MASENO UNIVERSITY

UNIVERSITY EXAMINATIONS 2016/2017

FOURTH YEAR SECOND SEMESTER EXAMINATIONS FOR THE DEGREE OF BACHELOR OF BUSINESS ADMINISTRATION WITH INFORMATION TECHNOLOGY

CITY CAMPUS – EVENING

ABA 419: INTERNATIONAL FINANCE

Date: 24th November, 2016 Time: 5.30 - 8.30 pm

INSTRUCTIONS:

- Answer question ONE and any other THREE questions.
- Marks allocated are shown at the end of each question.
- Show all your workings.
- Do not write on the question paper.

QUESTION ONE

a) XYZ Ltd, a UK firm has bought goods from a US supplier and must pay US $ 4 million in 3 months time. The company finance director wishes to hedge against the foreign exchange risk and is considering 3 methods:

- Using the forward exchange contract
- Using the money market hedge
- Using a lead payments

Annual interest rate and foreign exchange rate are given below:

	US $		UK £	
	Deposit Rate	Borrowing Rate	Deposit Rate	Borrowing Rate
1 month	7%	10.25%	10.75%	14.0%
3months	7%	10.75%	4.0%	14.25%

Spot rate	£1: $ 1.8625 – 1.8635
1 month forward	0.60 – 0.58 cents premium
3 months forward	1.80 – 1.75 cents premium

Required:

Advise the company on the best hedging strategy to use. (9 marks)

b) Evaluate the following types of foreign currency risk exposure:

i) Transaction exposure (2 marks)

ii) Translation exposure (2 marks)

iii) Economic exposure (2 marks)

c) IDP International Company Ltd, a Kenyan based international company is evaluating an investment in Germany. The project will cost DM 5 million and is expected to produce cash inflow of DM 5 million in year 1 and DM 4 million in years 2 and 3. Assume that the current spot rate is shs.60/DM 1 and the current risk free rate in Kenya is 12.3 % compared to that in Germany of 7 %. The appropriate discount rate for the project is estimated to be 16 % which is Kenyan cost of capital for the Germany project.

Required:

Should IDP International Company Ltd undertake the project?
Explain. (6 marks)

(d) "Like the traffic lights in the city, the international monetary system is taken for granted until it begins to malfunction and to disrupt people's daily lives". Robert Solomon.

Required:

Explain the relevance of the quotation and use one fundamental exchange rate relationship to demonstrate the working of international financial markets.

(4 marks)

QUESTION TWO

After the First World War there was complete lack of monetary co-operation among the countries of the world. The gold coin standard used before World War 1, was abandoned during the war. As a result of the breakdown in gold standard, the World lost the most efficient automatic standard upon which nations had for a long time a vehicle for restoring equilibrium in their balance of payments whenever it was disturbed. It was therefore necessary that a concerted effort be made on international level to create some effective international arrangement whereby exchange stability could be guaranteed. A common plan evolved at United Nations Monetary and Fiscal Conference of 44 world nations held at Bretton Woods, New Hampshire in July 1944. Out of the deliberation of this conference sprang up the Bretton Woods twins -the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD).

Required:

a) Critically describe the purposes of International Monetary Fund (10 marks)

b) Explain the relevance of International Bank for Reconstruction and Development mandate for a developing country like Kenya. (5 marks)

QUESTION THREE

(a) "Political risk of a country depends on the attitude of consumers in the host country." Elaborate on this statement.

(5 marks)

(b) You have been retained by the management of an international group to advice on the management of its foreign exchange exposure.

Required:

Advise on non-contractual arrangements which the corporate treasurer could consider to provide valid and relevant methods of reducing exposure to foreign exchange risk.

(10 marks)

QUESTION FOUR

a) In the context of international financial management:

i) Distinguish between Euro notes and Eurobonds. (2 marks)

ii) Explain the factors which influence the decision on whether to borrow in a domestic currency or in a foreign currency. (6 marks)

b) Global Exchange Ltd is a company based in Kenya in considering investing in a project in a foreign country. The project will be located in Plutonia, a country whose currency is the Peso (P). The Kenyan currency is the shilling (Kshs). The details of the project are presented below:

1. The initial capital outlay will be 10 million pesos. An additional 5 million pesos will be required at commencement of the project which will however be recovered on completion of the project.
2. The project will last for four years and is expected to generate annual profits before tax of 13 million pesos.

3. The cost capital of the project will be depreciated on a straight line basis over the duration of the project. Depreciation expense is allowed for tax purposes in Plutonia.
4. A double taxation agreement exists between Kenya and Plutonia. Global exchange Ltd. intends to repatriate all the project net cash inflows to Kenya at each year end.
5. The current exchange rate between the two currencies is: 1 peso = 50 Kenyan shillings. The shilling is expected to appreciate against the peso by 12 % per annum.

   The corporation tax rate in Plutonia is 25 % per annum.The project would be exempted from tax in Kenya.
6. The required rate of return on investments is 16 % per annum.

Required:

Using the net present value (NPV) approach, determine whether the project should be undertaken. (7 marks)

QUESTION FIVE

a) The following are expected interest rates and inflation rates in Canada and Britain over the next six months.

Country	Interest rate	Inflation rate
Canada	9%	4%
Britain	7%	2%

The current exchange rate between the Canadian dollar (C $) and the British pound (£) is 2 C $ = 1£.

Required:

Determine the six month forward exchange rate between the two currencies using the following approaches:

(i) Interest rate Parity (IRP) approach (2 marks)

(ii) Purchasing Power Parity (PPP) approach (3 marks)

b) By making imports more expensive and exports cheaper, neo-liberal economist (such as McKinnon (1973) and Shaw (1973)) asserts that currency devaluation will reduce trade imbalances, freeing more resources for debt repayment. Do you agree? Explain your answer. (10 marks)