# Assignment no 3

*For seminar Wednesday April 7 2010*

A) *The mean-variance model of the foreign exchange market*

1) Derive the demand for foreign currency for a risk-averse investor.
2) Discuss how the demand for currency depends on the investor's perception of exchange rate risk.
3) The exchange rate is floating. Derive the solution for the equilibrium exchange rate for given interest rates and given exchange rate expectations.
4) What will be the impact of an increase in the home interest rate on a) home and foreign investors´ demand for foreign currency given the initial exchange rate, b) the equilibrium exchange rate, c) the foreign currency holdings of the two groups of investors in equilibrium.
5) Suppose the expected rate of depreciation is zero and remains so. However, the percived level of exchange rate uncertainty increases. What effect will this have on the exchange rate? Explain why the effect depends on the interest rate differential.

B) *Excange rates and the current account*

1) Explain why over time a current account surplus tends to shift the supply curve for foreign currency to the right, and hence lead to appreciation of the currency. What does the degree of capital mobility mean for the size of the exchange rate effect?
2) In a country called Petrolia the current account suplus and the government surplus are huge and equal in size. The government surplus is being invested in foreign currency bonds. What are the net effect on the foreign exchange marekt and on the exchange rate?
3) Would the effect be any different if the government were investing in shares in foreign companies?