



Problem sets 3: Foreign exchange market

EE312: Intermediate macroeconomics

Semester 1/2018

Instructor: Dr. Kittichai Saelee

Due on September 19th, 2018 at the BE office. (before 3 pm)

Question 1: The law of one price revisited. (will not be graded)

- a) In class, we discussed an important proposition/theorem in international trade, known as the *law of one price*. The theorem suggests that, under the international trading system without trading frictions/restrictions, the price of an identical product must be the same across countries. *Explain the mechanism why the theorem holds true.*
- b) Suppose instead that international trading system is full of frictions. For example, government might impose tax on imports/exports of goods. Do you think the law of price can still hold if the imposition is to be lasting forever?
- c) Find a line of your own argument and convince that even under the trading frictions as mentioned in (b), *law of one price can still be established if factor inputs and firms can freely relocate across border*. Analyze the possibility that the statement can be correct with some economics intuitions provided.

Question 2: (Graded by your TA) Use the exchange rate theorem and analyze the impact of the following developments on the market exchange rate, i.e. the value of Thai baht against the USD. (When you answer each question, use the diagram that we discussed in class, and provide some economics intuitions that support your narrative answer.)

- a) Market expects that the Bank of Thailand will raise its policy rate soon.
- b) Productivity growth in Thailand has declined rapidly.
- c) Market expects that US dollar will be appreciating in the future.
- d) Rumor about the trouble in Thai banking sectors has become materialized.