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 – DECEMBER 2006
INTERNATIONAL FINANCE I [CFI 4102]
TIME ALLOWED: 3 HOURS 10 MINUTES

INSTRUCTIONS

1. Answer Question ONE and THREE others.
2. Show all workings.
3. Write Legibly

QUESTION 1

(a) **TEXAS Ltd** has agreed to import 15,000 cases of Botswana Marula wine for 16 million pula at today`s spot rate. The firm`s financial Manager, Don Thomas, has noted the following current spot and forward rates:

	US$/Bots Pula	Bots Pula/US$
Spot	0,16933	5,9055
30-day forward	0,16890	5,9207
90-day forward	0,16807	5,9499
180-day forward	0,16719	5,9812

On the same day, Thomas agrees to purchase 15,000 more cases of wine in 3 months at the same price of 16 million pula.

(i) What is the price of wine in dollars, if it is purchased at today`s spot rate? [3]

(ii) What is the cost, in dollars, of the second 15, 000 cases if payment is made in 90 days and the spot rate at that time equals 90-day forward rate? [3]

(iii) If the exchange rate for the Botswana pula is 5.00 to $1 in 90 days, how much will he have to pay for the wine, in dollars? [3]

(b) Assume that interest rate parity holds. In both the spot market and the 90-day forward 1 Japanese yen [¥] equals 0,0086 dollars. The 90-day risk-free securities yield 4,6% in Japan.

What is the yield on 90-day riskfree securities in the United States? [4]

(c) Motherland Corporation anticipates receiving £10 000 000 in exactly 3 months. The current value of the pound in American dollars is $1,80. The Corporation is considering the following alternatives:

(i) Lock-in an exchange rate for the pounds using a forward contract or a futures contract with an exchange rate of $1,80.
(ii) Lock-in a potential exchange rate for the pounds using a foreign exchange option that would allow the £10 000 000 to be converted into American dollars at an exchange rate of $1,80, or
(iii) Do nothing and accept the foreign exchange risk.

Compute the ultimate American dollar value of the £10 000 000 to Motherland Corporation using each of the three strategies. Examine three scenarios in which the value of the pound drops to $1,50, rises to $2,10, and stays at $1,80 at the end of the 3 months. Ignore the cost of purchasing the foreign exchange option. [10]

(d) Explain why we would expect prices to obey [approximately] the law of one price for some assets such as precious metals and oil than for others such as tropical fruit and vegetables and services in general. [2]

<u>QUESTION 2</u>

(a) Outline the problems associated with using forward or futures contracts to remove foreign exchange risk. [15]
(b) Explain how options on foreign exchange can be used to avoid the problems with forward and futures contracts in (a). [10]

<u>QUESTION 3</u>
Explain the role of Arbitrage in foreign exchange markets. In your answer pay particular attention to Triangular Arbitrage and Cross Rates. [25]

<u>QUESTION 4</u>
Discuss the economic arguments germane to whether, in general, exchange rates should float or be fixed. [25]

<u>QUESTION 5</u>

What are the principal currencies traded in the foreign exchange markets? Why are these currencies preferred over others? [25]

<u>QUESTION 6</u>

The major export for Botswana is diamonds and that for Fiji is Tourism, and most of their manufactured and other consumer goods are imported. Which exchange rate system [regime] would be most compelling for each or both of these countries? [25]