

Exercise 8

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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?)

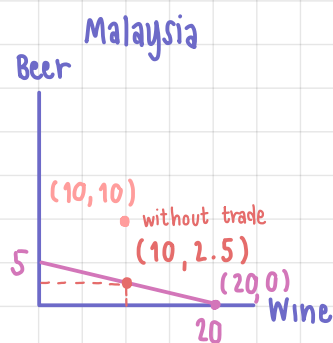
absolute advantage: advantage of one country when it use fewer resources to produce a good than the other country does

comparative advantage: advantage of one country when that it produces a good at a lower opportunity cost (in term of other goods that must be forgone) than the other country does

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

Production Possibility Frontier

	Thailand	Malaysia
Beer	$4 \times 5 = 20$	$1 \times 5 = 5$
Wine	$1 \times 5 = 5$	$4 \times 5 = 20$



Thailand has absolute advantage in beer production (1 worker \rightarrow 4 beers)

Malaysia has absolute advantage in wine production (1 worker \rightarrow 4 wines)

Thailand can allocate 5 workers for beer production to produce 20 beers

Malaysia can allocate 5 workers for wine production to produce 20 wines

with specialization and trade

Thailand can get 10 wines from Malaysia

Malaysia can get 10 beers from Thailand

Finally Thailand has 10 beers & 10 wines

Malaysia has 10 beers & 10 wines

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

current account surplus ($X > M$) represent trade surplus (inflows $>$ outflows)

deficit in capital account ($KA < 0$) means money is flowing out of the country (outflows $>$ inflows). The nation is increasing its ownership of foreign assets

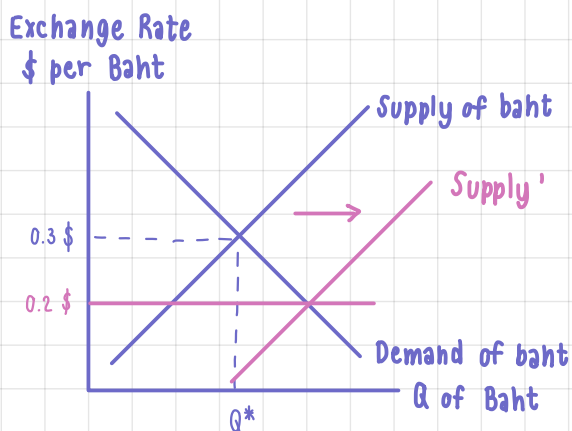
Balance of Payment (BoP) identity

$$\text{BoP} = \text{Current Account (CA)} + \text{Capital Account (KA)} = 0$$

means if we have CA deficit, we must have KA surplus

if we have CA surplus, we must have KA deficit

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.



To devalue THB, Central Bank has to increase supply of THB and buy USD. Then, the exchange rate of THB will fall (depreciation)

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)?

Floating exchange rate \rightarrow equilibrium rate is determined by the demand & supply of currency

- The rest of the world imports more from Thailand.
Appreciation of THB because demand for THB increase
- More Thai investors invest abroad.
Depreciation of THB because supply of THB increase
- Thailand will leave ASEAN (similar to the UK leaving the EU).
Depreciation of THB because demand for THB decrease

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

If there is an inflation in Thailand, the interest rate will increase. It means that the return from investment will be high, so foreigners will invest more in Thailand and cause to appreciation of THB.

On the other hand, domestic goods & services price will increase, then the export will decrease and it causes depreciation in THB.

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.

$$\begin{array}{l} \text{iPhone X} \\ 400 \text{ USD} \\ 300 \text{ GBP} \end{array} \Rightarrow \begin{array}{l} \text{PPP exchange rate} \\ 400 \text{ USD} : 300 \text{ GBP} \\ \frac{400 \text{ USD}}{300} : 1 \text{ GBP} \\ 1.333 \text{ USD} : 1 \text{ GBP} \end{array}$$

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.

$$\text{Real exchange rate (RER)} = \text{Nominal exchange rate (THB/GBP)} \times (P_{\text{UK}} / P_{\text{TH}})$$

$$\text{RER} = \frac{40 \text{ THB}}{1 \text{ GBP}} \times \frac{1 \text{ GBP}}{20 \text{ THB}} = 2$$

Real exchange rate (THB/GBP) is 2
mean people are willing to exchange 2 Thai apples for 1 UK apple

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

Law of one price \rightarrow if the costs of transportation are small, the price of the same good in different countries should be roughly the same.