5 practice problems

Business

An example of a political risk is d. both answers a and b are correct. Both expropriation of assets and adverse change in tax rules fall under political risks

Expropriation of assets

This is simply a situation where the government takes over a privately own business with the aim of benefiting the public. This is done with due compensation to the owner though without consent of the owner. Under insurance risk covers, expropriation of assets is classified under political risks that include confiscation, nationalization, and other foreign government actions (Meridian Finance par 1).

Adverse change in tax rules.

Factors that do affect business besides market based effects include government decisions or changes. Among decisions that the government can make changes on include taxes, and other factors. Depending on the government it can be adverse or favourable.

2. Suppose Mexico is a major export market for your U. S.-based company and the Mexican peso appreciates drastically against the U. S. dollar. This means that

c. your domestic competitors will enjoy a period of facing lessened price competition from Mexican imports.

If the US dollar is strong against another currency, it leads to increased demand of imports as prices go down. This inturn weakens export as foreign goods appear to be expensive outside the country. Importers prefer strong local currency while exporters prefer weak local currency (Econedlink par 11)

3. Suppose that Great Britain is a major export market for your firm, a U. S.-

based MNC. If the British pound depreciates against the U. S. dollar,

c. to protect U. K. market share, your firm may have to cut the dollar price of your goods to keep the pound price the same.

For an export business based in the US the ideal situation would be if the dollar weakens, this makes it attractive for foreigners to buy goods from US, but if it appreciates it, makes foreign goods seem expensive. To balance this fluctuation the company needs to cut the dollar price to match the prices in pounds (Econedlink par 11).

4. Suppose that you are a U. S. producer of a commodity good competing with foreign producers. Your inputs of production are priced in dollars and you sell your output in dollars. If the U. S. currency depreciates against the currencies of our trading partners, b. your competitive position is likely worsened.

When the dollar appreciates, this makes foreign goods seem cheaper and this improves their position in the market, but when the dollar depreciates the price of foreign goods seem expensive and this may probably worsen the position of foreign business (Econedlink par 11).

5. Suppose your firm invests $100, 000 in a project in Italy. At the time the exchange rate is $1. 25 = €1. 00. One year later the exchange rate is the same, but the Italian government has expropriated your firms assets paying only €80, 000 in compensation. This is an example of

b. political risk

It does not matter the exchange rate, what counts is the fact that the government has taken over a private own business. The government does this without the owner’s consent but there must be compensation (Meridian Finance par 1).

6. What major dimension sets apart international finance from domestic finance?

d. All of the above

The three major dimensions that set apart international finance from foreign finance include: Foreign exchange and political risks, Market imperfections and expanded opportunity set.

Works cited

Meridian Finance. Political Risk Insurance, Expropriation Of Assets. 2014. http://www. meridianfinance. com/political_risk. html 12 June 2014

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