1. (10p) Explain how the US Balance of Payments is affected by interest payments that Nike receives for investments in Europe, given that Nike uses that money to buy equipment from Germany.

2. (10p) Suppose the dollar exchange rates of the Canadian dollar and the Swiss franc are equally variable. The Swiss franc, however, tends to appreciate unexpectedly against the dollar when the return on the rest of your wealth is unexpectedly high, while the Canadian dollar tends to depreciate unexpectedly in the same circumstances. As a US resident, which currency, the Canadian dollar or the Swiss franc would you consider riskier?

3. (10p) Assume Greece’s foreign assets amount to 20% of its GDP and its liabilities to 50% of its GDP. 40% of their liabilities are denominated in USD and 60% of their assets are denominated in USD, the rest is denominated in their domestic currency, the euro. If the USD depreciates by 10% how much Greece’s net foreign wealth changes?
4. (5p) What is the $ return on a deposit in a German bank in a year when the interest rate on the euro is 3% and the $/€ exchange rate moves from 1.2 to 1.4?

5. (10p) In London 1 $ costs 7.5 Norwegian kroner, or it costs 1.25 Swiss francs. In NYC the exchange rate between the Norwegian kroner and the Swiss francs is 7. Find an arbitrage opportunity and estimate what your profit would be if you start with 10,000$.

6. (10p) According to the Financial Times of May 24, 2007 “Analysts said that the main driver of the recent bout of Canadian dollar appreciation was higher than expected April inflation data which saw the bond market fully price in a 25 basis point rise in Canadian interest rates by the end of the year”. Explain the apparent paradox that the appreciation of the Canadian dollar follows higher than expected inflation data.
7. (15p) The following report appeared in the New York Times on August 7, 1989:

“A soft landing would not force the Federal Reserve to push interest rates sharply lower to stimulate growth. Falling interest rate can put downward pressure on the dollar….In addition, the optimism sparked by the expectation of a soft landing can even offset some of the pressure on the dollar from lower interest rates”.

Interpret this paragraph using the short run model of exchange rates determination (represent graphically and explain). Focus on how E is affected by changes in the interest rates and expectations as implied by this quote.

8. (30p) Using the Foreign Exchange Market and Money Market show the effects that a permanent increase in the money demand have in the short run and in the long run on the interest rate, price level and the exchange rate. Explain both in words and graphically. Make sure to label the graphs and axes clearly.