

University of CA, Davis
Department of Economics

Home Assignment 1 [HA1]

Due Date: 04.22.2005

1. Purchasing KO textbook in Global Marketplace

Task: Shop for the best deal on Krugman and Obstfeld (KO) and report the details.

1. Find a foreign bookseller on the web. In this task, we call a vendor foreign bookseller if he quotes prices in a currency other than US dollar, and we call a vendor domestic if he quotes prices in dollars. Fill Table 1 to compare KO gross price at the foreign bookseller and at the domestic one (for example, UCD bookstore), (Options I and II).

When KO price is quoted in foreign currency, to convert this price to the dollar denominated price, one needs to know exchange rate, see KO, p. 324. There are many free web based currency converters/calculators, such as <http://fxtop.com>, that would help you to convert one currency into another. To fill Table 1 you may use currency converter. Please, report URL of the used converter. Appendix 1 (see below) provides examples of foreign vendors, and Appendix 2 -- notes on making purchases in foreign currency.

It is conventional to use three letter abbreviations for major currencies, with **USD** standing for US dollar, and **GBP** -- for United Kingdom Pound (aka Great Britain Pound). Table 1 uses **GBP** as foreign currency. Alternatively, you may use some other currency, such as **CAD** (Canadian dollar), **EUR** (Euro – European Union), etc. You should report dollar prices in columns 2 and 4, and prices in the same foreign currency in columns 3 and 5. Provide three letter abbreviation for this currency in row 4.

Gross KO price includes taxes, and, possibly, shipping charges and service fees (such as bank fees for currency conversion). You may leave the last row of Table 1 empty or report through which Option (I or II) your have purchased your copy of KO textbook.

Table 1

	Option I (Foreign bookseller)		Option II (Domestic bookseller)	
	USD	GBP	USD	GBP
Vendor's name / URL				
Quote prices in				
1. Net KO Price				
2. Taxes				
3. Shipping				
4. Other Fees				
Gross KO Price (1+2+3+4...				
Currency Converter URL				
Exchange Rate:	USD/GBP		GBP/USD	

1.2. Discuss pros and cons of Options I and II. Be concise: you may simply present a

short list of reasons that affect consumer choice between Options I and II. Speak in general, or present the reasons behind your own choice.

Hint A consumer's (textbook buyer) choice of a vender (textbook seller) for his transaction (purchase the textbook) depends on several factors, such as vendor differences in:

1. speed of delivery, 2. risks involved, 3. transparency of payment arrangements, 4. simplicity of payment arrangements, 5. condition of a specific KO copy 6. overall convenience (hours of vendor operation, speed and ease of your transaction, etc.)

1.3A. Calculate the difference in price (your gain or loss) between purchasing KO via Options I and II. Make the calculation twice: in **USD** and **GBP** (or foreign currency you use in Table 1). Convert the latter to **USD** and report the result in row 3.

Price difference between Options I and II:

1. Gain/Loss (USD)	
2. Gain/ Loss (GBP or foreign currency used in Table 1)	
3. Covert gain / loss from 2. into USD	

1.3B. Are price differences in rows 1 and 3 equal to each other? Why or why not?

1.3C. Are there positive gains from trade from importing KO textbook?

Appendix 1 Example 1: UK based book seller <http://www.abebooks.co.uk/>
Use advanced search to find KO (for example, use ISBN (KO ISBN is 0201770377).

Example 2: Amazon website in UK: <http://www.amazon.co.uk/>

In both examples prices are quoted in £, with symbol £ standing for **GBP**.

Appendix 2 To purchase from a foreign bookseller, you have to pay in foreign currency. Let's discuss how to do that. The easiest (and the fastest) is to pay via credit / debit card or paypal. Both these services perform a seamless currency conversion, i.e., they convert your **USD** denominated payment to foreign currency automatically (without your participation). If you pay with credit card, service charges for conversion may appear on your next bill. You should research the details with your card's issuer. The information about paypal service is available at <http://www.paypal.com/>. With both services, your actual conversion rate may slightly differ from estimates provided by web converters.

To familiarize yourself with the subject of this class, use web searches for words exchange rate or currency converter. This will return you sites with loads of interesting information about foreign exchange (FOREX) markets (such as <http://www.x-rates.com>).

1.4 Does the law of one price holds for KO?

1.5 Consider Harry Potter and the Order of the Phoenix (Harry Potter 5), J.K. Rowling and compare the prices at www.amazon.co.uk and www.amazon.com at the current exchange rate, please use the foloowing editions:

Bloomsbury Childrens Books ISBN: 0747561079 [0747561079 UK]

Scholastic Paperbacks ISBN: 0439358078 [0439358078 US]

Use the prices from Amazon websites to full the table below. Use current exchange rate

at row A. At the rows B and C subtract 0.25 and add 0.25 from the current exchange rate. Put the arrows ↓ or ↑ to indicate the direction of the change relative to A:

	\$/£	\$ Price of £ UK book	price of UK/US books	£/\$	£ Price of \$ US book	Price of UK exports US imports	Price of US exports UK imports	£ against \$ & \$ against £
			(relative)			Changes relative to A		
A	Curre	\$			£			
B	A-0.25	\$			£			
C	A+0.25	\$			£			

1.6. Does the law of one price holds for 1.5? Why or why not? Comment.

2. KO, Chapter 12, problem 2

3. KO, Chapter 13, problem 6

4. Discusses the effects of a rise in the interest rate paid by euro deposits on the exchanger rate. Please, illustrate your answer with a graph.

5. Explain what a “vehicle currency” is. Why is the U.S. dollar considered a vehicle currency?

6. What are the factors affecting the demand for foreign currency?

7. There are two investors interested in GM stock which is priced at \$100/share as of today. Mr. Right and Mr. Wrong forecast that the stock value will be \$80/share and \$120/share respectively in 1 month. Mr. Right short sells GM stock such that he agrees to sell 10,000 GM shares for \$90/share in 1 month. Mr. Wrong buys this contract.

a) What are the expected profits of the two investors per share?

b) Suppose that the price realization was \$85/per share, calculate the losses or profits of the two investors.

Note: Short selling is a promise (contract) to sell on a future date specified by the contract some asset, which you possibly (and likely) do not own at the time of your promise (i.e., when you sign the contract).

8. Multiple Choice Questions:

Please, record your answers in the table below (second column). Leave the third column empty for grading.

Question #	Your Answer	
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Chapter 12:

1) The GNP of the United States in 2000 was about

- A. 7 trillion dollars.
- B. 1 trillion dollars.
- C. 5 trillion dollars.
- D. 6 trillion dollars.
- E. 10 trillion dollars.

2) National income equals GNP

- A. less depreciation, less net unilateral transfers, less indirect business taxes.
- B. less depreciation, plus net unilateral transfers, plus indirect business taxes.
- C. less depreciation, less net unilateral transfers, plus indirect business taxes.
- D. plus depreciation, plus net unilateral transfers, less indirect business taxes.
- E. less depreciation, plus net unilateral transfers, less indirect business taxes.

3) GDP is supposed to measure

- A. the volume of production within a country's borders.
- B. the volume of services generated within a country's borders.
- C. the volume of production of a country's output.
- D. GNP plus depreciation.
- E. None of the above.

- 4) In open economies,
- A. saving and investment are necessarily equal.
 - B. as in a closed economy, saving and investment are not necessarily equal.
 - C. saving and investment are not necessarily equal as they are in a closed economy.
 - D. saving and investment are necessarily equal contrary to the case of a closed economy.
 - E. None of the above.
- 5) The CA is equal to
- A. $Y - (C+I+G)$.
 - B. $Y + (C+I+G)$.
 - C. $Y - (C+I+G)$.
 - D. $Y - (C+I-G)$.
 - E. $Y - (C+I+G) = -CA$, (i.e., minus the CA).
- 6) For open economies,
- A. $S = I$.
 - B. $S = I + CA$.
 - C. $S = I - CA$.
 - D. $S > I + CA$.
 - E. $S < I + CA$.
- 7) Ricardian equivalence argues that when the government cuts taxes and raises its deficit,
- A. consumers anticipate lower taxes to pay for the resulting government debt.
 - B. consumers anticipate better services from the government.
 - C. consumers anticipate higher taxes later to pay for the resulting government debt.
 - D. consumers anticipate it will affect their future taxes, in the direction of lowering future taxes.
 - E. None of the above.
- 8) A closed economy
- A. can save either by building up its capital stock or by acquiring foreign wealth.
 - B. can save only by building up its capital stock.
 - C. can save only by acquiring foreign wealth.
 - D. cannot save either by building up its capital stock or by acquiring foreign wealth.
 - E. None of the above.
- 9) Government savings, S^g , is equal to
- A. $T - G$.
 - B. $T + G$.
 - C. $T = G$.
 - D. $T + G - I$.
 - E. None of the above.

- 10) In a closed economy, private saving, S^p , is equal to
- A. $I - (G - T)$.
 - B. $I + (G - T)$.
 - C. $I + (G + T)$.
 - D. $I - (G + T)$.
 - E. $I + (G - T) + C$.

Chapter 13:

- 11) When a country's currency depreciates,
- A. foreigners find that its exports are more expensive, and domestic residents find that imports from abroad are more expensive.
 - B. foreigners find that its exports are more expensive, and domestic residents find that imports from abroad are cheaper.
 - C. foreigners find exports to be cheaper; however, domestic residents are not affected.
 - D. foreigners are not affected, but domestic residents find that imports from abroad are more expensive.
 - E. None of the above.
- 12) Which one of the following statements is the most accurate?
- A. A depreciation of a country's currency makes its goods cheaper for foreigners.
 - B. A depreciation of a country's currency makes its goods more expensive for foreigners.
 - C. A depreciation of a country's currency makes its goods cheaper for its own residents.
 - D. A depreciation of a country's currency makes its goods cheaper.
 - E. None of the above
- 13) Which one of the following is the most accurate? The term spot exchange rate is
- A. misleading because even spot exchanges usually become effective only three days after a deal is struck.
 - B. misleading because even spot exchanges usually become effective only four days after a deal is struck.
 - C. misleading because even spot exchanges usually become effective only five days after a deal is struck.
 - D. misleading because even spot exchanges usually become effective only six days after a deal is struck.
 - E. misleading because even spot exchanges usually become effective only two days after a deal is struck.
- 14) Forward and spot exchange rates
- A. are necessarily equal
 - B. do not move closely together
 - C. The forward exchange rate is always above the spot exchange rate.
 - D. while not necessarily equal, do move closely together.
 - E. None of the above.
- 15) An American put option on foreign exchange
- A. gives the buyer the right to sell the foreign currency at a known exchange rate at any time during the period of the option.

- B. gives the seller the right to sell the foreign currency at a known exchange rate at any time during the period of the option.
- C. gives the buyer the right to sell the foreign currency at a known exchange rate at a specific time in the future.
- D. obligates the buyer to sell the foreign currency at a known exchange rate at any time during the period of the option.
- E. None of the above.

16) If the dollar interest rate is 10 percent, the euro interest rate is 6 percent, and the expected return on dollar depreciation against the euro is zero percent, then

- A. an investor should invest only in dollars.
- B. an investor should invest only in euros.
- C. an investor should be indifferent between dollars and euros.
- D. It is impossible to tell given the information.
- E. All of the above.

17. If the dollar interest rate is 10 percent, the euro interest rate is 12 percent, and the expected return on dollar depreciation against the euro is negative 4 percent, then

- A. an investor should invest only in dollars.
- B. an investor should invest only in euros.
- C. an investor should be indifferent between dollars and euros.
- D. It is impossible to tell given the information.
- E. All of the above.

18) Which one of the following statements is the most accurate? Trades of U.S. dollars for Canadian dollars in New York are executed with

- A. a one-day lag.
- B. a two-day lag.
- C. a three-day lag.
- D. a four-day lag.
- E. a zero-day lag.

19) A foreign exchange swap

- A. is a spot sale of a currency.
- B. is a forward repurchase of the currency.
- C. is a spot sale of a currency combined with a forward repurchase of the currency.
- D. is a spot sale of a currency combined with a forward sale of the currency.
- E. None of the above.

20) How many British pounds would it cost to buy a pair of American designer jeans costing \$45 if the exchange rate is 2.00 dollars per British pound?

- A. 22.5 British pounds
- B. 32.5 British pounds
- C. 12.5 British pounds
- D. 40 British pounds
- E. 30 British pounds