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?)

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

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

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.
   - More Thai investors invest abroad.
   - Thailand will leave ASEAN (similar to the UK leaving the EU).

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

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.

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.

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

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?)

1) Absolute advantage = the ability of a country to produce a good or service more efficiently than its competitors

* A country should specialize in producing the good that it has absolute advantage

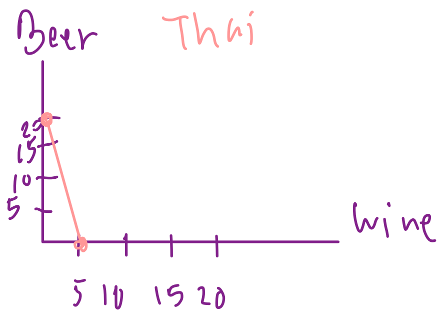
• two countries with different specialization can trade and both countries will benefit

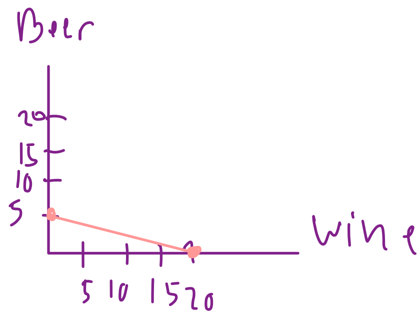
2) Comparative advantages

= the ability of country to produce goods & services less opportunity cost than its competitors.

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.

	Thailand	Malaysia
Beer	4 20	1 5
Wine	1 5	4 20





Thai allocate 1 to make 4 beer,
allocate 4 to make 1 beer

Malaysia allocat 1 to make 4 wine,
allocate 4 to make 4 wine

w/o trade

	TH	Malay
Beer	4	4
Wine	4	4

w/ specialisation

	TH		Malay
Beer	20	$\xrightarrow{10}$	0
Wine	0	$\xleftarrow{10}$	20

W/ specialisation + trade

	TH	Malay
Beer	10	10
Wine	10	10

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

current account surplus = it's when inflows more than outflow, meaning that a country has more exports than imports of goods and services

capital account deficit = money is flowing out of the country and it's suggest the is increasing its ownership of foreign assets

Balance of Payment

= statement of all transactions made between agents in one country an the rest of the world over a defined period of time

BOP = current account + capital account

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.

CB can increase supply of baht.
It can sell baht and buy USD from the foreign exchang market. This will lead to depreciation in THB.

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

In floating exchange rate regime

- Appreciation of currency, the rise in value of one currency relative to another

- Depreciation of currency, the fall in value of one currency relative to another.

1) the rest of the world imports more from Thailand

= increase in demand for Thai bath, thus Thai bath appreciates.

2) More Thai investors invest abroad

= more Demand of US D and more supply of thai bath

THB depreciates while USD appreciats

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

It can increase interest rate and attract foreign investors, demand for THB increases and THB appreciates.

But it can imply that domestic goods become more expensive, Thus reducing export while raising import. (THB depreciates)

moreover, the purchasing power of the currency is eroding, which discourages any one from holding the currency. (THB depreciates)

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.

$$\frac{300}{400}$$

$$= 3 \text{ GBP} / 4 \text{ USD}$$

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 exchang rate $= \frac{40}{1} \times \frac{1}{20}$

$= 2$

In terms of purchasing power, people are willing to exchange 2 Thai apple for 1 UK apple

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

Law of One price

: if the cost of transportation are small,

the price of the same good in different

countries should be roughly the same