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CIFA PART III SECTION 6

INTERNATIONAL FINANCE

THURSDAY: 28 November 2019. **Time Allowed: 3 hours.**

Answer ALL questions. Marks allocated to each question are shown at the end of the question. Show ALL your workings.

QUESTION ONE

(a) Explain the following terms as used in international finance:

(i) Floating rate notes (FRNs). (1 mark)

(ii) Forfaiting. (1 mark)

(iii) Crowd funding. (1 mark)

(iv) Green bond. (1 mark)

(b) One of the objective of the East African Community (EAC) bloc is to achieve economic integration among the member states.

In light of the above statement, describe five reasons why EAC is yet to achieve the above objective. (5 marks)

(c) Discuss three criticisms of the Heckscher-Ohlim Theory of international trade. (3 marks)

(d) The following information relates to the Wodu Republic for the financial year ended 31 December 2018:

	W $ "billion"
Exports of merchandise	3,344
Exports of services	1,491
Income receipts	2,454
Imports of merchandise	5,901
Imports of services	1,134
Income payments	2,211
Net transfers by Wodu Republic	336

Required:

(i) A current account for Wodu Republic for the year ended 31 December 2018. (4 marks)

(ii) Propose four measures that Wodu Republic could take to address the balance of payment (BOP) deficit obtained in (d) (i) above. (4 marks)

(Total: 20 marks)

QUESTION TWO

(a) Explain four reasons why multinational corporations (MNCs) forecast exchange rates. (4 marks)

(b) SPL Limited, a company based in Kenya expects to receive 2 million Euros in one year's time. The existing spot rate of the Euro is KES 120/EUR. The 1-year forward rate of the Euro is KES 121/EUR. The company expects the spot rate of the Euro to be KES 122/EUR in one year.

There are 1-year put options on Euros available in the market with an exercise price of KES 123 and a premium of KES 4 per unit.

The following money market rates are available:

	Kenya	Eurozone
Deposit rate	8%	5%
Borrowing rate	9%	6%

Required:

(i) The cash flow to be received in Kenya Shillings (KES) assuming SPL Limited uses money market hedge. (3 marks)

(ii) The cash flow to be received in KES assuming SPL Limited decides to use a put option hedge. (2 marks)

(iii) Advise the management on the best strategy to adopt. (1 mark)

(c) Douglas Kombo specialises in cross-rate arbitrage. He notices the following quotes:

Swiss Franc/United States dollar	=	SFr 1.5971/$
Australian Dollar/United States Dollar	=	A $ 1.8215/$
Australian Dollar/Swiss Franc	=	A $ 1.440/SFr

Required:

Arbitrage profit, if any, assuming Douglas has $1,000,000 to invest. (5 marks)

(d) The following interaffiliate cash flows are uncorrelated with one another:

Affiliate	Expected transaction ($)	Standard deviation ($)
United States	100,000	40,000
Canada	150,000	60,000
Zambia	175,000	30,000
Egypt	200,000	70,000

Required:

(i) The standard deviation of the portfolio of cash held in the central depository. (2 marks)

(ii) Outline three advantages of centralised cash management system to the multinational corporations (MNCs) (3 marks)

(Total: 20 marks)

QUESTION THREE

(a) Explain the following methods of payment that could be used by a multinational corporation (MNC) to settle international transactions:

Required:

(i) Prepayment. (2 marks)

(ii) Letters of credit (L/Cs). (2 marks)

(iii) Drafts. (2 marks)

(iv) Open account. (2 marks)

(b) Suggest three measures that a multinational corporation could take to address the issue of nepotism and corruption in the host country. (3 marks)

(c) Evaluate three factors that influence capital structure decisions for multinational corporations (MNCs). (3 marks)

(d) Tamco Limited, a Kenyan based company, is considering investing in a new project to be based either in Kenya or Rwanda. The project will constitute 30% of the total funds to be invested by the company.

The following information is a forecast of the proposed project over a period of 5-years:

Characteristics of proposed projects

	Existing Business	If located in Kenya	If located in Rwanda
Mean expected annual return on investments (ROI)	20%	25%	25%
Standard deviation of expected annual after-tax ROI	0.10	0.09	0.11
Correlation of expected annual after-tax ROI for similar business in Kenya	-	0.80	0.02

Required:

(i) The overall expected after-tax returns assuming that the new project is located in Kenya. (2 marks)

(ii) The overall variance in returns assuming Tamco Limited decides to locate the new project in Kenya. (2 marks)

(iii) The overall variability of the company's return assuming the project is located in Rwanda. (2 marks)

(Total: 20 marks)

QUESTION FOUR

(a) In a liberalised economy, market forces of demand and supply dictate the interest rates and exchange rates in the market.

With reference to the above statement, analyse two justifications why governments intervene in the exchange rate system. (2 marks)

(b) In an attempt to address the grave concern of illicit financial flows and the emerging risks of counterfeit, your country recently undertook an exercise known as "demonetisation" of the currency.

Required:

(i) Explain the term "demonetisation". (1 mark)

(ii) Argue two cases in favour of demonetisation and two cases against demonetisation. (4 marks)

(c) (i) Using relevant examples, distinguish between "macro political risk" and "micro political risk". (2 marks)

(ii) Suggest two techniques that a multinational corporation could adopt to minimise its exposure to political risks. (2 marks)

(d) It has been established that the United States Dollars (USD) exhibits a 6-month interest rate of 10% per annum while the Kenyan Shilling (KES) exhibits a 6-month interest rate of 15% per annum.

Required:

(i) The forward rate premium or discount of the USD with respect to Kenyan Shilling (KES) according to interest rate parity. (2 marks)

(ii) The 6-month forward rate of the USD with respect to the KES assuming that the current spot rate of the USD is KES 100. (2 marks)

(iii) A Kenyan investor intends to invest KES 30,000,000 in the United States for 6-months.

Compute the gain or loss from interest rate covered arbitrage approach. (5 marks)

(Total: 20 marks)

QUESTION FIVE

(a) Discuss four benefits that would accrue to a foreign investor investing in the international bonds and equity markets. (4 marks)

(b) Highlight four conditions that must be met by a subsidiary before it could be considered as a tax haven. (4 marks)

(c) Examine four strategies that a multinational corporation could use to hedge its economic exposure. (4 marks)

(d) (i) Explain the meaning of the term "tax drag". (2 marks)

(ii) The following information relates to Country A and Country B:

	A	B
Withholding tax rate	25%	15%
Dividend yield	2.5%	2.5%

Fidel Okumu, an investor from Country C has Sh.1 million to invest.

Required:

Advise Fidel Okumu on which Country to invest in by computing the tax drag arising from the difference in tax rates between Country A and Country B. (6 marks)

(Total: 20 marks)

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