CHUKA UNIVERSITY

UNIVERSITY EXAMINATIONS

RESIT/SPECIAL EXAMINATION

EXAMINATION FOR THE AWARD OF DEGREE OF BACHELOR OF COMMERCE

BCOM 434: INTERNATIONAL FINANCE

STREAMS: BCOM Y4S2 **TIME: 2 HOURS**

DAY/DATE: WEDNESDAY 12/09/2018 **2.30 P.M. – 4.30 P.M.**

INSTRUCTIONS:

- **Attempt Question One and any other two Questions**

Question One

a) A Kenyan citizen plans to visit the United States of America and has gathered that the usd ($) exhibits a one year risk free interest rate of 10 percent while the Kenya shillings exhibits a 2 percent rate. Assume that interest rate parity exists and the spot rate of the usd ($) is Ksh. 102.25.

Required:

i) The forward rate premium or discount. (3 marks)

ii) The one year forward rate of the usd ($). (3 marks)

b) Using appropriate examples differentiate between covered interest arbitrage and uncovered interest arbitrage as used in foreign exchange markets. (4 marks)

c) Distinguish between “integration of financial markets” and “segmentation of financial markets”. (4 marks)

d) Suppose that the Pound Sterling is bidding at \$1.9724 in New York and the Euro at \$1.3450 in Frankfurt. At the same time, London banks are offering the Pound Sterling at €1.4655.

Required:

Show the steps that an astute trader would follow to earn riskless profit assuming that the trader has £1,000,000. (6 marks)

e) Briefly explain any four factors that influence the Bid-ask spread on currency quotations. (6 marks)

f) Define a letter of credit and briefly explain its importance in international trade.(4 marks)

Question Two

a) Distinguish between 'multilateral cash netting' and 'bilateral cash netting'. (4 marks)

b) Describe any four main causes of capital markets segmentation. (6 marks)

c) A current spot exchange rate is \$1.50/£ and the three-month forward exchange rate is \$1.52/£. The three-month interest rate is 8.0 percent per annum in the U.S. and 5.8 percent per annum in the U.K. Assume that you can borrow as much as \$1,500,000 or £1,000,000.

Required:

i). Determine whether interest rate parity is currently holding. (4 marks)

ii). If IRP is not holding, determine the arbitrage profit. (6 marks)

Question Three

a) Distinguish between 'Locational arbitrage' and 'triangular arbitrage'. (4 marks)

b) Briefly describe 'foreign currency transaction risk' and explain three internal methods which could be used by MNCs to manage foreign currency transaction. (6 marks)

c) A U.S. MNC is considering a European investment opportunity. The initial cost of the investment is €200. The after-tax expected cash inflows from the investment are €200, €500 and €300 for the first, second and third year respectively. The inflation rate in the euro zone is $\pi_{€} = 3\%$, the inflation rate in dollars is $\pi_{\$} = 6\%$ and the business risk of the investment would lead an unlevered U.S.-based firm to demand a return of 15%.

The current Euro spot exchange rate is $1.25.

Required:

Advise whether the project should be implemented. (6 marks)

d) The services and operations of international banks are a function of the regulatory environment in which the bank operates and the type of banking facility established. Distinguish between a correspondent bank and a representative office. (4 marks)

Question Four

a) Briefly explain the role played by International Bank for Reconstruction and Development. (IBRD). (5 marks)

b) A US company expects to pay its German supplier €1.2 million in 90 days' time. The current spot rate quote for the Euro is $1.2582 and the 90-day forward rate is $1.2636. A call option on the Euro expiring in 90 days has an exercise price of $1.26 and a premium of $0.0098. The option is only exercisable at the end of the period. The forecast of the future spot rate is $1.25.

Required:

Evaluate how much the US company will pay its German supplier under each of the following alternatives.

i) No hedging takes place. (2 marks)

ii) Arranging a forward contract hedge. (2 marks)

iii) Arranging an option hedge. (5 marks)

c) A company whose home currency is the dollar ($) expects to receive 500,000 pesos in six months' time from a customer in a foreign country.

The following interest rates and exchange rates are available to the company:

Dollar Spot rate quote	15·00 peso
Dollar six-month forward rate quote	15·30 peso

	Home country	foreign country
Borrowing interest rate	4% per year	8% per year
Lending interest rate	3% per year	6% per year

Required:

Six-month dollar value of the expected receipt using a money-market hedge (6 marks)
