

KASNEB

CIFA PART III SECTION 6

INTERNATIONAL FINANCE

FRIDAY: 27 November 2015.

Time Allowed: 3 hours.

Answer ALL questions. Marks allocated to each question are shown at the end of the question. Show ALL your workings.

QUESTION ONE

- (a) Explain three major functions of the foreign exchange market, citing relevant players in each case. (6 marks)
- (b) In relation to purchasing power parity (PPP), discuss the following terms:
- (i) The law of one price. (2 marks)
 - (ii) Absolute purchasing power parity. (3 marks)
 - (iii) Relative purchasing power parity. (3 marks)
- (c) You are provided with the following market conditions:
- Annual interest rate in Japan: 1.0% per annum.
 - Annual interest rate in Germany: 6.0% per annum.
 - Current spot exchange rate: Japanese Yen (¥)114.4733/Euro (€).
 - One-year forward exchange rate: ¥110.2423/€

An arbitrageur borrows ¥100,000,000 or its equivalent € amount.

Required:

- (i) Determine whether interest rate parity (IRP) is holding. (Ignore transaction costs). (2 marks)
- (ii) Determine the arbitrage profit. (4 marks)

(Total: 20 marks)

QUESTION TWO

- (a) Explain the following exchange rate regimes based on international monetary fund (IMF) classification:
- (i) Fixed or pegged exchange rate system. (1 mark)
 - (ii) Free floating or flexible exchange rate system. (1 mark)
 - (iii) Managed floating exchange rate system. (1 mark)
- (b) Evaluate two advantages and two disadvantages of a free floating exchange rate system. (4 marks)
- (c) Summarise three benefits of regulating bank capital. (3 marks)
- (d) Philip Woods, a resident of United States of America who is a venture capitalist holds a major stake in a motor vehicle manufacturing plant in London, Britain. He is concerned with the Pound value of his British equity position and has provided you with the following scenarios:
1. If the British economy booms in the future, his stake would be worth 980,000 Sterling Pounds (£) and the exchange rate would be United States Dollars (\$)1.40/£.
 2. If the British economy experiences a recession, his equity would be worth £1,000,000 and the exchange rate would be \$1.50/£.
 3. If the British economy stagnates, his equity would be worth £1,070,000 and the exchange rate would be \$1.60/£.
 4. The probability that the British economy would experience either of the above possible states would be a third ($\frac{1}{3}$) for each state.

Required:

- (i) Estimate Philip Woods' exposure to the exchange rate risk. (6 marks)
- (ii) Outline four strategies that Philip Woods could use to manage the operating exposure experienced in (d) (i) above. (4 marks)

(Total: 20 marks)

QUESTION THREE

- (a) International trade has expanded substantially in the last few decades. However, this has led to greater uncertainty for multinational companies.

Required:

Discuss three ways in which increased globalisation could adversely affect multinational firms. (6 marks)

- (b) (i) Explain the term "balance of payment". (2 marks)
- (ii) Analyse four factors that affect a country's financial account. (8 marks)

- (c) The government of country M is willing to provide a loan of Sh.10 million at an interest rate of 5% per annum to a multinational corporation (MNC) to build a factory in country M. The loan would be paid off in equal annual instalments over a 5-year period. The market interest rate for such an investment is 14% per annum.

Required:

Before tax value of the interest subsidy. (4 marks)

(Total: 20 marks)

QUESTION FOUR

- (a) The following information relates to Apex Forwarders Limited, a multinational corporation based in Switzerland:

1. The company is considering a project which involves establishing a 2-year venture in Malaysia with an initial investment of 60 million Swiss Francs (CHF).
2. The company's weighted average cost of capital (WACC) is 10%.
3. The required rate of return on this project is 12%.
4. The project is expected to generate cash flows of 24 million Malaysian Renggit (MYR) at the end of year one and 60 million MYR at the end of year two, excluding the salvage value.
5. The exchange rate is expected to be stable at 1.35 MYR/CHF.
6. All cash flows are remitted to the parent company.

Required:

(i) The break-even salvage value. (4 marks)

(ii) Advise the management on whether to undertake the project. (1 mark)

- (b) Discuss three mechanisms that could be used by a multinational corporation in its attempt to repatriate blocked funds from a host country. (6 marks)

(c) Examine five objectives of international cash management. (5 marks)

(d) Suggest four basic drivers of cross-border mergers. (4 marks)

(Total: 20 marks)

QUESTION FIVE

- (a) (i) Evaluate five strategic objectives of international transfer pricing. (5 marks)

- (ii) A multinational organisation, Demers Ltd. has two divisions, Division A and Division B, each based in a different country. Division A produces a product called "Malewa" and transfers it to Division B which operates in another country.

The domestic tax-rates for Division A and Division B are 40% and 50% respectively.

25% import duty on the price of product "Malewa" is also assessed. The full cost per unit of "Malewa" is Sh.190 while the variable cost is Sh.60.

Required:

Advise the management of Demers Ltd. on whether to use variable cost or full cost transfer price. (5 marks)

(b) Assess five functions of United Nations Conference on Trade and Development (UNCTAD). (5 marks)

(c) Faremall Group Limited, a multinational company with its head office in Kenya is considering issuing a dual-currency international bond.

The following information relates to the bond:

1. The par-value of the bond is Kenya Shillings (KES) 20 billion.
2. The tenor of the bond is 10 years with an annual coupon payment of 8%, payable in KES.
3. The bond will be redeemed in United States Dollars (USD) for a total of USD 191,764,850.30.
4. The current spot exchange rate is KES 104.2944 per USD.
5. The KES yield curve is flat at 4% and the USD curve is flat at 12%.

Required:

(i) The theoretical value of the dual-currency bond. (3 marks)

(ii) Comment on the importance of issuing a dual-currency bond. (2 marks)

(Total: 20 marks)

.....

