Total No. of Pages: 3

END SEMESTER EXAMINATION- NOV/DEC 2019

PAPER CODE: MGF05 TITLE OF PAPER- INTERNATIONAL FINANCIAL MGMT

Time: 3:00 Hours Max. Marks: 60

Part A: Case Study

America's current account deficit, though, is more persistent: indeed, it seems to be widening again. If this trend continues, American firms and politicians are likely to blame it on the dollar's rise against the Yen over the past year, and to review their demands for a cheaper dollar. Yet the experience of the past decade or so suggests that devaluation is an ineffective weapon against America's external deficit.

After narrowing a bit last year, the country's current account deficit, which stood at \$30 billion in the fourth quarter of 1995, hit \$39 billion in the second quarter of this year. In July, America had its biggest monthly trade deficit since 1987. On current trends the current account deficit for 1996 as a whole is likely to hit \$150 billion roughly the same as in the past two years, and not much below its peak of \$166 billion in 1987. (Relative to GDP, the deficit has shrunk a bit.)

The dollar's slide over the past decade or so has failed to dent the deficit. And what a slide: from ¥270 in 1982 to ¥80 in April, 1995. Since then, however, the dollar has rebounded to around ¥110. American manufacturers moan that this is 38% above its low point, but by most measures the dollar is still cheap against the Yen. Moreover, in trade-weighted terms the currency has risen by only 9% leaving it 40% below its peak in 1985.

Until last year American governments had often tried to talk the Yen up and to jawbone the Bank of Japan into supporting its currency with high interest rates in the hope that this would trim both Japan's surplus and America's deficit. The policy has been a failure: a study by Ronald Mckinnon, Renichi Ohno and Kazuko Shirono explains why.

Traditional exchange rate theory says that in the long run, currencies will move towards their Purchasing Power Parity (PPP) – the rate that leaves an identical basket of goods and services costing the same in two countries. The original version of this theory says that exchange rates adjust in line with inflation differences. Thus, if Japan had a lower inflation rate than America, this would lead to a rise in the Yen. Japan's experience, however, suggests that causation also runs the other way from exchange rate movements to relative price levels.

Q.1) The article mentions that devaluation can be an ineffective weapon while attempting to reduce the current account deficit. However, common sense tells us that devaluation of a currency should make the country's exports cheaper, imports more expensive and thus narrow the external deficit. Explain how the two positions can be reconciled. [10]

Q.2) PPP states that relative inflation rates should determine the exchange rate between two currencies. On the other hand, the findings of the study reported in the article indicate that exchange rate movements can determine the relative inflation rates. Which view do you support and why? [10]

Part B:

Q.1)

An Indian Company has a payable of US $100,000 due in 3 months. The company is considering to cover the payable through the following alternatives:

i. forward contract, and
ii. money market, and
iii. option.

The following information is available with the company:

Exchange rate: Spot Rs./$ 45.50/45.55

3-m forward 40/45

3-m interest rates (%):

US 4.5/5.0

India 10.0/11.0

Call option on $ with a strike price of Rs.46.00 is available at a premium of Rs.0.10/$. Put option on $ with a strike price of Rs.46.00 is available with a premium of Rs.0.05/$.

Treasury department of the company forecasted the future spot rate after 3 months to be:

Spot rate after 3-m	Probability
Rs.45.60/$	0.10
Rs.46.00/$	0.60
Rs.46.40/$	0.30

You are required to

a. Suggest the best alternative of hedging

b. Explain why it is/it is not better to have the exposure unhedged. [5+5=10]

Q.2)

Amico, an American company imported machinery worth Euro 1 million on April 05, 2000, from a firm based in Switzerland. The payable is due in June. Amico is considering whether this exposure should be left open or hedged through forward or option market.

The market rates obtained by Amico are:

$/Euro spot 0.9580/0.9590

2-months forward 20/30

July call options with a strike price of $0.9610/Euro are available at a premium of 0.005 $ per Euro. You are required to:

a. Define the cash outflows for Amico if the exposure is left open, hedged through forward market and hedged through option market. [4]

b. Find at what expected spot rate will Amico be indifferent between

i. Open position and forward hedge

ii. Open position and hedge through call option

iii. Forward hedge and hedge through call option. [2+2+2=6]

Part C: Attempt any 2 out of 3

Q.1) What is RCEP ? What will happen if India joins RCEP at current terms and conditions ? [10]

Q.2) Differentiate between [5+5=10]

a.) Commercial Paper & Certificate of Deposits

b.) Banker's Acceptance(B/A) & Letter of Credit(L/C)

Q.3) Describe the rationale for existence of Eurobond Market ? [10]