Question Paper

International Management – I (MB3G2IB) : January 2009

Section A : Basic Concepts (30 Marks)

- This section consists of questions with serial number 1 - 30.
- Answer all questions.
- Each question carries one mark.
- Maximum time for answering Section A is 30 Minutes.

1. As per exchange control regulations, licenses are issued for import of goods into India for ______ value. <Answer>

(a) FOB
(b) C&F
(c) CIF
(d) FOB value plus 21.125%
(e) Cost plus 20%.

2. Which of the following is **not** an external hedging technique? <Answer>

(a) Forwards
(b) Exposure netting
(c) Futures
(d) Options
(e) Money markets.

3. The system in which the exchange rates are determined by the demand and supply position for the currencies in the foreign exchange market is known as <Answer>

(a) Target zone arrangement system
(b) Crawling peg system
(c) Fixed exchange rate system
(d) Floating exchange rate system
(e) Currency board system.

4. Dumping means <Answer>

(a) Destroying the goods to create scarcity
(b) Throwing the goods into the sea to create scarcity
(c) Donating the goods to least developed countries as charity
(d) Selling the goods at actual cost
(e) Selling the goods below the cost.

5. An exporter requested his banker to quote a rate for his receivable of $10,000. The banker agrees to quote the rate relying on the inter bank rate for dollar that is Rs.48.75/77$ by loading a margin of 0.15% on the rate. The rate quoted by the banker is <Answer>

(a) Rs.48.68/$
(b) Rs.48.70/$
(c) Rs.48.82/$
(d) Rs.48.84/$
(e) Rs.48.83/$.

6. Which form of purchasing power parity refers to the Law of One Price? <Answer>

(a) Numerical form
(b) Relative form
(c) Accounting form
(d) Absolute form
(e) Expectations form.

7. Under which of the following International Commercial Terms (INCOTERMS), the seller places the goods at his premises at the disposal of the buyer or any other named place, say factory, warehouse etc? <Answer>

(a) Cost and Freight (CFR)
(b) Carriage paid to (CPT)
(c) Ex works (EXW)
(d) Free carrier (FCA)
(e) Free on Board (FOB).

8. For compilation of Balance of Payment(BoP) India follows the principles laid down by the <Answer>

I. The Income Tax Act.
II. The Foreign Trade (Development and Regulation) Act.
III. The IMF manual.
IV. The Foreign Exchange Management Act.

(a) Only (I) above
(b) Only (II) above
(c) Only (III) above
(d) Both (I) and (IV) above
(e) Both (II) and (IV) above.

9. Which of the following statements is **true** when a country has a current account surplus in its balance of payment account? <Answer>

(a) Country is not a net lender to the rest of the world
(b) Country would need not borrow from outside to build-up its productive capabilities in order to achieve high rates of growth
(c) Country is living above its means
(d) It is not beneficial for a developing country
(e) Country is consuming as much as it is producing.

10. Consider the following rates quoted in Chennai forex market: <Answer>

Rs./€ : 62.36/38
€/£ : 1.1761/63

The synthetic quotes of Rs./€ are

(a) 73.34/73.38
(b) 53.02/53.03
(c) 0.0301/0.0313
(d) 53.80/53.84
(e) 73.75/73.78.

11. If there are no barriers to trade among the member countries and the external barriers for non-members are also common, then this form of trading block falls under <Answer>

(a) Free trade area
(b) Common Market
(c) Customs Union
(d) Economic Union
(e) Autarky.

12. Which of the following is **false** about a forward contract in foreign exchange? <Answer>

(a) A forward contract can be either outright forward or option forward
(b) It is an agreement where the parties agree to buy or sell a currency at a future date
(c) The future date should be beyond one month from the date of contract
(d) The price of the currency is fixed at the time of contract
(e) The terms of delivery and payments are also fixed at the time of contract.

<Answer>

13. Bank of Misr (BOM), Cairo is having an euro currency account with Commerz Bank, Frankfurt. When Citizens Bank of Canada, Vancouver refers to this account of BOM, while corresponding with Commerz Bank, Frankfurt, it would refer as

(a) Shadow account
(b) Vostro account
(c) Nostro account
(d) Loro account
(e) Mirror account.

<Answer>

14. Economic exposure can be managed by which of the following techniques?

I. Forwards.
II. Futures.
III. Market Selection.
IV. Product Mix.

(a) Both (I) and (II) above
(b) Both (I) and (III) above
(c) Both (I) and (IV) above
(d) Both (II) and (III) above
(e) Both (III) and (IV) above.

<Answer>

15. Consider the following:

One year euro interest rate is 5% (compounded quarterly)
One year dollar interest rate is 3% (compounded quarterly)
The Spot exchange rate is \$1.2788/€.

According to interest rate parity, the 6 months forward exchange rate is

(a) \$1.2725/€
(b) \$1.2915/€
(c) \$1.2824/€
(d) \$1.2919/€
(e) \$1.3077/€.

<Answer>

16. As per the exchange control regulations, an exporter is required to submit all the shipping documents evidencing export to an authorized dealer within

(a) 3 days from the date of shipment
(b) 7 days from the date of shipment
(c) 15 days from the date of shipment
(d) 21 days from the date of shipment
(e) 30 days from the date of shipment.

<Answer>

17. The letter of credit which can be cancelled by the issuing bank at the request of the applicant without the consent of the beneficiary is called

(a) Deferred Payment letter of credit
(b) Transferable letter of credit
(c) Non-transferable letter of credit
(d) Revolving letter of credit
(e) Revocable letter of credit.

<Answer>

18. Which of the following advances is a pre-shipment credit?

(a) Advances against receivables from the Government of India
(b) Advances against retention money relating to exports
(c) Advances against approved deemed exports
(d) Packing credit
(e) Advance against export bills.

<Answer>

19.Which of the following statements is **true** in case of a direct quote?

(a) Exchange margin is to be added to the bid rate and ask rate
(b) Exchange margin is to be added to the bid rate and deducted from the ask rate
(c) Exchange margin is to be deducted from the bid rate and the ask rate
(d) Exchange margin is to be deducted from the bid rate and added to the ask rate
(e) Exchange margin is to be added to the bid rate only.

<Answer>

20.Consider the following rates:

Rs./$	Spot	45.98/45.99	
	3 months		22/21

The annualized percentage discount on dollar for 3 months will be

(a) 1.57%
(b) 1.24%
(c) 1.73%
(d) 1.74%
(e) 1.87%.

<Answer>

21.Which of the following theories states that new products are developed as a result of technological innovations and trade patterns are determined by the market structure and the phase in a new product's life?

(a) Theory of Comparative Advantage
(b) Theory of Absolute Advantage
(c) Imitation Gap Theory
(d) International Product Life Cycle Theory
(e) Heckscher-Ohlin Model.

<Answer>

22.The exposure that arises from the need to convert values of assets and liabilities denominated in a foreign currency into the domestic currency is called

(a) Transaction exposure
(b) Transformation exposure
(c) Translation exposure
(d) Operating exposure
(e) Financial exposure.

<Answer>

23.When 'Suzuki' a Japanese company is floating USD denominated bonds in New York, the bond is known as

(a) Samurai bond
(b) Shogun bond
(c) Shibosai bond
(d) Yankee bond
(e) Geisha bond.

<Answer>

24.In balance of payments statement, short term inflows and outflows of capital are recorded in

(a) Current account
(b) Capital account
(c) Official reserves account
(d) Errors and omissions account
(e) Transfer payments account.

<Answer>

25.An Indian company based in Mumbai needs short term funds of Rs.50 million for a period of 3 months. The company collected the following information from its banker

Spot :Rs/$	:	45.90/92
3 months forward	:	15/17 paise

If the company decides to borrow dollar for the purpose, the amount of dollars required to borrow is

(a) $10,88,850
(b) $10,89,325
(c) $10,85,776
(d) $10,84,834
(e) $10,85,305.

<Answer>

26. Which of the following is **not correct**?

(a) Important function of the IMF is to provide reserve credit to the member countries facing temporary balance of payment problem
(b) Oil facility is a type of IMF lending
(c) International Development Association (IDA) endeavors to finance those projects in developing countries, which may not be financially profitable
(d) International Finance Corporation (IFC) insists on government guarantee for financing projects
(e) IFC helps the development of private sector in different countries.

<Answer>

27. Which of the following is **true** under a currency board system?

(a) The interest rates are automatically set by the market mechanism
(b) When there is a higher demand for the anchor currency, the reserves with the currency board gets enhanced
(c) Lending to either the government or the domestic banks by the currency board is allowed
(d) The board can act as the lender of the last resort
(e) Exchange rates are unstable.

<Answer>

28. Which of the following statements is **not true** as per the exchange control regulations governing imports?

(a) Normally remittances against imports shall be completed within 6 months from the date of shipment
(b) Foreign exchange for import payment can be sold to persons in Nepal or Bhutan
(c) Goods imported from Nepal or Bhutan against Letter of Credit (LC), payment will be made in Indian Rupees and LC will be treated as Domestic LC
(d) Authorized dealers can deliver the import documents to the holders of letter of authority
(e) An importer shall hold an Import-Export Code Number allotted by Director General of Foreign Trade.

<Answer>

29. If a country has a Balance of Payments surplus and the Central Bank is following floating exchange rate system, then the foreign exchange rate for its currency would

(a) Rise, its exports would increase and its imports would decrease
(b) Rise, its exports would decrease and its imports would increase
(c) Fall, its exports would increase and its imports would decrease
(d) Fall, its exports would decrease and its imports would increase
(e) Be stable.

<Answer>

30. Under which of the following facilities IMF extends help to prevent countries, suffering due to price shocks?

(a) Extended Facility
(b) Standby arrangement
(c) Buffer Stock Financing Facility
(d) Compensating Financing Facility
(e) Supplementary Financing Facility.

END OF SECTION A

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Section B : Problems/Caselets (50 Marks)

- This section consists of questions with serial number 1 – 6.
- Answer all questions.
- Marks are indicated against each question.
- Detailed workings/explanations should form part of your answer.
- Do not spend more than 110 - 120 minutes on Section B.

<Answer>

1. Ayur Pharmaceuticals, Kottakal, a Kerala firm has exported drugs valuing

US$100,000 to Nigeria on 01-10-2008 on the condition that the importer undertakes to pay the bill within180 days from the date of shipment. The importer confirmed that the payment would be made on 31st March, 2009, 180th day from the date of shipment. The bank charges interest @8.5% on export bills discounted from customers.

The exchange rates and interest rates prevailing on 01-10-2008 are as under

Exchange rates	Spot	Rs./$ 48.60/62
	6 months forward	48.90/92

Interest rates	Mumbai Rs.	8% - 9%
	New York $	3% - 4%

The exporter needs rupee funds immediately to execute another export order.

You are **required** to determine which of the following options ensure maximum inflow of rupee without exposing the company to exchange risk:

a. Forward cover. **(3 marks)**

b. Money market cover. **(5 marks)**

<Answer>

2. A Multinational Dairy products manufacturing company in Copenhagen, Denmark, proposes to invest its surplus funds of DKr 20 million for six months. The Treasury Manager has collected the following information from his banker to invest in euro and Pound Sterling currencies including that of home currency to earn more interest income. The company does not want to expose the investment to exchange risk, for that the company will take cover in the forward market.

Spot	DKr/US$	4.7960/4.7966
	US$/£	1.9639/ 1.9642
6 months forward	DKr/US$	4.8436/ 4.8442
	US$/£	1.9495/1.9497

6 months interest rates (p.a.)

US $: 3.20% – 3.50%

DKr : 5.40% – 5.60%

£ : 6.20% – 6.50%

You are **required** to determine the currency in which the company should invest to have more returns. **(12marks)**

Caselet 1

Read the caselet carefully and answer the following questions:

<Answer>

3. The US economy is suffering from recession on one hand, whereas the emerging Asian economies are reeling under inflation on the other hand. In this context, explain the probable impact of 'Global Inflation' on the US and other Asian economies. **(7 marks)**

<Answer>

4. Elucidate the measures taken by the monetary authorities to contain the inflation in India. **(8 marks)**

The US economy is a powerful force in world trade. A slowdown is bound to generate global ripples. For years, the US has been importing deflation to its shores from surplus labor markets such as India and China. Now that indigenous inflation has risen in those markets, the economic utility has changed. US economy is expected to grow at 0.50% in 2008 as compared to 2.20% in 2007. Asia (including Japan) and European growth will also slow as result of US recession. Asian growth is expected to grow at 6.20% in 2008 (from 7.40% in 2007) while European economic growth is expected to decline sharply, by 1.25 percentage points to 1.50% in 2008. India and Chinese GDP growth rates will fall marginally by 0.50% in 2008 (from 2007 growth). Japan and Australian growth rates will also slowdown in 2008. The earlier theory of Asia and other emerging nation growth being delinked from a US recession has failed. In fact, Asia and other emerging nations have been affected by a US led recession.

Global inflation has risen mainly due to unstoppable rise in crude oil prices and sharp rise in food prices. Global central banks have to choose between inflation and growth. The US Federal Reserve has chosen growth while the European Central Bank, the Reserve Bank of India, Chinese Central Bank and other central banks have give preference to inflation in their monetary policy decisions. Inflation rise may not overheat the global economy in the short-term. In the long-term, crude oil prices will be the key. As and when crude oil prices fall sharply for a sustained period of time, global economy will overheat. If US economy moves away from recession, India and Chinese growth rates will soar and global growth rates will rise sharply which could overheat the global economy. Everything will depend on how the quickly the world emerges from the energy price shock and food price shock it is experiencing. The US recession has not had a major impact on commodities consumption outside of the US, and rather, the big fear seems to be inflation, more specifically, rising energy and food prices. Emerging market economies, where spiraling food and energy prices make up a larger component of the CPI, are most at risk of `overheating' and might use tighter monetary policy as a balance. However, the world economy is not out of the woods yet. The full effect of the US recession could make for a period of much slower growth for the world economy in the coming few years.

Oil and fuel prices have found new plateaus. They're not likely to return to their previous levels unless there's a significant shift in supply and/or a diminution in demand. It's hard to grow an economy nowadays without relying upon oil. Long-term fundamentals are bullish due to supply constraints and ever rising demand. There is lack of new discovery in crude oil.

In the previous decade, inflation arose mostly because of domestic factors (supply usually outstripped by demand), but now the situation is different. Today's inflation is wrought largely by global forces. Imbalances in the global economy have led many countries, to engage in `competitive devaluation' of their currencies to gain access to markets like the US. Central banks foster accumulation of foreign exchange, notably the US dollar at the expense of home currencies. This artificial undervaluation of currencies has been a significant contributor to increased global liquidity.

END OF CASELET 1

Caselet 2

Read the caselet carefully and answer the following questions:

5. "Capital account convertibility (CAC) is widely regarded as one of the hallmarks of a developed economy". In the light of above statement, discuss the basic tenets required for successful implementation of safe CAC. **(7 marks)** <Answer>

6. 'Following the East Asian crisis, even the most ardent votaries of CAC in the World Bank and the IMF realized that the dangers of going in for CAC ….' In the light of the above statement, briefly discuss the arguments against the fuller convertibility of rupee. **(8 marks)** <Answer>

In simple language Capital account convertibility (CAC) means that it allows anyone to freely move from local currency into foreign currency and back.

Current account convertibility allows free inflows and outflows for all purposes other than for capital purposes such as investments and loans. In other words, it allows residents to make and receive trade-related payments – receive dollars (or any other foreign currency) for export of goods and services and pay dollars for import of goods and services, make sundry remittances, access foreign currency for travel, studies abroad, medical treatment and gifts etc. In India, current account convertibility was established with the acceptance of the obligations under Article VIII of the IMF's Articles of Agreement in August 1994.

Contrary to general belief, CAC can coexist with restrictions other than on external payments. It does not preclude the imposition of any monetary/fiscal measures relating to forex transactions that may be warranted from a prudential point of view.

CAC is widely regarded as one of the hallmarks of a developed economy. It is also seen as a major comfort factor for overseas investors since they know that anytime they change their mind they will be able to re-convert local currency back into foreign currency and take out their money. In a bid to attract foreign investment, many developing countries went in for CAC in the 80s not realizing that free mobility of capital leaves countries open to both sudden and huge inflows as well as outflows, both of which can be potentially destabilizing. More important, that unless you have the institutions, particularly financial institutions, capable of dealing with such huge flows countries may just not be able to cope as was demonstrated by the East Asian crisis of the late nineties.

The East Asian experience made the monetary authorities to move slowly but cautiously towards CAC with priority being accorded to fiscal consolidation and financial sector reform above all else.

In India, the Tarapore committee had laid down a three-year road-map ending 1999-2000 for CAC. It also cautioned that this time-frame could be speeded up or delayed depending on the success achieved in establishing certain pre-conditions-primarily fiscal consolidation, strengthening of the financial system and a low rate of inflation.

Convertibility of capital for non-residents has been a basic tenet of India's foreign investment policy all along, subject of course to fairly cumbersome administrative procedures. It is only residents – both individuals as well as corporates – who continue to be subject to capital controls. However, as part of the liberalization process the government has over the years been relaxing these controls. Thus, a few years ago, residents were allowed to invest through the mutual fund route and corporates to invest in companies abroad but within fairly conservative limits.

Buoyed by the very comfortable build-up of forex reserves, the strong GDP growth figures and the fact that progressive relaxations on current account transactions have not lead to any flight of capital, the government announced further relaxations on the kind and quantum of investments that can be made by residents abroad.

END OF CASELET 2

END OF SECTION B

Section C : Applied Theory (20 Marks)

- This section consists of questions with serial number 7 - 8.
- Answer all questions.
- Marks are indicated against each question.
- Do not spend more than 25 - 30 minutes on Section C.

7. Multinational companies will have multiple divisions in different countries. Each of the division is exposed to different cash positions, receivables and payables in different currencies. What is the technique used by the MNCs for a better cash management? Discuss its advantages and disadvantages in brief. **(10 marks)** <Answer>

8. Write **short notes** on: <Answer>

a. The mechanism of Letter of Credit and the limitations of Letter of Credit. **(5 marks)**

b. Post-shipment credit. **(5 marks)**

END OF SECTION C

END OF QUESTION PAPER

Suggested Answers
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Section A : Basic Concepts

Answer **Reason**

1. C Import licenses for import of goods are issued for CIF value. < TOP >

2. B External hedging techniques are the ones which do not form part of the day-to-day activities .Viewed against the above, exposure netting being done on a continous basis is an internal technique whereas all others form external techniques in which external parties are involved. < TOP >

3. D The exchange rates under floating exchange rate system are determined by the demand and supply position for the currencies in the foreign exchange market. < TOP >

4. E Dumping means selling the goods below the cost. < TOP >

5. A The banker who considers the bid rate of Rs.48.75, loads a margin of 0.15% on the rate. The margin of 0.15% is deducted from the bid rate. < TOP >

	48.75
Less: Margin at 0.15%	0.07
	Rs.48.68

The rate quoted by the banker is Rs.48.68.

6. D Absolute form of purchasing power parity refers to the law of One Price. < TOP >

7. C Ex Works means that the seller has delivered if he places the goods at the disposal of the buyer at the seller's premises or any other named place (works, factory, warehouse, etc.) < TOP >

8. C For BOP compilation India follows the principles laid down by the IMF manual. < TOP >

9. D A current account surplus implies that a country is not consuming as much it is producing, or in other words, is living below its means. While this type situation is may be beneficial to a developed country, a developing country already facing scarcity of resources can hardly afford not to consume what it is capable of producing. Instead, a developing country would need to borrow from outside to build-up it productive capabilities in order to achieve high rates growth. Hence, option (d) is true and correct answer. All other statements are false. < TOP >

10. A < TOP >

$(Rs./£)_{bid} = (Rs./€)_{bid} \times (€/£)_{bid}$

$= 62.36 \times 1.1761 = 73.34$

$(Rs./Euro)_{ask} = (Rs./€)_{ask} \times (Rs./€)_{ask}$

$= 62.38 \times 1.1763 = 73.38$

$Rs./Euro = 73.34/38$

11. C If there are no barriers to trade among the member countries and the external barriers for non-members are also common, then this form of trading block falls under customs union. < TOP >

12. C In outright forward contracts the future date can be any date beyond two business days (spot). < TOP >

13. D Bank of Misr (BOM), Cairo is having an euro currency account with Commerz Bank, Frankfut. When Citizens Bank of Canada, Vancouver refers to this account of BOM, while corresponding with Commerz Bank, Frankfurt, it would refer as Loro account. Loro account means "their account with you". < TOP >

14. E Economic exposure can be managed by the techniques, market selection and product mix. < TOP >

15. B $\left(1+\dfrac{0.03}{4}\right)^2 = \dfrac{1}{S}\left(1+\dfrac{0.05}{4}\right)^2 \times 1.2788$ < TOP >

= $1.2915/€.

16. D An exporter has to submit all the shipping documents evidencing export, to an Authorized Dealer within 21 days from the date of shipment. < TOP >

17. E A revocable letter of credit is one which can be canceled or revoked by the issuing bank at the request of the applicant without the consent of the beneficiary. < TOP >

18. D Packing credit is a Pre-shipment credit. Pre-shipment credit is given to the exporter to purchase/process the raw materials and export the finished goods. Credit extended to the exporters, prior to the shipment of goods is called Pre-shipment credit Post-shipment credit is the credit given to the exporter after the shipment of goods. All options under (a), (b) (c) and (e) are the examples of post shipment credit. Hence the correct answer is (d). < TOP >

19. D In the case of direct quote, the principle followed is "Buy low – sell high". Hence the exchange margin is to be deducted from the bid rate and added to the ask rate. < TOP >

20. E The annualized percentage discount on dollar for 3 months < TOP >

$$= \frac{\text{Forward(A/B)}_{\text{mid}} \text{-Spot(A/B)}_{\text{mid}}}{\text{Spot(A/B)}_{\text{mid}}}$$

$$= \frac{\left(\dfrac{45.76+45.78}{2}\right)-\left(\dfrac{45.98+45.99}{2}\right)}{\left(\dfrac{45.98+45.99}{2}\right)} = \frac{45.770-45.985}{45.985}\times\frac{12}{3}\times 100 = 1.87\%$$

21. D International Product Life Cycle (IPLC) theory, given by Vernon, explain the various stages in the life of a new product and the resultant international trade. The important principles of this theory are: < TOP >

- New products are developed as a result of technological innovations.
- Trade patterns are determined by the market structure and the phase in a new product's life.

22. C The exposure that arises from the need to convert values of assets and liabilities denominated in a foreign currency into the domestic currency is called translation exposure. < TOP >

23. D Dollar denominated bonds issued in the US domestic markets by non-US companies are known as < TOP >

'Yankee bond'.

24. B Though the outflows or inflows of capital are short term, they are still recorded in the capital account. < TOP >

25. B $\dfrac{50000000}{45.90} = \$10,89,325.$ < TOP >

26. D Statements in options (a), (b), (c) and (e) are correct. It is incorrect that IFC insists on government guarantee for financing projects. In fact IFC does not insist on government guarantee. Correct answer is (d). < TOP >

27. A In the currency board system, the board does not have any discretionary powers over the monetary policy; the interest rates are automatically set by the market mechanism. Options (b), (c), (d) and (e) are not true. < TOP >

28. B Foreign exchange for import payment can be sold to by Authorized Dealer only to persons resident in India. For this purpose, persons, companies or other organizations resident in Nepal and Bhutan should be treated as Non-resident. All other options are true. < TOP >

29. B If a country has a balance of payments surplus and the Central Bank is following floating exchange rate system, then the foreign exchange rate for its currency would rise. As a result of this exports would decrease and its imports would increase. < TOP >

30. C Buffer Stock Financing Facility introduced in 1969, this scheme provides for countries receiving financial assistance from IMF in order to purchase approved primary products. This help is extended to prevent countries from suffering due to price shocks. < TOP >

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Section B : Problems/Caselets

1. i. Forward cover: < TOP >

Bank will pay at forward buying rate and collects interest for 180 days at 8.5%. The amount receivable by the exporter after recovery of interest is:

1,00,000 at Rs.48.90	=	Rs.48,90,000
Less interest for 180 days at 8.5%		
$\frac{4890000 \times 0.085 \times 180}{365}$	=	2,04,978
Rupee amount payable by the Bank	=	46,85,022

ii. Money market cover:

Borrow US$ at 4% and the US $ receivables after 180 days will be utilized to clear the loan with interest. The amount of US$ that can be borrowed today so that it becomes equal to the bill amount after 180 days.

$$\frac{100000}{\left(1+\frac{0.04 \times 180}{365}\right)} = \mathbf{98065.55} \approx 98066$$

Get this amount converted at spot rate that is 98066×48.60 = Rs.47,66,008

The money market cover generates more inflow of rupees.

2. If the company can invest in home currency DKr at 5.40%, or invest in US$ 3.20%, euro at 5.10% and £ at 6.20% for 6 months. < TOP >

I. **Investment in DKr**

$$\text{DKr } 20{,}000{,}000 \times \left(1+\frac{0.05400}{2}\right) = 20{,}540{,}000$$

Return after 6 months = 20,540,000 – 20,000,000
= DKr 540,000

II. **Investment in US$**

Surplus of DKr 20 million is to be converted into US dollars at Dkr/US$ spot ask rate 4.7966 and is invested in US dollars at 3.20% for 6 months. The amount receivable in US $ together with interest is converted into DKr by covering at 6 month forward rate.

$ received at spot = 20,000,000 / 4.7966
= 4,169,620

Amount to be invested in US$ = 4,169,620

US$ 4,169,620 invested at 3.20% for 6 months, the amount receivable after 6 months together with interest

$$= 4{,}169{,}620 \times \left(1+\frac{0.0320}{2}\right)$$

= $ 4,236,333.92 ≈ $ 4,236,334

Convert into DKr at 6 months forward buying rate of 4.8436

= 4,236,334 × 4.8436 = DKr 20,519.107.36 ≈ DKr 20,519,107

Return after 6 months = DKr 20,519,107 - 20,000,000 =DKr 519,107.

IV. **Investment in £**

DKr20,000,000 is to be converted into £ at DKr/ £ spot ask rate ,

using synthetic quote

Spot $(\text{DKr} / £)_{bid} = (\text{DKr} /\text{US\$})_{bid}$ x $(\text{US\$} / £)_{bid}$ = 4.7960 × 1.9639 = 9.4189

Spot (DKr / £)ask = (DKr /US$)ask x (US$ / £)ask = 4.7966 × 1.9642 = 9.4215

6 Months Forward $(\text{DKr} / £)_{bid}$ =6 Months FW $(\text{DKr} /\text{US\$})_{bid}$ x $(\text{US\$} / £)_{bid}$ = 4.8436 × 1.9495 = 9.4426

6 Months Forward (DKr / £)ask =6 Months FW (DKr /US$)ask x (US$ / £)ask = 4.8442 ×

1.9497=9.4447

20,000,000 / 9.4215 = £2,122,804.42 ≈£2,122,804

£2,122,804 invested at 6.20% for 6 months will fetch $= £2,122,804 \text{ x } \left(1+\frac{0.0620}{2}\right)$

=£2,188,610.92 ≈ £2,188,611

£2,188,611 converted into £ at 6 months forward bid rate DKr 9.4426/£

= £2,188,611 x 9.4426 = DKr 20,666,178.23 ≈ 20,666,178

Return after 3 months = 20,666,178 – 20,000,000 =DKr 666,178

Return on investment in DKr =DKr 540,000

Return on investment in US$ = DKr 519,107

Return on investment in £ = DKr 666,178

The company should invest in £, since the return in investment is more when compared to the others.

3. The US economy because of its size, purchasing power and productive output, is a powerful force in world trade. A slowdown in US is bound to generate global ripples. But the US is a part, not the entirety of the global economy. For years, the US has been importing deflation to its shores from surplus labor markets such as India and China. Now that indigenous inflation has risen in those markets, the economic utility has changed. < TOP >

- The earlier theory of Asia and other emerging nation growth being delinked from a US recession has failed. In fact, Asia and other emerging nations have been affected by a US led recession. So far, the US recession has not had a major impact on commodities consumption outside of the US, and rather, the big fear seems to be inflation, more specifically, rising energy and food prices.
- Emerging market economies, where spiraling food and energy prices make up a larger component of the CPI, are most at risk of `overheating' and might use tighter monetary policy as a balance. The full effect of the US recession could make for a period of much slower growth for the world economy in the coming few years.
- Global inflation has risen mainly due to unstoppable rise in crude oil prices and sharp rise in food prices. Global central banks have to choose between inflation and growth. The US Federal Reserve has chosen growth while the European Central Bank, the Reserve Bank of India, Chinese Central Bank and other central banks have give preference to inflation in their monetary policy decisions. Inflation rise may not overheat the global economy in the short-term. In the long-term, crude oil prices will be the key. As and when crude oil prices fall sharply for a sustained period of time global economy will overheat. If US economy moves away from recession, India and Chinese growth rates will soar and global growth rates will rise sharply which could overheat the global economy. Everything will depend on how the quickly the world emerges from the energy price shock and food price shock it is experiencing.
- The increase in energy and commodity prices across the globe, represent a durable relative price shift, reflecting long-lasting global demand and supply trends. Commodity prices, by nature, are cyclical so there's likely to be price shifts in the future. New technology can create alternative products or increase productive capacity. Consumptive patterns, too, can change. The acute investment demand for commodities, as well, may wane when the equities and debt markets stabilize. All that, of course, takes time.
- At least 15% of the rise in energy prices and commodity prices is due to investment interest. Long-term fundamentals are bullish due to supply constraints and ever rising demand. Nearly 50% of the world is urbanized and is on the rise with passing of each day. Greater urbanization will result in continuous rise in demand for energy and other commodities. Supply constraints are bound to persist. There is lack of new discovery in crude oil. Global warming has started affecting crop production globally. Australia, US, Ukraine the key major producers of wheat have been affected due to weather constraints. Further, greater land use for bio fuels has reduced area under cultivation of essential food crops in US and other nations. There is a durable relative price shift, reflecting long-lasting global demand and supply trends. However, in the next two to three years apart from fundamentals, investment interest will be the key for energy prices and commodity prices.

In the previous decade, inflation arose mostly because of domestic factors (supply usually outstripped by demand), but now the situation is different. Today's inflation is wrought largely by global forces. International farm prices have risen because of supply pinches in the Australian and Brazilian growing regions. That's rippled through to the Indian market.

4. Measures taken by the monetary authorities to control inflation in India: < TOP >

- The government has banned commodity trading in certain commodities (like wheat, tur, rice, urad, etc.) and cracking down on the hoarders who are trying to create an artificial supply shortage and rise in these commodities due to supply constraints. Now further bans are being considered.
- The government is giving subsidy on petrol, diesel, LPG and kerosene prices. There are various pro poor schemes which include the use of public distribution schemes (PDS) to distribute wheat, sugar at lower rates. Crude oil prices are over $130 a barrel. If the government does not give subsidies Indian petrol, diesel and LPG prices need to rise over 20% which will result in a double digit rise in inflation. Excise duty, other central and state levies are over 20% in petrol and diesel prices. The government should first reduce the indirect tax element in petrol and diesel to curb inflation.
- Giving subsidy and encouraging innovations in financial markets are two separate things. Encouraging innovations in financial markets can be done by a clear cut policy guidelines in every financial instrument. These guidelines should not change overnight as per the convenience of the government

The long-term measures to enhance the supply and curtail energy prices are:

The small farmer should get the real benefit of higher prices. Unless the small farmer gets a major portion of the price rise, food security will never be attained.

- A large section of the small farmer still takes loans from the local money lender at unreasonably high rates only to become landless later on. The government should promote microfinance schemes so that the small farmer goes to the state run banks for all his needs and not get caught in the Web of the local moneylender.
- Private insurance companies should be allowed to enter to crop insurance sector.
- Limit the city growth so that the growth in city does not take over agricultural land. Increasing the number of floors will reduce the pace of urbanization.
- Population needs to be checked. Unless population growth is not checked, all the measures will be useless at some point.
- Easy access of modern seeds and other technology to small-and- medium-sized farmers.
- It's time for the government to consider targeting inflation's root cause and revalue the rupee upward while simultaneously addressing supply side constraints. Since much of the world trade is denominated in the US dollars, a stronger rupee would lower the purchase price of commodities.
- Ethanol blending with petrol is getting delayed. The government should cover the entire country with ethanol blending as early as possible.
- Compressed Natural Gas (CNG) is yet to be implemented in the whole of India.
- Promoting alternate energy by tapping solar energy hither to untapped. The government should use a combination of subsidy and tax incentives to promote solar energy.
- Energy efficiency norms implementation is increased along with greater supervision at ground level, the pace of rise of energy demand will come down.

  The most important effect of the unilateral increases in oil, refined products, and natural gas prices is using the market mechanism to force consumers to ration their demand.

5. The basic requirements for a safe CAC are as follows: < TOP >

Banking and capital market regulatory system

Many Indian banks are under-capitalized, and their balance sheets characterized by large amounts of Non-Performing Assets (NPAs). This is not a welcome sign as banks intermediate a good amount of funds in India and about 64% of the total financial assets belong to the banks. Capital account convertibility requires flexibility, dynamism and foresight in the banking and financial institutions. Hence, unless the banking standards get a facelift to make banks competitive it would not be advisable to shift to CAC.

Transparency and discipline in fiscal and financial policies

If the government wants to win the confidence of the investors then it has to be more transparent. Fiscal deficit will have to be through concerted efforts from the government; otherwise, capital flight might become a reality to reckon with.

Strong Macroeconomic Fundamentals

India's macroeconomic fundamentals are certainly better than before, but they need to firm up more to attract the confidence of the investors. With large NPAs of the public sector banks, a weak financial market and a heavily corrupt business environment are all points to be considered.

Once the interest rate differentials between the different countries fade out, the flight of capital might increase further while at the same time the inflows into the country cannot be guaranteed. Hence, the government should attempt to increase the FDI which has the potential to promote employment and growth, but minimize the inflow of short-term capital.

6. The various arguments against the full convertibility of rupee are as follows: < TOP >

1. An open capital account could lead to the export of domestic savings, which for capital scarce developing countries would cripple the financing of domestic investment.
2. It would weaken the ability of the authorities to tax domestic financial activities, income and wealth.
3. Capital convertibility could expose the economy to greater macroeconomic instability arising from the volatility of short-term capital movements, the risk of large capital outflows and associated negative externalities.
4. Premature liberalization (that is, if the speed and sequencing of reforms are not appropriate) could initially stimulate capital inflows that would cause real exchange rate to appreciate and thereby destabilize an economy undergoing the fragile process of transition and structural reform. Once stabilization program lacks credibility, currency substitution and capital flight could trigger a BoP crisis, depreciation and spiraling inflation.
5. It is commodity convertibility rather than financial convertibility that is of the greatest welfare significance.
6. Speculative short-term movements in the interest rates may make monetary policy ineffective.
7. Due to higher capital inflows following capital convertibility, the appreciating real exchange rate would divert resources from tradable to non-tradable sectors (like construction, housing, hotels and tourism etc;) and this would happen in the face of rising external liabilities (i.e., the risk of the "Dutch disease effect").
8. A convertible capital account could lead to financial bubbles, especially through irrational exuberance of investment in real estate and equity market financed by unbridled foreign borrowing.
9. Capital convertibility would expose the distortions in the price of borrowing from abroad vis-à-vis the domestic market and under such circumstances private firms would borrow more than what is socially optimal. This generally increases the cost of foreign borrowings for all borrowers.

Section C: Applied Theory

7. MNCs will have multiple divisions/subsidiaries in different countries. Each of the subsidiary < TOP > or division will have cash positions, receivables and payables in the same currencies or different currencies. The composition of receivables and payables and cash can be in any combination. One division may have huge receivables in the US dollar and hedged with a short position while another division which has a huge dollar payable, might have hedged with a long position with the same maturity. Similarly, one division may be having a surplus cash position while another division in another country may be having a cash deficit and borrowing at a high cost. These type of situations warrant proper cash management systems. To overcome these type of problems for cash management, MNCs resort to centralized cash management system.

Advantages

i. **Netting**: In large MNC's, intra-corporate transactions among various subsidiaries of the parent company or subsidiaries with parent corporate are a common feature. As a consequence there will be receivables and payables among the group subsidiaries resulting in cash inflows and outflows in different currencies. At times the inflows and outflows between two subsidiaries may have matching maturities or may have maturity mismatches. If the receivables and payables are of different currencies, the transaction costs can be higher.

In a centralized cash management system all cash transactions of group companies are settled through a single point.

In such circumstances, netting is possible whereby the receivables are netted out against payables and net cash flows are settled among the group subsidiaries.

When we are considering the transactions between the subsidiaries, leading and lagging of receivables/ payables is possible to enable matching of maturities. Netting with other corporate entities is also possible.

ii. **Management of currency exposure:** Another advantage of centralized cash management system is exchange risk management. In a centralized cash management system, the parent can evolve a corporate strategy for exchange risk management keeping overall position of receivables and payables in different currencies of the various subsidiaries in mind. This strategy will reduce the transaction cost of the hedging which otherwise would be incurred by each subsidiary individually.

iii. **Pooling of cash:** Each of the subsidiary will maintain certain amount of liquid position. Some of the subsidiaries may have surplus cash whereas some others may have a deficit. In a centralized cash management system, the center may pool up the cash from surplus subsidiaries for transfer to the deficit units. This will eliminate borrowing cost to the deficit units. The existence of cash pooling center will reduce the burden of cash management at the subsidiary level.

Disadvantages:

It is rarely possible to hold all cash in a major international financial centre. This is because there may be unpredictable delays in moving funds from the financial center to other countries. If an important payment is due, especially if it is to a foreign government for taxes or to a local supplier of a crucial input, excess cash balances should be held where they are needed, even if these mean opportunity costs in terms of higher interest earnings available elsewhere. When the cash needs in local currencies are known well ahead of time, arrangements can be made in advance for receiving the needed currency, but substantial allowances for potential delay should be made.

Complete centralization of management is difficult because local representation is often necessary for dealing with local clients and banks. Even if a multinational bank is used for accepting receipts and making payments, problems can arise that can only be dealt with on the spot. Therefore, the question a firm must answer is the degree of centralization of cash management that is appropriate, and in particular which activities can be centralized and which should be decentralized.

8. a. In order to make payment to the overseas supplier, the buyer of goods approaches his bank for opening a letter of credit in favor of the supplier. < TOP >

After considering the request of the buyer and fulfillment of the necessary formalities, the issuing bank (i.e. the buyer's bank) opens the letter of credit in favor of the supplier. The letter of credit is transmitted to the advising bank (usually an intermediary bank located in supplier's the credit, the advising bank advises the credit to the beneficiary (i.e. the supplier). The beneficiary verifies the letter of credit and checks for any discrepancies vis-à-vis, the sale contract. If any discrepancies are noticed, the buyer is asked to incorporate the necessary changes/amendments to the LC. The supplier then proceeds to ship the goods.

Shipment of goods is followed by submission of necessary documents by the supplier to the negotiating bank in order to obtain payment for the goods. The negotiating bank, upon receipt of commercial documents and the bill of lading from the exporter, scrutinizes the documents in relation to the LC and if found to be in order, negotiates the bill and makes payment to the supplier. The negotiating bank then claims reimbursement from the issuing bank by mailing the documents to it or any other bank authorized for the said purpose. Disadvantages/Limitations

A letter of credit is not a cent per cent safe deal either for the exporter or for the importer. To the exporter, the undertaking of the issuing bank is only conditional. The documents tendered should strictly comply with the requirements of the credit. It is only the bank that would decide if the documents are as per the terms of the credit; any slight variation or non-fulfillment or excess detail in the documents tendered give scope for the bank to claim that the documents are not as per the terms of the credit. Moreover, the credit does not protect the exporter from the governmental action that may deter payment.

To the importer, the major disadvantage is that it does not ensure that he would be receiving the goods of the specific condition and order. In letter of credit transactions, all parties deal with documents and not in goods. He stands committed to reimburse the issuing bank when documents as required are tendered to him. But this does not ensure the receipt of proper goods. Though the risk is safeguarded by calling for special documents like packing list, etc., the risk of falsification of documents still remains.

b. Pre-shipment Credit

The purpose of this credit is to provide the necessary funds to the exporter to procure raw material and meet the costs involved in manufacturing the goods. This credit may be initially extended without any security in which case it is known as extended packing credit. At this stage it remains a clean advance. The funds so lent are used to procure the raw material, which then is charged to the bank. Then the advance becomes a secured advance. The advance is given either in the form of a loan or in the form of an operating account. The advance so given has to be adjusted with the proceeds of the export. Hence it is necessary to ensure that the loan given for executing a particular export order is adjusted out of the sale proceeds of that export. However the banker is vested with the authority by RBI to waive this condition and to allow the advance to be adjusted from the proceeds of any export transaction.

Pre-shipment credit is extended for the period which matches with the operating cycle of the activity. However, the period of credit is normally restricted to a maximum of 180 days. It is envisaged that the export will be materialized within the due date and the loan will be adjusted from the export proceeds. However, the banks have the discretion to extend the period of credit up to 360 days under special circumstances. In order to ensure that export will materialize banks normally insist for a Letter of Credit opened in the name of the exporter or a confirmed order

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