FINAL EXAMINATION
SPRING SESSION 2004

SCHOOL OF ECONOMICS AND FINANCE

Student Name: 

Student Number: 

Course: 

Unit Name: INTERNATIONAL BUSINESS FINANCE
Unit Number: 61124
Time Allowed: 3 hours plus 10 minutes reading time.
Number of Questions: 3 Parts
Total Number of Pages: 8
Lecturer’s Name: Dr. Ian Nelso

INSTRUCTIONS
PLEASE READ CAREFULLY BEFORE PROCEEDING

1. Write your name and student number on the top of this examination paper and on each answer booklet that you use.

2. CLOSED BOOK EXAMINATION

3. "Write multiple choice answers on scan sheet provided"

4. Each part is worth 20 marks for a total of 60 marks. The exam is worth 50% of the total course mark. The exam mark out of 60 will be converted to a mark out of 30. The value of each question is indicated.

5. Non-programmable business calculators are permitted

6. Attempt all the multiple-choice questions, all the short answers and one of the essay questions

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Page 1 of 8
PART A: 20 Multiple-Choice questions (1 mark each)

1. Licensing obligates a firm to provide __________, while franchising obligates a firm to provide __________.
   A) a specialized sales or service strategy; its technology
   B) its technology; a specialized sales or service strategy
   C) its technology; its technology
   D) a specialized sales or service strategy; a specialized sales or service strategy

2. If interest rate parity exists, transactions costs are zero, and the forward rate is an accurate predictor of the future spot rate, then the effective financing rate on a foreign currency:
   A) would be equal to the U.S. interest rate.
   B) would be less than the U.S. interest rate.
   C) would be more than the U.S. financing rate.
   D) would be less than the U.S. interest rate if the forward rate exhibited a discount and more than the U.S. interest rate of the forward rate exhibited a premium.

3. Which of the following theories suggests that firms seek to penetrate new markets over time?
   A) theory of comparative advantage.
   B) imperfect markets theory.
   C) product cycle theory.
   D) none of the above.

4. ________ are most commonly classified as a direct foreign investment.
   A) Foreign acquisitions
   B) Purchases of international stocks
   C) Licensing agreements
   D) Exporting transactions

5. Which of the following is an example of direct foreign investment?
   A) Exporting to a country.
   B) Establishing licensing arrangements in a country.
   C) Purchasing existing companies in a country.
   D) Investing directly (without brokers) in foreign stocks.

6. The variance in financing costs over time is ______ for foreign financing than domestic financing. The variance when financing with foreign currencies is lower when those currencies exhibit ______ correlations, assuming the firm has no other business in those currencies.
   A) lower; low
   B) lower; high
   C) higher; high
   D) higher; low
7. If interest rate parity exists, transactions costs are zero, and the forward rate is an accurate predictor of the future spot rate, then the effective financing rate on a foreign currency:

A) would be equal to the U.S. interest rate.
B) would be less than the U.S. interest rate.
C) would be more than the U.S. financing rate.
D) would be less than the U.S. interest rate if the forward rate exhibited a discount and more than the U.S. interest rate if the forward rate exhibited a premium.

8. 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

9. Under a managed float exchange rate system, the Fed may attempt to stimulate the U.S. economy by ______ the dollar. Such an adjustment in the dollar's value should ______ the U.S. demand for products produced by major foreign countries.

A) weakening; increase
B) weakening; decrease
C) strengthening; increase
D) strengthening; decrease

10. Assume countries A, B, and C produce goods that are substitutes of each other and that these countries engage in trade with each other. Assume that country A's currency floats against country B's currency, and that country C's currency is pegged to B's. If A's currency depreciates against B, then A's exports to C should ______, and A's imports from C should ______.

A) decrease; increase
B) decrease; decrease
C) increase; decrease
D) increase; increase
11. Which of the following is true regarding the euro?

A) Exchange rate risk between participating European currencies is completely eliminated, encouraging more trade and capital flows across European borders.
B) It allows for more consistent economic conditions across countries.
C) It prevents each country from conducting its own monetary policy.
D) All of the above are true.

12. MNCs can use short-term foreign financing to reduce their exposure to exchange rate fluctuations. For example, if an American-based MNC has ___________ in Algerian dinars, it could borrow ___________, resulting in an offsetting effect.

A) payables; dinars
B) receivables; dinars
C) payables; dollars
D) receivables; dollars

13. Which of the following is true?

A) Most forward contracts between firms and banks are for speculative purposes.
B) Most forward contracts represent a conservative approach by firms to hedge foreign trade.
C) The forward contracts offered by banks have maturities for only four possible dates in the future.
D) None of the above.

14. If you expect the euro to depreciate, it would be appropriate to ______ for speculative purposes.

A) buy a euro call and buy a euro put
B) buy a euro call and sell a euro put
C) sell a euro call and sell a euro put
D) sell a euro call and buy a euro put

15. If you expect the British pound to appreciate, you could speculate by ______ pound call options or ______ pound put options.

A) purchasing; selling
B) purchasing; purchasing
C) selling; selling
D) selling; purchasing
16. If interest rate parity exists and transactions costs are zero, foreign financing with a simultaneous forward purchase of the currency borrowed will result in an effective financing rate that is:
A) less than the domestic interest rate.
B) greater than the domestic interest rate.
C) equal to the domestic interest rate.
D) greater than the domestic interest rate if the forward rate exhibits a premium and less than the domestic interest rate if the forward rate exhibits a discount.

17. Assume that the U.S. and Chile nominal interest rates are equal. Then, the U.S. nominal interest rate decreases while the Chilean nominal interest rate remains stable. According to the international Fisher effect, this implies expectations of _______ than before, and that the Chilean peso should _______ against the dollar.
A) lower U.S. inflation; depreciate
B) lower U.S. inflation; appreciate
C) higher U.S. inflation; depreciate
D) higher U.S. inflation; appreciate

18. A firm without any exposure to foreign exchange rates would likely increase this exposure the most by:
A) borrowing domestically.
B) borrowing a portfolio of foreign currencies that are not highly correlated.
C) borrowing a portfolio of foreign currencies that are highly correlated.
D) borrowing two foreign currencies that are negatively correlated.

19. A negative effective financing rate for a U.S. firm implies that the firm:
A) will incur a loss on the project financed with the funds.
B) paid more interest on the funds than what it would have paid if it had borrowed dollars.
C) will be unable to repay the loan.
D) none of the above.

20. Assume a central bank exchanges its currency for other foreign currencies in the foreign exchange market, but does not adjust for the resulting change in the money supply. This is an example of:
A) pegged intervention.
B) indirect intervention.
C) nonsterilized intervention.
D) sterilized intervention.
PART B: 5 Short Answer Questions (Each question is worth 4 marks: Total of 20 marks)
Answer all five questions

1) The following exchange rates are quoted simultaneously in three different financial centres.
   AUD/USD 1.2936
   AUD/EUR 1.6032
   EUR/USD 0.7936

a) Do these rates allow profitable three-point arbitrage?
b) Identify the profitable sequence
c) Starting with one million USD, calculate arbitrage profit
d) What is the EUR/USD rate that eliminates the possibility of profitable arbitrage?

2) Assume the U.S. interest rate is 7.5%, the New Zealand interest rate is 6.5%, the spot rate is USD/NZD 0.52, and the one-year forward rate is USD/NZD 0.50. Calculate the effective financing rate for a U.S. firm that takes out a one-year, uncovered NZD loan if the end of year exchange assumes the following values.

a) USD/NZD 0.48.
b) USD/NZD 0.50.
c) USD/NZD 0.54.

Interpret what the effective financing rate values you have calculated mean from the point of view of the borrowing firm.

3) The price of a commodity in New Zealand is NZD12, while the price of the same commodity in Australia is AUD8. The current exchange rate (NZD:AUD) is 1.45.

a) Show that these values represent a violation of the Law of One Price (LOP)
b) Which currency is overvalued?
c) Demonstrate a profitable arbitrage strategy
d) What is the exchange rate consistent with PPP?
e) What is the Australian price of the commodity consistent with the LOP?

4) You are given the following information:
   Spot AUD/GBP = 2.88
   3-month AUD/GBP forward exchange rate: 2.75 AUD/GBP
   Australian 3 month interest rate = 9.5% p.a.
   GB 3 month interest rate = 11% p.a.

Is covered interest arbitrage possible? If so, demonstrate a profitable arbitrage strategy.
5) An Australian firm has net payables of USD 250,000 in 180 days. The spot exchange rate is AUD/USD 1.6536. The US interest rate is 7% p.a. The Australian interest rate is 6% p.a. Show how the Australian firm can implement a foreign market hedge in these circumstances.

PART C: Essay Questions

Answer ONE of the following essay questions. (20 Marks)

1) How did exchange rate volatility contribute to the 1997 Asian crisis?

2) How do international business managers go about reducing company exposure to the various forms of risk they experience in the international marketplace?

3) How did the international monetary system known as the classical gold standard operate?

4) Outline the pros and cons of globalisation, with particular reference to the implications of globalisation for international business operations.
Formulas

Cross Exchange Rate: \( \frac{x}{y} = \frac{x/z}{y/z} \)

Absolute PPP: \( P = SP' \)

(Covered) Interest Parity: \( (1 + i) = \left( \frac{F}{S} \right) (1 + i') \)
\( (i - i') = f(1 + i') \)

CIP forward rate: \( \bar{F} = S \left[ \frac{1+i}{1+i'} \right] \)

Law of One Price (LOP): \( P_t = SP_t' \)

Real Interest Parity: \( r = i - \Delta P \)

Relative PPP: \( \Delta S = \Delta P - \Delta P' \)

Effective financing rate: \( (1 + i') (1 + \bar{S}) - 1 \)