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MMS / PGDM (Fin)- 2016-18;Tri V

International Finance

(End-Trimester Examination)

Max marks 50 | Duration: 3 Hrs | Date : 03/01/2018

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

1. Answer **any four** questions from Section A
2. Case studies in Section B are **compulsory**

Section A

1. Explain with suitable examples transaction, translation and economic risks faced by an MNC.
2. What impact would the following events have on India's trade and balance of payments if
   A) Brexit on Indian currency
   B) Crude oil price falls
   C) Dollar (currency)appreciates with respect to Indian rupee
   D) India imposes import duty on auto and electronics goods sector
   E) India liberalizes capital inflows by additional $ 5bln to government securities
3. Write short notes on
   i. Gold Standard and automatic adjustment
   ii. European Monetary system
   iii. Bretton Woods System
4. Differentiate between the following terms:
   i. Dollarization and Currency Board arrangement
   ii. Pegged and Crawling peg Exchange Rate System
   iii. Fixed and Floating exchange rate system
5. Explain the following terms:
   i. Exchange rate and effective exchange rate
   ii. Government intervention in currency markets
   iii. Key factors in rating Country risk

6. Differentiate between the following terms with suitable examples:
   i. Spot and forward rate
   ii. Direct and indirect rate
   iii. Interbank and merchant rate
   iv. Bid and ask rate

Section B (10 marks- 5 for each case)

7. Case Study-1 – Quantitative easing, inflation and dollar value(Case copy provided)

Discussion questions

a) What do you understand by quantitative easing (QE) and why was it undertaken in US?
b) US inflation rate was expected to rise with increased dollar supply in the economy. But US inflation rates were falling. What could be possible reasons?
c) What was the effect of QE on global currency markets and US dollar?
d) Explain the result of QE both in short and long-run?

Case Study 2 – Russian Currency crisis (Case copy provided)

Discussion Questions

a) What were the causes of the surge in inflation in Russia during the early 1990s? Could these have been avoided? How?
b) What does the decline in the value of rube against dollar between 1992 and 1998 teach about relationship between inflation and currency value?
c) During the mid-1990ss, the IMF wanted Russia to raise tax rates, close loopholes in the tax system and cut public spending. Russia was unable to do this. Why?
d) In the early 2000s Russia cut tax rates for individuals and corporations and government tax revenue surged. Why? Does this result suggest that the IMF policy prescriptions were wrong?

Q 7- Section B – Case Studies – International Finance- MMS/PGDM (F)

a) Quantitative easing, inflation and exchange rate

After the global financial crisis in 2008, US Federal Reserve in the year 2010 took a decision to expand the US money supply by entering into open market and purchasing %600 billion in government bonds from bondholders, a technique called quantitative easing (QE). It meant that Fed had printed dollars and used this cash to pay for the bondholders. This was undertaken to stimulate the economic recovery and reduce high unemployment rate and drive the low economic growth rate upwards. Initial action soon after the crisis in term of lowering of interest rates to almost zero levels as a short-term measure could not help recovery. It further pumped in additional rounds of dollars through QE in the year 2011 and 2012 and announced that it will continue till unemployment rate falls below 6.5%.

Many critics claimed that this policy of printing dollars will fuel inflation and lead to decline in dollar value and promote exports which are a form of mercantilism.

However, these charges may be unfounded due to two reasons. Core inflation in US was lowest in past 50 years and this was leading to fall in aggregate demand and increasing unemployment. Fed felt that a little inflation was good for economic recovery. There was excess productive capacity in the economy since unemployment rate is low and economic growth is falling. Consequently, if money supply is injected, it would stimulate demand. Currency markets reaction was muted that can be noticed by the value of dollar index that was at 72.016 in November 2010 and it reached to 73.4087 by the end of January 2013, a little changed. It appears that currency traders did not sell in anticipation of high inflation rate.

b) Russian Rouble crisis

In the early 1990s, following the collapse of communism, Russian government implemented economic reforms. The idea was to transform the economy to a market based economy with ending the price controls. In Jan 1992, when the price controls were removed inflation rose to 30% and for the year it stood at 3000%. Annual rate of inflation was approximately 900^.

Several factors contributed to this high inflation rate. Prices were kept artificially low for a prolonged periods and there were shortages of many goods. People horded currency and when price controls were removed there was shortage of supply of goods. Massive unemployment and shortages of supply led to led to government to continue subsidize the operations of many state-owned enterprises. This led to increase in budget deficits that rose from 1.5% of GDP in 1992 to 17% in 1993.

Unable to increase tax to fund budget deficit, government resorted to print money and this action fuelled inflation rate. Ruble tumbled with this high inflation rate from \$1 = R125 in 1992 to \$1 = R480 by 1993 and by the end of 1993 it had fallen to $1 = R1500 and reached low value of 41 = R3926 by October 11 and foreign exchange markets were closed!

Despite measures of tight controls on money supply, intervention and tough budget plan, rouble was falling continuously. Officials announced $ 10 billion draw down from reserves to defend currency at R4,300 to 4,900. Russian governemt had to take another rescue from IMF loan and agreed to limit growth of money supply and rise tax rates, cut on expenditure. This package seemed to work initially as inflation started declining to about 15% by 1997 and exchange rate within a band of 4.3 to 4.3 and balance of payments remained broadly favourable.

In 1997, the economy registered half of one percent growth rate. However public debt, tax revenues were lower than projected. Government announced that spending amounted to 18.3% of GDP, while revenues were at 10.8% implying deficit of 7.5% of GDP, which was financed by expansion in public debt.

Crisis – IMF suspended its scheduled payment that resulted in Russian central bank to increase interest rate on overnight loans to 150 percent and agreed to rise corporate tax. In 1998, US government supported the bail out and IMF released $640 million to preserve stability of exchange rate. As the funding announcement was made, Russian government was forced to take concrete steps to improve tax collections, increase personal tax rates and reduce government spending. A bill was sent to parliament where it was emasculated by anti-government forces. This led to holding of fund release by the IMF resulting in stock market fall by 6.5% and fal in foreign exchange reserves. Social tensions, redemption of domestic bonds, depletion of reserves made Russian government to take measures to address these concerns and restructure the debt and allow rouble to decline by 34% against USD.

Aftermath : After the default on government debt, IMF left it for Russian government to fix its problem. Government with no options left, took two pronged strategy by slashing public spending and reinforced tax system that was ignored previously. Cut in corporate and personal tax rates, closing the loopholes, revenue collections have improved. In addition to these measures, oil price rise increased current account surplus due to increased exports.

As a result of these changes Russian economy grew at an average rate of 6.5% between 1998-2004. Foreign debt declined and reserves increased tenfold to $120 billion. The government was running budget surplus and also repaid IMF loan. Despite these positives, Russian economy had numerous structural weaknesses like dependence on commodity exports, weak banking system, corruption, the manufacturing infrastructure is poor.

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