



**THE UNIVERSITY OF THE WEST INDIES
CAVE HILL**

EXAMINATIONS OF APRIL/MAY 2013

CODE AND NAME OF COURSE: MGMT3053 - INTERNATIONAL FINANCIAL MANAGEMENT

DATE AND TIME:

DURATION: 2 HOURS

INSTRUCTIONS TO CANDIDATES: This paper has 8 pages and 4 questions.

Section one is compulsory and has one question worth 20 marks.

Section two has three questions from which candidates may answer any two questions.

Each question is worth 25 marks.

Section one: Answer all questions in this section

Question 1:

1. Which of the following would likely have the *least* direct influence on a country's current account?
 - a) inflation.
 - b) national income.
 - c) exchange rates.
 - d) a tax on income earned from foreign stocks

2. The international money market primarily concentrates on:
 - a) short-term lending (one year or less).
 - b) medium-term lending.
 - c) long-term lending.
 - d) placing bonds with investors.

3. LIBOR is:
 - a) the interest rate commonly charged for loans between banks.
 - b) the average inflation rate in European countries.
 - c) the maximum loan rate ceiling on loans in the international money market.
 - d) the maximum interest rate offered on bonds that are issued in London.

TURN OVER

4. When the "real" interest rate is relatively low in a given country, then the currency of that country is typically expected to be:
- a) weak, since the country's quoted interest rate would be high relative to the inflation rate.
 - b) strong, since the country's quoted interest rate would be low relative to the inflation rate.
 - c) strong, since the country's quoted interest rate would be high relative to the inflation rate.
 - d) weak, since the country's quoted interest rate would be low relative to the inflation rate.
5. The equilibrium exchange rate of pounds is \$1.70. At an exchange rate of \$1.72 per pound:
- a) Demand for pounds would exceed the supply of pounds for sale and there would be a shortage of pounds in the foreign exchange market.
 - b) Demand for pounds would be less than the supply of pounds for sale and there would be a shortage of pounds in the foreign exchange market.
 - c) Demand for pounds would exceed the supply of pounds for sale and there would be a surplus of pounds in the foreign exchange market.
 - d) Demand for pounds would be less than the supply of pounds for sale and there would be a surplus of pounds in the foreign exchange market.
6. Assume the following bid and ask rates of the pound for two banks as shown below:

	<u>Bid</u>	<u>Ask</u>
Bank A	\$1.41	\$1.42
Bank B	\$1.39	\$1.40

As locational arbitrage occurs:

- a) the bid rate for pounds at Bank A will increase; the ask rate for pounds at Bank B will increase.
- b) the bid rate for pounds at Bank A will increase; the ask rate for pounds at Bank B will decrease.
- c) the bid rate for pounds at Bank A will decrease; the ask rate for pounds at Bank B will decrease.
- d) the bid rate for pounds at Bank A will decrease; the ask rate for pounds at Bank B will increase.

TURN OVER

7. Thornton, Inc. needs to invest five million Nepalese rupees in its Nepalese subsidiary to support local operations. Thornton would like its subsidiary to repay the rupees in one year. Thornton would like to engage in a swap transaction. Thus, Thornton would:
- a) convert the rupees to dollars in the spot market today and convert rupees to dollars in one year at today's forward rate.
 - b) convert the dollars to rupees in the spot market today and convert dollars to rupees in one year at the prevailing spot rate.
 - c) convert the dollars to rupees in the spot market today and convert rupees to dollars in one year at today's forward rate.
 - d) convert the dollars to rupees in the spot market today and convert rupees to dollars in one year at the prevailing spot rate.
8. If you expect the British pound to appreciate, you could speculate by _____ pound call options or _____ pound put options.
- a) purchasing; selling
 - b) purchasing; purchasing
 - c) selling; selling
 - d) selling; purchasing
9. Assume that a speculator purchases a put option on British pounds (with a strike price of \$1.50) for \$.05 per unit. A pound option represents 31,250 units. Assume that at the time of the purchase, the spot rate of the pound is \$1.51 and continually rises to \$1.62 by the expiration date. The highest net payoff possible for the speculator based on the information above is:
- a) \$1,562.50.
 - b) -\$1,562.50.
 - c) -\$1,250.00.
 - d) -\$625.00.

TURN OVER

10. Assume the following information:

- You have \$300,000 to invest
- The spot bid rate for the euro (€) is \$1.08
- The spot ask quote for the euro is \$1.10
- The 180-day forward rate (bid) of the euro is \$1.08
- The 180-day forward rate (ask) of the euro is \$1.10
- The 180-day interest rate in the U.S. is 6%
- The 180-day interest rate in Europe is 8%

If you conduct covered interest arbitrage, how much will you have after 180 days?

- a) \$318,109.10.
- b) \$330,000.00.
- c) \$312,218.20.
- d) \$323,888.90.

11. Which of the following is correct?

- a) The longer the time to maturity, the less the value of a currency call option, other things equal.
- b) The longer the time to maturity, the less the value of a currency put option, other things equal.
- c) The higher the spot rate relative to the exercise price, the greater the value of a currency put option, other things equal.
- d) The lower the exercise price relative to the spot rate, the greater the value of a currency call option, other things equal.

12. A firm will likely benefit *most* from diversifying if:

- a) the correlations between country economies are high.
- b) the correlations between country economies are low.
- c) the variability of all country economy levels is high.
- d) the correlations between country economies are low AND the variability of all country economy levels is high.

13. If interest rate parity exists and transactions costs are zero, the hedging of payables in euros with a forward hedge will:

- a) have the same result as a call option hedge on payables.
- b) have the same result as a put option hedge on payables.
- c) have the same result as a money market hedge on payables.
- d) require more dollars than a money market hedge.

TURN OVER

14. It has been argued that the exchange rate can be used as a policy tool. Assume that the government would like to reduce unemployment. Which of the following is an appropriate action given this scenario?
- a) weaken the dollar.
 - b) strengthen the dollar.
 - c) buy dollars with foreign currency in the foreign exchange market.
 - d) implement a tight monetary policy.
15. Given a home country and a foreign country, purchasing power parity (PPP) suggests that:
- a) a home currency will depreciate if the current home inflation rate exceeds the current foreign interest rate.
 - b) a home currency will appreciate if the current home interest rate exceeds the current foreign interest rate.
 - c) a home currency will appreciate if the current home inflation rate exceeds the current foreign inflation rate.
 - d) a home currency will depreciate if the current home inflation rate exceeds the current foreign inflation rate.
16. Assume that interest rate parity holds. The U.S. five-year interest rate is 5% annualized, and the Mexican five-year interest rate is 8% annualized. Today's spot rate of the Mexican peso is \$.20. What is the approximate five-year forecast of the peso's spot rate if the five-year forward rate is used as a forecast?
- a) \$.131.
 - b) \$.226.
 - c) \$.174.
 - d) \$.140.
17. Jacko Co. is a U.S.-based MNC with net cash inflows of Singapore dollars and net cash inflows of Sunland francs. These two currencies are highly negatively correlated in their movements against the dollar. Kriner Co. is a U.S.-based MNC that has the same exposure as Jacko Co. in these currencies, except that its Sunland francs represent cash outflows. Which firm has a high exposure to exchange rate risk?
- a) Jacko Co.
 - b) Kriner Co.
 - c) the firms have about the same level of exposure.
 - d) neither firm has any exposure.

TURN OVER

18. Laketown Co. has some expenses and revenue in euros. If its expenses are more sensitive to exchange rate movements than revenue, it could reduce economic exposure by _____. If its revenues are more sensitive than expenses, it could reduce economic exposure by _____.
- a) decreasing foreign revenues; decreasing foreign expenses
 - b) decreasing foreign revenues; increasing foreign expenses
 - c) increasing foreign revenues; decreasing foreign revenues
 - d) decreasing foreign expenses; increasing foreign revenues
19. Ideally, a firm desires to denominate bonds in a currency that:
- a) exhibits a low interest rate and is expected to appreciate.
 - b) exhibits a low interest rate and is expected to depreciate.
 - c) exhibits a high interest rate and is expected to depreciate.
 - d) exhibits a high interest rate and is expected to appreciate.
20. If the Fed desires to weaken the dollar without affecting the dollar money supply, it should:
- a) exchange dollars for foreign currencies, and sell some of its existing Treasury security holdings for dollars.
 - b) exchange foreign currencies for dollars, and sell some of its existing Treasury security holdings for dollars.
 - c) exchange dollars for foreign currencies, and buy existing Treasury securities with dollars.
 - d) exchange foreign currencies for dollars, and buy existing Treasury securities with dollars.

(Total 20 marks)

TURN OVER

SECTION 2: Choose two questions from this section

Question 2

- A. Four main schools of thought exist as to the relevance of exchange rate risk. The Multinational Corporation's treatment of exchange rate risk is a result of their thoughts on exchange rate risk. Discuss these thoughts surrounding exchange rate risks, and the MNC's response to these arguments. (10 marks)
- B. Langford Inc. expects to pay S\$2,125,000 in one year on a loan. The existing spot rate of the Singapore dollar is \$.58. The one-year forward rate of the Singapore dollar is \$.62. Langford created a probability distribution for the future spot rate in one year as follows:

<u>Future Spot Rate</u>	<u>Probability</u>
\$.57	30%
.60	35
.65	35

Assume that one-year put options on Singapore dollars are available, with an exercise price of \$.64 and a premium of \$.04 per unit. One-year call options on Singapore dollars are available with an exercise price of \$.59 and a premium of \$.03 per unit. Assume the following money market rates:

	<u>U.S.</u>	<u>Singapore</u>
Deposit rate	8%	5%
Borrowing rate	9	6

Required:

- Given this information, determine whether a forward hedge, money market hedge, or a currency options hedge would be most appropriate. (10 marks)
- Calculate the effective exchange rate that Langford would lock in on its payables position if it used a money market hedge. (2 marks)
- Compare the most appropriate hedge to an unhedged strategy, and decide whether Langford should hedge its payables position. (3 marks)

TURN OVER

Question 3

- A. With reference to the recent quantitative easing exercises of larger developed countries, explain the difference between sterilized and non-sterilized government intervention, and state the type of currency systems that are best suited for each type. (10 marks)
- B. A put option on British pounds (£) exists with a strike price of \$1.60 and a premium of \$.03 per unit. Another put option on British pounds has a strike price of \$1.62 and a premium of \$.04 per unit.

Required:

- i) Describe how a bullspread can be constructed using these options, and explain the difference between using put options versus call options to construct a bullspread. (4 marks)
- ii) Compute the payoff on this bullspread at \$1.55 and \$1.67. (4 marks)
- iii) If the British pound spot rate is \$1.60 at option expiration, compute the total profit or loss for a bearspread. (3 marks)
- iv) Construct a contingency graph for the above bearspread (4 marks)

Question 4

- A. Compare and contrast the theories of Interest Rate parity, Purchasing Power parity, and the International Fisher effect. Include in your discussion the validity of these theories as shown by empirical evidence. (15 marks)
- B. Identify the four methods of forecasting exchange rates and list the advantages and disadvantages of each method. (10 marks)

END OF QUESTION PAPER