

International Finance
Problem set 3
City University
Spring 2007

Question 1:

Suppose you are a US resident, trying to decide whether to hold a US dollar deposit, or a Euro deposit in France.

Assuming you care only about expected returns, and ignoring risk, what are the factors that will influence your decisions?

Let $R\$$ be the interest rate per year on dollar deposits, R the rate on Euro deposits, and denote by e the exchange rate, defined in dollars per Euro. Furthermore, let eE be the expected (dollars per Euro) exchange rate a year in the future.

1. Is an increase in e an appreciation or a depreciation of the dollar against the Euro?
2. On a graph with e on the vertical axis, and expected returns on deposits on the horizontal axis, show the equilibrium value of the exchange rate. (Hint: Remember that the dollar rate of return on Euro deposits is given by $R + (eE - e)/e$)
Explain how, starting from a value of the exchange rate greater than the equilibrium, e adjusts to its equilibrium value.
Does an increase in the interest rate on dollar deposits lead to an appreciation or a depreciation of the Euro against the dollar?

1. Suppose that $R\$ = 2\%$, $R = 4\%$, and $eE = \$0.97$
What is the equilibrium value of e if uncovered interest parity holds?

Question 2:

Suppose you expect the Croatian currency, the Kuna, to appreciate 5% relative to the UK Pound over the next 6 months. What additional information would you need in order to decide whether it is a good time to buy Kuna? Suppose you find out in the newspapers that the interest rate on Kuna deposits is 7%. What is the expected Pound return on Kuna deposits? What must the UK interest rate be if the uncovered interest parity condition holds?

Question 3:

Suppose you are a producer of asphalt located in China. Petroleum is one of the major inputs for asphalt. Your company must import petroleum which is sold in a world market and priced in U.S. dollars. How are the profits of your company affected when the yuan appreciates against the dollar?

Question 4:

Suppose you are producing bicycles in Poland and you sold on credit merchandise worth £1 million to a German distributor. They are due to pay you in 3 months. Under what exchange rate expectations (expected depreciation or appreciation of the Pound) would it be to your advantage to delay this payment?