Econ 429 | University of Illinois
Spring 2003/04 | Willmann

Homework 3

due: Thursday, April 1, in class

Problem 1: Portfolio Balance Model

a) The portfolio approach assumes that domestic and foreign bonds are imperfect substitutes. List reasons for this assumption and explain.

b) Analyze a monetary expansion in this model. What are the immediate effects, the short-run real effects, and the long-run effects. What is the reason the exchange rate overshoots in this model?

c) Consider the relationship between the current account and the exchange rate. How do the Keynes-Mundell-Fleming framework and the portfolio differ in their interpretation of this relationship?

Problem 2: Efficient Market Hypothesis

a) Explain the efficient market hypothesis. Derive the equation $fp_t = \Delta s_{t+k} + \epsilon_{t+k} + \lambda_t$.

b) Simlulate your own random walk, i.e. use a random generator to generate 5 series of 20 observations each. Compare the series you obtain to time paths of actual exchange rates.

c) How have people tested the equation you derived in a)? What has been their conclusion. Discuss different explanations that have been offered and feel free to formulate your own.