Samuel.

KENYATTA UNIVERSITY

SCHOOL OF ECONOMICS

DEPARTMENT OF APPLIED ECONOMICS

EXAMINATIONS FOR 2019/2020 ACADEMIC YEAR FOR

MASTER OF ECONOMICS

EAE 812: INTERNATIONAL FINANCE

Externally Moderated
04/02/2020

INSTRUCTIONS: Answer ALL the Questions

Question One

a. Suppose the dollar/franc exchange rate equals \$0.50 per franc. According to the purchasing power-parity theory, what will happen to the dollar's exchange value under each of the following circumstances?

  i. The U.S. price level increases by 10 percent, and the price level in Switzerland stays constant (4 marks)

  ii. The U.S. price level increases by 10 percent, and the price level in Switzerland increases by 20 percent (4 marks)

b. An exchange rate is said to overshoot when its short-run response (depreciation or appreciation) to a change in market fundamentals is greater than its long-run response. Identify the factors that account for changes in a currency's value over the short and long run. (9 marks)

Question Two

a. Suppose the interest rate (on an annual basis) on three-month Treasury bills is 10 percent in London and 6 percent in New York, and the spot rate of the pound is \$2.

  i. How can a U.S. investor profit from uncovered interest arbitrage? 4 marks

  ii. If the price of the three-month forward pound is \$1.99, will a U.S. investor benefit from covered interest arbitrage? If so, by how much? (5 marks)

b. The supply and demand for foreign exchange are considered to be derived schedules. Demonstrate and explain this scenario. (6 marks.)

Question Three

a) Given the following simple Keynesian Model:

$$Y = C + I + X - M$$

$$C = 60 + 0.8Y$$

$$I = 140$$

$$X = 120$$

$$M = 10 + 0.2Y$$

Required

i. Establish by how much income would have to change in order to make $X = M$ (With no change in X) (2 marks)

ii. Establish by how much would autonomous investment change in order to generate this change? (3 marks)

iii. Suppose autonomous exports increase by 20 to X=140. Calculate the impact upon the current account (3 marks)

b. Explain 7 factors that contribute to currency crises in an economy. 7 marks

Question Four

a. Assume the United States exports 1,000 computers at a price of $3,000 each and imports 150 UK autos at a price of £10,000 each. Assume that the dollar/ pound exchange rate is $2 per pound.

ii. Calculate, in dollar terms, the U.S. export receipts, import payments, and trade balance prior to a depreciation of the dollar's exchange value. 2 marks

iii. Suppose the dollar's exchange value depreciates by 10 percent. Assuming that the price elasticity of demand for U.S. exports equals 3.0 and the price elasticity of demand for U.S. imports equals 2.0, does the dollar depreciation improve or worsen the U.S. trade balance? Why? 3 marks

iv. Now assume that the price elasticity of demand for U.S. exports equals 0.3 and the price elasticity of demand for U.S. imports equals 0.2. Does this change the outcome? Why? 3 marks

c. Under a system of floating exchange rates and high capital mobility, is monetary policy or fiscal policy better suited for promoting internal balance? Demonstrate your answer using graphs.