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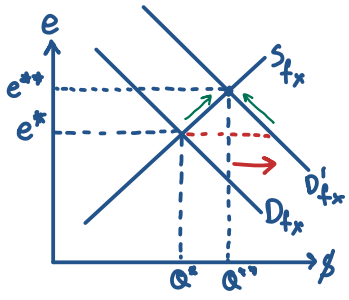
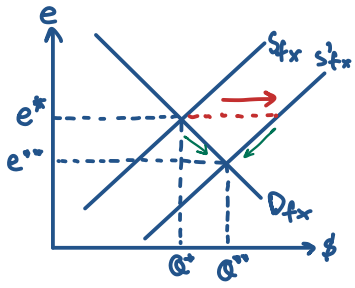
1.2 Market expects that US dollar will be appreciating in the future.



Since the market expects that USD will be appreciating in the future; therefore, the demand for USD will increase. The demand curve shifts to the right from D_{fx} to D'_{fx}. At e^{*}, there exists the excess demand for USD. The exchang rate increases from e^{*} to e^{**} which is new equilibrium. Since the increasing in exchange rate, supply of USD increases because Thai baht depreciates. Not only this but also demand for USD decreases due to the appreciating in USD. Both the previous reasons are the reasons that how the market clears the excess demand at e^{*}. Hence, the prediction is the exchange rate will increase.

1.4 A positive improvement in production technology of Thailand causes a decrease in domestic price.



Because of the decreasing in domestic price, the demand for THB will increase. Since, demand for THB increases; therefore, supply of USD will increase that supply curve shifts to the right from S_{fx} to S'_{fx}. At e^{*}, there exists excess supply of USD. The exchange rate decreases from e^{*} to e^{**} that is new equilibrium. Due to the decreasing in exchange rate, THB gets appreciates. Therefore, supply of USD is decreasing. Apart from this, because THB gets appreciates; then, USD will get depreciate. Therefore, demand for USD increases. The excess supply was cleared by this two reasons. Hence, the prediction is the exchange rate will decrease.

Question 2 Suppose that S&P, an international credit-rating agency, has decided to *downgrade* the credit rating of Thai economy. Answer the following problems.

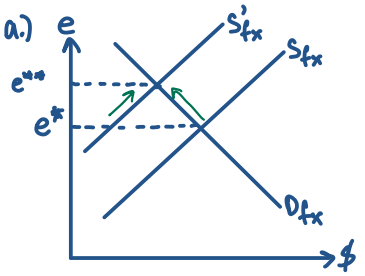
{Thai economy become riskier ↑

a) Under the flexible exchange rate, how does the *downgrade* of credit rating affect the value of Thai currency?

b) If the authority wishes to resist the movement of the exchange rate (baht/USD), what does the authority need to do? Explain about the implementation process under the forex market intervention.

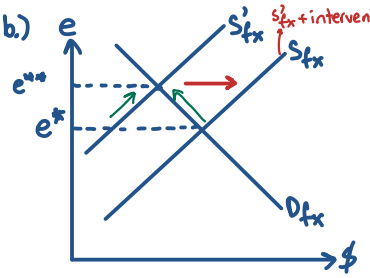
c) Discuss about the unintended impact of the forex market intervention on the domestic financial system. If the authority wishes to limit the sided effect of the forex market intervention, what does the authority need to do?

a.)



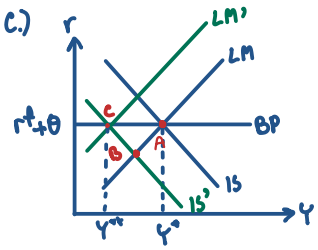
Since Thai economy was downgraded of credit rating by S&P agency. Generally speaking, Thai economy become riskier. Due to this phenomena, the demand for THB decreases. In other word, supply of USD decrease. It causes supply curve shifts to the left. Therefore, at e^{*}, there is excess money demand for USD. Then, the exchange rate increases from e^{*} to e^{**}. THB gets depreciated. Therefore, supply of USD increases and demand for USD decreases. Under the flexible exchange rate, excess demand for USD was cleared by increasing the exchange rate.

b.)



If authority wants to resist the increasing in the exchange rate, at e^{**} there is an excess demand for USD. Therefore, center bank must intervene the market by selling USD to the market. Then, supply curve shifts to the right from S'_{fx} to S'_{fx}+intervention. Then, the exchange rate decrease to e^{*} again. THB gets appreciated.

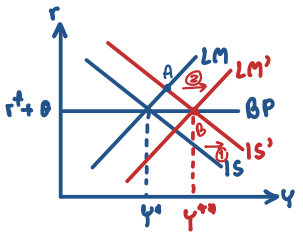
C.)



According to Thai economy becomes riskier, IS curve shifts left due to less in investment At point B, Balance of payment is deficit (BOP<0). If the authority wishes to limit this side effects in the forex market; then, center bank needs to sell USD. Therefore, money supply of THB decreases. LM curve shifts to left from LM to LM'(M↓). Therefore, there is new equilibrium at point C which output reduces from Y^* to Y''.

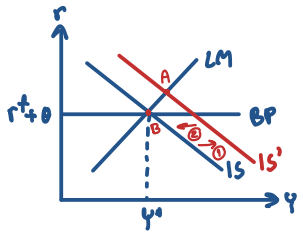
3.2) An increase in government spending.

fixed exchange rate:



When government increases government spending, IS curve shifts to the right. At point A, It exists Balance of payment surplus (BOP>0). Therefore, center bank must buy USD in order to peg the exchange rate. Since center bank buys USD, the money supply of THB increase. Then, LM curve shifts to the right. Therefore, the new equilibrium occurs at point B, where IS=LM=BP and output increases from Y^* to Y''.

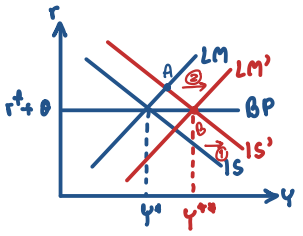
flexible exchange rate:



According to the increasing in government spending, IS curve shifts to the right from IS to IS'. At point A, there is a surplus in balance of payment. Under the flexible exchange rate, real exchange rate decreases; THB gets appreciated. Therefore, export is decreasing and import is increasing. Therefore, there is a decreasing in current account. IS curve shifts to the left and meets the same equilibrium at point B, output = Y^*.

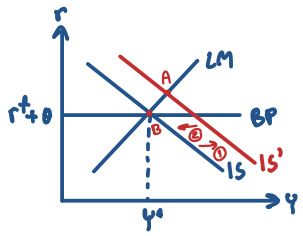
3.4) Thai's credit rating condition has been improved.

fixed exchange rate:



Since Thai's credit rating condition has been improved, generally speaking, our country has a lower risk, stable in economy. foreigners want to invest in our country. Then, IS curve shifts to right. At point A, there exists a surplus in BOP; Then, under fixed exchange rate, government would buy USD. Therefore, money supply of THB increases, LM shifts to the right and exists new equilibrium at point B, Y increases from Y^* to Y''

flexible exchange rate:



Since Thai's credit rating condition has been improved, generally speaking, our country has a lower risk, stable in economy. foreigners want to invest in our country. Then, IS curve shifts to right. At point A, there exists a surplus in BOP; Then, Under the flexible exchange rate, real exchange rate decreases; THB gets appreciated. Therefore, export is decreasing and import is increasing. Therefore, there is a decreasing in current account. IS curve shifts to the left and meets the same equilibrium at point B, output = Y^*.