



Quiz 2: Forex market

EE312: Intermediate macroeconomics

Semester 1/2018

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Question 1 (10 points) True or False. **Comment on the statement.** Supplement your analysis with figures or graphs.

"As the expansionary fiscal policy tends to push up the market interest rates, domestic currency is expected to appreciate"

Most answered that it is correct. The line of argument is follows: rising interest rate creates a capital inflow. This results in the increase in supply of the USD in the forex market. Therefore, Baht should get appreciated. (I will omit the figure.) As I don't require your comprehensive answer, you will get full marks for this answer.

My comment to your answer is that you don't really comment the statement. To comment on thing, you should discuss more about what might be not given, but considered important. Now, I'd like to give you another version of the answer that some of your friends made in the quiz. And, this answer is correct. The argument your friends made was that "Because income usually rises along with the expansionary fiscal policy, it will create more demand for imports. This will turn to create higher demand for the USD, and hence a depreciation then". The line of reasoning is as equally correct asy yours! (Those who answer this way will get full marks as well.) You and your friends are doing the same thing, but you and your friends might have different assumptions. So, to comment the statement, you should mention both cases and come up with a statement that warp up everything. (One one hand,... this is true, on the other hand, this is also true....)

So, it comes to you judgment when you make some comments on the statement. That is, you should answer that it depends on which one is dominating. If the supply side of USD matters more, the statement above is correct. If the demand side of USD matters more, the statement above is wrong. Generally, the answer to this question will be related to the degree of capital mobility. The higher degree of capital mobility, the more likely it is that the statement is true. That's because the capital account is likely to be dominating the whole balance of payments. (Imagine the horizontal BP line.) The opposite is true when there are frictions that make it hard to make the capital mobile across countries. (Imagine the case with perfect capital control. In that case, trade balance matters only – i.e. vertical BP line)

Those are my general comments to your work.