Summer Examinations 2015

ACC301615N

Module Title: International Trade Finance
Level: Six
Time Allowed: Two hours, plus fifteen minutes reading time. Students must not commence answering the questions until the reading time has ended.

Instructions to students:

- Enter your student number not your name on all answer books.
- During the fifteen minutes reading time, students are not permitted to make notes on the examination paper or answer booklet. Students should begin answering the questions after the reading time has ended.
- Answer three questions out of seven.
- All questions are equally weighted.
- Begin each question in a separate answer book; label each answer book clearly with the number of the question you are answering.
- Neither books nor notes may be taken into the examination.
- The use of a non-programmable calculator is permitted.

<table>
<thead>
<tr>
<th>No. of Pages</th>
<th>8</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of Questions</td>
<td>7</td>
</tr>
</tbody>
</table>
Answer three out of seven questions.

**Question 1**

a. Explain the difference between absolute and comparative advantage in international trade. Provide an example to support our answer.  
   (5 marks)

b. Discuss the arguments in favour and against the introduction of barriers to international trade.  
   (8 marks)

c. International flows are recorded by each country in its Balance of Payments. Identify and explain the transactions that are recorded in each of the two main accounts of the Balance of Payments. Discuss the fundamentals that explain why some countries typically present a surplus in the Current Account while others generate consecutively a deficit in this account.  
   (12 marks)

(Total: 25 marks)
Question 2

a. As a foreign exchange dealer, you observe the following exchange rate quotes from 3 different banks:

ULC Bank: £0.712/$  PARITAS Bank: $1.02/€  BIC Bank: £0.806/€

Required:

Explain how you could pursue a triangular arbitrage strategy by trading in these quotes. Assuming that you had £10,000 to invest, calculate the risk-free profit you will obtain from this trading strategy.

(8 marks)

b. Arthur Jones is an investment manager working for a bank in London. He has AUD 6,500,000 or its sterling equivalent for a short term money market investment and wonders if he should invest in Australian dollars for four months or make a covered interest arbitrage investment in sterling.

He faces the following rates:

<table>
<thead>
<tr>
<th>BID</th>
<th>ASK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spot</td>
<td>£ 0.528/AUD</td>
</tr>
<tr>
<td>Four months forward</td>
<td>25/30</td>
</tr>
<tr>
<td>basis points</td>
<td></td>
</tr>
<tr>
<td>UK sterling interest</td>
<td>2.00% per year</td>
</tr>
<tr>
<td>rate_4 months</td>
<td></td>
</tr>
<tr>
<td>Australian dollar</td>
<td>4.00% per year</td>
</tr>
<tr>
<td>interest rate_4 months</td>
<td></td>
</tr>
</tbody>
</table>

Required:

i. Where would you recommend Arthur Jones to invest and why?  

(10 marks)

ii. Explain and distinguish covered interest rate parity from uncovered interest rate parity.

(7 marks)

(Total: 25 marks)
Question 3

a. Economic exposure to exchange rate risk affects the long-term competitiveness of Multinational Companies (MNCs). Discuss the fundamental factors that influence the pricing strategy of MNCs when facing economic risk exposure.

(8 marks)

b. Distinguish economic exposure from transaction exposure. Discuss the commercial and accounting implications if a company decides not to hedge against these types of risk exposure.

(9 marks)

c. Explain the ways a company can use internal hedging techniques to reduce transaction exposure. Discuss the advantages and disadvantages of using these techniques to hedge exchange rate risk.

(8 marks)

(Total: 25 marks)
Question 4

Woggard Construction plc is an import/export merchant who has significant foreign trade, mainly with Europe. The company has entered into the following transactions on 10\textsuperscript{th} of March 2014 whereby the payments/receipts are due to be settled within the next 6 months:

<table>
<thead>
<tr>
<th>Transactions</th>
<th>Date</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchases of goods</td>
<td>cash payment</td>
<td>€250,000</td>
</tr>
<tr>
<td></td>
<td>due in 3 months</td>
<td></td>
</tr>
<tr>
<td>Purchase of goods</td>
<td>cash payment</td>
<td>€400,000</td>
</tr>
<tr>
<td></td>
<td>due in 6 months</td>
<td></td>
</tr>
<tr>
<td>Sale of goods</td>
<td>cash receipt</td>
<td>€440,000</td>
</tr>
<tr>
<td></td>
<td>due in 6 months</td>
<td></td>
</tr>
<tr>
<td>Sale of goods</td>
<td>cash receipt</td>
<td>€720,000</td>
</tr>
<tr>
<td></td>
<td>due in 6 months</td>
<td></td>
</tr>
</tbody>
</table>

Exchange rates:

<table>
<thead>
<tr>
<th>Exchange Rates</th>
<th>£/€</th>
</tr>
</thead>
<tbody>
<tr>
<td>SPOT</td>
<td>0.7332 - 0.7348</td>
</tr>
<tr>
<td>1 month forward</td>
<td>20/30</td>
</tr>
<tr>
<td>2 month forward</td>
<td>32/40</td>
</tr>
<tr>
<td>3 month forward</td>
<td>45/55</td>
</tr>
<tr>
<td>6 month forward</td>
<td>90/108</td>
</tr>
</tbody>
</table>

Interest rates:

<table>
<thead>
<tr>
<th>Interest Rates</th>
<th>Borrowing %</th>
<th>Deposit %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sterling (£)</td>
<td>6</td>
<td>4</td>
</tr>
<tr>
<td>Euros (€)</td>
<td>8</td>
<td>7</td>
</tr>
</tbody>
</table>

**Required:**

Calculate the net sterling receipts/payments that Woggard Construction plc might expect for both its 3 month and 6 month transactions if the company hedges its foreign exchange rate risk using:

a. The forward foreign exchange market. (10 marks)

b. The money market. (15 marks)

(Total: 25 marks)
Question 5

Beazley Development plc is a medium sized manufacturing company selling caravan spares mainly in the USA and Europe. The treasury department expects to receive a substantial sum of money in the next 6 months, expected to be $10,000,000 representing the sale of one of its subsidiaries in the USA. There is some concern that dollar will weaken against pound although this is not the consensus of the whole department. However, they all agree that a currency hedge would be sensible.

It is now May 1st 2013 and the treasury department of Beazley Development plc is contemplating a hedging strategy using currency options. The following data is available to the treasury department to help them make decisions:

\[
\begin{array}{c|c|c}
\text{US $} & \text{Spot} & 1.6462 \quad - \quad 1.6474 \\
\end{array}
\]

**Currency options:**
*Sterling £31,250 contracts (cents per £)*

<table>
<thead>
<tr>
<th>Exercise price</th>
<th>Calls</th>
<th>Puts</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1.60/£</td>
<td>Nov</td>
<td>Nov</td>
</tr>
<tr>
<td>0.80</td>
<td>1.88</td>
<td></td>
</tr>
</tbody>
</table>

**Required**

a. Assuming the franchise is won, illustrate the results of using option currency hedges if the US$/£ spot exchange rate is:
   i. $1.50
   ii. $1.70

   **(18 marks)**

b. Discuss the advantages and disadvantages of using option contracts instead of forward contracts to hedge exchange rate risk.

   **(7 marks)**

**Total: 25 marks**
Question 6

Hillside plc is a car parts manufacturer located in Liverpool. They have recently entered into the export/import market after dealing only with UK based clients.

They have come to you with some questions with regards to a proposed export contract that they are negotiating with a foreign importer. They need advice on the meaning of the following shipping terms:

a.  
   i.  FAS Plymouth,  
   ii. CIF Marseilles,  
   iii. DDP Avignon.

You are required to explain these terms and advise what the responsibilities expected of Hillside plc would be under each of these different terms.  

(15 marks)

b. While discussing these terms Hillside plc also asked for an explanation of what INCOTERMS (International Commercial Terms) are used for and how they benefit both exporters and importers.

(10 marks)

(Total: 25 marks)
Question 7

Tim Jones, managing director of Leapfrog Technology Ltd based in Manchester, is delighted to have just won a £6m contract to supply high tech equipment to Myanmar. At the same time, Tim is concerned of the potential country risk that his company is facing as this is the first export contract it has signed with Myanmar. Tim has heard of a UK government scheme to help exporters and has approached you, an international trade consultant, for advice.

Required:

a. Explain the role and services of UK Export Finance

(10 marks)

b. Show Tim Jones how he can mitigate his risk in doing business with importers in Myanmar with the Supplier Credit Facility

(15 marks)

(Total: 25 marks)