NATIONAL UNIVERSITY OF SCIENCE AND TECHNOLOGY
FACULTY OF COMMERCE
DEPARTMENT OF FINANCE
BACHELOR OF COMMERCE HONOURS DEGREE IN FINANCE
PART IV 1ST SEMESTER FINAL EXAMINATION – NOV/DEC 2005
INTERNATIONAL FINANCE I [CFI 4102]
TIME ALLOWED :3 HOURS

INSTRUCTIONS

Answer All Questions.

QUESTION 1

The following information is given:-

Dollar Spot – Forward Against the dollar

	CLOSING SPOT	ONE MONTH FORWARD	THREE MONTHS FORWARDS	ONE YEAR FORWARD
Germany (DM/$)	1.7076-1.7083	1.7111	1.7154	1.7159
Japan (¥en /$).	103.300-103.325	103.19	100.88	100.88

Use the information in the table, "Dollar spot – forward against the Dollar" to answer the following.

(a) Estimate the dollar cost or value to your company of:-

(i) buying DM 140,000 spot.
(ii) selling ¥en 200m spot.
(iii) Selling DM 75,000 spot.
(iv) Buying ¥en 500m spot. [8]

(b) Calculate the cross rate for purchasing ¥en against DM`s spot.

(c) If the ¥en/$ exchange rate changes from ¥103.3 – 103.325/$ to ¥100.15 – 100.175/$, and the Japanese government wants to keep the exchange rate fixed, then how should the Bank of Japan operate in the foreign exchange market? [3]

(d) What are the **major** differences between the following paired instruments?

(i) Spot and forward exchange.
(ii) Forward exchange and currency futures.
(iii) Currency futures and foreign exchange options. [9]

QUESTION 2

Where applicable use the information in the table, "Dollar spot – forward against the Dollar" to answer the following:-

(a) Explain the following terms:-

(i) Covered interest parity.
(ii) Uncovered interest parity.
(iii) Risk premium.
(iv) Arbitrage [12]

(b) Using the average spot rate for each currency compute the premium or discount per annum for the forward contracts of three months maturity. [5]

(c) Indicate whether you would expect three months interest rates to be:-

(i) higher or lower in Germany than the U.S.
(ii) higher or lower in Japan than the U.S

(d) Given six month Euro-Mark and Euro-Dollar rates of $5\frac{9}{16} - 5\frac{7}{16}$ % and $4\frac{3}{8} - 4\frac{1}{4}$ % respectively, obtain the six months forward rate quotation that would satisfy the covered interest parity condition.

QUESTION 3

(a) Explain the following terms:-

(i) Law of One price,
(ii) Absolute Purchasing Power Parity (PPP),
(iii) Relative Purchasing Power Parity (PPP),
(iv) Big Mac Index [12]

(b) Highlight some of the reasons for short term divergence from Absolute PPP [7] (c) The expected yearly inflation rate is 2.3% in Germany and 0.6% in Japan. The current exchange rate is 60.5 ¥en per DM. Assuming that the relative form of PPP holds, what is the expected exchange rate in one year? [2]

QUESTION 4

(a) Why would anyone ever buy a forward contract given that a futures contract is like a forward contract that has an added benefit of being tradeable? [7]

(b) Explain how speculation can have positive effects in foreign exchange markets? [5]

(c) Explain why central banks would routinely intervene in the foreign exchange markets. Why is their policy referred to as leaning against the wind"? [15]