KENYATTA UNIVERSITY

UNIVERSITY EXAMINATIONS 2016/2017

FIRST SEMESTER EXAMINATION FOR THE DEGREE OF MASTER OF ECONOMICS

EAE 812: INTERNATIONAL FINANCE

DATE: Tuesday, 29th November 2016 **TIME:** 2.00 p.m. - 5.00 p.m.

INSTRUCTIONS:

1. **Answer ALL questions.**
2. **Each question carries 25 marks.**

Question One

(a) (i) What is the difference between the forward market, the futures market and the option. (3 marks)

(ii) In your understanding of global financial asset flows, does it ever make sense to invest abroad at a lower interest rate than at home? If so, when and why? (3 marks)

(iii) What is the covered interest arbitrage parity? (2 marks)

(iv) What is the uncovered interest arbitrage parity? (2 marks)

(v) What is the law of one price? (3 marks)

(b) (i) Draw the IS – LM curves and explain why they slope in opposite directions. (8 marks)

(ii) What causes a shift in the IS curve? (4 marks)

Question Two

Due to Kenya's worsening balance of trade from Ksh 537 billion in 2010 to Ksh 1,081 billion in 2014, Kenya's currency has depreciated from Ksh 79.23 to the US \$ in 2010 to Ksh 87.92 to the US \$ in 2014 (Economic Survey, 2015).

Suppose a Kenyan businessman had US \$3 million at his disposal for speculative purposes, and the following were the foreign exchange rates on the international money markets:

1 pound sterling (£)	= 1.624 US \$
1 Euro	= 1.4882 US \$
1 US \$	= 90.15 Japanese Yen

Suppose the interest rate on 90-day treasury bill of the Central Bank of Kenya (CBK) for the October month of 2014 was 8% per annum. And suppose the 90-day <u>forward</u> exchange rate in Nairobi for January 2015 had been agreed in October was Ksh. 93.92. Suppose the Tokyo (Japan) 90-day <u>forward</u> exchange rate for January 2015 was set in October 2014 at 90.43 yen. The interest rate on the October 2014 government securities in Tokyo was 3% per annum.

(a) If the Kenyan businessman is a rational investor, which speculative investment option between Nairobi and Tokyo will maximize his returns?
The answer should emerge from calculation. (15 marks)

(b) What are the economic implications of the drop in the shilling's value on:
   (i) Government revenue? (explain clearly) (3 marks)
   (ii) Kenya's exports? (explain clearly) (3 marks)
   (iii) The balance of payments (explain clearly) (3 marks)

(c) What are the policy implications of the drastic drop in the shilling's value on:
   (i) The foreign exchange regime operating in Kenya. (3 marks)
   (ii) The country's promotion of exports strategy. (3 marks)

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<u>Question Three</u>

Given the following simple Keynesian model:

$$Y = C + I + X - M$$
$$C = 60 + 0.8Y$$
$$I = 140$$
$$X = 120$$
$$M = 10 + 0.2Y$$

(a) (i) By how much would income have to change in order to make X = M (with no change in X)? (4 marks)
   (ii) By how much would autonomous investment change in order to generate the change in (i)? (4 marks)

(b) Suppose autonomous exports increase by 20 to 140, calculate the impact upon the current account. (6 marks)

(c) How much would autonomous exports have to change in order to produce an equilibrium income level at which the current account was in balance? (6 marks)

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<u>Question Four</u>

(a) Use the Swan diagram to explain how government instruments can be used to achieve internal and external balance in the economy. (21 marks)

(b) What are the four main criticisms of the Swan model in explaining government interventions policies? (4 marks)

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