CHUKA UNIVERSITY

UNIVERSITY EXAMINATIONS

FOURTH YEAR EXAMINATIONS FOR THE AWARD OF DEGREE OF BACHELOR OF COMMERCE

BCOM 432: INTERNATIONAL FINANCE

STREAMS: BCOM (Y4S2) **TIME: 2 HOURS**

DAY/DATE: WEDNESDAY 13/7/2016 **2.30 P.M. – 4.30 P.M.**

INSTRUCTIONS: Attempt All questions

Question One

(a) Briefly explain any four factors that influence the Bid-ask spread on currency quotations. [6 marks]

(b) Define a letter of credit and briefly explain its important in international trade.[3 marks]

(c) A Kenyan citizen plans to visit the United States of America and has gathered that the USD exhibits a one year risk free interest rate of 10 percent while the Kenya shillings exhibits a 2 percent rate. Assume that interest rate parity exists and the spot rate of the USD is ksh. 102.25.

Required:

(i) The forward rate premium or discount. [2 marks]

(ii) The one year forward rate of the USD. [2 marks]

(d) Using appropriate examples differentiate between covered interest arbitrage and uncovered interest arbitrage as used in foreign exchange markets. [4 marks]

(e) Distinguish between “integration of financial markets” and “segmentation of financial markets”. [4 marks]

(f) Suppose that the Pound Sterling is bidding at $1.9724 in New York and the Euro at $1.3450 in Frankfurt. At the same time, London banks are offering the Pound sterling at €1.4655.

Required:

Show the steps that an astute trader would follow to earn riskless profit assuming that the trader has £1, 000, 000. [6 marks]

(g) The adjusted present value (APV) model is a value-additive approach to capital budgeting. Briefly explain the model showing how it differs from the net present value. [3 marks]

Question Two

(a) Distinguish between 'Locational arbitrage' and 'triangular arbitrage'. [4 marks]

(b) Briefly describe 'foreign currency transaction risk' and explain three internal methods which could be used by MNCs to manage foreign currency transaction. [6 marks]

(c) A U.S MNC is considering a European investment opportunity. The initial cost of the investment is €200. The after-tax expected cash inflows from the investment are €200, €500 and €300 for the first, second and third year respectively. The inflation rate in the euro zone is $\pi_{€} = 3\%$, the inflation rate in dollars is $\pi_{\$} = 16\%$ and the business risk of the environment would lead unlevered U.S.-based firm to demand a return of 15%.
The current Euro spot exchange rate is $1.25

Required:

Advise whether the project should be implemented. [6 marks]

(d) The services and operations of international banks are a function of the regulatory environment in which the bank operates ant the type of banking facility established. Distinguish between a Correspondent Bank and a representative office. [4 marks]

Question Three

(a) Briefly explain the role played by International Bank for Reconstructionand Development. (IBRD). [5 marks]

(b) A US company expects to pay its German supplier €1.2 million in 90 days' time. The current spot rate quote for the Euro is $1.2582 and the 90-day forward rate is $1.2636. A call option on the Euro expiring in 90 days has an exercise price of $1.26 and a premium of $0.0098. The option is only exercisable at the end of the period. The forecast of the future spot rate is $1.25.

Required:

Evaluate how much the US Company will pay its German supplier under each of the following alternatives.

(i) No hedging takes place. [2 marks]

(ii) Arranging a forward contract hedge. [2 marks]

(iii) Arranging on option hedge. [5 marks]

(c) A company whose home currency is the dollar ($) expects to receive 500,000 pesos in six months' time from a customer in a foreign country.

The following interest rates and exchange rates are available to the company:

Dollar Spot rate quote	15.00 peso
Dollar six-month forward rate quote	15.30 peso

	Home country	foreign country
Borrowing interest rate	4% per year	8% per year
Lending interest rate	3% per year	6% per year

Required:

Six – month dollar value of the expected receipt using money- market hedge.[6 marks]
