

ECON3171
Fall 2007
Homework #3

Due November 26, 2007.

1. State whether each of the following represents a debit or a credit on the U.S. current account.

- A. Purchase of a Boeing aircraft by a Chinese airline
- B. Expenditures by an American on vacation at EuroDisney
- C. Purchase by a U.S. automaker of Brazilian steel
- D. A U.S. telecommunications company hires a French firm to launch a new space satellite
- E. A Hong Kong-based corporation pays its annual dividend to its U.S. stockholders

2. On April 17, 1993, the average price of a Big Mac in the United States was \$2.28. Based on the actual market exchange rates and the local currency Big Mac prices, the British *Economist* magazine compiled the Big Mac index to determine whether and by how much a currency is undervalued or overvalued relative to the PPP exchange rate (i.e., the exchange rate that ensures purchasing power parity for different currencies). According to the table below, what is the PPP exchange rate for each of the four currencies versus the U.S. dollar such as ¥/\$ and DM/\$?

<u>Country</u>	<u>Currency</u>	<u>Price of a Big Mac</u>	<u>Actual ER</u>
Japan	Yen	¥391	¥137/\$
Russia	Ruble	R780	R686/\$
Germany	Mark	DM4.6	DM1.58/\$
Mexico	Peso	Mex\$7.09	Mex\$3.10/\$

3. Using supply and demand analysis for the US spot market for euros, predict what will be the effect on the dollar to euro exchange rate of the following events:

- A. The People's Bank of China decides to unload a large part of its US dollar reserves in order to invest more in European stock markets.
- B. High stock market returns in the EU provide incentive for many investors to change the destination of their current portfolio investments out of US assets and into European stocks.
- C. The Federal Reserve's FOMC decides to decrease interest rates by a quarter of a point in order to spur economic activity in the US.