Solutions

2.1

- CA $= (210 - 180) - 12 + 4 = +\mathbf{22}$.
- Financial account $= -\mathbf{22}$ – the country invests abroad.

2.2

- $CA = S - I = +22$: national saving exceeds investment by 22.
- The country is a net LENDER to the rest of the world.

2.3

- PPP $= 1{,}170/900 = \mathbf{1.30}$ dollars per home currency.
- Market $1.20 < 1.30$: the home currency looks CHEAP.
- The force: buy the cheap currency / its goods – exports and inflows should push the rate toward parity.

2.4

- Expected rate $= 1.20 \times 1.04/1.06 = \mathbf{1.177}$.
- The home currency is expected to APPRECIATE about 2%.
- A saver comparing deposits is indifferent under the model – the 2-point rate gap is exactly the expected gain.

2.5

- Tightening $\rightarrow$ capital inflow $\rightarrow$ home currency appreciates $\rightarrow$ exports dearer, imports cheaper $\rightarrow$ the current account narrows (moves toward deficit).
- The exchange rate is a transmission channel, not a scoreboard.

2.6

- PPP: baskets differ, transport and borders are real – it anchors decades, not months.
- Carry traders: UIP fails in the short run, so borrowing low and lending high can earn the gap without the offsetting depreciation – riskily.

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