

UNIVERSITY OF FORT HARE
DEPARTMENT OF ECONOMICS

EAST LONDON CAMPUS

ECF 529E

NOVEMBER EXAMINATION 2019

Time: 3 Hours

Subject: Foreign Exchange Markets

Marks: 100

This paper consists of 4 pages including the cover page

Internal Examiners

Dr I. Akpan

Mr Hompashe

External Examiner

Prof A Maredza

Instructions

1. There are **two (2)** sections in this paper: **Section A** has five (5) questions while **Section B** has only one (1) question
2. Answer any **three (3)** questions in Section A and the **one (1)** question in Section B
3. Ensure that you answer **four (4)** questions in all.
4. All questions carry equal marks

SECTION A

Question 1

25marks

Provide a brief overview of the foreign exchange markets with emphasis on the **functions, organisation** of the market and market **participants**. 20marks

Why is foreign exchange markets **not** sometimes considered a financial market in the true sense of the word? 5marks

Question 2

25marks

Demgro is a South African company that sells goods in international markets. In August 2019, the company exported goods worth \$300 000 to the United States and payment for the goods is expected in November. In August, the rand/dollar exchange rate was R14.10 to \$1 and consensus among analysts is that South Africa has a positive economic outlook which will continue into the first quarter of 2020.

- (a) What would be the effect of analysts' position on the rand (2marks)
- (b) Predict the effect of this outlook on the company's export earnings in November (3marks)
- (c) Provide two hedging strategies for the company (10marks)
- (d) Distinguish between uncovered interest arbitrage and covered interest arbitrage (strategies) and explain how foreign exchange risk could be reduced through one of these strategies. (10marks)

Question 3

25marks

- (a) Discuss the different exchange rate regimes that countries could adopt (9marks)
- (b) If exchange rates adjust freely, using a diagram in each of the scenarios and holding all other factors constant, illustrate and explain how exchange rates can adjust to:

- (i) Rise in interest rates in South Africa (4marks)
- (ii) Preference of Chinese goods over South African goods (4marks)
- (iii) Increase in inflation rate in South Africa (4marks)
- (iv) Discovery of a sustainable source of energy in South Africa that would drive the cost of energy down (4marks)

Question 4

25marks

Exchange rate is believed to be one of the short term factors behind balance of payment deficit.

- (a) Using appropriate diagram, explain this assertion. (10marks)
- (b) Show how exchange rate could be used to close the balance of payment **deficit** using appropriate graph (10marks)
- (c) Illustrate how a restrictive exchange control will correct a balance of payment **surplus**. (5marks)

Question 5

25marks

By means of the Mundell-Fleming model, illustrate the effect of a restrictive monetary policy in a fixed exchange rate system with:

- (a) Imperfect capital mobility, and (13marks)
- (b) Perfect capital mobility (12marks)

SECTION B - COMPULSORY

Question 6

25marks

July would have been a worse month for the rand if it weren't for the US Federal Reserve. South Africa's currency has weakened about 1% against the dollar this month, buffeted by Eskom's financial crisis and the strain it's putting on government coffers. But the prospect

2019-07-31
2019-07-31

55

of a Fed rate cut on Wednesday has capped the rand's losses as money continues to flow into high-yielding assets.

"Recent news around South Africa has not been positive," said Carl Vermassen, a Zurich-based senior portfolio manager at Vontobel. "But South Africa is what we would call a typical emerging-market liquidity market. This means that the performance of the market is at least partly driven by global risk appetite. As such, Fed policy is important."

Lower US rates would increase the rand's carry appeal as the hunt for yield trumps bad news from South Africa, at least for now. The currency's implied carry — a measure of expected returns for dollar-funded rand investments — is at the highest since May 2018. While Eskom's troubles are daunting, South Africa still has time to avoid losing its last investment-grade credit rating, according to Lukman Otunuga, a London-based research analyst at FXTM. Moody's Investors Service, which rates the country's debt at Baa3, is reviewing its assessment in November. While a downgrade from Moody's could send the dollar-rand cross back to levels not seen since March 2016 — around **R16 per dollar** — the currency could strengthen to **R12.50 per dollar** if South Africa avoids the junk rating and the Fed continues to ease policy, he said.

(This is where the rand could go by the end of 2019. [Bloomberg 31 July 2019.](https://businesstech.co.za/news/finance/332505/this-is-where-the-rand-could-go-by-the-end-of-2019/)
<https://businesstech.co.za/news/finance/332505/this-is-where-the-rand-could-go-by-the-end-of-2019/>

Answer the following questions based on above article:

- (a) Explain how the Fed rate cut has "capped the rand's losses" 5marks

- (b) In the article, Carl Vermassen implies that "the performance of the South African market is at least partly driven by global risk appetite. As such, Fed policy is important." Explain the meaning of this statement and its effect on the rand 10marks

- (c) Identify and explain the exchange rate determination approach that is implied in the article 5marks

- (d) Explain the effect of a possible credit rating downgrade on the rand 5marks

.....*Good luck*