Question Paper

International Management – I (MB3G2IB) : October 2008

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. The phenomenon of a particular country simultaneously importing and exporting the same product is known as <Answer>

(a) Inter-industry trade
(b) Intra-industry trade
(c) Inter-commodity trade
(d) Intra-commodity trade
(e) Cross country trade.

2. The following is **not** an example of fixed exchange rate system <Answer>

(a) Currency board system
(b) Target zone arrangement
(c) Crawling peg system
(d) Monetary union
(e) Bretton Woods system.

3. The term risk-free arbitrage refers to the process of <Answer>

(a) Buying one currency and selling another currency at the same time in the same market or across different markets
(b) Buying and selling the same currency at the same time in the same market
(c) Buying and selling the same currency at the same time in the same market or across different markets
(d) Buying or selling the same currency at the same time in the same market or across different markets without commitment of any capital or risk
(e) Buying or selling the same currency at the same time in the same market or across different markets using money market.

4. A letter of credit which allows the Issuing bank to make payment to the beneficiary in installments is known as <Answer>

(a) Red clause L/c
(b) Green clause L/c
(c) Revolving L/c
(d) Transferable L/c
(e) Deferred L/c.

5. Consider the following information: <Answer>

One-year interest in U.K is 5% p.a.
One-year interest in India is 8% p.a

The spot exchange rate is Rs.83.84/£. If the interest rate parity holds good what would be the 6-month forward exchange rate?

(a) Rs.81.51/£
(b) Rs.82.63/£
(c) Rs.85.07/£
(d) Rs.85.18/£
(e) Rs.85.24/£.

6. Triffins Paradox is associated with <Answer>

(a) Purchasing power parity
(b) Interest rate parity
(c) Forecasting of exchange rates
(d) Computation of trade deficit
(e) Collapse of Bretton Woods system.

7. In which of the following statements/returns the details of export bills which remain outstanding beyond the due <Answer>

date for payment are to be furnished to RBI?

(a) XOS statements
(b) BEF statements
(c) R-returns
(d) ENC statements
(e) GR forms.

<Answer>

8. Which of the following would **most** likely cause a nation's currency to depreciate?

(a) An increase in the nation's domestic inflation rate
(b) A decrease in domestic real interest rates
(c) A decrease in the nation's domestic inflation rate
(d) An increase in inflation rate of the nation's trading partners
(e) A decrease in money supply in the domestic economy.

<Answer>

9. Which of the following are the privately placed bonds issued and offered to different market segments that consist of institutional investors, including banks in the Japanese markets?

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

<Answer>

10. M/s. Bharat Overseas Corporation is a star trading house engaged in exports and imports. On April 30, 2008, the company who has an import worth $200,000, booked a two month forward contract for the import transaction at Rs.41.64/$.

On June 14, 2008 the company requested the bank to extend the contract for delivery on July 31, 2008.

The following are the on going market rates and the forward premium:

	June 14, 2008
Spot	41.02/04
June	09/11
July	36/38
August	54/56

Forward rate for the import transaction given by the bank on 14.06.08 (after ignoring margin) was

(a) Rs.41.38
(b) Rs.41.40
(c) Rs.41.42
(d) Rs.41.56
(e) Rs.42.02.

<Answer>

11. The difference between the time when a new product is introduced in the country and the time when the consumers in the other country require it, is called

(a) Imitation lag
(b) Supply lag
(c) Technology lag
(d) Demand lag
(e) Production lag.

<Answer>

12. Which of the following international institutions endeavors to finance the projects which may not be financially profitable in developing countries?

(a) International Bank for Reconstruction and Development
(b) International Finance Corporation
(c) International Development Association
(d) International Monetary Fund
(e) UNESCO.

<Answer>

13. Which of the following statements is **false** in respect of exports under exchange control regulations?

(a) Export proceeds have to be realized on due date or within six months from the date of shipment whichever is earlier
(b) Exporters having a good track record may be permitted to open foreign currency accounts with banks abroad for crediting the export proceeds
(c) Every exporter is required to obtain an Importer-Exporter Code Number from the Director General of Foreign Trade
(d) Export proceeds cannot be received in foreign currency notes
(e) Exporter is required to submit shipping documents to authorized dealer within 21 days from the date of shipment.

<Answer>

14. Which of the following policies does **not** help a country to correct its current account deficit?

(a) Subsidizing the exports
(b) Letting the exchange rate depreciate
(c) Free foreign grants
(d) Expanding aggregate demand
(e) Taxing imports.

<Answer>

15. Which of the following statements is/are **true** about ‘leading and lagging technique’?

I. It is an internal hedging technique.
II. Leading involves making payment before it is due.
III. Lagging means postponing a payment beyond its’ due date.
IV. A company may lead the payment in a currency that is likely to appreciate.
V. A company may lag the payment that is likely to depreciate.

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

<Answer>

16. Which of the following serves as an evidence that the goods have actually been imported into India for the remittance sent in foreign currency by an Authorized Dealer (AD)?

(a) Bill of Lading
(b) Bill of Entry
(c) Air Way Bill
(d) Combined Transport Bill of Lading
(e) House Airway Bill.

<Answer>

17. If a country follows floating exchange rate system, which of the following statements is **not true**?

(a) The exchange rates between the currencies are variable
(b) The exchange rates are determined by the demand and supply for the currencies in the international market
(c) International trade in goods and services facilitates the movement of currencies between the countries
(d) If the country is facing a deficit or surplus the exchange rates get automatically adjusted and this leads to a correction of imbalance
(e) The exchange rates are determined as a result of pegging to either some common commodity or currency.

<Answer>

18. The relationship between the spot and forward exchange rates between a pair of currencies is brought about principally through

(a) The Fisher effect
(b) Purchasing power parity
(c) Covered interest rate arbitrage
(d) Uncovered interest rate arbitrage
(e) Interest rate parity.

<Answer>

19. Consider the following:

Rs/Can$	Spot :	41.19/41.21
Interest rates (1 year)	Rs. :	6.00% - 6.50% p.a.
	Can$:	3.50% - 3.75% p.a.

What should be the 1-year forward bid rate of dollar to prevent arbitrage?

(a) $\leq$ Rs.42.21
(b) $\leq$ Rs.42.40
(c) $\geq$ Rs.42.30
(d) $\leq$ Rs.45.85
(e) $\leq$ Rs.44.78.

<Answer>

20. Expropriation refers to

(a) Government restraining repatriation of profits
(b) Government taking over without paying compensation
(c) Government taking over by paying compensation
(d) Government restraining future investments by foreign investors in home country
(e) Government treating a country as enemy country.

<Answer>

21. In which of the following cases of International Commercial Terms (INCOTERMS), the seller has to make payment of freight charges for transportation of goods to buyer

(a) EXW (Ex Works)
(b) FAS (Free Alongside Ship)
(c) DES (Delivered Ex Ship)
(d) FCA (Free Carrier)
(e) FOB (Free on Board).

<Answer>

22. Payment to a foreign technical consultant for professional services rendered by him is recorded under which of following heads of Balance of payments (BOP) statement?

(a) Merchandise
(b) Miscellaneous
(c) Unilateral transfers
(d) Official reserves account
(e) Errors and Omissions.

<Answer>

23. An import quota is

(a) A tax on imported goods
(b) A ban not to import such goods
(c) A flat duty on imports
(d) A limit on the number of units that can be imported
(e) A tariff barrier.

<Answer>

24. Dendanske Bank, Copenhagen is maintaining a Pound Sterling account with Marine Midland Bank, London. Dendanske Bank while corresponding with Marine Midland Bank, London, refers this ‘Pound Sterling’ account as

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

<Answer>

25. Consider the following rates quoted in forex market:

Rs./$: 42.66/68
$/£ : 1.9484/86

The synthetic quotes of Rs./£ are

(a) 83.12/17
(b) 83.13/39
(c) 83.15/18
(d) 83.18/24
(e) 83.21/27.

<Answer>

26. The capital inflow of a country is influenced by

I. Return on investment.
II. Risk exposed.
III. Political stability.
IV. Stage of the economic cycle.
V. Movement of exchange rate.

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

27. Which of the following states that the real interest rates are equal across different countries? <Answer>

(a) Purchasing power parity
(b) Interest rate parity
(c) International Fisher effect
(d) Fisher open condition
(e) Marshall-Lerner condition.

28. The mechanism of protecting the domestic economic activity from external disturbances is called <Answer>

(a) Price specie flow mechanism
(b) Sterilization
(c) Deneutralization
(d) Perfectionism
(e) Economic adjustment mechanism.

29. Forward spread means <Answer>

(a) The spread between two forward rates of different maturities
(b) The spread between two option forward rates
(c) The spread between outright forward rate and option forward rate
(d) The spread between two forward rates
(e) The spread between forward rate and spot rate.

30. When some foreign countries subsidize their exports, the importing country may impose a duty, which is called as <Answer>

(a) Anti-dumping duty
(b) Specific duty
(c) Ad-valorem duty
(d) Countervailing duty
(e) Compound duty.

END OF SECTION A

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.

1. Bombay Swadeshi Silk Exports (P) Ltd., Mumbai, imports raw silk from China and exports silk sarees, fabrics and scarves to east Asian and European countries. Imports are invoiced in US dollars and exports are invoiced in euro currency. The company has receivables of €500,000 and payables of $200,000 three months from now. The Vice-President (Finance) Mr. Khemchand Bhatia, obtained the following exchange rates quotations from the market and is considering to cover the exposures either through the forward market or money market. <Answer>

Exchange rates	Rs./Euro	Rs./$
Spot	62.96/98	40.06/08
Three month forward	63.24/26	40.30/32

The current interest rates (per annum) are as under

Maturity	Rupee (%)	Euro (%)	$ (%)
3 months	6.00/8.00	4.50/4.70	2.50/2.70

You are **required** to advise Mr. Khemchand Bhatia as to which alternative should be better for covering both the payables and receivables.

(10 marks)

2. A Multi National Corporation based in Australia has identified surplus funds to the tune of Aus$5 million for three months. The Vice-President (Finance) has collected the following information from his banker to invest in any currency including home currency to earn more interest without exposing the investment to exchange risk. For this purpose he proposes to cover the foreign exchange exposures through forward market.

<Answer>

Aus$/$	Spot	1.0841/44
	3 months	54/56
€/$	Spot	0.6338/41
	3 months	11/13
Can$/$	Spot	0.9886/93
	3 months	02/04

3 months interest rates (p.a.)

Aus$:	2.40%-2.80%
€ :	4.20%-4.50%
Can$:	3.60%-4.00%

You are **required** to determine the currency in which the company should invest to earn more interest on the surplus funds.

(10 marks)

Caselet 1

Read the caselet carefully and answer the following questions:

3. "The asset demand for gold is traditionally associated with the view that gold provides as effective hedge against inflation and other forms of uncertainty". Discuss the various reasons that lead to the spurt in the demand of gold.

<Answer>

(8 marks)

4. Enumerate the factors that are driving up the gold prices in the current scenario.

<Answer>

(7 marks)

The demand for gold comes from two different sources first is the 'use demand' where it is used directly in the production of jewellery and the second is the 'asset demand' for gold as an investment.

The first approach models variation in the price of gold as a result of changes in the macroeconomic variables, such as exchange rates, interest rates, world income and political shocks. The second approach focuses on speculative-versus-rationality factors behind the gold price movements. The third approach examines gold as a hedge against inflation with particular emphasis on short-run and long-run relationships between gold and the general price level. In the recent past, decoupling seems to have been happening between the exchange rates and gold prices with the dollar losing its shine as the world's reserve currency and the absence of any other currency that has the potential to take its place. Given this scenario, gold is emerging as an asset worth owning and hence unabated demand will continue as long as the uncertainty on the exchange rate front continues.

Easy monetary policies by central banks have created global cash glut and a credit bubble. This mammoth global monetary growth has led to easy cash availability in the market place which has a tendency to bid up prices for goods, services and housing thus resulting in severe inflationary pressures. India is the world's largest consumer of gold jewelry. In India, gold is ranked just below bank deposits as a savings and investment vehicle. Internationally, despite the mayhem in the stock markets, by January end, gold prices rose and reached a new all-time high of $924 an ounce in the London spot market. The gold price at the close of January was above $920 per ounce. In line with international price movements, gold prices in India rose and in February, reached Rs. 11,895 on the bullion market.

However, "the combination of record prices and high volatility is a deterrent to jewelry buying by both the trade and consumers. This form of demand may not therefore be strong in the first quarter of 2008 and may remain under pressure while prices remain volatile."

END OF CASELET

1

Caselet 2

Read the caselet carefully and answer the following questions:

5. 'Depreciating dollar is perhaps bad news not only for the US but also to rest of the world'. Discuss the various reasons for depreciation of dollar against the other currencies. <Answer>

(8 marks)

6. 'The collapse of the dollar may put the global economy in a slump'. Discuss the probable impact of depreciating dollar on the emerging economies like India and China. <Answer>

(7 marks)

The dollar has depreciated against other major currencies. After the Federal Reserve announced the reduction in interest rates, the dollar fell even further, to a level not seen since 1997. The falling dollar could be an outcome of trade account and current account deficits run by the US in the past. Since then, from its peak in 2002 and October 2007, the dollar has fallen approximately 28% in nominal terms and about 25% in real-terms. A weak dollar is not a novel concern. This gradual decline of the US dollar could lead to the discarding of huge dollar reserves held by countries worldwide. In addition to this, the risk of US recession or other factors that could also cause a loss of confidence in the dollar, pose major risks to this scenario. A dollar crisis will be very damaging for the global economy, making the expected slowdown much deeper and long-lasting.

Some of the countries want to explore other growing economies for investment opportunities. The slowdown of US economy is compelling investors to look for better returns elsewhere causing the outflow of dollars from the US. Net private capital inflows into the US have weakened sharply since August 2007. This downward trend of dollar and current account adjustment had also happened in the 1980s. The downward pressure of dollar is causing an imbalance in the world economy. Fed's new Chairman Ben Bernanke hinted at a rise in inflation levels, resulting in slackening of the US economy. Due to excess capacity available in the world economy, it is difficult to avoid the impending crisis. The excess capacity in the world is also due to wrong policy action of many governments which bailed out their financial institutions by expanding their credits. Their currency always flowed into the US in search of a safe investment option, these are signs of change that may further weaken the dollar.

Many economists are forecasting that the dollar will fall against the yen and the euro for the next couple of years and it is inevitable. If the same trend continues at the same pace, the dollar will lose its sheen in the international finance segment. It will have serious repercussions for the US economy and the world economy at large.

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. Exporters are to be provided adequate credit at competitive interest rates in order to ensure steady export growth. Explain in detail about the pre-shipment finance. <Answer>

(10 marks)

8. Write short notes on: <Answer>

a. International Cartels. **(5 marks)**

b. Imitation Gap Theory of International trade. **(5 marks)**

END OF SECTION C

END OF QUESTION PAPER

Suggested Answers
International Management – I (MB3G2IB) : October 2008

Section A : Basic Concepts

Answer	Reason
1. B	The phenomenon of a particular country simultaneously importing and exporting the same product is known as intra-industry trade. < TOP >
2. C	Under crawling peg system, while the value of a currency is fixed in terms of a reference currency, this peg itself keeps changing in accordance with the underlying economic fundamentals whereby market forces play a role in the determination of the exchange rate < TOP >
3. D	The term risk-free arbitrage refers to the process of buying or selling the same currency at the same time in the same market or across different markets without commitment of any capital or risk < TOP >
4. E	A letter of credit which allows the issuing bank to make payments in installments is known as 'Deferred L/C'. < TOP >
5. C	Spot rate Rs./£ = 83.84; 6-month forward rate = $\frac{83.84\left(1+\frac{0.08}{2}\right)}{\left(1+\frac{0.05}{2}\right)}$ = Rs.85.07/£ < TOP >
6. E	Triffins paradox is associated with collapse of Bretton Woods system. < TOP >
7. A	The details of export bills which remain outstanding beyond the due date for payment are to be furnished to RBI in XOS statements. < TOP >
8. A	Option in (a) would most likely cause a nation's currency to depreciate. < TOP >
9. C	Shibosai Bonds are privately placed bonds issued in the Japanese markets. Shibosai bonds are offered to a different market segment that consists of institutional investors, including banks. • Samurai bonds are issued by non-Japanese borrowers in the domestic Japanese markets. • Dollar denominated bonds issued in the US domestic markets by non-US companies are known as 'Yankee bond'. • Bulldog bonds are sterling denominated foreign bonds which are raised in the U.K. domestic securities market. • Yankee bonds are US dollar denominated issues by foreign borrowers usually foreign governments or entities, supra-nationals and highly rated corporate borrowers in the US markets. • 'Shogun Bonds 'are publicly floated bonds in Japanese market in foreign currency by non-Japanese borrowers. < TOP >
10C	Forward rate given by the bank for import transaction on 14.06.08 = 41.04 + 0.38 = Rs.41.42/$. < TOP >
11D	The difference between the time a new product is introduced in the country and the time when the consumers in the other country require it, is called Demand lag. < TOP >
12C	International Development Association endeavors to finance the projects in developing countries which may not be financially profitable, but indirectly may have a positive effect on the concerned economy. < TOP >
13D	Export proceeds may also be paid by foreign currency notes/foreign currency travelers cheques by the buyer on his visit to the country. All other options are true. < TOP >
14D	Expanding aggregate demand do not help a country correct its current account deficit. Hence option < TOP >

(d) is said to be the correct answer.

15E It is an internal hedging technique (I) .Leading involves making payment before it is due (II) .Lagging means postponing a payment which is already due (III). A company may lead the payment in a currency that is likely to appreciate (IV). A company may lag the payment that is likely to depreciate (V). < TOP >

16B Bill of Entry serves as evidence that the goods have actually been imported into India for the remittance sent in foreign currency by the ADs. Options in (a), (c), (d) and (e) are documents of title to the goods and these documents are issued by carrier agents.

17E Under fixed exchange rate system, the value of a currency in terms of another is fixed. The fixed exchange rates result from countries pegging their currencies to either some common commodity or to some particular currency. < TOP >

Statements (a), (b), (c) and (d) represent the characteristics of floating exchange rate system.

18C The relationship between the spot and forward exchange rates between a pair of currencies is brought about principally through covered interest arbitrage. The fisher effect says that the real interest rates are equal across different countries. Purchasing power parity says that the exchange rate between two countries currencies is determined by the respective price levels in the two countries. Correct answer is (c). < TOP >

19B Assume we borrow Rs. 100 for 1 year < TOP >

We should pay after 1 year (100) (1+0.065) = Rs.106.50

If we convert Rs. 100 into Canadian dollars for investment we obtain 100/41.21 = Can$2.4266

If we invest $ 2.4266 for 1 year @ 3.5% p.a., the investment would yield (2.4266) (1+0.035)

Can$ 2.5115 after one year

To prevent arbitrage,

Rs.106.50 $\geq$ Can$ 2.5115 F_b

$F_b \leq$ Rs. 42.40/Can$

20C Expropriation refers to Government taking over by paying compensation < TOP >

21C In the case of delivered ex-ship contract, the seller has to make payment of freight changes for transportation of goods to buyer. In all other cases of options a, b, d, and e the buyer has to bear the freight changes. < TOP >

22B Payment made to a foreign technical consultation for professional services rendered by him will appear as a debit item under the head 'Miscellaneous'. < TOP >

23D An import quota is a limit on the number of units that can be imported. < TOP >

24A Dendanske Bank, Copenhagen is having an account with Marine Midland Bank, London. When Dendanske Bank, Copenhagen refers to this account, while corresponding with Marine Midland Bank, London, it would refer to this account as Nostro account. Nostro account means "our account with you". < TOP >

25A Rs./£ bid = Rs./$ bid x $/£ = 42.66x 1.9484 = Rs.83.12/£ < TOP >

Rs./ £ ask = Rs./$ ask x $/£ ask = 42.68 x 1.9486 =Rs.83.17/£

Rs./ £ synthetic quote = 83.12/83.17.

26E The capital inflow of a country is influenced by return on investment, risk exposed, political stability, stage of the economic cycle and movement of exchange rate. < TOP >

27D Fisher open condition states that the real interest rates are equal across different countries. < TOP >

28B The mechanism of protecting the domestic economic activity from external disturbances is called 'sterlization'. It is also known as neutralization. < TOP >

29E Forward spread means the spread between forward rate and spot rate. Other options in (a), (b), (c) and (d) are not correct. < TOP >

30D When some foreign producer is found selling his product at a price which will not fetch him his cost even, anti-dumping duty may be levied which is different from the countervailing duty imposed on goods which have been subsidized by the foreign country. Specific duty is a flat duty based on the number of units regardless of the value of goods. Ad valorem duty is expressed a percentage of the value of goods. A compound duty is a combination of specific and ad valorem duty.

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Section B : Problems/Caselets

< TOP >

1.a. Payable of US$ 200,000 after 3 months

(i) Cover through forward market

Rupee outflow = $200{,}000 \times 40.32$

= Rs.8,064,000

(ii) Cover through money market

Borrow rupee, convert it into US$ at spot rate and invest for 3 months.

US dollars to be invested = $\frac{200{,}000}{\left(1+\frac{0.0250}{4}\right)}$

= \$198,757.764≈ 198,758

This amount with interest which is \$ 2,000,000 after 3 months is used to settle the payable

Amount to be borrowed now in rupees

198,758 X 40.08

= Rs.79,66,220.64

say Rs.79,66,221

Amount to be repaid with interest

= $79{,}66{,}221\left(1+\frac{0.08}{4}\right)$

≈ Rs.81,25,545

We see that outflow under forward cover is less than the money market cover. Therefore the company must cover the exposure through the forward cover.

b. Receivables of Euro500,000 after 3 months

i. Cover through forward market

Rupee inflow = $500{,}000 \times 63.24$

= Rs.3,16,20,000

ii. Cover through money market

Borrow € 500,000 for 3 months convert into rupee and invest for 3 months

€ to be borrowed = $\frac{500{,}000}{\left(1+\frac{0.047}{4}\right)}$

= 49,41,93.23 ≈ 4,94,193

Rupee inflow at spot rate = 4,94,193 X 62.96 = Rs.3,11,144,391.28

Rupee inflow after 3 months with interest at 6%

= $.3{,}11{,}144{,}391.28\left(1+\frac{0.06}{4}\right)$

= Rs.31,581,107.15

Rupee inflow is less under money market cover than forward cover. The company must use forward market cover to have more inflow of rupees for the receivable.

2. The company can invest in home currency Australian$ (Aus$) at 2.40%, € at 4.20%, Can$ at 3.60%, and £ 5.50% for 3 months.

<
TOP
>

(i) Investment in Aus$

$5{,}000{,}000 \times \left(1+\frac{0.0240}{4}\right) = \text{Aus\$ } 5{,}030{,}000$

Return after 3 months = Aus$ 5,030,000 – 5,000,000 = Aus$ 30,000

(ii) Investment in €

$\text{Aus\$ / € bid rate} = \left(\frac{\text{Aus\$}}{\$}\right) \text{bid rate} \times \left(\frac{\$}{\text{Euro}}\right) \text{bid rate} = \left(\frac{\text{Aus\$}}{\$}\right) \text{bid rate} \times \frac{1}{\left(\frac{\text{euro}}{\$}\right)} \text{ask rate}$

$1.0841 \times \frac{1}{0.6341} = 1.7097$

$\text{Aus\$ / € spot ask rate} = \left(\frac{\text{Aus\$}}{\$}\right) \text{ask rate} \times \left(\frac{\$}{\text{euro}}\right) \text{ask rate} = \left(\frac{\text{Aus\$}}{\$}\right) \text{ask rate} \times \frac{1}{\left(\frac{\text{euro}}{\$}\right)} \text{bid rate}$

$= 1.0844 \times \frac{1}{0.6338} = 1.7109$

$\text{Aus\$ / € 3 months bid rate} = \left(\frac{\text{Aus\$}}{\$}\right) \text{3 months bid rate} \times \left(\frac{\$}{\text{euro}}\right) \text{3 months bid rate}$

$= \left(\frac{\text{Aus\$}}{\$}\right) \text{3 months bid rate} \times \frac{1}{\left(\frac{\text{euro}}{\$}\right)} \text{3 months ask rate}$

$= 1.0895 \times \frac{1}{0.6354} = 1.7147$

$\text{Aus\$ / € 3 months ask rate} = \left(\frac{\text{Aus\$}}{\$}\right) \text{3 months ask rate} \times \left(\frac{\$}{\text{euro}}\right) \text{3 months ask rate}$

$= \left(\frac{\text{Aus\$}}{\$}\right) \text{3 months ask rate} \times \left(\frac{1}{\frac{\text{euro}}{\$}}\right) \text{3 months bid rate}$

$= 1.09 \times \frac{1}{0.6349} = 1.7168$

Surplus of Aus$ will be converted into €

at Aus$/€ ask rate = $\frac{5{,}000{,}000}{1.7109}$ = € 2922438.48≈ 2,922,438

Invest at 4.20% for 3 months: $2{,}922{,}438 \left(1+\frac{0.0420}{4}\right)$ =€ 2,953,123.60 ≈ 2,953,124

Convert into Aus$ at 3 months forward bid rate of at 1.7147

2,953,124 × 1.7147 = Aus$5,063,721.72≈ 5,063,722

Return after 3 months =Aus$ 5,063,722 – 5,000,000 = Aus$ 63,722

(iii) Investment in Can$

$\text{Aus\$ /Can\$ spot bid rate} = \left(\frac{\text{Aus\$}}{\$}\right) \text{bid rate} \times \left(\frac{\$}{\text{Can\$}}\right) \text{bid rate}$

= × = 1.0841 × = 1.0958

3. The various reasons for the spurt in the demand for Gold are as following:

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In the last three decades, though inflation has occurred at regular intervals the price of gold has not shown huge spikes as the fear of recession has been limited. So the gold prices today have become more of an index of the health of the world economy and as such gold prices are affected by many more factors than mere inflation.

Studies found that gold price movements in the international markets have explanatory power with respect to exchange rate movements, over and above the effects of movements in monetary fundamentals and other variables that enter standard exchange rate models. A crucial assumption in their analysis was that gold is `an asset without a country'.

Investigation on the gold and foreign exchange markets found that although the price of gold is usually denominated in US dollars, real appreciations or depreciations of the European currencies have profound effects on the price of gold in all other currencies. Further it is also found that the floating exchange rates contributed substantially to the instability of the gold price in the period. Fluctuations in the real exchange rates amongst the major currencies accounted for almost half the variance in the price of gold.

In the recent past, decoupling seems to have been happening between the exchange rates and gold prices with the dollar losing its shine as the world's reserve currency and the absence of any other currency that has the potential to take its place. Given this scenario, gold is emerging as an asset worth owning and hence unabated demand will continue as long as the uncertainty on the exchange rate front continues.

Some studies found a close correspondence between the time series of the relative price of gold and the time series properties of real interest rates. Accordingly, the relative price of gold corresponds to market fundamentals and the process generating first differences of market fundamentals is stationary, therefore actual price movements do not involve rational bubbles.

The demand for gold jewelry has been experiencing a steady growth from year to year. Countries primarily responsible for this growth are India, China, Italy, Saudi Arabia and the US. The renewed interest in gold has also extended to Japan, with a significant surge in demand.

In the recent past that the risky paper instruments fail to offer a decent return. Years of low return on risky capital go with years of high returns on gold. Lower yield on such securities leads to soaring gold prices. As a result of low return offered by the debt securities a lot of funds have been channelized to gold investment.

Now gold can be purchased like any other listed stock at some selected stock exchanges around the world, which increases the liquidity of gold investments to a great extent. Gold Electronic Traded Funds (Gold ETF) initiated by the World Gold Council have shown very good performance and growth in volumes since their launch.

Persistent weakening in the dollar value, and euro's disability to replace dollar as an anchor currency will almost certainly force the central banks to add to the gold reserves, and not sell them off.

A study on the purchasing power of gold revealed that gold is a poor hedge against major inflations; it appreciates in operational wealth in major deflations and is an ineffective hedge against yearly commodity price increases. Nevertheless, gold does maintain its purchasing power over long periods of time.

Some studies found that the US price level and the price of gold moved together in a statistically significant long run relationship supporting the view that a 1% increase in the general US price level leads to a 1% increase in the price of gold. However, they found that there are short run deviations from the long run relationship between the price of gold caused by short run changes in the US inflation rate, inflation volatility, credit risk, the US dollar trade-weighted exchange rate and the gold lease rate.

4. The factors that are driving up the gold prices in the current scenario are:

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Recession in the US and Dollar Woes

Over the past five years, the dollar has lost 50% of its value against the euro. Large institutions and central banks are moving their dollar-based assets into non-dollar-based assets. This is coming at a time when the US economy is slowing down to a crawl. As the dollar falls, investors are moving their dollar-based assets into assets such as gold - increasing the demand and pushing the price even higher. Recent studies have shown that there exists a negative correlation as high as 70% between gold prices and the value of the dollar.

Subprime Crisis

The subprime mortgage crisis was the catalyst that pushed gold to 28-year highs, and now investors are making a flight to quality as fundamentals are supporting strong prices. The gold rally can thus be attributed largely to fears of further losses in traditional investments that are highly leveraged on a problematic subprime mortgage market, pushing investors towards safe assets such as gold. With gold falling into the asset class that typically moves counter-cyclical to the general economy, it has provided portfolios with much-needed protection from fluctuations with the added advantage of increasing its value.

The Gold Cousins - Yellow and Black Gold

Historically, the average oil/gold ratio has been around 15:1, meaning that the price of 15 barrels of oils equals the price of one ounce of gold. That ratio in the 1990s dropped to around 9:1. While oil prices rose sharply due the

tightness of the oil markets, the gold prices after climbing as high as $850 an ounce in 1980 dropped to as low as $252 an ounce in 1999. These lower prices and stringent environmental controls discouraged mining companies from spending money to find new supplies of gold. This lack of investment during the low price period now implies that mine production is falling and at the same time the global demand is rising.

Excess Liquidity

Easy monetary policies by central banks have created global cash glut and a credit bubble. This mammoth global monetary growth has led to easy cash availability in the market place which has a tendency to bid up prices for goods, services and housing thus resulting in severe inflationary pressures.

So now the concern is not excess liquidity but that of pressure on growth. This will imply that excess liquidity will continue to exist which may result in decline in confidence in the US dollar.

Central Bank Transactions

Central bank sales which served to depress the price of gold throughout the 1990s have come to a screeching halt, with most central banks having already liquidated their gold reserves to a bare minimum. Instead of selling, central banks are becoming buyers. This reduction in physical gold sales by central banks has contributed to tighter physical markets, exerting upward pressure on prices.

Gold as an Investment

In recent years, there has been a tremendous increase in institutional demand for gold. Even though investment demand has been relatively muted in the US, there is plenty of demand from the flourishing middle classes in China and India and from central banks of some countries that have enjoyed gains from foreign trade (such as Russia and China).

The growing thirst for oil in the US and elsewhere has driven up prices and filled the coffers of oil-producing nations. Since the dollar is the primary currency in oil trade the oil-exporting nations are accumulating huge amount of dollars. These reserves are being used by the Organization of the Petroleum Exporting Countries (OPEC) members to buy more gold.

Gold: A Part of the Commodities' Super-Cycle

The new generation of `super-cycle' proponents believes that supply shortages in growing economies in China and India will send commodity prices and gold up for another 15 to 20 years. With forces that have driven commodity prices higher in the past couple of years largely in place: Strong global economic growth; plentiful and increasing liquidity - the demand for commodities will continue to grow in emerging Asia as the region industrializes and wealth grows.

5. The various reasons for depreciation of dollar against other currencies are given hereunder:

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The dollar has depreciated against other major currencies could be an outcome of trade account and current account deficits run by the US in the past.

A weak dollar is not a novel concern. The US government has been running huge fiscal deficit and capital account deficit. These deficits are mainly financed by inflows of forex reserve maintained by other countries.

In the view of many analysts and policymakers, dollar depreciation remains a key mechanism for addressing this export-import imbalance and restoring the international competitiveness of American producers.

The gradual decline of the US dollar could lead to the discarding of huge dollar reserves held by countries worldwide. In addition to this, the risk of US recession or other factors that could also cause a loss of confidence in the dollar, pose major risks to this scenario.

The magnitude of the US trade and current account deficits makes it clear that the dollar is very high fluctuating to a long run equilibrium level. The trade deficit in 2006 the current account deficit was substantial.

A decline of the real value of the dollar that is large enough to reduce the current account deficit requires a significant decline in the nominal value of the dollar. The falling dollar can also impact inflation. The dollar's depreciation has made some investors nervous but such fears can be discounted as currency moves depend not only on direct factors but also on indirect factors.

A new set of countries with dollar reserve trades with other countries for currencies other than dollar. This may help them to build their deposits of other currencies. These currencies may help them to acquire other assets in other parts of the world. Many Asian countries have stopped accumulating dollar reserves as they do not find it attractive when euro and other currencies are strengthening.

Some of the countries want to explore other growing economies for investment opportunities. The slowdown of US economy is compelling investors to look for better returns elsewhere causing the outflow of dollars from the US.

Most of upcoming economies like China, India and South Korea have plenty of foreign exchange reserves in dollars. Experts suggest that there has been artificial demand for the dollar which has kept the dollar appreciating. But now with this hype gone, repercussions of excess supply have become evident.

If the dollar sees a downward trend the values of these reserves decline, out of fear of capital losses from dollar depreciation. This leaves a doubt over the credibility of dollar as foreign reserve. The subprime debacle and ongoing turmoil in the credit markets have made uncertainty for dollar-denominated assets.

6. The probable impact of depreciation dollar on emerging economies like India is given below: < TOP >

The downward pressure of dollar is causing an imbalance in the world economy. The collapse of the dollar may put the global economy in a slump. The falling dollar may be affecting the other economies more than itself. For example, the Chinese economy holds about $1.2 tn in dollar-denominated assets. China is a developing country and has underdeveloped capital markets. Hence, the position of China becomes more susceptible compared to the US.

The major problem here is unbalanced demand and supply. The excess capacity in the world is also due to wrong policy action of many governments which bailed out their financial institutions by expanding their credits. Their currency always flowed into the US in search of a safe investment option. Many oil-producing countries have reduced their exposure to the dollar and shifted their income to other currencies like euros, yen and sterling. The difference is relatively small, but in absolute terms, it is significant. These are signs of change that may further weaken the dollar.

A number of factors are responsible for this. As a result of high prices, a new set of countries with dollar reserve trades with other countries for currencies other than dollar. This may help them to build their deposits of other currencies. These currencies may help them to acquire other assets in other parts of the world. Many Asian countries have stopped accumulating dollar reserves as they do not find it attractive when euro and other currencies are strengthening. Some of the countries want to explore other growing economies for investment opportunities. The slowdown of US economy is compelling investors to look for better returns elsewhere causing the outflow of dollars from the US.

If the dollar sees a downward trend the values of these reserves decline, out of fear of capital losses from dollar depreciation. This leaves a doubt over the credibility of dollar as foreign reserve. The subprime debacle and ongoing turmoil in the credit markets have made uncertainty for dollar-denominated assets. Net private capital inflows into the US have weakened sharply since August 2007. This downward trend of dollar and current account adjustment had also happened in the 1980s. During that troubled period, the dollar value fell by around 50% against the major currencies like yen of Japan and mark of German to restore the equilibrium in Current Account Deficit (CAD). In the current environment, "the depreciation of the dollar to the tune of 50% will not be sufficient to restore the CAD and also this depreciation will be against many currencies rather than only yen or euro", said an analyst.

The US$ is in a win-win situation. If the developing economies start shifting their reserves to other currencies, this may lead to further depreciation of the dollar by reducing the demand for it. As a result this may lead to their reserves losing value.

Presently, the rupee is becoming stronger vis-à-vis the dollar. India's current account balance of payments is in surplus for the first time in 25 years. The interest rate in India is 4-5% above that in the US. The colossal inflows of foreign direct investments and foreign institutional investments owing to robust economy, low inflationary pressure are the contributing factors towards an appreciating rupee. The depreciating dollar and appreciating rupee being beneficial for India is not true to a large extent. When we make an observation, we take into account around two million IT workers but tend to ignore 88 million textiles and apparel industry workers. The appreciating rupee is not conducive for the better because their margins have been dented and prices of the product have seen an upward trend.

There is little risk of losing money in converting rupees into dollars in the near future. So, it is a lucrative option for non-resident Indians to borrow in the US at say 1.5-2% and invest in India at 6% and then convert it back into dollars after maturity. The Indian banks and the corporate sector are also exploring this opportunity. The RBI also finds it expensive to keep high forex reserves of dollars as it earns low rate of return. The appreciating rupee against the dollar would mean that Indian goods would be more expensive in dollar terms. India's export earnings may also suffer.

The changing pattern of rupee can influence the exchange rate. But the exchange rate impact can be noticeable after some time as export-import contract remains valid for sometime. So, if the rupee sees an upward trend against the dollar and other currencies, the country's export gets affected. If the rupee appreciates against the dollar, Indian exporters will gain in terms of rupee earnings.

The depreciation of the dollar is beginning to pose the biggest risk for the Indian software and IT-enabled companies as their exposure in the US currency is more than 80%. For the textile sector, the US serves as the main market. But the US economy itself is undergoing slowdown and rupee appreciation will reduce its competitiveness in the market. Erosion of prices of generic and non-tariff barriers are also seen as hurdles to Indian pharmaceutical exports. The gainers from this trend will be auto, engineering and aviation companies. They have to spend less over procuring the raw materials.

Section C: Applied Theory

7. Pre-shipment finance is basically a short-term finance (inventory finance) extended to exporters in anticipation of export of goods. This finance enables exporters to procure raw materials, process, manufacture, and warehouses, ship the goods meant for export.

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Pre-shipment finance can be classified as

a. Packing credit

b. Advance against incentives receivable from Government covered by ECGC Guarantee

c. Advance against cheques/drafts received as advance payment.

Packing Credit

It is a loan or advance granted to the exporter for purchase of raw materials/processing/packing based on Letter of Credit (LC) opened in his favor by the importer. The LC/Confirmed order will be retained by the bank and will be endorsed accordingly indicating that the exporter has availed of packing credit.

Eligibility

An exporter who wants to avail of pre-shipment finance should obtain an importer-exporter code number from the DGFT. In addition, the exporter should not be under the caution list/special approval list of RBI/ECGC.

Usually, packing credit is extended to exporters who have the export order/letter of credit in their name. It can also be extended where the contract is concluded by exchange of messages between the two parties, with the opening of LC to be followed later on provided the track record of the exporter is good. In such instances banks may grant packing credit based on the communication, provided the following information is made available:

a. Name of the overseas buyer

b. Particulars of goods to be exported

c. Quantity and unit prices or value of order

d. Dates of shipment

e. Terms of sales and payments.

Packing credit is also extended to supporting manufacturers/suppliers of goods who do not have LCs in their own name but an LC holder has placed orders on them for supply of goods.

Type of Finance

Packing credit is normally a funded advance. It takes the form of an unsecured/clean loan in the initial stages of disbursement of funds (i.e. when raw materials are yet to be procured). It is called extended packing credit. When the exporter gets a title to the goods it becomes a secured advance.

At times pre-shipment finance will be extended in a non-fund form, like issuing LCs favoring the suppliers of raw materials, opening guarantees for credit purchases, etc.

Quantum of Finance

Quantum of loan will not normally exceed FOB value of goods or domestic market value of goods whichever is lower. However, there are certain exceptions to this. Packing credit may be granted up to the domestic cost of goods even if it is higher than the FOB value, provided the goods are covered by export incentives of the Government of India and availability of Export Production Finance Guarantee offered by ECGC. The excess of advance over FOB value should be adjusted from the cash incentives/duty drawback received.

Margin Requirements

Pre-shipment finance being a need based finance; banks have the freedom to determine the margin that is to be brought in by the exporters.

The percentage of margin will depend on the nature of the order, commodity, capability of the exporter, etc. Disbursement of funds under packing credit takes place in phases depending on the length of the operating cycle.

Period of Finance

Packing credit can be extended at a concessional rate of interest for a maximum period of 180 days or for the operating cycle of the particular activity whichever is lower. Banks may

further extend this period to an additional 90 days (i.e. 180 + 90 = 270 days). Alternately, banks may extend packing credit for a maximum period of 270 days from the beginning itself. If the packing credit is outstanding after the due date it is called overdue packing credit. Overdue packing credit is not eligible for concessional rate of interest.

It should be noted that concessional rates of interest will be applicable only if export of goods takes place within the time stipulated. This period has been fixed as 360 days from the date of availing the finance. In case export of goods does not take place within the stipulated period, banks are eligible to charge interest from the very first day of advance at a rate prescribed for 'Export credit not otherwise specified'.

Liquidation of Packing Credit

All packing credit advances should be liquidated from funds received by the exporter from either one or a combination of any of the following sources:

a. Proceeds of export bills negotiated, purchased, or discounted

b. Proceeds of payments receivable from the Government of India, in the form of duty drawback or a payment from the Market Development Fund (MDF) of the Central Government or from any other relevant source.

If a packing credit advance is not liquidated by export proceeds, that particular advance will not be entitled for concessional rate of interest.

Advances against Incentives Receivable from Government of India

These advances are generally granted at post-shipment stage. However, in exceptional cases, where the value of material to be procured for export is more than the FOB value of the contract and considering the availability of receivables from Government of India, advances are granted for a maximum period of 90 days for more than the FOB value. These advances are liquidated by negotiation of export bills and out of proceeds of receivables from Government of India.

Advance against Duty Drawback

Pre-shipment finance can also be extended against duty drawback entitlements provisionally certified by the Customs. The loans so extended will be adjusted when the final assessment is made by customs and they refund duties. Banks normally grant duty drawback loans at the post-shipment stage for a period not exceeding 90 days at lower interest rate as specified.

8. a. The formation of an international cartel means that government or private corporations located in various countries, agree to effectively restrict competition among themselves in an effort to exploit their joint monopoly power. An example of an international cartel is Organization of Petroleum Exporting Countries (OPEC).

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The formation of an international cartel is an attempt to reap greater profits by acting as a single profit maximizing monopolist, in this, the cartel members as a group agree to supply (or export) to the rest of the world alternative quantities of the cartelized commodity (such as oil) at alternative prices. The conditions necessary for a successful cartel are

1. The elasticity of demand for imports by the rest of the world must be low in the relevant price range.
2. The cartel members must adhere to the official set of policies voted by the cartel members.

The first condition is actually a combination of following three conditions:

- The elasticity of demand for total consumption by the rest of the world must be low
- The cartel must control a very large share of the world market for the cartelized commodity
- The elasticity of supply of the cartelized commodity by the rest of world must be low.

An international cartel can maintain a high monopoly price if individual cartel members do not selfishly attempt to capture more profits for themselves by behaving competitively. This point can be illustrated with the story of a dog. A dog had stolen a piece of meat and was crossing a river on his way home when he saw his own shadow

reflected in the stream below. Thinking that it was another dog with a larger piece of meat, he snapped at the supposed treasure. In the process, he dropped the bone he was carrying and so lost all.

In an international cartel, each cartel member faces such a temptation because at the monopoly equilibrium, the marginal cost is much lower than the price. Each individual cartel member has the illusion that it can increase its own profits by raising its own output. When greedy cartel members behave in this manner, the cartel is not in a position to effectively restrict output and raise the price. This is the most important reason for the eventual collapse of a cartel. Thus, the member countries in the cartel must work in unison for the success of that cartel.

b. Imitation Gap theory, given by Posner, considers the possibility of trade between two countries having similar factor endowments and consumer tastes. According to this theory, improvement in technology is a continuous process and the resulting inventions and innovations in existing products give rise to trade between such countries.

The degree of trade between such countries will depend upon the difference between the demand lag and the imitation lag. **Demand lag** is the difference between the time a new or an improved product is introduced in one country and the time when consumers in the other country start demanding it. **Imitation lag** is the difference between the time of introduction of the product in one country, and the time when the producers in the other country start producing it. Imitation lag depends on a number of factors including the readiness of the producers in the second country to adopt new technology, availability of patent protection to the original producer, time taken by the second country producers to learn the new process and to adapt the existing plant and machinery to it, the simplicity or otherwise of the innovation, and the likelihood of the second country producers developing the technology on their own due to a constant process of research and development. Demand lag depends to a large extent on the speed and effectiveness of flow of information, the readiness of the consumers in the second country to use innovative products, the speed with which they react to changes in technology, and their ability to convert their desires into demand (i.e., their financial ability to purchase the products). If due to any of the above factors, the imitation lag is shorter than the demand lag, no trade will take place between the two countries. However, normally demand lag can be expected to be shorter than imitation lag. In such a case, the country coming out with the innovation will be able to start exporting to the second country as the consumers there become aware of its product, and the exports will keep growing as more and more consumers become aware. These exports will continue to increase till the demand lag is over, i.e. till all the consumers react to the innovation. If the local producers can start producing the same product before this time period, they can arrest the growth of these imports into their country, otherwise the exports will continue and will stabilize at a particular level. At the end of the imitation lag, the trade will start coming down and will be finally eliminated. If due to further technological innovations in the first country, it is able to come out with a still better product before the elimination of these exports, the second cycle would start even before the first one has ended. On the other hand, if there are no further innovations in the first country and the second country producers are able to come out with another new product due to the stimulation received by research in their country, the whole cycle will reverse.

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