UNIVERSITY OF COLOMBO, SRI LANKA
FACULTY OF MANAGEMENT AND FINANCE

Bachelor of Business Administration (Level II – Semester VI)
Examination –November 2018

BEC 2304/INB 2304 – International Finance

Time: Three (03) Hours
Answer Four (04) Questions Including Question 1.

---

1 i. Moonriver is a small economy and had steady economic growth. However, recently the government has noticed a slowdown of aggregate demand and wants to implement the fiscal policy. The government intervention in economic activities is minimum.

a. Using a suitable model, explain the impact of using an expansionary fiscal policy.

b. The government decides to finance the spending by issuing bonds. Using a suitable model, explain the impact on the economy.

(12 Marks)

ii. In Moonriver ABC limited is listed in its stock exchange. Its current share price is 130$. An investor, Mr. A, is worried about the current situation. The following options of three months duration are available;

Call option with an exercise price of 135$ at a premium of 1.23$

Put option with an exercise price of 135$ at a premium of 1.24$.

If Mr A were to write a three month option he could write the following

Call option with an exercise price of 140$ at a premium of 1.30$

Put option with an exercise price of 132$ at a premium of 1.29$

a. State under what circumstances Mr A could use a bear spread and a bull spread.

b. Calculate the payoff and profit per share if the stock price is 145$ after three months if Mr A implemented a covered call and a protective put.

(06 Marks)

iii. Further in Moonriver a presidential election was held and the winner was unexpected. This has brought about fear among investors when investing in domestic assets.

a. Using a suitable model, explain the impact of this on the economy.

b. Explain the three types of exchange rate exposures ABC limited faces due to the fluctuations in exchange rate.

(11 Marks)

iv. The newly elected president has decided to implement a fixed exchange rate in the economy. Along with this, he has advised the monetary authority to revalue the currency. Using the Monetary Approach to the Balance of Payments, explain the impact of a revaluation on Moonriver.

(07 Marks)

v. Following the revaluation of the currency the president expected to see a change in trade. However this change did not happen immediately.

Explain to him why trade did not change immediately following the revaluation.

(04 Marks)

(Total 40 marks)

2 i. Graphically explain how a contractionary fiscal policy with sterilization impacts the economy.

(06 Marks)

ii. "The real interest rate differential model explains how overshooting occurs." Explain this statement.

(05 Marks)

iii. Explain the impact of implementing a contractionary monetary policy using the monetary approach to the balance of payments.

(09 Marks)

(Total 20 marks)

3 i. A will receive 500,000 Euros in three months' time. Following data is also available.

Today's exchange rates	171-174 Rs/Euro
Interest rates	Rupee 10%, Euro 5%
Three month forward rates	172-175Rs/Euro

Using the above information, recommend a method for A to reduce exchange rate risk.

(04 Marks)

ii. B needs to borrow 400,000$ at a floating rate which he can obtain at LIBOR+1.5%. He also can borrow Sterling Pounds (£) at 8.75%. C needs to borrow 225000£ at a fixed rate which he can obtain at 9.5%. He has the ability to borrow $ at LIBOR+0.75%.

a. Using the above information show how a currency swap could be created.

b. Is the swap beneficial to the two parties? Justify your answer.

(04 Marks)

iii Briefly explain regressive and static expectations.

(04 Marks)

iv Briefly explain four (04) reasons as to why purchasing power parity might not hold.

(08 Marks)

(Total 20 marks)

4 The government of Legoland maintains floating exchange rates. The central bank has decided to intervene in the economy using the monetary policy.

i Explain using a suitable model, the short run impact of a contractionary foreign exchange operation.

(05 Marks)

ii. Applying the model used in (i) explain the long run impact of a contractionary foreign exchange operation.

(05 Marks)

iii How would the outcome explained in (i) change if the central bank implements a sterilized contractionary foreign exchange operation?

(05 Marks)

iv Explain the impact of using an expansionary open market operations in the economy.

(05 Marks)

(Total 20 marks)

5 i. Briefly explain what is the real balance effect as per the Absorption Approach to the Balance of Payments.

(04 Marks)

ii. Briefly explain uncovered interest and uncovered interest parity conditions

(04 Marks)

iii Cookieland is a small economy. The government maintains a floating exchange rate, however has no intervention in capital movements at all. The government wishes to use the fiscal and monetary policy to achieve the following. Recommend with justification which policy is suited to achieve each.

a. Increase national income

b. Increase the value of domestic currency

(12 Marks)

(Total 20 marks)

6 Wolverine Corp. currently has no existing business in New Zealand but is considering establishing a subsidiary there. The following information has been gathered to assess this project.

1. The initial investment required is $20 million in New Zealand dollars (NZ$) which will include funds to support working capital. Given the existing spot rate of $.50 per New Zealand dollar, the initial investment in U.S. dollars is $10 million.
2. The project will be terminated at the end of Year 3.
3. The price, demand, and variable cost of the product in New Zealand are as follows:

	Year 1	Year 2	Year 3
Price per unit	NZ$500	NZ$511	NZ$530
Demand in NZ	40,000 units	50,000 units	60,000 units
Variable Cost	NZ$30	NZ$35	NZ$40

4. The fixed costs, such as overhead expenses, are estimated to be NZ$6 million per year.
5. The plant and equipment are depreciated over 10 years using the straight-line depreciation method. Since the plant and equipment are initially valued at NZ$50 million, the annual depreciation expense is NZ$5 million.
6. The New Zealand government will impose an income tax of 30 percent on income. In addition, it will impose a withholding tax of 10 percent on earnings remitted by the subsidiary. The U.S. government will allow a tax credit on the remitted earnings and will not impose any additional taxes.
7. All cash flows received by the subsidiary are to be sent to the parent at the end of each year.
8. In 3 years, the subsidiary is to be sold. Wolverine expects to receive NZ$12 million. Assume that this amount is not subject to a withholding tax.
9. Wolverine requires a 20 percent rate of return on this project.

Period	1	2	3	4
Discounting Factor	0.833	0.694	0.579	0.482

Determine the net present value of this project. Should Wolverine accept this project?

(Total 20 marks)