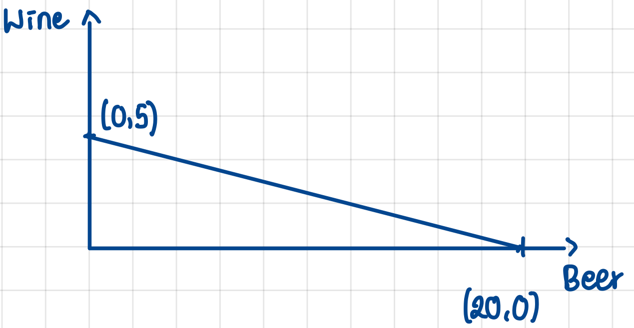
Answer

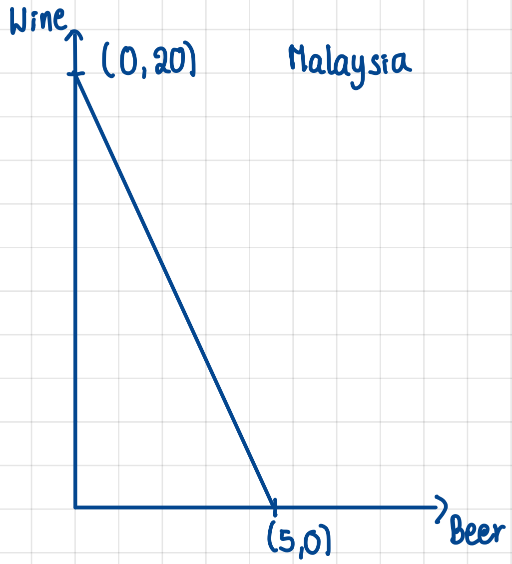
Exercise 8

1. The difference between "absolute" and "comparative" advantages is that absolute refers to when a country can produce a goods / service with fewer resource than other countries. Whereas, comparative advantage refers to when a country has lower opportunity cost than other country when producing a goods / service.

2. Thailand



Malaysia



For Thailand, to produce 1 unit of wine, they need to sacrify beer $= \frac{20}{5} = 4$ beer. And, to produce 1 beer, they to sacrify wine: $\frac{5}{20} = \frac{1}{4}$ beer. So, Thailand is good at producing beer.

For Malaysia, to produce 1 unit of wine, they need to sacrify $\frac{5}{20} = \frac{1}{4}$ beer. To produce 1 beer, they need to sacrify wine $= \frac{20}{5} = 4$ beer. So, Malaysia is good at producing wine.

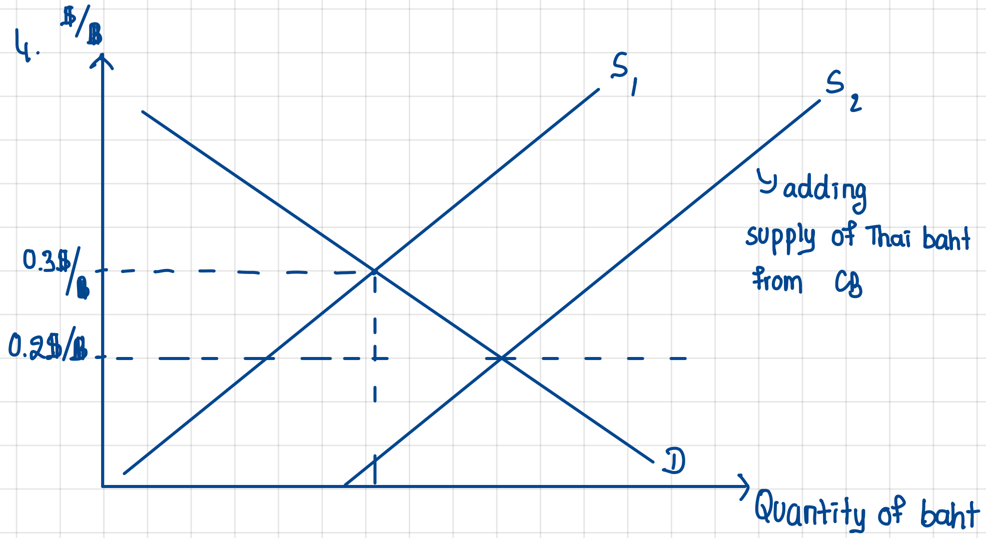
Both country can benefit from trading. If Thailand offers some beers to get wine from Malaysia instead of producing wine by themselves. Likewise, Malaysia can give some wine to Thailand and get beer instead of producing. With trading, both countries can produce outside PPF curve.

3. Current account surplus represents when $X > M$.

Capital account deficit represents when $K < 0$ or outflows > inflow.

The identity of BoP is when $CA + KA = 0$. That means, when we have CA surplus, we must have KA deficit and vice versa.

4.



Central bank can devalue Thai baht from $0.3/1฿ to $0.2/1฿ by selling baht to increase supply in the market and buying dollar as foreign reserve.

5. Floating exchange rate regime depends on the demand and supply of the currency.

- The rests of the world import more from Thailand
  - ↳ Demand for Thai baht increases
  - ↳ Thai baht appreciate.
- More Thai investors invest abroad
  - ↳ D for USD increases.
  - ↳ Thai baht depreciates.
- Thailand leave ASEAN
  - ↳ Thai baht depreciate.

6. Inflation cause a currency to appreciate or depreciate because when there's inflation.

- Interest rate increases which attracts foreign investors ⇒ D for baht increases ⇒ Thai baht appreciates.
- Price of domestic products rises which discourages export and raising import. ⇒ D for THB decreases ⇒ THB depreciates
- Purchasing power goes down, so people don't want to hold THB ⇒ D for THB drops ⇒ THB depreciates.

7. Calculate PPP : $\frac{\$400}{£300} = \$\frac{4}{3} = £1$

8. Calculate Real exchange rate : $\frac{40฿}{1} \times \frac{1}{20฿} = 2$

↳ It implies that 1 apples in UK = 2 apples in Thailand.

9. Assumptions that are required for the Law of One Price to hold is the cost of transportation is small or zero, so the price of goods at every where must be the same.