UNIVERSITY OF COLOMBO, SRI LANKA

FACULTY OF MANAGEMENT & FINANCE

Bachelor of Business Administration in Finance (Level II, Semester VII)

Examination – July 2016

FIN 2208 – International Financial Management

Two (02) hours

Answer **All** Questions

Use of calculator is permitted

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1. As more and more countries within the European Union (EU) struggle economically, questions are increasingly being raised on the sustainability of the EU. The credit crunch in the euro zone, winding up of failing institutions, the rising sovereign debt, growing unemployment, uncertainty, and falling growth have raised questions over the single unit currency. Analysts and economists are worried over the growing criticism against European Union and with the public opinion on the downward slide in crisis hit nations, doubts over the single currency are only growing. The euro, the common currency of the European Union (EU), was adopted to bring about higher degree of equality among the differing economies of the EU and enable them to develop together. However, in recent years the euro has been facing problems both on the economic and political front. While the member states are struggling because of the low economic growth rate, European Central Bank is finding it difficult to set an interest rate that would benefit all the varied economies and simultaneously check inflation. Besides, the rejection of the EU Constitution by France and the Netherlands in a referendum further fuelled the whole crisis. Some politicians and economists feel that the euro has failed to meet its objective and should therefore be withdrawn. You are required to

   i. Analyze and discuss the reasons behind the recent Eurozone Crisis.
   (08 Marks)

   ii. Debate whether the Eurozone should break.
   (06 Marks)

   iii. Discuss the options for the European Central Bank, in framing the monetary policy given the prevailing economic and political conditions within EU.
   (05 Marks)

iv. Explain briefly the consequences of this on the future of the Euro.

(06 Marks)

(Total 25 Marks)

2. i. What is the traditional gold standard, how does it differ from our current monetary system, and how does it work to resolve trade imbalances?

(06 Marks)

ii. Debate whether Bretton Wood System (BWS) and International Institutions (IMF and World Bank) save the global economy?

(09 Marks)

iii. "BOP deficit will most likely lead to a depreciation of the currency if it is sustained over a long period of time." Justify this statement.

(05 Marks)

(Total 20 Marks)

3. i. Explain the difference between transaction, translation, and economic risk. Which one is easiest to hedge and why?

(07 Marks)

ii. Flower Company located at Kuwait, has shipped goods to an American importer under a letter of credit arrangement, which calls for payment at the end of 90 days. The invoice is for $124,000. At present the exchange rate is 5.70 Kuwaiti Dinar to the dollar. If the Kuwaiti Dinar were to strengthen by 5 percent by the end of 90 days. what would be the transactions gain or loss in Kuwaiti Dinar? If the Kuwaiti Dinar were to weaken by 5 percent, what would happen? (*Note*: Make all calculations in Kuwaiti Dinar per dollar)

(06 Marks)

iii. Assume that you are a British, exporting to Frankfurt and would like to sell euros against pounds. The following market rates prevail:

Euro/US $	1.1875/1.1890
£/US $	0.6957/0.7008

If your customer wants a cross rate for £/euro from you, what rate will you quote assuming you want a spread of 0.0020 points?

(05 Marks)

iv. Suppose that the current spot exchange rate is €1.50/£ and the one-year forward exchange rate is €1.60/£. The one-year interest rate is 5.4% in euros and 5.2% in pounds. You can borrow at most €1,000,000 or the equivalent pound amount, i.e., £666,667, at the current spot exchange rate.

a. Is there an incentive to engage in covered interest arbitrage? If so, calculate the arbitrage profit? (Assume that you are a euro-based investor)

b. Suppose you are a pound-based investor. Show the covered arbitrage process and determine the pound profit amount.

(07 Marks)

(Total 25 Marks)

i. Describe the distinctive features of the foreign exchange market.

(06 Marks)

ii. Discuss the theory of comparative advantage by David Ricardo with the help of example.

(08 Marks)

iii. Wheat sells for $4 a bushel in the United States. The price in Canada for a bushel of wheat is 4.56 Canadian dollars. The exchange rate is 1.2 Canadian dollars to $1 US. Does purchasing-power parity exist? If not, what changes would need to occur for it to exist?

(04 Marks)

iv. Write short notes on

a. Forward Premium and Discount
b. Bid, the Ask, and the Bid-Ask Spread
c. Green field investments
d. Foreign Direct Investment

((3 X4) = 12 Marks)

(Total 30 Marks)

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