KENYATTA UNIVERSITY

UNIVERSITY EXAMINATIONS 2016/2017

SECOND SEMESTER EXAMINATION FOR THE DEGREE OF BACHELOR OF ECONOMICS

EAE 308: INTERNATIONAL ECONOMICS II

DATE: Wednesday, 10th May 2017 **TIME: 4.30 p.m. - 6.30 p.m.**

INSTRUCTIONS:

1. **Answer question ONE and any other TWO**
2. **Question ONE (1) is compulsory and carries 30 Marks**
3. **All other questions carry 20 marks each**

1. a) Suppose that in London $e_{£/\$} = 0.6$, while in New York $_{¥/\$} = 120$ and in Tokyo $e_{¥/£}$

Required:

i. Is it possible to exploit any arbitrage opportunity? Explain. (5 Marks)

ii. Starting with £1,000,000 suggest a strategy from which you can profit from the transactions (assume that transaction costs are negligible). (5 Marks)

b) Explain the main determinants of the quantity demanded of foreign exchange. (6 Marks)

c) Using a diagram explain uncovered interest parity (UIP) relationship. (10 Marks)

d) Explain the meaning of the following terms as used in international economics. (4 Marks)

- i) Interest differential
- ii) Futures contract
- iii) Arbitrage
- iv) Balance of payments

2. a) State the Gresham's law. (2 Marks)

b) The exchange rate between the KSH and South African Rand (SAR) is 4 KSH/SAR. If the price of a spare part manufactured in Kenya is KSh.10, what is the price of the spare parts in SAR? If on the other hand the price of the same spare part is 3 SAR in Uganda, what is the price of the spare part in KSH? Does the law of one price- hold? Explain why. (8 Marks)

c) Graphically describe how a fixed exchange rate works. (10 Marks)

3. a) Explain the main functions of Foreign Exchange Market for currencies. (6 Marks)
   b) Clearly explain the difference between spot and forward market and give the risk of each. (4 Marks)
   c) Using illustration, explain the difference between a permanent and a temporary increase in demand of foreign currency. (10 Marks)

4. a) Highlight the main criticism of International Monetary Fund. (5 Marks)
   b) Explain the main function of World Trade Organization. (5 Marks)
   c) Explain the following:
      i) Trade diverting customs union. (2 Marks)
      ii) Using a diagram explain how a trade diverting customs union occur. (8 Marks)

5. a) There is a close relationship between the law of one price and purchasing power parity. Explain. (6 Marks)
   b) Given the following information for Kenya for the year 2014. Answer the questions below:
      1. USA Tourist Ksh.24m
      2. Export of coffee Ksh 400m
      3. Toyota V8 from Japan Ksh120m
      4. Donated Elephants to China Ksh60m
      5. Import of Fertilizer Ksh 500m
      6. Gifts to Kenya from UK Ksh 50m
      7. Remittances by Kenyan Somalies Ksh 150m
      8. Payments to Kenyan Students in UK Ksh 70m
      9. Interest to IMF Ksh 40m
      10. Safaricom Dividends from Vodacom UK Ksh 100m
         i) Which BOP Account would you place the above listed items? (1 Mark)
         ii) Prepare the BOP Account for Kenya for the year 2014 and determine BOP deficit or surplus. (6 Marks)
         iii) Comment on your answer in (i) above. (1 Mark)

   c) Outline the components of the official settlement account. (6 Marks)