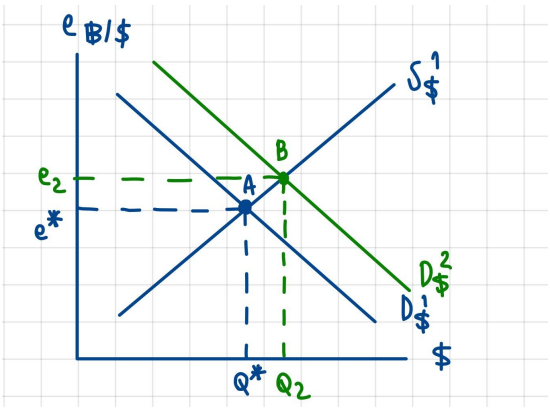
Group 2

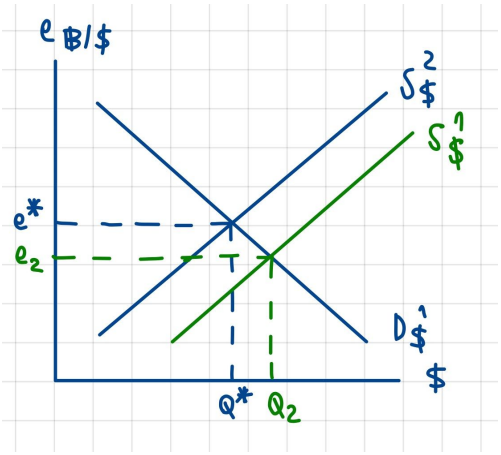
Question 1

1.2 Market expects that USD will be appreciating in the future



Demand for dollar increases so $D_{\$}$ shifts to the right from ($D^1_{\$}$ to $D^2_{\$}$)
At e*, there is an excess demand for dollar which can be eliminated by increasing exchange rate (e_1 to e_2) so that thai currency or baht will be depreciating, and dollar will be appreciating.

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



As the domestic price decreases, demand for domestic goods increases leading to a rise in export. Consequently, supply for dollar increases so $S_{\$}$ shifts to the right from ($S^1_{\$}$ to $S^2_{\$}$)
At e*, there is an excess supply for dollar which can be eliminated by decreasing exchange rate (e_1 to e_2) so that thai currency or baht will be appreciating, and dollar will be depreciating.

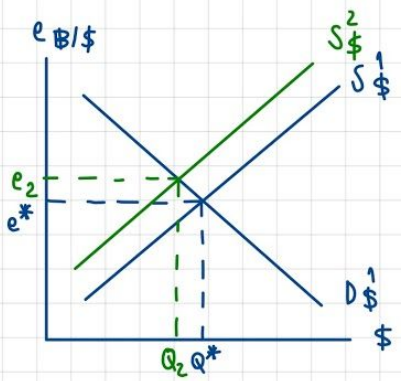
Question 2 Suppose that S&P, an international credit-rating agency, has decided to *downgrade* the credit rating of Thai economy. Answer the following problems.

a) Under the flexible exchange rate, how does the ~~upgrade~~ downgrade of credit rating affect the value of Thai currency?

b) 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.

c) 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?

a) Flexible exchange rate



relative risk of domestic asset ↑

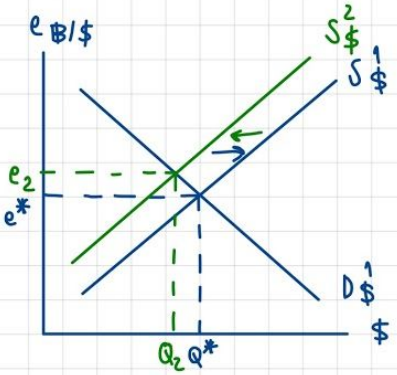
demand for domestic asset ↓

supply of $ ↓

$S_\$$ shifts to the left ($S^1_\$ \rightarrow S^2_\$$)

so, value of Thai currency (฿) is depreciating.

b) Manage Float



At e^*, excess demand for $ BOP < 0

to resist the movement of exchange rate, CB sells $ making $S^2_\$$ shift back to $S^1_\$$ exchange rate e_2 goes back to e^* and Q_2 back to Q^*

c) As CB sells $, this means that CB buys ฿.

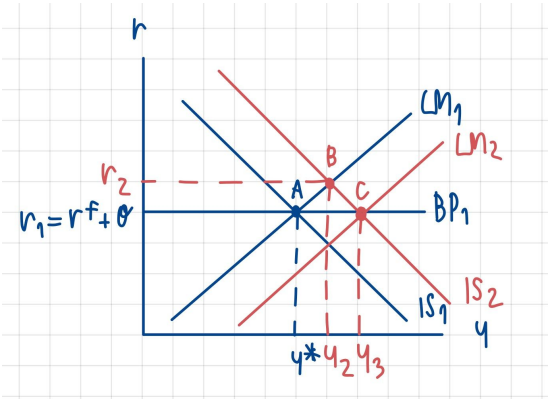
Foreign currency reserve ↓ monetary base ↓ money supply ↓

This is so called "unintended outcome of forex intervention"

CB needs to sterilize forex intervention by OMO purchase (CB buys securities) so that monetary base is fixed and also money supply.

Question 3

3.2 An increase in government spending
Fixed exchange rate

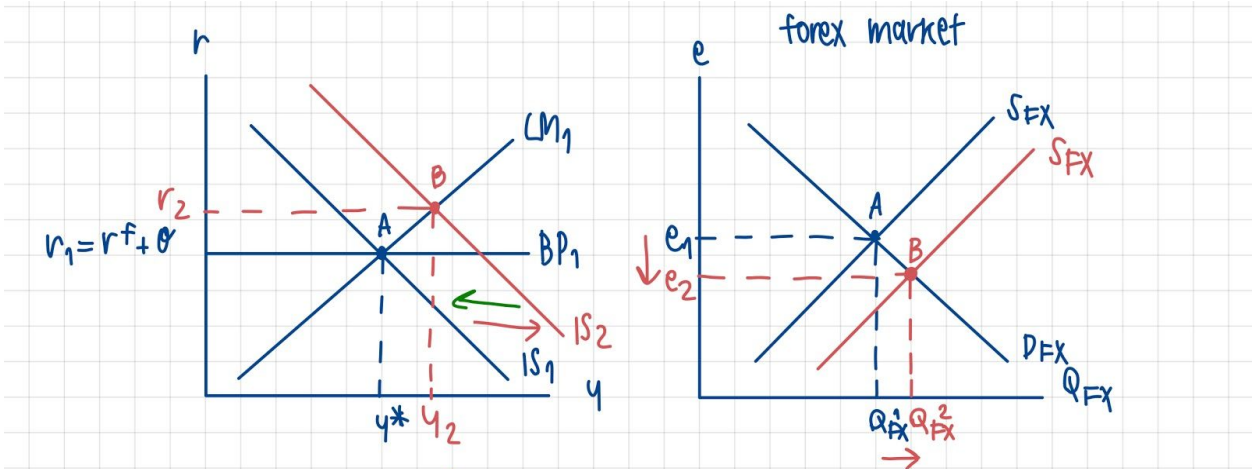


At point A, $r = r_1 = r^f + \theta$, $Y = Y^*$, BOP = 0.
BP curve is a horizontal line due to a perfect capital mobility.
As the government increases its spending, IS curve shifts to the right from IS_1 to IS_2.
Income increases from Y^* to Y_2 , and interest rate increases from (r_1 to r_2).
This implies that $r_2 > r^f + \theta$ which leads to a huge rise in capital inflow and then capital asset (KA).
Then BOP > 0 or BOP surplus. There is an excess supply of foreign currency (FX).
To fix the exchange rate (e), the central bank needs to buy FX and sell domestic currency making money supply increase so that the LM curve shifts to the right from LM_1 to LM_2. Interest rate decreases from r_2 to r_1 (back to the initial r), and income increases from Y_2 to Y_3.

Outcome;
Y increase from Y^* to Y_3 (Amplified)
r is constant
e is constant

Therefore, fiscal policy is effective because Y increases and is amplified.

3.2 Flexible Exchange Rate



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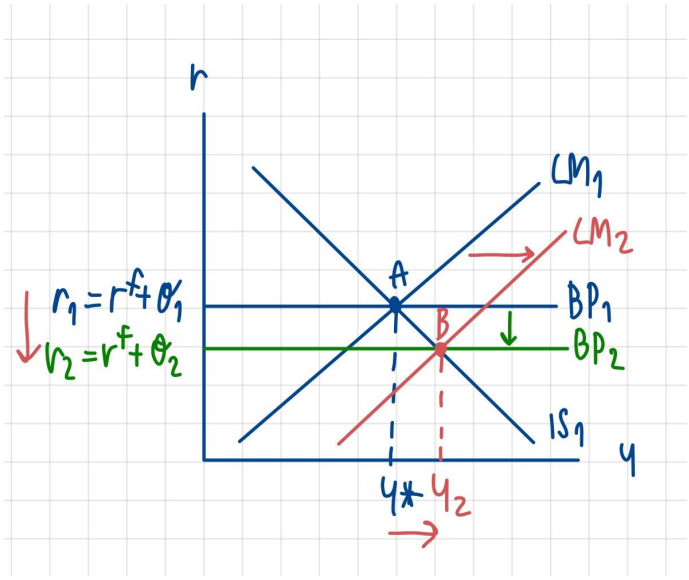
Income increases from Y^* to Y_2 , and interest rate increases from (r_1 to r_2).
This implies that $r_2 > r^f + \theta$ which leads to a huge rise in capital inflow and capital asset (KA). Supply of the foreign currency increases making S_{FX} shift to the right from S^1_{FX} to S^2_{FX} . There is an excess supply of FX.
To eliminate excess supply of FX, exchange rate need to be decreased from e_1 to e_2
Foreign goods become relatively cheaper so that import increases but export decreases. Therefore, net export decrease; IS curve shift to the left from IS_2 back to IS_1.
Y decrease from Y_2 back to Y_3 and interest rate decrease from r_2 back to r_1.

Outcome:
Y is constant
r is constant
e decreases from e_1 to e_2
Foreign currency depreciated, and domestic currency appreciated.

Therefore, fiscal policy is not effective because Y does not change or is insulated.

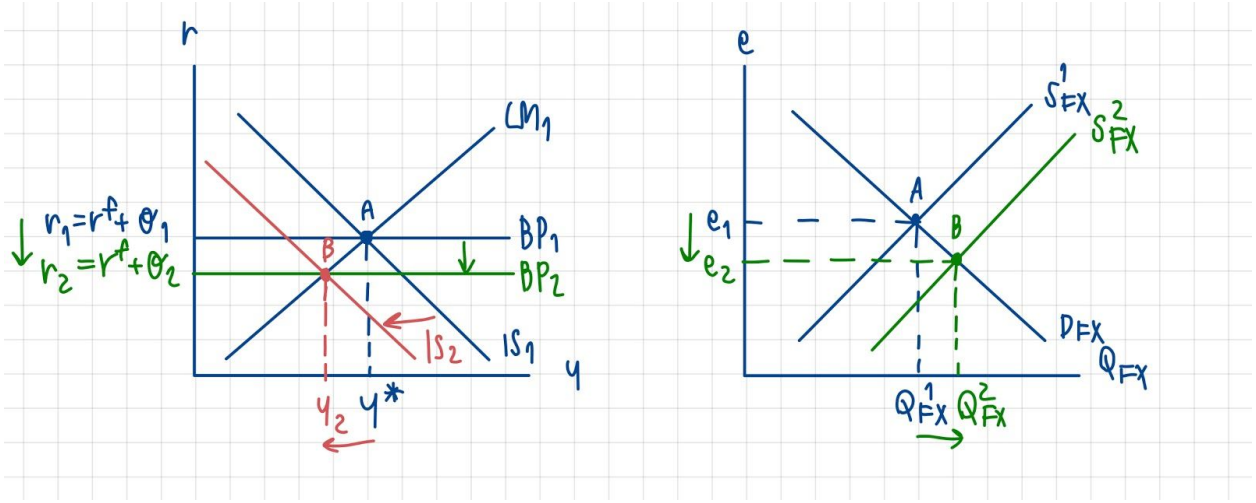
3.4 Thai's credit rating condition have been improved
Fixed Exchange Rate



At point A, $r = r_1 = r^f + \theta$, $Y = Y^*$, BOP = 0.
BP curve is a horizontal line due to a perfect capital mobility.
As credit rating increases, risk decreases from θ_1 to θ_2.
BP shifts down BP_1 to BP_2.
This implies that $r_1 > r^f + \theta_2$ which leads to a huge rise in capital inflow and then capital asset.
Then, BOP > 0 or BOP surplus. There is an excess supply of foreign currency (FX).
To fix the exchange rate (e), the central bank needs to buy FX and sell domestic currency making money supply increase so that the LM curve shifts to the right from LM_1 to LM_2. Interest rate decreases from r_1 to r_2 , and income increases from Y^* to Y_2.

Outcome :
r decreases from r_1 to r_2
Y increases from Y^* to Y_2 (Amplified)
e is constant

3.4 Flexible Exchange Rate



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Foreign goods become relatively cheaper so that import increases but export decreases. Therefore, net export decrease; IS curve shift to the left from IS_1 to IS_2 making Y decrease from Y* to Y_2.

Outcome:
Y decreases from Y* to Y_2 (Amplified)
r decreases from r_1 to r_2
e decreases from e_1 to e_2