

Finance 30220
Solutions to Problem Set #10

- 1) The real exchange rate is defined as the relative price of foreign goods in terms of domestic goods as is calculated as

$$Q = eP^*/P$$

In this case, we have the dollar price of Baht is .023, the US price level is \$177 and the Thai price level is 5,850.

$$Q = .023 * 5850 / 177 = .76 \text{ Thai goods per US good.}$$

- 2) The Euro exchange rate is 1.45 \$/Euro while the dollar Rupee exchange rate is .02 \$/Rupee. Therefore,

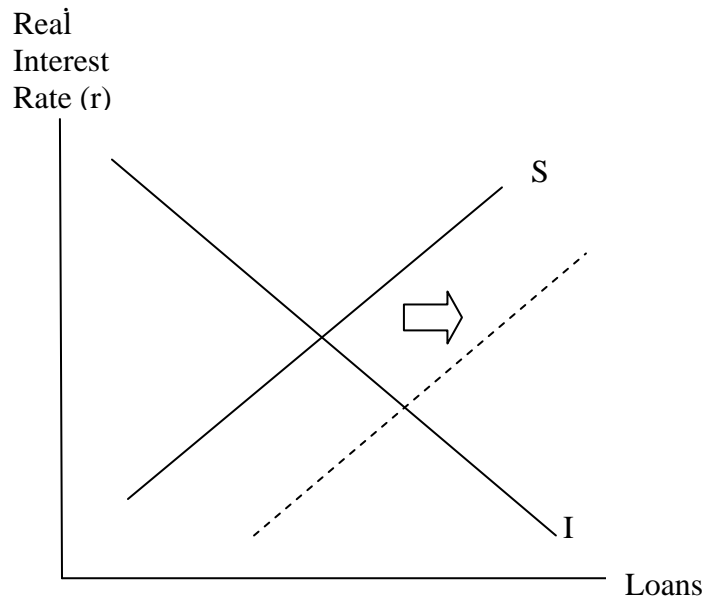
$$1.45 / .02 = 72.5 \text{ Rupees/Euro or } .014 \text{ Euros/Rupee}$$

- 3) Uncovered interest parity implies that interest rates and exchange rates should adjust so that nobody expects to make money. The bottom line is that any difference between foreign and domestic interest rates should be offset by currency appreciation depreciation.

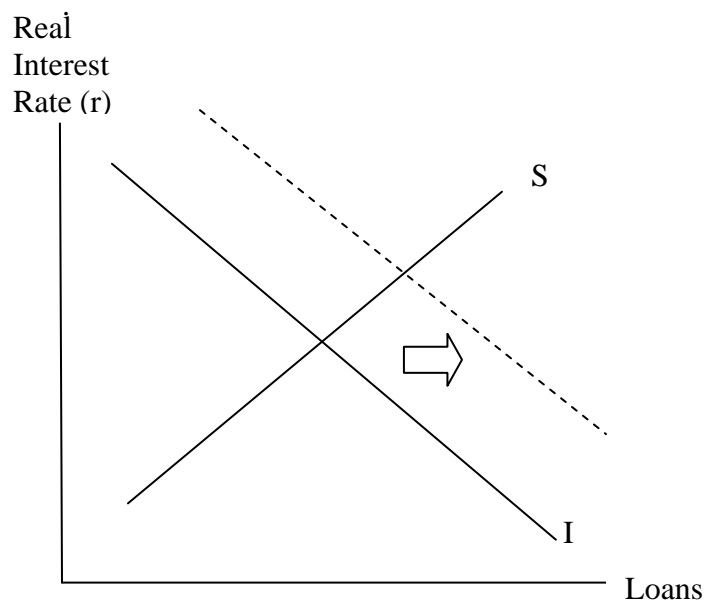
European risk free returns are one percent higher per year than the dollar risk free rate of return. Therefore, for European and US risk free assets to pay equivalent same currency returns, the Euro would need to depreciate by 1% (to 1.53) over the coming year.

4)

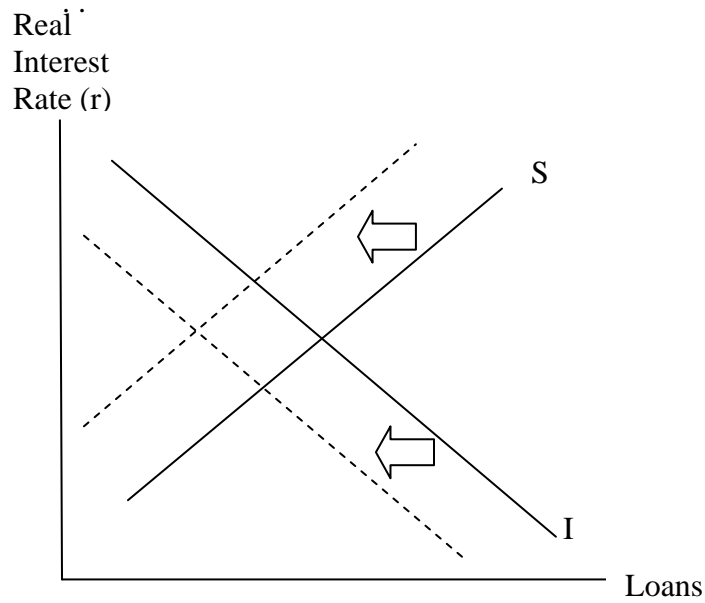
- a) Savings will most likely increase in anticipation of bad times ahead. Investment is unchanged and the trade balance improves.



- b) Investment increases, savings is unchanged and the trade balance worsens.



- c) Investment falls, savings falls (assuming that this oil price hike is temporary) and the trade balance effect is ambiguous



- d) Assuming people spend the tax cut, interest rates rise and the trade balance worsens. However, if people save the tax cut, interest rates remain the same, as does the trade balance.

