AFRICA UNIVERSITY

A United Methodist-Related Institution

"Investing in Africa's Future"

COLLEGE OF BUSINESS, PEACE, LEADERSHIP & GOVERNANCE

COURSE CODE AND TITLE: MEC 402-International Finance

END OF FIRST SEMESTER EXAMINATION

MAY 2020

LECTURER: Mr L. NGENDAKUMANA

DURATION: 48 HOURS

INSTRUCTIONS

Answer **any Five [5] questions.**
Total possible mark is 100

Start **each** question on a new page in your answer booklet.

The marks allocated to **each** question are shown at the end of the section.

Show all your workings.

Credit will be awarded for logical, systematic and neat presentations.

Question One

(a). Purchasing power parity **(PPP)** and the quantity theory of money are some of the key factors that explain why some currencies tend to appreciate in the long run while others tend to depreciate. Explain this statement using the PPP and quantity of money equations**.** **[12]**

(b). Distinguish between the major types of transactions or activities that result in supply of foreign currency and those that result in demand for foreign currency in the spot foreign exchange market? **[8]**

Question Two

(a)You are an advisor to a Kenyan based investor who is considering investing into international financial money market's instruments. Using the following markets' data:

The annualized interest rate on 60 day- Kenyan shilling denominated bonds is 5 percent; the annualized interest rate on 60 day- South African Rand denominated bonds is 11 percent; the current spot exchange rate is KSh 9.50/R 1 and the current 60 day forward exchange rate is KSh 10/R1:

i. Is the Kenyan Shilling at a forward premium or discount? **[2]**

ii. Should a Kenya based investor make a covered investment in Rand denominated 60 day bonds rather than investing in 60 day Kenyan Shilling denominated bonds? **[3]**

iii. Should a South Africa based investor make a covered investment in Kenyan Shilling denominated 60 day bonds rather than investing in 60 day Rand denominated bonds? **[3]**

iv. Because of covered interest arbitrage, what pressures are there likely to be placed on the various rates? If the only rate that actually changes is the forward exchange rate, to what will its value be driven? **[3]**

(b). Domestic investor is considering investing in international financial assets. Use numerical examples and your knowledge on:

(i) The annualized interest rates on domestic bond and any foreign country's bond of your choice;

(ii) The current spot and the future spot exchange rates of the two countries' currencies, to advise that investor in which country to invest **[6]**

(c).Using the information in (b), explain the concept of appreciation/depreciation of one of the two currencies, and compute the annualized percentage rate of appreciation/depreciation **[3]**

Question Three

(i). Why is the foreign exchange market important in International Finance? **[5]**

(ii). How do key variables such as real output or income and the country's interest rate affect the country's balance of payment both in the short and long run? **[5]**

(iii). In 2015, the price level for the U.S was 100, the price level for Pugelovia was .
also 100 and in the foreign exchange market one Pugelovian pnut was equal to $1. In 2017, the U.S price level has risen to 260, and the Pugelovian price level has risen to 390.

a. According to the PPP, what should the dollar- pnut exchange rate be in 2017? **[4]**

b. If the actual dollar- pnut exchange rate is $1/pnut in 2005, is the pnut overvalued or undervalued relative to PPP? Explain **[3]**

(iv). Briefly explain the concept of twin deficit **[3]**

Question Four

What does perfect capital mobility mean for the effectiveness of monetary and fiscal policies under fixed exchange rates? **[20]**

Question Five

Briefly explain the following concepts used in International Finance:

a. Sterilization **[3]**
b. Perfect capital mobility **[3]**
c. Current account **[3]**
d. Internal balance **[3]**
e. Forward exchange rate **[3]**
f. Eurocurrency **[3]**
g. Triangular arbitrage **[2]**

Question Six

(a). Using grammatical tools and the concept of floating exchange rates, explain 2 factors which can cause a shift in the foreign currency supply curve. **[8]**
(b). Use the answer in (a) to explain the concepts of appreciation and depreciation of currencies. **[4]**
(c). Explain how a government can intervene in the foreign exchange market when it implements:

(i) a devaluation of its currency **[4]**
(ii) a revaluation of its currency **[4]**

Use diagrammatical tools in your explanations.

End of paper