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Exercise 8

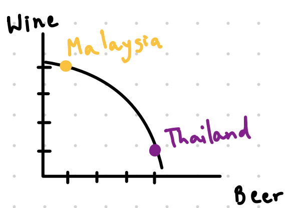
International Economics

1. What is the difference between "absolute" and "comparative" advantages? What are the main implications of these two theories? (i.e. what do they suggest?)

- These two theories supports free trade, stating that all countries gain from free trade.
- Absolute Advantage is the advantage of one country when it uses fewer resources to produce a good than the other country does.
- Comparative Advantage is the advantage of one country when that it produces a good at a lower opportunity cost than the other country does.

2. The table below shows the amount of production that <u>one worker</u> in each country can produce. Assume that each country has 5 workers. **<u>Draw a PPF and show</u>** that both countries will benefit from trade.

	Thailand	Malaysia
Beer	4	1
Wine	1	4



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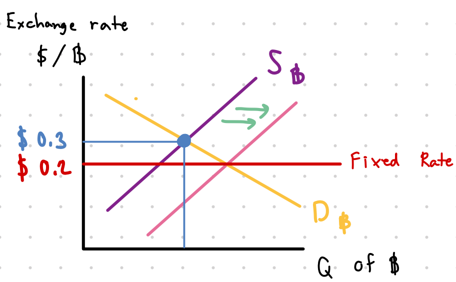
3. What do “current account surplus” and “capital account deficit” represent? What is the “Balance of Payment Identity”?

- Current Account surplus = X > M → trade surplus
- Capital Account deficit = KA < 0 → money is flowing out
- Balance of Payment Identity = a statement of all transaction made between agents in a period of time

4. Suppose the current market exchange rate is $0.3 / 1 Baht. Use the foreign exchange market diagram to explain how the Central Bank of Thailand can “devalue” Thai baht to $0.2 / 1 Baht under the fixed exchange rate regime.



5. How does the floating exchange rate regime work? Under such regime, how does each of the following events affect Thai Baht (assumed to be a domestic currency)?
   - The rest of the world imports more from Thailand. Demand ฿ (Appreciation ฿)
   - More Thai investors invest abroad. Supply ฿ (Depreciation)
   - Thailand will leave ASEAN (similar to the UK leaving the EU). Supply ฿ (Depreciation)

6. In the floating exchange rate regime, why might inflation cause a currency to appreciate and depreciate?

1. interest rate increase
2. price of domestic goods becomes expensive
3. purchasing power of the currency is eroding

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7. Suppose an iPhoneX is priced at 400 USD in the US and 300 GBP in the UK. Calculate the PPP exchange rate between USD and GBP.

PPP exchange rate = $\frac{400}{300} \approx 1.333$

8. Suppose the nominal exchange rate is 40 THB / 1 GBP. One apple costs 20 THB in Thailand, but costs 1 GBP in the UK. Calculate the real exchange rate.

real exchange rate = $\frac{40\ ฿}{1\ ¢} \times \frac{1\ ¢}{20\ ฿}$

$= 2\ ¢$

9. What assumptions are required for the Law of One Price to hold?

- cost of transportation are small so price of the same good in different countries should be the same.

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