AFRICA UNIVERSITY

(A United Methodist-Related Institution)

"Investing in Africa's Future"

COLLEGE OF BUSINESS, PEACE, LEADERSHIP &GOVERNANCE

COURSE TITLE: **MEC 402- INTERNATIONAL FINANCE**

SEMESTER 2: **FINAL EXAMINATION APRIL 2019**

LECTURER: **MR. L. NGENDAKUMANA**

TIME: **3 HOURS**

INSTRUCTIONS

Answer **all questions in section A and TWO questions in section B.** 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.

SECTION A

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). For your next foreign vacation, would it be better to go to a country whose currency is overvalued relative to PPP or one whose currency is undervalued relative to PPP (other attraction being equal) ? **[8]**

Question Two

(i). Financial investors are considering investing in international financial markets in which the annualized interest rate on 60 day- dollar denominated bonds is 6 percent and the annualized interest rate on 60 day- pound denominated bonds is 12 percent. Given that the current spot exchange rate is \$1.45/£ and the current 60 day forward exchange rate is \$1.60/ £:

a. Is the pound at a forward premium or discount? Explain. **[3]**
b. Should a U.S based investor make a covered investment in pound denominated 60 day bonds rather than investing in 60 day dollar denominated bonds? **[3]**
c. Because of covered interest arbitrage, what pressures are placed on the various rates? If the only rate that actually changes is the forward exchange rate, to what will its value be driven? **[4]**

(ii). Domestic investors are considering investing in international financial assets. Use numerical examples and your knowledge on:

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

(b) The current spot and the future spot exchange rates of the two countries' currencies, to advise those investors in which country to invest [Hint: Use investors from two different countries of your choices] **[8]**

(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 **[2]**

Question Three

a. Using grammatical tools and the concept of floating exchange rates, explain 2 factors which can cause a shift in the foreign currency demand 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.

SECTION B

Question Four

(i) A country initially has achieved both external and external balances. International financial capital is reasonably mobile, so the country FE curve is upward sloping (and flatter than the LM curve). The country has a floating exchange rate and defends it using official intervention. The country does not sterilize. As a result of the election of a new government, foreign investors become bullish on the country. International financial capital inflows increase dramatically, and remain higher for a number of years.

a. What shift occurs in the FE curve because of the increased capital inflows? Explain **[3]**
b. What change in the exchange rate occurs to reestablish external balance? **[3]**
c. As a result of the exchange rate change, how does the country adjust back to external balance? **[3]**
d. Illustrate this using an IS-LM-FE graph. What is the effect of all this on the country‘s internal balance? **[5]**

(ii) State the various shapes of the LM and FE curves and explain how they relate to the balance of payments **[6]**

Question Five

(a) State and define any three financial instruments that fall under the international bond market and explain why there are classified under the financial market. **[8]**

(b) What is the relationship between the stock market and the foreign exchange markets? (Hint: You may refer to the demand and supply of foreign currencies) **[4]**

(c) 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 and explain each one of them **[8]**

Question Six

Briefly explain the following concepts used in International Finance:

a. Balance of payment **[3]**
b. Covered interest differential **[3]**

c. Perfect capital mobility **[3]**
d. Purchasing power parity **[3]**
e. Foreign exchange market **[3]**
f. Expected uncovered interest differential **[3]**
g. Triangular arbitrage **[2]**

End