END OF CHAPTER EXERCISES

Chapter 16 : Spot FX : Fundamentals And Noise Traders

Investments : Spot and Derivatives Markets

(Keith Cuthbertson, Dirk Nitzsche)

1. Why might a rapid growth in the domestic money supply lead to a depreciating exchange rate? Do you know of any instances where this has occurred?

2. If exchange rates are fixed, then what determines the rate of price inflation in a small open economy?

3. Why might the economy take a long time to achieve PPP ?

4. Suppose that the 1-year spot interest rate in Euroland is r = 8% and in USA is r* = 5% and (rather stupidly) FOREX dealers (who are risk neutral) expect the Euro-USD exchange rate over the next year to remain unchanged ?

   (a) What will happen to the spot exchange rate, today and why?
   (b) At what point will the spot exchange rate stop rising or falling? (i.e. equilibrium is restored on the capital account)
   (c) What are the likely consequences for UK exports and imports in the short-term and in the longer term ?

5. In practice what do you think determines 'short run' and 'long run' changes in the exchange rate?

6. Do monetary models of the exchange rate explain past movements in spot FX-rates ?

7. What are the principal mechanisms that produce exchange rate overshooting ?