1. **Fixed exchange rates**: The only way to keep the exchange rate (peso/$) fixed at a lower rate than the market would bear on its own would be for the Mexican central bank to purchase pesos to keep its value high. This purchase of pesos lowers the amount of pesos in circulation, thereby reducing the money supply. The way they do this is by selling an equal value of their dollar denominated asset holdings.

2a. **Fixed exchange rates**: The initial effect is for the foreign return curve to shift down. On its own this would produce an equilibrium at point c with a drop in the exchange rate from \( E_f \) to \( E_1 \) (an appreciation in the value of the domestic currency). However, the domestic central bank is committed to maintaining an exchange rate of \( E_f \) by the use of monetary policy. To keep this exchange rate the domestic interest rate must also fall, implying that the domestic money supply must increase. This increase is shown above and moves the equilibria to points b.

3. **Balance of Payments**

   As stated in the question, all transactions are as they would appear on the U.S. BOP accounts.

   **a)** A California computer manufacturer purchases a hard disk from a Malaysian company, using a bank account in Malaysia.

<table>
<thead>
<tr>
<th>Description</th>
<th>BOP Account</th>
<th>Credit</th>
<th>Debit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hard disk imported from Malaysia</td>
<td>CA (↓)</td>
<td></td>
<td>-</td>
</tr>
<tr>
<td>Withdrawal from Malaysian bank account</td>
<td>FA (↑)</td>
<td>+</td>
<td></td>
</tr>
</tbody>
</table>

   **b)** The U.S. central bank sells some of its holdings of U.S. Treasury bonds to a British financial firm.

<table>
<thead>
<tr>
<th>Description</th>
<th>BOP Account</th>
<th>Credit</th>
<th>Debit</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Treasury bonds sold to British firm</td>
<td>FA (↑)</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>U.S. central bank receives £ deposits in payment for bonds</td>
<td>FA (↓)</td>
<td></td>
<td>-</td>
</tr>
</tbody>
</table>

4. **BOP Accounting**

   **a)** \( \text{BOP} = CA + FA + KA = 0 \)
CA + KA = -FA  

Current account deficit of $1 billion ($1000 million) and the capital account is in a $100 million surplus.

-1000 + $100 = -FA

FA = $900

The financial account records financial flows into and out of the country. In this case, the FA surplus indicates that on net, foreigners purchased more Ikonomian assets (FAL) than Ikonomians purchased foreign assets. Therefore, the external wealth of Ikonomia declined by $900 million.

b) The current account can be split into three components: the trade balance (final goods and services), net factor income from abroad (payments to/from factor services) and net unilateral transfers.

CA = TB + NFIA + NUT

-1000 = -800 + NFIA + 0

NFIA = -$200

In the question, we are given the trade balance (-$800 million) and the current account (-$1000 million).

Net factor income from abroad is -$200 million. This implies that foreign factors of production located in Ikonomia earned more than Ikonomian factors abroad.

NFIA = EX_{FS} – IM_{FS}

-200 = 700 – IM_{FS}

IM_{FS} = 900

Foreign factors located in Ikonomia earned $900 million.

c) See above. NFIA = -$200 million

d) We know that GDP = C + I + G + (EX – IM)

GNI = GDP + NFIA

GNI = $9,000 + (-$200)

GNI = $8,800