

Problem Set 2

1. A U.S. dollar costs 7.5 Norwegian kroner, but the same dollar can be purchased for 1.25 Swiss francs. What is the Norwegian krone/Swiss franc exchange rate?
2. For the following 15 cases, compare the dollar rates of return on dollar and euro deposits:

Case	Dollar Interest Rate, $R_{\$}$	Euro Interest Rate, $R_{\text{€}}$	Expected Rate of Dollar Depreciation Against Euro	Rate of Return Difference Between Dollar and Euro Deposits
1	0.1	0.06	0	
2	0.1	0.06	0.04	
3	0.1	0.06	0.08	
4	0.1	0.12	-0.04	
5	0.1	0.18	0	
6	0.15	0.06	0	
7	0.15	0.06	0.04	
8	0.15	0.06	0.08	
9	0.15	0.12	-0.04	
10	0.15	0.18	0	
11	0.2	0.06	0	
12	0.2	0.06	0.04	
13	0.2	0.06	0.08	
14	0.2	0.12	-0.04	
15	0.2	0.18	0	

3. Krugman's textbook (9th edition), 14-7:

Traders in asset markets suddenly learn that the interest rate on dollars will decline in the near future. Use the diagrammatic analysis of chapter 14 to determine the effect on the current dollar/euro exchange rate, assuming current interest rates on dollar and euro deposits do not change.

4. Suppose that the European Union (EU) has taxation policy for capital flow. In particular, the EU imposes a capital tax rate τ for the U.S. investor, i.e., the expected rate of return on EU monetary asset is $\left(R_{\text{€}} + \frac{E_{\$/\text{€}}^e - E_{\$/\text{€}}}{E_{\$/\text{€}}}\right) (1 - \tau)$. If the EU government removes the capital taxation policy, what is the effect on the exchange rate? Provide both analytical and graphical analysis.