EC 5007- INTERNATIONAL FINANCE

TERM 1

STUDENT NAME:

DATE:

ABSTRACT

The given assignment reflects the adjustment of spot rate as per the purchasing power parity and the explanation on Law of one price. The relation between the purchasing power parity and the Law of one price has also been explained. An attempt has been made to solve both the practical questions given in the assignment.

Contents

Answer 1

Forward contract National = USD 2,000,000

Forward exchange rate = 0.8009 GBP/USD

Counterpart A is short on the GBP/USD forward contract since it wants to buy USD, and a fixed exchange rate is wanted.

If the spot exchange rate on the 30th august 2019 with the value 0.8020

At the future spot rate of 0.8020, as B has a locked rate of 0.8009, so it is likely to default, to sell USD 2 million to counterpart A.

Counterpart B's opportunity cost in the forward contract is calculated as follows:

= (Future spot rate – Forward exchange rate) * National

= (0.8020-0.8009) *$2,000,000

= $2200

If the spot exchange rate on the 30th august 2019 with the value 0.8001

At the future spot rate of 0.8001, as A has a locked rate of 0.8009, so it is likely to default, to sell USD 2 million to counterpart B.

Counterpart B's opportunity cost in the forward contract is calculated as follows:

= (Forward exchange rate – Future spot rate) * National

= (0.8009-0.8001) *$2,000,000

= $1600

If the spot exchange rate on the 30th august 2019 with the value 0.8009

Neither party is going to default as the spot rate = forward rate

Counterpart A's opportunity cost in the forward contract = (Forward exchange rate – Future spot rate) * National

= (0.8009-0.8009) * $2000000

= 0

Answer 2

As per the question, it has been assumed that Spot rate = 0.1131 GBP/CNY

China inflation rate = 5%, UK inflation rate = 2%

As per the purchasing power parity condition

Expected future spot rate = Spot rate GBP/CNY * ((1+ UK inflation rate)/ (1+ China inflation rate))

= 0.1131*((1+2%)/ (1+5%))

= 0.109868 GBP/CNY

Answer 3

The Law of one price (LOOP) states that if the prices the goods are stated in the same currency, then such goods should have the same price (Cardebat et al., 2017). However, there are many assumptions that need to be assumed in this Law.

Competition in the market is free.

There are no restrictions on trade.

Prices are flexible. It means buyers, as well as sellers, cannot manipulate the prices of the goods.

Moreover, arbitrage opportunities will arise if the prices of the same goods are not the same. If the prices of the goods are not kept the same, then opportunities for arbitration will arise. It means that a trade can be conducted by persons by buying goods at lower prices and then selling such goods at a higher price in another market, thus, making a profit on the same goods by dealing in different markets. Sometimes, Law of one price does not hold good every time. For instance, if there are some goods on which there are trade barriers, or on which there is an involvement of transaction costs, then on such goods, this la will not hold good.

It has been believed that the Law of one price is much better applicable in the financial market as compared to international trade.

According to the Law of one price, Pd = pf*S

Where: pd- good's price in the domestic country, pf – good's price in the international country, S- exchange rate of national and international country

Purchase Price Parity can also be measured from this Law. As per the purchasing power parity, Equal purchasing power should be established in relation to the goods in two different markets (Lothian, 2016). The purchase price parity should be maintained between two nations so as to keep the principle of one price in contempt of the differences in currencies.

REFERENCES

Cardebat, J.M., Faye, B., Le Fur, E. and Storchmann, K., 2017. The law of one price? Price dispersion on the auction market for fine wine. *Journal of Wine Economics*, *12*(3), p.302.

Lothian, J.R., 2016. Purchasing power parity and the behavior of prices and nominal exchange rates across exchange-rate regimes. *Journal of International Money and Finance*, *69*, pp.5-21.