K. J. SOMAIYA INSTITUTE OF MANAGEMENT STUDIES & RESEARCH
VIDYA NAGAR, VIDYA VIHAR (E), MUMBAI- 400 077

PGDM-Exec 2018-19; Batch 8; Tri V

International Finance

(End- Trimester Examination)

Max marks: 50
Duration: 3 Hrs December 23, 2019

Note: All questions carry equal marks. Restrict each of your answers to around 40 lines.

Answer **ANY FIVE** of the following questions (5*10)

Q1. Discuss the role of Treasurer and Controller in the Finance Function of a Multi-National Corporation in terms of risks and emerging challenges.

Q2. Identify the following transactions from Indian perspective in terms of current, capital and reserve account credit or debit (inflow/outflow):

a) Indian company buys property worth 1 mln $ in Turkey
b) US investor buys Indian G securities valued at 3 mln USD
c) Indian citizen invests in ADR at Nasdaq worth USD 1mln
d) China imports automobile components from India worth USD 10 bln and exports to China capital equipment worth 10 bln
e) US exports aircrafts to India worth 20 bln USD and imports jewelry worth 20 bln USD
f) Germany invests in healthcare products in India worth 20 mln and India exports textiles worth 20 mln USD to Germany
g) Japan invests in Andhra Pradesh for infrastructure projects 10 mln USD and Indian company acquires 10% stake in Japanese firm worth 10 mln USD
h) IMF provides short-term loan to worth 10 bln USD to tide over import bill.
i) ADB invests in Indian mono rail project worth 2 bln USD for a period of 10 years
j) India provides aid to Myanmar worth 3 bln USD

Q3. Write short notes on

a) Purchasing Power Parity Theory

b) Interest Rate Parity Theory

Q4. Discuss the features of Indian Foreign exchange markets with reference to Spot, Forward markets, Regulations, and Participants.

Q5. Discuss various methods of exchange rate forecasting. Explain the terms NEER and REER.

Q6.The Sterling Crisis of early 1985 - When the pound fell to nearly $1.00-Case study

As can be seen from exchange rate data, for the period from 1981 to 1985 was one of a massive decline in the $/£ exchange rate. But this fall was not steady. It was greatly influenced by speculation. Whenever speculators believed that the rate would fall there would be a new wave of selling sterling (and buying dollars), and sure enough the rate would fall – and often quite dramatically.

In November 1984, at a time when the exchange rate was falling (from $1.26 to $1.22), the government *reduced* interest rates. The intention was to stimulate demand and prevent further rises in unemployment. This triggered off a massive selling of sterling, a problem aggravated by the growing attractiveness of the dollar. But it was not until January 1985, with the exchange rate down to $1.12, that the government eventually raised interest rates.

By this time speculation had reached fever pitch, and it was not just the pound that was coming under pressure. Unprecedented sales of sterling and other currencies took place as dealers rushed to buy the soaring dollar. The following is an extract from the *Financial Times* of 26 February 1985:

Banks powerless as dollar soars

Central banks stood by powerless yesterday as a remarkable surge in the dollar's value swept it to record highs against sterling and other European currencies …

Sterling closed in New York at $1.0565 after finishing in London down 2.25 cents at an all time low of $1.054. The French franc, Italian lira and many other currencies were at their lowest ever against the dollar.Dealers cited as reasons for the latest surge …the expectation of higher US interest rates and President Reagan's rejection of moves to depress the US currency. Central bankers acknowledged that intervention against such a strong trend would have been hopeless.

But then the following day the central banks fought back. The following extract is from the *Financial Times* of 28 February:

Dollar falls in chaotic trading after central bankers' intervention

Large-scale and concerted intervention by central banks sent the dollar plunging against other leading currencies in chaotic trading on foreign exchange markets yesterday.

The intervention, one of the largest ever and the first joint move for more than a month, triggered off what dealers called panic selling of the US currency …

Over the next few days, the fall of the dollar continued, and the pound consequently rose against it. Within a few weeks the exchange rate was around $1.25, and a few weeks after that it was around $1.40.

Case Questions

a) How in practice could central banks decide when to intervene if a currency is plummeting?
b) How in practice could central banks decide when to intervene if a currency is plummeting?
c) What are the mesures undertaken by RBI in handling rupee volatility in the year 2013-2014?

Q7. Zimbabwe – Case study

Zimbabwe plans to adopt the Chinese yuan as legal tender in return for debt cancellation worth about $40m - a move one economist predicted "has no future at all".

China has become the largest investor in Zimbabwe, which has been shunned by the West over its human rights record and is struggling to emerge from a deep 1999-2008 recession that forced the government to ditch its own currency in 2009.

Zimbabwe's Finance Minister Patrick Chinamasa announced the plan in a statement on Monday and said the use of the yuan "will be a function of trade between China and Zimbabwe and acceptability with customers in Zimbabwe".

In the last five years, Zimbabwe has received more than $1bn in low-interest loans from China, which is Harare's second largest trading partner after South Africa.

"They [China] said they are cancelling our debts that are maturing this year and we are in the process of finalising the debt instruments and calculating the debts," Chinamasa said.

However, according to one Zimbabwean analyst, the yuan has already been a legal tender for the past two years and Chinamasa's comments are rather puzzling.

"Nothing looks to change from this latest move," economist John Roberston told Al Jazeera.

"Yuan was included in the so-called multi-currency system a couple of years ago. It's nothing new. What is different is the attachment to debts. It seems that the government is trying to pass this on as a concession by China.

"But they don't need to make concessions. This is pretty meaningless as it stands."

China has been accused of exploiting the continent's vast mineral and energy resources at the expense of local people.

On a rare visit to Harare by a Chinese leader, President Xi Jinping witnessed the signing of 10 economic agreements earlier this month, including a $1bn loan to expand Zimbabwe's largest thermal power plant.

"There is no yuan circulating in the country," said Robertson. "South African rand and the US dollar have been the dominant currencies. So it's a strange situation now as the yuan has no future at all."

But people accepting payment will want it in dollars as opposed to yuan and that will be very damaging to China's interest

John Robertson, Zimbabwe economics expert

Zimbabwe's central bank Chief John Mangudya was in negotiations with the People's Bank of China "to see whether we can enhance its usage here", according to the finance minister.

But Robertson suggested although China is active in Zimbabwe's markets and economy, it does not want to sell goods there in return for Chinese currency.

"Nearly everything Zimbabwe can make it imports for a lot of money, and China wants to be a main supplier of these imported goods and would want to take the US dollar in return," he said.

China-Zimbabwe relations date back to 1979 and the African country's "Look East" policy has made China a strong ally in the market.

Relations were further improved when President Robert Mugabe was awarded China's alternative to the Nobel Peace Prize in October for what the committee called his inspired national leadership and service to pan-Africanism.

Mugabe has placed great importance on Zimbabwe's relations with China, especially after the 2003 standoff with the EU that resulted in the economic depression when the interest rate shot up to almost 600 percent.

"China is desperate for the consumer goods market, basically whatever anyone with the buying power can pay for.

"We can see evidence of that in the country all the time. But people accepting payment will want it in dollars - as opposed to yuan - and that will be very damaging to China's interest here in Zimbabwe," said Robertson.

Source: Al Jazeera and agencies

Case Questions

a. What is the impact of dollarization on Zimbabwe
b. What is the role of China in overcoming crisis in Zimbabwe

Q8. Japan Airlines Losses – Case study

One of the world's largest airlines, Japan Airlines (JAL), is also one of the best customers of Boeing, the world's biggest manufacturer of commercial airplanes. Every year JAL needs to raise about $800 million to purchase aircraft from Boeing. Boeing aircraft priced in the US dollars, with the prices ranging from about $35 million for a 737 to $160 million for a top-of-the-line 747-400. JAL orders an aircraft two to six years before the plane is actually needed and normally pays Boeing a 10% deposit when ordering. The bulk of the payment is made when the aircraft is delivered.

The long lag between placing an order and making a final payment presents a conundrum for JAL. Most of JAL's revenues are in Japanese Yen, not US dollars (which is not surprising for a Japanese airline). When purchasing Boeing aircraft, JAL must change its yen into dollars for making payment to Boeing. In the interval between placing an order and making a final payment, the value of yen against the dollar may change. This can increase or decrease the cost of an aircraft. Consider an order placed for a 747 aircraft that was to be delivered 5 years from now. The dollar value of this order was $100 million. Suppose the prevailing exchange rate at the time of ordering was $1 = ¥ 240 (one dollar worth 240 yen), making the price of the 747 ¥ 2.4 billion. When the final payment is due, however, the dollar/yen exchange rate might have changed. The yen might have declined in value against the dollar. For eg: the dollar / yen exchange rate might be $1 = ¥ 300. If this occurs, the price of the 747 would go up from ¥ 2.4 billion to ¥ 3.0 billion, a 25% increase. Another (more favourable) scenario is that yen might rise in value against the dollar to $ 1 = ¥ 200. If this occurs, the yen price of the 747 would fall 16.7 % to ¥ = 2.0 billion.

JAL has no way of knowing what the value of the yen will be against the dollar in five years. However, JAL can enter into a contract with foreign exchange traders to purchase dollars five years based on the assessment of those traders as to what they think the dollar/yen exchange rate will be then. This is called entering into a forward exchange contract. The advantage of entering into a forward exchange contract is that JAL knows now what it will have to pay for the 747 in five years. For instance, if the value of the yen is expected to increase against the dollar, foreign exchange traders might offer a forward contract that allows JAL to purchase dollars at a rate of $1 = ¥ 185 in five years, instead of $1 = ¥240 rate that prevailed at the time of ordering. At this forward exchange rate 747 would only cost ¥ = 1.85 billion, a 23% saving over the yen price implied at the time of ordering.

JAL was confronted with just the scenario in 1985 when it entered into a 10- year forward exchange rate contract with a total value of about $3.6 billion. This contract gave JAL the right to buy US dollars from a consortium of foreign exchange traders at various points during the next 10 years for an average exchange rate of $1 = ¥185. This looked like a great deal to JAL given the 1985 exchange rate of $1 = ¥ 240. However, by September 1994when the bulk of the contract was executed, it no longer looked like a good deal. To every ones' surprise, the value of the yen surged against the dollar. By 1992, the exchange rate stood at $1 = ¥ 120 and by 1994, it was $1 = ¥ 99. Unfortunately, JAL could not take advantage of this more favorable rate. Instead JAL was bound by the terms of the contract to purchase dollars at the contract rate of $1 = ¥ 185, a rate that looked outrageously expensive. This misjudgment cost JAL dearly. In 1994, JAL admitted publicly that the loss in its most recent financial year from this misjudgment amounted to $450 million or ¥ 45 billion. Furthermore, foreign exchange traders speculated that JAL had probably lost ¥ 155 billion or $1.5 billion on this contract since 1988.

Source: W. Dawkins, "JAL to disclose huge currency hedge loss", Financial Times, October 4, 1994, p 19 and W. Dawkins "Tokyo to Lift Veil on Currency Risks", Financial Times, October 5, 1994, p 23.

Case Questions

a. What are the possible ways to avoid the loss in revenue in the above case
b. How do you forecast exchange rate in floating exchange rate regime

Q9. Balance of Payments Case

"Government of India closely watching rise in the FOREX reserves."

"BOP situation for India worsens over last few months due to bird flu scare."

"RBI considering possible hike in CRR, thereby signaling possible tight monetary policy."

"Political parties demanding compensation in dollar terms, for farmers for chickens culled."

These words were some of the headlines screaming for your attention before the annual board meeting. You – the CEO of a mega property developing corporation – call up the chief economist to take her views into consideration. Your company has heavily invested in many mega projects and you are planning to ride the retail boom. The organization has ambitious plans to make foray into airport and seaport privatization process. This will mean hand holding with international agencies and taking loans and, possibly, equity partnership. These inflows will have the usual condition of repayment of interest and minimum guaranteed dividends in dollar terms.

Your phone rings and chief economist explains, "On one hand, India has a promising future in retail market as it is evident from the shopping malls boom in all metros and mini metros. Therefore, our investments are well protected. GDP is projected to grow about 8% over next five year. This will mean a much larger foreign trade component, giving fillip to requirement of airport and seaport infrastructure. In such a scenario, we should be able to establish our self in this sector as well. However, on the other hand, there is a definite possibility that in case this GDP growth is not achieved, unemployment will rear its head once again, causing supply side shortages and unabated demand in some sectors- thereby meaning inflation will soar, and, in turn, interest rates will go up; and finally this will put downward pressure on rupee against all major currencies. This will erode our credibility and profitability in the market. The signs of impact could be visible in six months from now and among the first indicators of this shift looming over the horizon will be change in India's BOP account." You listen to her silently on your intercom.

You give a sigh of relief as soon as her prognosis is over. You call up your treasurer for a small chat. After all, he is the person who deals in foreign exchange market on minute-to-minute basis.

Case Questions

a) Name one each positive and negative news or events that impact BOP
b) What are the factors used in assessing country risk

*****