products drop, foreign countries would demand our domestic products more. Therefore, this will result in an increase in exports, causing supply for USD to increase, as shown by the graph, S_{fx} shifts to the right to S'_{fx}. This initial excess supply will be eliminated by having USD depreciated and THB appreciated. (e goes down to e')

Group 4

Question 2

A. Under the flexible exchange rate, the downgrading in credit rating of Thai economy causes the increasing in exchange rate (Thai bath depreciation) which means that Thai currency will have less value than before.

b) The downgrading of Thai credit rating causes the exchange rate to increase or Thai Baht depreciation in the flexible exchange rate regime. So, the exchange rate after the situation occurred is less than the initial exchange rate or in other words, Thai Baht is overvalued and consequently the excess demand for foreign currency will occur in the economy. If the authority wants to maintain the exchange rate at the initial level, it has to sell the forex reserve in order to clear the excess demand for foreign currency.

c) Under the fixed exchange rate regime, the unintended effect will occur as the central bank wants to keep the exchange rate and intervene the market. In this case when central bank sells its forex reserve to the market the foreign currency reserve (FRA) will be decrease and it causes the decrease in money base and money supply since the banks have less money to create loan. Consequently, it drives the interest rate to go up as an unintended effect.

To limit the side effect of the intervention, central bank needs to rebalance the balance sheet without the effect to money base by purchasing more government bond or gold in order to offset the decrease in FRA.

Question 3

3.2) Increase in government spending

An increase in government spending will make IS curve shift to the right and effect the real interest rate to increase causing BP surplus. After interest rate increase there will have huge capital inflow, foreign firms will want to invest, hiring more people or decrease in unemployment rate also lead to more output

In fixed exchange rate, the central bank wants the real interest rate to remain the same. So, the central bank will buy foreign currency in the market leading to rising in money supply, LM shift to the right where the interest rate declines. Everything will return to BOP equal to 0. As a result, the output furthermore increased.

In a flexible exchange rate, many foreign currencies come into the country. The domestic currency appreciates making domestic products expensive so the export will be less, and aggregate expenditure will drop. Real interest rate will get adjusted by getting down to the original level where output remains the same.

3.4) Thai's credit rating condition has been improved.

Thai's credit rating condition has been improved, which means international investors are confident to invest in the country. People hold more cash and money supply will increase shifting the LM curve to the left. BOP surplus occurs where the interest rate increases.

In fixed exchange rate, the central bank wants the real interest rate to remain the same. The Central bank will buy foreign currencies making the money supply to increase and LM will shift right back to the original LM curve. This result in an increase in interest rate and output will remain the same.

In a flexible exchange rate, exchange rate decreases where THB appreciates damaging the export sector to decrease, import to increase and so the aggregate expenditure drops. Firms will invest less there is less demand for employment so the unemployment rate will increase and the output will decrease. IS will shift to the left and the interest rate will decrease back to the original spot.