<u>Set 2 – Currency forwards</u>

Basic terms:

- Currency forward - its characteristics, conditions and use
- Non-deliverable forward (NDF)
- Forward with variable settlement date
- Interest rate arbitrage
- Speculation based on short selling and speculation with forwards

Exercise 1

Let’s assume following quoted prices:

3-month *USD deposit* rate	2.46% p. a.
3-month USD *loan* rate	2.56% p. a.
3-month EUR *deposit* rate	2.63% p. a.
3-month EUR *loan* rate	2.69% p. a.
Spot rate EUR/USD	1.5000 - 11
3-month forward rate EUR/USD	1.4946 - 63

We don’t account for any other transactional cost. Answer the following questions:

- Is there any market discrepancy we could capitalize on?
- If so, what would be your steps you take when exercising a covered interest arbitrage, if you could borrow 1.5 million USD (1 million EUR respectively)? What would the process of exchange rate realignment look like?
- What would be the equilibrium forward rate?

Exercise 2

Let's assume following quoted prices:

USD interest rate	2 % p. a.
EUR interest rate	4 % p. a.
Spot rate	1.5000 EUR/USD
3-month forward rate	1.4926 EUR/USD

Over the 3-month horizon we expect USD depreciation up to 1.5268 EUR/USD.

- What would be our profit from exercising this speculation, if our expectations came true and we could borrow 1 million USD?
- What would be the result of this speculation if our expectations failed and USD appreciates up to 1.4892 EUR/USD?
- What would the alternative speculation using forward contract look like?