QUESTION 1. FOREIGN EXCHANGE MARKETS AND FOREIGN INVESTMENTS

1. Suppose that a US importer wants to purchase $1m worth of intermediate goods from Mexico to be used in the production of final goods, and that the importer wants to finalize this transaction within 48 hours.
   a) Describe the sequence of trades and actions through which the importer can achieve this international trade via the foreign exchange market.
   b) Is the importer subject to any foreign exchange rate risk and, if so, can this risk be hedged?
   c) Show the impact of the transaction for the balance sheets of
      i) the importing firm
      ii) the commercial bank at which the importing firm is a customer
      iii) the exporting firm in Mexico
   d) Suppose that the exporting firm in Mexico allows the US importer six months to pay for the purchase. Under what types of circumstances do you think the US importer would choose to accept this credit offer rather than pay within 48 hours? [Hint: think about alternative investment opportunities.]

2. Explain each of the following types of trade and describe the implications of each for the position statement of a trader:
   a) Arbitrage
   b) Hedge
   c) Speculation
   Are any of these types of trade inconsistent with market efficiency? Why?

3. Suppose that you are a financial institution, trying to determine your asset portfolio allocation with respect to different interest-bearing, foreign exchange denominated assets. What factors will you take into account when determining your portfolio allocation? In general, will you choose to hold only (exchange rate and default) risk-free assets?

4. Explain what we mean by uncovered interest rate parity and covered interest rate parity? How do these conditions differ?
QUESTION 2. CENTRALIZED FOREIGN EXCHANGE MARKETS

1. What do we mean by “centralized” markets?

2. Why is the futures market an attractive venue for speculators?

3. Why is the options market an attractive venue for hedgers?

4. Explain carefully the difference between the time value of an option and the intrinsic value of an option. Which is more relevant for potential speculators?

5. For what reasons do futures and options exchanges specify so many explicit details of the foreign exchange asset contracts in which they permit trades?

6. Using Table 1-3 in Chapter 1 of the textbook, calculate the intrinsic values of June call options for the British pound and German mark. Compute the time value for those options that are “out of the money”. Assuming that forward exchange rates reflect market expectations of future exchange rates, what do the pound and mark forward rates in Table 1-1 say about the time values you have just calculated? Explain.