Notes to candidates:
1) The question paper consists of 4 pages and 2 sections.
2) Section A: 20 Multiple Choice Questions.
   Section B: 4 Essay Questions.
3) Answer ALL questions.
Section A: Multiple-Choice Questions
Answer ALL questions (2 x 10 = 20 marks)

1. The international money market primarily concentrates on:
   A) short-term investment and borrowing
   B) long-term investment and borrowing
   C) Eurobond and foreign bond
   D) Investment in bonds and equity

2. The …………… is the exchange rate used for immediate exchange of currencies.
   A) spot rate
   B) forward rate
   C) future rate
   D) swap rate

3. Futures contracts are typically _______; forward contracts are typically _______.
   A) sold on an exchange; sold on an exchange
   B) offered by commercial banks; sold on an exchange
   C) sold on an exchange; offered by commercial banks
   D) offered by commercial banks; offered by commercial banks

4. If interest rate parity exists, which of the following is not feasible?
   A) Purchasing power parity
   B) International Fisher Effect
   C) Covered interest arbitrage
   D) forward trading

5. If the interest rate is higher in the U.S. than in the United Kingdom, and if the forward
   rate of the British pound (in U.S. dollars) is the same as the pound’s spot rate, then:
   A) U.S. investors could possibly benefit from covered interest arbitrage.
   B) British investors could possibly benefit from covered interest arbitrage.
   C) neither U.S. nor British investors could benefit from covered interest arbitrage.
   D) A and B
6. Which of the following is an example of economic exposure but not an example of transaction exposure?
A) An increase in the dollar’s value hurts a U.S. firm’s domestic sales because foreign competitors are able to increase their sales to U.S. customers.
B) An increase in the pound’s value increases the U.S. firm’s cost of British pound payables.
C) A decrease in the peso’s value decreases a U.S. firm’s dollar value of peso receivables.
D) A decrease in the Swiss franc’s value decreases the dollar value of interest payments on a Swiss deposit sent to a U.S. firm by a Swiss bank.

7. If the Malaysian Ringgit appreciates against the U.S. dollar over this year, the consolidated earnings of a U.S. company with a subsidiary in Malaysia will be ____ as a result of the exchange rate movement.
A) negative
B) adversely affected
C) favorably affected
D) unaffected

8. When the “real” interest rate is relatively low in a given country, then the currency of that country is typically expected to be:
A) weak, since the country’s quoted interest rate would be high relative to the inflation rate.
B) strong, since the country’s quoted interest rate would be low relative to the inflation rate.
C) strong, since the country’s quoted interest rate would be high relative to the inflation rate.
D) weak, since the country’s quoted interest rate would be low relative to the inflation rate.

9. A U.S. company needs to pay a British supplier six month later. Which of the following can be used for hedging?
A) purchase a currency put option in British pounds.
B) sell pounds forward.
C) sell a currency call option in British pounds.
D) borrow U.S. dollars, convert them to pounds, and invest them in a British pound deposit.

10. To hedge future payables, the firm may ………… a currency futures contract for the currency that it will be paying.
A) sell
B) buy
C) contra
D) hedge.
Section B
Answer ALL Questions.

**Question 1** (Total 20 marks)

(a) Explain the relationship between inflation rate and foreign exchange rate using the concept of Purchasing Power Parity (PPP). (8 marks)

(b) Assume the inflation rate in UK is 2.3%, while inflation rate in the US is 2.4%. According to purchasing power parity, how much is the percentage change in value for pound? (3 marks)

(c) Briefly explain the three common forms of arbitrage. (9 marks)

**Question 2** (Total 20 marks)

David is a currency speculator. He observes the following information:
- US annual interest rate is 2.2%
- UK annual interest rate is 2.4%
- Spot rate is $2.20/£.
- One-year Forward rate of pound is $2.30/£

(a) Does interest rate parity exist? Draw a graphic analysis of the interest rate parity. (5 marks)

(b) Who can benefit from covered interest arbitrage? US investors or UK investors? (3 marks)

(c) Explain how covered interest arbitrage can be done to obtain profits. You can start with either $1,000,000 or £1,000,000. (12 marks)
Question 3  
(Total 20 marks)

Vision Corporation, a US based company, imports raw material from Singapore. Vision Edge needs S$5,000,000 in 1 year period to pay its purchases.

The following interest rates are observed:

<table>
<thead>
<tr>
<th></th>
<th>Annual Deposit Rate (%)</th>
<th>Annual Lending Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Singapore Bank</td>
<td>0.35%</td>
<td>0.80%</td>
</tr>
<tr>
<td>US Bank</td>
<td>1.13%</td>
<td>3.32%</td>
</tr>
</tbody>
</table>

The following exchange rates are observed:

<table>
<thead>
<tr>
<th></th>
<th>USD0.60/S$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spot rate for Singapore dollar</td>
<td>USD0.60/S$</td>
</tr>
<tr>
<td>12-month forward rate for Singapore dollar</td>
<td>USD0.64/S$</td>
</tr>
</tbody>
</table>

Which is the best hedging strategy for Vision Corporation? Money market hedge or forward contract? Explain your analysis in detail.  
(20 marks)

Question 4  
(Total 20 marks)

(a) How translation exposure can be avoided?  
(5 marks)

(b) You observe the following information:

<p>| | |</p>
<table>
<thead>
<tr>
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<tbody>
<tr>
<td>Spot rate of Canadian dollar</td>
<td>$0.90</td>
</tr>
<tr>
<td>180-day forward rate of Canadian dollar</td>
<td>$0.92</td>
</tr>
<tr>
<td>180-day Canadian interest rate (Annual rate is 6%)</td>
<td>3.0%</td>
</tr>
<tr>
<td>180-day US Interest rate (Annual rate is 5%)</td>
<td>2.5%</td>
</tr>
</tbody>
</table>

(i) According to interest rate parity, how much should be the 180-day forward rate of Canadian dollar?

(ii) Given this information, explain how covered interest arbitrage can be performed. Assume that you have initial capital of $100,000.  
(15 marks)