

Home Assignment 2

**FIN 319
Winter 2001**

**University of Michigan
Business School**

Maximum total score is 100, plus 10 extra for a bonus question. The maximum score for each question is in brackets.

Question 1

1. [20, 4 points each] Choose ONLY 5!! out of 10. [No extra credit for more]. Define the following concepts:

1.1 Money, and its functions.

1.2 Government credibility, and its connection to government ability to commit.

1.3 Rules of the game. Give an example with explanation of the system workings (features and means of sustaining the specific foreign exchange regime).

1.4 Covered Interest rate parity

1.5 Relative PPP

1.6 Fixed exchange rate

1.7 Pegged exchange rate

1.8 Arbitrage. Give an example

1.9 Speculation. Give an example

1.10 Perfect Capital Market (PCM).

Question 2 [35, 5 pt each] True or false questions. Please, explain your choice in 1 or 2 sentences

2.1 The modern markets are increasingly volatile because they are more sophisticated.

2.2 More mature markets, i.e. the markets with higher trading volumes, are more stable, i.e. less volatile.

2.3 More mature markets, i.e. the markets with higher trading volumes, are more profitable.

2.4 When investors are risk-neutral, rate of return of capital does not depend on the default rate.

2.5 Risk-averse investors require risk premium and, thus, earn a higher return than the risk-neutral ones.

2.6 Risk averse investors do not hold short positions.

2.7 Risk-neutral investors have a better ability to hedge, which makes their returns higher than that of the risk-averse investors.

2.8 Transaction costs are lower for high volume investors. Therefore, their rate of return is higher.

2.9 Offshore customers are high volume customers. Their lower transaction costs permit them cheaper financing of their needs through the use of the offshore markets than they have onshore.

2.10 Risk-neutral investors cannot improve their returns through diversification.

Question 3 [20, 4 pt each]

3.1 State the reasons for emergence of the offshore markets

3.2 Define offshore and onshore markets

3.3 Why financial institutions offer both types of contracts, offshore and onshore?

3.4 Why some companies are listed on several exchanges? Please, list the associated costs and benefits.

3.5 Define the concept of Pareto improvement. Give an example.

Question 4 [25] Derivative securities markets

4.1 [10] Explain the empirical fact of increased volatility with the higher transaction taxes.

4.2 [5] Through what channel the speculators could reduce the costs of hedging?

[10] Give the reason why derivative securities are present in the market.

BONUS [10]:

Please read the article "Conspiracy Theory Gains New Currency, Thanks to Prof. Auriti – His Odd Monetary Experiment Ignites a Shopping Frenzy In a Small Italian Town," Wall Street Journal: New York, N.Y.; Oct 6, 2000. Make an educated comment about the story (incentives behind the actions of the government / banking officials, academicians, etc). Why / how did the story "make it" to the Wall Street Journal first page?