1) As the Chinese economy grows, pressure grows to think carefully about the economic relationship we have with the country. In an essay, please identify the gains and costs of engaging in free trade with the Chinese. Be complete. At the end of your essay, tell me whether you are in favor or opposed to free trade with China and why. Your answer should be typed, 2 pages in length, and double-spaced.

I trust that you can explain the gains from trade at this point. See the answers to the midterm if you have trouble.

Other issues that are relevant:
- religious freedom in China
- worker conditions in China
- environmental conditions in China
- political freedom in China

2) Explain how a futures contract can be used to “hedge” (or cover) against the exchange rate risk that a company faces if it signs a contract to exchange goods for foreign currency at some point in the future. In your answer, be sure to identify what the risk is.

In a futures contract, you agree to sell x units of the foreign currency for y units of the home currency at a specified date in the future. So you can arrange to exchange your foreign currency for domestic in advance and so eliminate any of the risk involved. (The exchange rate risk is that between now and the date in the future the foreign exchange will depreciate and so not be worth as much (in terms of the home currency) when you finally get the payment.)

3) Page 797, Working with the Web #3 (Note: You may want to go directly to the St. Louis Fed cite or to some other source for the data given how Economagic handles the data.)
Overall there is no strong relationship. In the mid-70’s through late-80’s it looks like there is a positive relationship. Then from the late-80’s on there looks to be a negative relationship.

Keynesians would argue that running fiscal deficits will spur consumption (including imports) and so lead to a bigger trade deficit. Hard to say that this data supports that.

4) In class, someone asked whether exchange rates vary much over time. This exercise is meant to answer that question.

Go to http://www.globalfindata.com/.

a) Plot the $-yen exchange rate for February 28, 2001 to February 28, 2002 on the web site. You will not be able to print this out to paper as far as I know so this will not be turned in.

b) Suppose you had 1,000,000 yen (a bit under $10,000). If you were to invest it in $ at the beginning of the period and convert back to yen at the end, approximately what rate of return would you have earned? Is that good or bad relative to the stock market returns of the past year?

At the beginning of the period, the exchange rate is about 1:118. So I could get $8475. At the end of the period, the exchange rate is about 1:135. So the $8475 (even if held in a mattress) would be worth $1,144,067—a gain of about 14.4%. If you had invested the $ in a guaranteed-type fund (say, US bonds) and earned 4%, then you’d have $8814 to exchange which would turn into 1,189,890—and you’d gain about 19%.

c) Now suppose you had a little more time to play with this money. Each month, on the first of the month you decided whether to move money from $ to yen or the other way around. Supposing you made each decision exactly right (that is, if the yen was rising you held your investment in yen while if the yen was declining you held your investment in dollars.) What rate of return would you have earned?
Here’s the order of what you do—(“buy” means buy $ with yen and “sell” means sell $ for yen):
Buy at 1:119—you have $8475
Sell at 1:126.5—you have 1,072087.5 yen
Do nothing
Buy at 1:119—you have $9009
Hold
Sell at 1:125—you have 1,126,142 yen
Buy at 1:119—you have $9463
Do nothing
Do nothing
Do nothing
Do nothing
Do nothing
Sell at 1:135—you have 1,277,556 yen or a gain of almost 28%. Again, if you had held both the $ and yen in a conservative fund earning 4% you could have done a little better—about 32% gain.