

Do not write your name on the assignment. Write your name only on the back of this sheet of paper and staple your answers on the front of this sheet of paper. Failure to follow these directions will cost you 1 point on the assignment.

We will be meeting during my office hours on Thursday. Come by some time between 4:00 and 5:00 to discuss the test and the material you are reading.

This assignment covers 14.4 - through section 15.2. Note that if we go as described, we will never have a homework assignment on the last chapter. So, I will try to slowly get "caught up."

1) (25 points) Suppose that you are a foreign student that knows they will have to pay tuition at Bethany in August. The tuition, fees, etc., total \$10,000 for the semester. Explain how you can reduce exchange rate risk by using options and futures. Explain why the risk is smaller in both cases.

2) (10 points) If the US\$ was selling at a forward premium of 2% against the C\$, what does that mean? What are people expecting to happen?

3) (25 points) On the diagram of "Covered Interest Arbitrage Parity," why is the blue area labeled CIA outflow? What is leaving and why is it leaving? Why does that happen when the annual gain is less than 1/4 of 1% per year?

4) (20 points) In an old issue of *The Economist*, we find that the two-year government bonds in the USA are earning 2.00% and in Japan are earning 0.05%. The spot exchange rate between the yen and dollar is $US\$0.8/100¥ = 125¥/US\$$. It did not give the forward rate. Suppose the forward rate was $US\$1.0/100¥ = 100¥/US\$$. Is there flow of money? If yes, which way and why? If no, why not?

5) (20 points) Explain why absolute PPP should hold and why it may not hold.