Session 12: Post class test solutions -

1. **d. Differences in inflation.** Since it is the same company raising money for the same project, the risks should be the same, no matter what currency the lending is in, leaving inflation to be the one variable that can cause differences.
2. **c. 22.86 pesos/US$.** Expected exchange rate using interest rate parity = 22.00 *(1.06/1.02) = 22.86
3. **b. $1.18/£.** Use the differential inflation compounded over ten years. Expected exchange rate = 1.30 $(1.01/1.02)^{10}$ = $1.18/£. The dollar has less inflation. So, it appreciates relative to the pound.
4. **c. Rs 102.84/$.** Since the inflation rate changes in Indian rupees over time from 10% in years 1-2 to 6% in the following years, you have to compound carefully: Expected exchange rate = $75*(1.1^2*1.06^{3)})/(1.01^5$ = Rs 102.84/£.