UNIT OUTLINE
2002

ECON 867
INTERNATIONAL FINANCE MANAGEMENT

Unit homepage: www.econ.mq.edu.au/ courses/ econ867

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- Teaching Program
- Coursework and Assessment
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Dr Kim Hawtrey
Lecturer-in-charge
(khawtrey@efs.mq.edu.au)
1. COURSE OVERVIEW

This course employs analytical techniques to study international finance and investment.

World financial markets and global flows of funds today form an influential part of the economic landscape. The aim in this course is to sift through the language of international finance and understand the key issues, including interest and inflation parity benchmarks, exchange rate movements (real and nominal), foreign exchange trading and hedging, and cross-border business investment.

2. TEACHING PROGRAM

Staff for the course:

Dr Kim Hawtrey                                                   Lecturing weeks 1-13
(C5C Room 392. Telephone 98508504. Email khawtrey@efs.mq.edu.au)

Enquiries about the subject matter of lectures can be directed to the lecturer in the first instance by email, or by phone or in person. Dr Hawtrey can answer general enquiries about course administration and assessment.

Classes consist of a three-hour lecture block, held as follows:

    Thursdays 6-9 pm       W5AT2

There are no separate tutorials, however lectures will incorporate applications and practical exercises to aid understanding of concepts.

3. COURSEWORK AND ASSESSMENT

Assessment for ECON867 is based on an assignment and final exam, weighted as shown below:

    Assignment                  30%
    Examination                70%
The **Assignment** (30%) is to be submitted by **6pm sharp Monday 6 May 2002**, and should be lodged in the ECON867 box in ERIC (C5C244). It must be submitted using the official cover sheet (see page 9) with plagiarism declaration signed (page 10). Keep a dated, witnessed copy of your assignment in case of misadventure. Late assignments may or may not be received, at the discretion of the Lecturer-in-charge, and will be subject to a lateness penalty. After staff processing, marked assignments will be returned to students in Week 13 of semester.

The assignment **TOPIC** can be found on pages 6-8 of this unit outline.

The **Examination** (70%) will be two hours in duration and will consist of a mix of multiple choice and long-answer questions.

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### 4. TEXTBOOK

The core text for the course is:


Set chapters in the textbook corresponding to each lecture topic (see calendar below) are examinable and students are strongly recommended to read the textbook in conjunction with lectures.

Other useful reference texts (optional) for the course include:


Additional readings may also be recommended in lectures on a topic-by-topic basis, for those students wishing to go deeper into particular aspects of the course.

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### 5. LECTURE TOPICS

**Week 1: Introduction to foreign currency markets**

Provides an overview of the broad features and functions of foreign exchange (FX) markets, especially in the Australian context. How foreign currencies trading operates. Explanation of spot, forward and expected future exchange rates.
**Week 2: Interest rate parity**
Relates spot and forward exchange rates to international interest rate differentials, a relationship known as the ‘interest parity theorem’. The role of arbitrage in maintaining interest parity relationships. Discussion of covered and uncovered interest parity. Hedging and speculation in currency markets.

**Week 3: Purchasing power parity**
Develops the concept of the real, effective exchange rate. Distinguishes between bilateral and multilateral exchange rates, and between nominal and real exchange rates. The concept of ‘purchasing power parity’ (PPP).

**Week 4: Currency risk I – Understanding risk premia**
Considers risk premiums in foreign exchange and global interest rates, building upon the earlier discussion of interest rate parity. Considers various risk premia, such as exchange rate risk (both nominal and real), sovereign risk, country risk.

**Week 5: Currency risk II – Hedging**
Ways of managing foreign currency risk exposure. Evaluation of ‘natural’ hedging approaches. Discussion of ‘market’ hedging instruments, both short and long term and involving either spot or forward markets.

**Week 6: Currency risk III – VAR**

**Week 7: Currency risk IV – Swaps**
Looks at the economics of foreign swaps, including hedging and cost factors. The role of swaps in risk-management. Accounting for swaps.

**Week 8: Currency risk V – Options**
Exchange rate risk may be hedged through the FX options market. Discussion of types of options, option pricing and strategies.

**Week 9: Currency risk VI – Futures**

**Week 10: Modelling the exchange rate**
Deals with the economics of exchange rate determination in the broader macroeconomic context. Factors affecting the equilibrium exchange rate. Approaches to modelling the historical path of the exchange rate.

**Week 11: Forecasting the exchange rate**
Discusses techniques for predicting the future path of the exchange rate. The relative merits of econometric models versus other approaches to forecasting currency movements.
**Week 12: International investing**
Examines the decision making requirements involved in offshore portfolio and direct investment, from a macro perspective. The role of taxation, including the impact of differential capital income and withholding tax regimes. The impact of Foreign Controlled Company legislation.

**Week 13: International capital budgeting**
Deals with decisions relating to foreign direct investment projects from a micro perspective, at the level of the individual firm. Defining the ‘international cost of capital’.

### COURSE CALENDAR

<table>
<thead>
<tr>
<th>Week no.</th>
<th>Date commencing</th>
<th>Topic</th>
<th>Textbook chapter set reading</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>4 March</td>
<td>Introduction</td>
<td>2</td>
</tr>
<tr>
<td>2</td>
<td>11 March</td>
<td>Interest rate parity</td>
<td>3</td>
</tr>
<tr>
<td>3</td>
<td>18 March</td>
<td>Purchasing Power Parity</td>
<td>5</td>
</tr>
<tr>
<td>4</td>
<td>25 March</td>
<td>Currency risk I</td>
<td>13</td>
</tr>
<tr>
<td></td>
<td>(mid semester break)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>15 April</td>
<td>Currency risk II</td>
<td>14</td>
</tr>
<tr>
<td>6</td>
<td>22 April</td>
<td>Currency risk III</td>
<td>15</td>
</tr>
<tr>
<td>7</td>
<td>29 April</td>
<td>Currency risk IV</td>
<td>10</td>
</tr>
<tr>
<td>8</td>
<td>6 May</td>
<td>Currency risk V</td>
<td>18</td>
</tr>
<tr>
<td>9</td>
<td>13 May</td>
<td>Currency risk VI</td>
<td>16</td>
</tr>
<tr>
<td>10</td>
<td>20 May</td>
<td>Modelling the exchange rate</td>
<td>21</td>
</tr>
<tr>
<td>11</td>
<td>27 May</td>
<td>Forecasting the exchange rate</td>
<td>22</td>
</tr>
<tr>
<td>12</td>
<td>3 June</td>
<td>International investing</td>
<td>23</td>
</tr>
<tr>
<td>13</td>
<td>10 June</td>
<td>International capital budgeting</td>
<td>25</td>
</tr>
</tbody>
</table>

- Assignment due by 6 pm Monday 6 May
6. **ASSIGNMENT TOPIC**

DUE DATE: 6pm 6 May 2002 (to be deposited in ECON867 box in ERIC)

NATURE OF ASSIGNMENT: Applied exercises and case study

**PART ONE: Exchange rates (30% of assignment mark)**

1. In foreign exchange quotes, explain the difference between a ‘price taker’ and a ‘price maker’.

2. Suppose there are two currencies: AUD and USD. In the following cases, identify which party is the price taker and price maker, respectively:
   - (a) Bank X calls Bank Y for a USD/AUD quote
   - (b) Bank X calls an importer who is offering to sell AUD
   - (c) an exporter calls Bank X seeking to sell USD

3. From the following descriptions of each party, deduce who is calling whom and what they are seeking to do (assume the domestic currency is AUD and foreign currency is USD):
   - (a) importer is price taker, Bank X is price maker
   - (b) Bank X is price maker, exporter is price taker
   - (c) Bank X is price maker, Bank Y is price taker

4. Assume the following bid or offer rates are being quoted:
   (Note – exchange rate symbols are written with the variable currency in the numerator and base currency in the denominator)

<table>
<thead>
<tr>
<th>Currency</th>
<th>Bank X</th>
<th>Bank Y</th>
</tr>
</thead>
<tbody>
<tr>
<td>USD/AUD</td>
<td>0.5200/05</td>
<td>0.5198/03</td>
</tr>
<tr>
<td>Euro/USD</td>
<td>1.1260/70</td>
<td>1.1263/78</td>
</tr>
<tr>
<td>JPY/USD</td>
<td>134.15/20</td>
<td>134.12/18</td>
</tr>
<tr>
<td>USD/GBP</td>
<td>1.4316/22</td>
<td>1.4313/19</td>
</tr>
<tr>
<td>GBP/USD</td>
<td>0.6982/85</td>
<td>0.6984/87</td>
</tr>
</tbody>
</table>

   (Memo item: GBP/USD 0.6982/85 0.6984/87)

   At what price will the following trades be made:
   (Note - in cases where two banks are involved, assume that the first bank mentioned is the ‘price taker’)
(a) importer buying USD against AUD from Bank Y
(b) exporter selling USD against AUD from Bank X
(c) Bank Y buying AUD against USD from Bank X
(d) Bank Y buying USD against JPY from Bank X
(e) importer buying Euro against USD from Bank Y
(f) Bank Y selling GBP against USD to Bank X
(g) Bank Y selling GBP against AUD to importer
(h) Bank Y buying Euro against JPY from Bank X
(i) Bank X selling GBP and buying Euro from Bank Y
(j) exporter selling JPY against AUD to Bank X
(k) importer selling AUD against GBP to Bank Y
(l) exporter selling EUR against AUD to Bank X

(Hint: parts g and following involve cross-rates)

5. If Bank Y’s quote on GBP was changed to 1.4312/14, then:

   (a) explain how an importer can deal with both Bank X and Bank Y in GBP/USD and make an ‘arbitrage’ profit
   (b) if the importer in (a) deals GBP1,000,000 how much profit will be made, measured in USD?
   (c) what is the AUD equivalent of the profit in (b) if the importer converts it to AUD by dealing with Bank X?

**PART TWO: Purchasing power parity (70% of assignment mark)**

Build, estimate and interpret a simple econometric test equation (using actual data) of the purchasing power parity (PPP) hypothesis.

Steps to follow:

(a) AIM: state your null hypothesis (ie the PPP hypothesis in either absolute or relative form) and outline in one or two paragraphs the economic rationale for PPP

(b) METHOD: specify a simple test equation in line with the hypothesis

(c) DATA: collect data which will allow you to test the hypothesis using your equation, for Australia and the US or any two countries you select; attach the data as an appendix and be careful to provide all data definitions and sources
(d) RESULTS: econometrically estimate the equation in (b) using the data in (c) using a standard time series estimation package such as Shazam or Excel; attach the summary program output for the preferred equation to your assignment as an appendix.

(e) DISCUSSION: write one-two pages interpreting your results in (d) and discussing the implications of your empirical results for the PPP hypothesis.

Additional comments:

1. State (eg in a footnote) the econometric package you have used.
   
   Hints:
   If using EXCEL: go to ‘Tools’, then click on ‘Data Analysis’, then on ‘Regressions’.

2. Simple time series estimation only is required; more advanced econometric issues (such as unit roots, heteroskedasticity etc) can be Ignored for the purposes of this assignment.

3. Data may be obtained from dX on the student network. The time span is at the student’s discretion, but should be at least ten years or more.

Optional reference:

7. **ASSIGNMENT COVER SHEET**  
(To be attached to the front of your assignment)

DUE DATE: 6pm 6 May 2002 (to be deposited in ECON867 box in ERIC)  
NATURE OF ASSIGNMENT: Applied exercises and case study

**FULL NAME:** ........................................................................................................

**STUDENT No:** ......................................................................................................

<table>
<thead>
<tr>
<th>ASSESSMENT:</th>
<th>Good</th>
<th>Fair</th>
<th>Poor</th>
</tr>
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<tbody>
<tr>
<td>Presentation</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Length</td>
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<td>Analysis</td>
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<td>Expression</td>
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<td>Layout</td>
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</tbody>
</table>

Marks deducted:  
Lateness ............  
Poor presentation ............  
No acknowledgments ............  
Length ............  
Poor grammar ............  
No data attached ............  
No estimates attached ............

**FINAL MARK (out of 30)** ............

Marker’s comment:
PLAGIARISM DECLARATION

Plagiarism involves using the work of another person and presenting it as one’s own. Any of the following acts constitutes plagiarism unless the source of each piece of borrowed material is clearly acknowledged:

(a) copying out part(s) of any document or audiovisual material, including computer or web based material

(b) using or extracting another person’s concepts, computations, experimental results or conclusions

(c) summarising another person’s work

(d) submitting substantially the same wording, results or material as another student.

Encouraging or assisting another person to commit plagiarism is also an improper form of academic conduct and may attract the same penalties as plagiarism.

STATEMENT TO BE SIGNED BY STUDENT:

1. I have read the description of plagiarism above

2. In my assignment I have carefully acknowledged the source of any material which is not my own work

3. I am aware that plagiarism can attract severe academic penalties

.................................................................................. .................................................. ..............................
(NAME)                            (STUDENT I.D.)                (signature)

THIS PAGE MUST BE COMPLETED AND ATTACHED TO THE ESSAY.