



e) Same as d) but the costs of fulfilling Universian regulatory requirements are \$US 20,000.

f) Same as d) but the costs of fulfilling Universian regulatory requirements are \$US 50,000.

## Question 2

A 1 year US government US\$1m bond pays 5% interest, with certainty, in 1 year's time. Yellow County (USA) wants to borrow US\$1m and repay in 1 year with interest. Yellow County finances are considered a bit suspicious, with the probability of default estimated at 1% within a year. In the event of default, investors believe they can sue the Yellow County, incurring a legal cost of \$US 100,000. They are certain that the Court rules that the county sells the swimming pool, which it owns, and directs the money from the sale to be distributed between the investors. The investors estimate that pool can be sold for \$600 000.

A Pan-European country, Smiley Land, also wants to borrow US\$1m to repay in a year. Investors believe in 1% probability of default, in which case the president of Smiley Land will mysteriously disappear, and investors' money will be lost, as legal rights in Smiley Land are not enforceable.

(a) Calculate the interest rates investors should charge Yellow County and Smiley Land if the investors **are risk neutral** (all they care about is the expected return they get). (Note: the expected return on equal investments should be equal, i.e. US government bond, the bonds issued by Yellow County or Smiley Land have to provide equal returns.)

(b) Comment, how your answer to question a) changes, if the investors are risk averse, i.e. prefer a certain return.

(c) From a) and b), say something about the relationship between risk aversion, legal protection, and the relative cost of borrowing in USA and Smiley Land.

**Question 3 (Please, be concise, limit your answer by one page at most).**

See Levich, pages 34 - 35, "The Floating-Rate Dollar Standard, 1973-1984," and Box 2.4. Comment on the features, the reasons of introduction and the means of sustaining this exchange regime.

**Question 4 (Please, be concise, limit your answer by one page at most).**

"A country imports more than exports, and has a current account deficit. It means that imports are too cheap, the exchange rate is overvalued, and the country is living beyond its means." Indicate whether this statement is true or false.

**Question 5 (Bonus) (Please, be concise, limit your answer by one page at most).**

Comment on resignation of Gavin Casey (CEO of LSE), and briefly evaluate his tenure. For the related information, see Wall Street Journal, September 18, 2000, and The Times, September 16, 2000 (see the course web cite for the articles). Feel free to use other publications of your choice. Please, attach to your answer a copy of the additional resources (if any were used).