Dr. Ozan Hatipoglu

1) Suppose the 12-month interest rates on simple deposits in Turkey and US are 10% and 5% respectively. Current exchange rate, $S_t$, is 1.3. A risk-neutral investor has 10,000 YTL which he wants to invest either in a Turkish or US bank.

i) Suppose the investor expects the US$ to depreciate by 10%. Which country will he choose to invest his money in? Calculate the difference between expected nominal returns in each country in terms of YTL.

ii) Assume the investor is a risk-averter and requires 2% premium on the risky investment. Which country will he choose to invest his money in?

iii) What’s the investor’s net position in i) if he chooses to invest in US? (i.e. long-short=?)

iv) Suppose exchange rate forward contracts become available and the current 12 month forward rate between $ and YTL is 1.4 ($F_t = 1.4$). The investor still expects $ to depreciate by 10%. What’s the best strategy for the investor? Solve numerically.

v) Assuming all agents are unbiased (fully informed) rework iv)

2) Explain the efficient market hypothesis

3) Using the monetary model under fixed exchange rates show how an increase in money supply affects the real output and the foreign exchange reserves. (by clear drawing of the graphs, putting down the labels, using necessary algebraic equilibrium conditions, clearly indicating the reasoning and its flow)

4) Using equilibrium conditions in goods and money markets and assuming perfect foresight in labor markets, show the effect of an increase in the real exchange rate on real output. (by clear drawing of the graphs, putting down the labels, using necessary algebraic equilibrium conditions, clearly indicating and explaining the reasoning and its flow)
5) Rework 4) under assuming sticky prices in short run
6) Briefly list and explain the reasons why absolute PPP might not hold.