



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

EXAMINATIONS OF APRIL/MAY 2010.

CODE AND NAME OF COURSE: MGMT3053 - INTERNATIONAL FINANCIAL MANAGEMENT

DATE AND TIME:

DURATION: 2 HOURS

INSTRUCTIONS TO CANDIDATES: This paper has 9 pages and 23 questions.

This paper has two (2) sections. Section One is compulsory and has twenty questions worth 1 mark each. Section Two has three questions from which candidates must answer any two questions. Each question is worth 25 marks.

SECTION 1

This section is compulsory.

1. Which of the following theories identifies specialization as a reason for international business?
 - A) theory of comparative advantage.
 - B) imperfect markets theory.
 - C) product cycle theory.
 - D) none of these.

2. A high home inflation rate relative to other countries would _____ the home country's current account balance, other things equal. A high growth in the home income level relative to other countries would _____ the home country's current account balance, other things equal.
 - A) increase; increase
 - B) increase; decrease
 - C) decrease; decrease
 - D) decrease; increase

TURN OVER

3. A weak home currency may not be a perfect solution to correct a balance of trade deficit because:
- A) it reduces the prices of imports paid by local companies.
 - B) it increases the prices of exports by local companies.
 - C) it prevents international trade transactions from being prearranged.
 - D) foreign companies may reduce the prices of their products to stay competitive.
4. Assume the Canadian dollar is equal to \$.88 and the Peruvian Sol is equal to \$.35. The value of the Peruvian Sol in Canadian dollars is:
- A) about .3621 Canadian dollars.
 - B) about .3977 Canadian dollars.
 - C) about 2.36 Canadian dollars.
 - D) about 2.51 Canadian dollars.
5. The international credit market primarily concentrates on:
- A) short-term lending (less than one year).
 - B) medium-term lending.
 - C) long-term lending.
 - D) placing newly issued stock in fore
6. 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.
7. 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.
8. If U.S. inflation suddenly increased while European inflation stayed the same, there would be:
- A) an increased U.S. demand for euros and an increased supply of euros for sale.
 - B) a decreased U.S. demand for euros and an increased supply of euros for sale.
 - C) a decreased U.S. demand for euros and a decreased supply of euros for sale.
 - D) an increased U.S. demand for euros and a decreased supply of euros for sale

TURN OVER

9. 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.
10. The phrase "the dollar was mixed in trading" means that:
- A) the dollar was strong in some periods and weak in other periods over the last month.
 - B) the volume of trading was very high in some periods and low in other periods.
 - C) the dollar was involved in some currency transactions, but not others.
 - D) the dollar strengthened against some currencies and weakened against others.
11. Kalons, Inc. is a U.S.-based MNC that frequently imports raw materials from Canada. Kalons is typically invoiced for these goods in Canadian dollars and is concerned that the Canadian dollar will appreciate in the near future. Which of the following is *not* an appropriate hedging technique under these circumstances?
- A) purchase Canadian dollars forward.
 - B) purchase Canadian dollar futures contracts.
 - C) purchase Canadian dollar put options.
 - D) purchase Canadian dollar call options.
12. The one-year forward rate of the British pound is quoted at \$1.60, and the spot rate of the British pound is quoted at \$1.63. The forward _____ is _____ percent.
- A) discount; 1.9
 - B) discount; 1.8
 - C) premium; 1.9
 - D) premium; 1.8
13. 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.

14. If your firm expects the euro to substantially depreciate, it could speculate by _____ euro call options or _____ euros forward in the forward exchange market.
- A) selling; selling
 B) selling; purchasing
 C) purchasing; purchasing
 D) purchasing; selling
15. 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.
16. 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, what amount will you have after 180 days?
- A) \$318,109.10.
 B) \$330,000.00.
 C) \$312,218.20.
 D) \$323,888.90.
 E) none of these.
17. Economic exposure refers to:
- A) the exposure of a firm's ongoing international transactions to exchange rate fluctuations.
 B) the exposure of a firm's local currency value to transactions between foreign exchange traders.
 C) the exposure of a firm's financial statements to exchange rate fluctuations.
 D) the exposure of a firm's cash flows to exchange rate fluctuations.
 E) the exposure of a country's economy (specifically GNP) to exchange rate fluctuations.

TURN OVER

18. Assume zero transaction costs. If the 180-day forward rate is an accurate estimate of the spot rate 180 days from now, then the real cost of hedging receivables will be:
- A) positive.
 - B) negative.
 - C) positive if the forward rate exhibits a premium, and negative if the forward rate exhibits a discount.
 - D) zero.

19. Assume the following information:

You have \$1,000,000 to invest		
Current spot rate of pound	=	\$1.30
90-day forward rate of pound	=	\$1.28
3-month deposit rate in U.S.	=	3%
3-month deposit rate in Great Britain	=	4%

If you use covered interest arbitrage for a 90-day investment, what will be the amount of U.S. dollars you will have after 90 days?

- A) \$1,024,000.
 - B) \$1,030,000.
 - C) \$1,040,000.
 - D) \$1,034,000.
20. An argument for MNCs to have a debt-intensive capital structure is:
- A) they are well diversified.
 - B) foreign government tax rules may change over time.
 - C) exposure to exchange rate fluctuations.
 - D) exposure to fund blockage.

TURN OVER

SECTION 2

Answer any two (2) questions.

Question 1

- a) Oxygen Co. expects to pay S\$1,050,000 in one year on a loan. The existing spot rate of the Singapore dollar is \$.59. The one-year forward rate of the Singapore dollar is \$.62. Oxygen created a probability distribution for the future spot rate in one year as follows:

<u>Future Spot Rate</u>	<u>Probability</u>
\$.58	30%
.60	35
.65	35

Assume that one-year put options on Singapore dollars are available, with an exercise price of \$.63 and a premium of \$.04 per unit. One-year call options on Singapore dollars are available with an exercise price of \$.60 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:

- i) Given this information, determine whether a forward hedge, money market hedge, or a currency options hedge would be most appropriate. (10 marks)
 - ii) Calculate the effective exchange rate that Oxygen would lock in on its payables position if it used a money market hedge. (2 marks)
 - iii) Compare the most appropriate hedge to an unhedged strategy, and decide whether Oxygen should hedge its payables position. (3 marks)
- b) Compare and contrast transaction exposure, economic exposure and translation exposure, giving an example of each type of exposure. (7 marks)
 - c) State in your opinion, and with supporting arguments, whether an MNC should attempt to hedge its translation exposure. (3 marks)

TURN OVER

Question 2

- a) Klondike, Inc., a U.S.-based MNC, has screened several targets. Based on economic and political considerations, only one eligible target remains in Malaysia. Klondike would like you to value this target and has provided you with the following information:
- Klondike expects to keep the target for three years, at which time it expects to sell the firm for 500 million Malaysian ringgit (MYR) after deducting the amount for any taxes paid.
 - Klondike expects a strong Malaysian economy. Consequently, the estimates for revenues for the next year are MYR300 million. Revenues are expected to increase by 9% over the following two years.
 - Cost of goods sold are expected to be 60% of revenues.
 - Selling and administrative expenses are expected to be MYR40 million in each of the next three years.
 - The Malaysian tax rate on the target's earnings is expected to be 30%.
 - Depreciation expenses are expected to be MYR15 million per year for each of the next three years.
 - The target will need MYR9 million in cash each year to support existing operations.
 - The target's current stock price is MYR35 per share. The target has 11 million shares outstanding.
 - Any cash flows remaining after taxes are remitted by the target to Klondike, Inc. The exchange rate is currently \$.22. The 3 year annualized interest rate in the United States is 8% while the 3 year annualized interest rate in Malaysia is 6%. Assume Interest rate parity exists for the three year horizon and the forward rate is used to forecast exchange rates.
 - Klondike's required rate of return on similar projects is 13%.

TURN OVER

Question 2 (cont'd)

- i) Calculate the net present value of this target. (14 marks)
- ii) The target's board has indicated that it finds a premium of 30 percent appropriate. You have been asked to negotiate for Klondike with the Malaysian target. Calculate the maximum percentage premium you should be willing to offer for the target. (3 marks)
- b) 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 **three** thoughts surrounding exchange rate risks, and the MNC's response to these arguments. (8 marks)

Question 3

- a) Stacey is a currency speculator. She believes that the Euro will fluctuate widely against the U.S. dollar in the coming month. Currently, one-month call options on Euro are available with a strike price of \$1.10 and a premium of \$.025 per unit. One-month put options on Euro are available with a similar strike price and a premium of \$.017 per unit. One option contract on Euro contains 500,000 Euro.

Required:

- i) What type of derivative should Stacey enter into? Explain why she should choose this type of derivative. (2 marks)
- ii) Construct a contingency graph representing Stacey's expected payoff on her chosen type of derivative if she takes a short position in this derivative. (in I above) (5 marks)
- iii) What is Stacey's total profit or loss if the value of the Euro in one month is \$1.75? (3 marks)

TURN OVER

Question 3 (cont'd)

b) Assume the following information:

Spot rate of Chilean peso = \$.100

180-day forward rate of Chilean peso = \$.098

180-day Chilean interest rate = 8%

180-day U.S. interest rate = 5%

Required:

- i) Given this information, determine if covered interest arbitrage is worthwhile for Chilean investors who wish to invest in the US. Explain your answer with reference to any known theory. **(4 marks)**
 - ii) If covered interest arbitrage is indeed feasible, explain the market forces which would occur to eliminate any further possibility of covered interest arbitrage. **(3 marks)**
- c) Compare and contrast the theories of Interest Rate parity, Purchasing Power parity, and the International Fisher effect. **(8 marks)**

END OF QUESTION PAPER