

Economics W4505: International Monetary Theory and Policy

Homework 8

Due April 8, 2010 in class

1. Use the concepts developed in class as a theoretical basis to provide a critical analysis of the attached article entitled “Carry on speculating,” which appeared in the February 24, 2007 edition of the *The Economist* magazine.
2. When considering covered interest rate parity in class we abstracted from bid ask spreads. In this homework you are asked to derive a covered interest rate parity condition taking into account bid and ask spreads. Let i_a denote the ask annual domestic nominal interest rate and i_b the corresponding bid rate. Similarly, let i_a^* and i_b^* denote the foreign ask and bid interest rates. The bid and ask spot exchange rates are denoted S_b and S_a and we follow the convention from class that S is the domestic currency price of one unit of foreign currency. Finally, let F_a and F_b denote the ask and bid 1-year forward exchange rate. Suppose the domestic currency is the US\$ and the foreign currency in the €. The (annual) bid domestic nominal interest rate is 2 percent, and the (annual) ask domestic nominal interest rate is 2.1 percent. The bid and ask interest rates for the Euro are 2.5 percent and 2.55 percent respectively. The bid and ask spot exchange rates (in units of \$ per €) are 1.3503 and 1.3506, respectively. Given this information find the values for the one-year bid and ask forward rates such that covered interest rate parity holds. Find the minimum bid ask spread in the forward market that is consistent with covered interest rate parity.