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PGDM- IB IV; Trim 2016-18

International Finance

(End- Trimester Examination)

Max marks 50 | Duration: 3 Hours | Date : 18/09/2017

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

1. Answer **any four** questions from Section A (4*10)
2. Both case studies in Section B are **compulsory (2*5)**

Section A

1. What is the role of hedgers, speculators and arbitrageurs in the foreign exchange market? Explain briefly the following terms with suitable examples:
   a) Bid rate and ask rate
   b) Spot rate and forward rate
   c) Direct rate and indirect rate
   d) Interbank and merchant rate
2. How is the exchange rate determined under the gold standard? Differentiate between the following terms:
   a) Gold standard and Bretton Woods system
   b) Bretton Woods system and European Monetary System
   c) Intervention mechanism of Bretton Woods system
3. Explain the major components of balance of payments. What impact would the following events have on India's balance of payments?
   a) India encourages capital inflows of investments in government securities and portfolio investments
   b) China devalues its currency
   c) USA imposes a quota on import of garments from India
   d) Thai Baht appreciates with respect to all major currencies

4. Write short notes on
   a) Law of one price
   b) Real returns and nominal returns
   c) Fisher Effect and International Fisher Effect
   d) NEER and REER
5. Explain briefly different kinds of risks in foreign exchange faced by MNCs. Discuss with suitable examples the following internal methods of hedging:
   a) Invoicing and risk sharing
   b) Exposure netting
   c) Leading and Lagging
6. What is translation exposure? Critically evaluate the statement 'Managing translation exposure is a waste of precious time of management'. Briefly explain the following methods of translation exposure:
   a) Current/non-current methods
   b) Monetary/non-monetary methods
   c) All current methods

Section B

a) South Korean Currency Crisis

In early 1997, Korean economy had a spectacular growth from one of poor countries to the eleventh largest economy in the world. By end 1997, the won had lost 67% of its value against the USD and IMF was ready for a rescue package of USD 55 billion. South Korean large industrial conglomerates or *Chaebol* to invest heavily in new factories. *Cheabol* always relied on heavy borrowing with huge debts on average four times their equity.

As the volume of investments expanded during the 1990s, the quality of many of these investments declined significantly. Many of these investments were done on unrealistic projections about future demand conditions. For instance, investment in manufacturing of (semi-conductor factories) shot up when there was a global shortage. However, as shortage started to disappear by 1996, prices plunged and earnings for the manufacturers fell by 90%, which led to default on debt payments.

Much of the Korean borrowings had been in USD as opposed to home currency won. Dollar

Won exchange rate was \$1=W850. By 1997, foreign investors become alarmed at rising debt levels of Korean companies. Defaults by *Chaebol* led to selling of Won and the exchange rate further depreciated to W900 = \$1.

Central bank stepped into forex market to stabilize the exchange rate above W1000=\$1 by intervention to restore the investor confidence. However, this could not achieve expected results due to high debt levels and depletion of reserves. Further the downgrading of the country's sovereign debt by S&P led to further downfall and resulted in huge foreign exchange losses to the corporates.

Discussion questions

1. What role did the Korean government play in creating the 1997 crisis?
2. What role did Korean enterprises play in creating the 1997 crisis?
3. Why was Korean central bank unable to stop the decline in the value of the won?
4. In late 1997, the IMF stepped in with a rescue package that included \$55 billion in emergency loans to support the currency. These loans had the effect of stabilizing the won, and over the next few years South Korea enjoyed a strong recovery. If the IMF had not stepped in, what might have occurred?

b) Quantitative Easing, Inflation, and the value of US Dollar

In the year 2010, the US Federal reserve decided to expand the US money supply by entering the open market and purchasing \$600 billion in US government bonds from bond holders, a technique known Quantitative easing. Where did the \$600 billion come from? The Fed simply created new bank reserves and used this cash to pay for the bonds. In effect it had printed the money. This action was aimed to stimulate the US economy after the financial crisis of 2008-09. It also reduced short-term interest rates to near zero. It further infused two rounds of QE in 2011 and 2012 and announced that it will continue until the unemployment rate fell below 6.5 %.

Critics were quick to attack the Fed's moves. Many claimed that expanded money supply would fuel inflation and lead to decline in value of dollar on foreign exchange market.

However, these charges may be unfounded for two reasons. First, at the time, the core US inflation rate was the lowest in 50 years. In fact, fear of deflation is a dangerous as it results in collapse of aggregate demand and lead to high unemployment. Secondly, US was facing weak economic growth, high unemployment and excess capacity. Consequently, if the injection of money supply did stimulate and not translated into inflation due to business started expanding the capacity. As for the currency market, its reaction was muted and traders did not seem to be selling off the dollar or reflecting worries of high inflation rate.

Discussion questions

1. How quantitative easing helps to recover economy from recession?
2. Why it did not impact US inflation?
3. What is the relationship between unemployment and inflation?
4. How money supply expansion is stimulates the demand and recovery in the economy?

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