UNIVERSITY OF COLOMBO, SRI LANKA
FACULTY OF MANAGEMENT AND FINANCE

Bachelor of Business Administration (Level II – Semester VI)
Examination –December 2017

BEC 2304/INB 2304 – International Finance

Time: Three (03) Hours
Answer only <u>Four</u> (04) Questions. Use of Calculators Is Allowed

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1 i. Briefly explain the condition for a devaluation to improve the current account as per the Elasticity Approach.

(03 Marks)

ii. Briefly explain the 'covered interest rate parity condition'.

(03 Marks)

iii. "Stickiness of prices and incomplete pass-through are two of many reasons as to why purchasing power parity might not hold." Do you agree? Justify your answer

(05 Marks)

iv. An economy with fixed exchange rates and limited regulations on capital inflows wishes to implement either an expansionary monetary policy or fiscal policy. Applying a suitable model show the impact of each policy on the economy.

(14 Marks)

(Total 25 marks)

2. i. Briefly explain what is meant by a 'real balance effect' as per the Absorption Approach to the Balance of Payments.

(04 Marks)

ii. Show how a contractionary fiscal policy with sterilization impacts the economy.

(07 Marks)

iii. Applying the Monetary Approach to Balance of Payments compare and contrast the impact of a contraction of money supply under fixed and floating exchange rate regimes.

(14 Marks)

(Total 25 marks)

3 i. A will receive 400,000 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

Based on the above recommend a method that A can adopt to reduce exchange rate risk.

(04 Marks)

ii. B needs to borrow 300,000$ at a floating rate which he can obtain at LIBOR+2%. He also can borrow Sterling Pounds (£) at 9%. C needs to borrow 175000£ at a fixed rate which he can obtain at 10%. He has the ability to borrow $ at LIBOR+1%.

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 A US importer needs to pay 2000,000 sterling pounds (£) in 3 months' time. The current three month future on the pound is 2$/1£. Three months later the spot rate is 2.1$/1£ while the future is 2.08$/1£. Determine how much the importer needs to pay at the expiry of the futures contracts (1 contract is for 62500£) to buy the £.

(04 Marks)

iv. Mr C is considering investing in 1000 shares of Company X currently selling at 103$ per share. 3 month options (100 shares per contract) for these shares are given below,

Call option – exercise price of 105$ at a premium of 1.19$ per share.

Put option – exercise price of 105$ at a premium of 1.59$ per share.

a. Calculate the profit at the expiry of the option, if the share price is 102$ and he implemented a Protective Put strategy.

b. Draw the payoff and profit graph if he used a straddle.

(04 Marks)

v. Briefly explain how the money market, domestic bonds, and foreign bonds schedules are derived in the Portfolio Balance Model.

(09 Marks)

(Total 25 marks)

4 i. Briefly explain extrapolative and adaptive exchange rate expectations.

(04 Marks)

ii. Explain the impact of an increase in money supply on the economy using the Sticky Price Model.

(10 Marks)

iii. Applying a suitable model of exchange rates, assess the impact on the economy if people perceive that foreign bonds are riskier than domestic bonds.

(05 Marks)

iv. Using a suitable model of exchange rates show the impact of bond financed government spending on the economy.

(06 Marks)

(Total 25 marks)

5 i. Show how a revaluation of the currency impacts the economy using the Monetary Approach to the Balance of Payments.

(10 Marks)

ii. "Sticky Price Model improves on the Flexible Price Model of exchange rates. However it too has its own weaknesses." Do you agree? Justify your answer.

(10 Marks)

iii. 'Overshooting of exchange rates depends on real interest differential'. Do you agree? Justify your answer using Frankel's Real Interest Rate Differential Model.

(05 Marks)

(Total 25 marks)

6 i. Portfolio Balance Model addresses some of the weaknesses of the monetary models of exchange rates. Do you agree with this statement? Justify your answer.

(07 Marks)

ii. Compare and contrast the short run impact of a contractionary open market operation and a contractionary foreign exchange operation on the economy.

(08 Marks)

iii. Compare and contrast the impact of a contractionary monetary policy if the economy has floating exchange rates, and has perfectly mobile capital and immobile capital.

(10 Marks)

(Total 25 marks)