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Sample Preview of the Solved Sample Question Papers

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QUESTION PAPER

June – 2023

(Solved)

INTERNATIONAL BUSINESS FINANCE

I.B.O.-6

Time: 3 Hours] *[Maximum Marks: 100*

Note: *(i) Answer any **five** questions. (ii) All questions carry **equal** marks.*

Q. 1. ***(a)*** **Discuss the working of the Bretton Woods System. What were its weakneses?**

Ans. Ref.: See Chapter-1, Page No. 7, Q. No. 4.

(b) **What is International Monetary System? Why is there need for such a system?**

Ans. International Monetary System is a set of rules, arrangements, practices and procedures on the basis of which different national currency transactions are made worldwide. Such a system is essential to describe a universal standard of value for the world's currencies. Important features of this system includes:

(i) To provide financial support to countries that faces serious financial and economic complexities using funds deposited with the IMF by institution's member countries;

(ii) To limit irregularities in balances of expenses and in the exchange rate systems of member countries which may weaken the development of trade and the flow of capital worldwide.

Also Ref.: See Chapter-1, Page No. 2, Q. No. 1.

Q. 2. ***(a)*** **Explain the purchasing power parity theory.**

Ans. Purchasing Power Parity Theory has been widely used by Central Banks for establishing par values of their currencies. Purchasing Power Parity means that the exchange rate between two currencies is determined by the relative purchasing power of the two currencies. Say, for example, if Cocacola costs $1 in USA and Rs. 50 in India, the exchange rate between US Dollar and Indian Rupee is determined as 1$ = Rs. 50. It means that the exchange adjusted price level remains the same throughout the world and the the assumption of free trade between countries equalises prices of goods in all the countries when determined in local currencies. As per the above example, if the exchange rate is 1 US $ = Rs. 55, it gives an opportunity for arbitrage. In such case, Indian exporter would buy Cocacola for Rs. 50 and export it to the US for one dollar, thereby getting Rs. 55 in exchange and having a profit of Rs. 5 for each Cocacola exported to US.Then the supply of Cocacola in India would be reduced which, in turn, will increase its price in the Indian market. On the other hand, the increased supply of Cocacola to USA would increase its supplies and its price would come down in the US markets. Indian exporters would remain busy in converting US Dollars in Indian Rupees to purchase more Cocacola. This would raise the supply of US dollar and also increase the demand for Indian Rupee. When Rupee becomes more valuable, lesser Rupee would be required to purchase US dollars. The exchange rate would go from present Rs. 55 to Rs. 50 per US Dollar. So, this is how the exchange rate keeps changing in line with the absolute purchasing power parity.

As per the relative version of Purchasing Power Parity, exchange rates between the home currency and the foreign currency gets adjusted to show the changes in the price levels of the two countries. Say, for example, if the inflation rate in the USA is 3% and it is 6% in India, the dollar value of the Indian Rupee must fall by 3% so that the dollar price of goods in the two countries are equalised. Purchasing Power Parity states that just like the prices of goods in one year cannot be compared to the prices in the another year without adjusting with the inflation, the exchange rate also show that the countries have different rates of inflation. According to Purchasing Power Parity, the movements in exchange rate should cancel changes in the foreign price level in relation to the domestic price level which should not affect the relative competitive position of domestic and foreign competitors. Therefore, the changes in the nominal exchange rate may not be of much importance

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for determining the true effects of currency changes on a company and a country and focus should be on changes in the real purchasing power of one currency in relation to the other and not on the nominal changes in exchange rate. So, Purchasing Power Parity states that those currencies which have high inflation rates should devalue in relation to those currencies which have low rate of inflation.

***(b)* Explain the rationale of foreign direct investment.**

Ans. Ref.: See Chapter-10, Page No. 91, Q. No. 8.

Q. 3. Differentiate between transaction exposure and translation exposure with examples. Discuss the various currency translation methods.

Ans. Ref.: See Chapter-9, Page No. 76, Q. No. 1 and Page No. 77, Q. No. 2.

Q. 4. Explain the different types of guarantee used in international trade. Also explain advantages of each guarantee for the buyers.

Ans. Guarantees for export trade–A bid bond, also known as **tender guarantee**, compensates the damages if the exporter reverses the tender, refuses to sign the contract after the tender has been accepted or fails to arrange the performance bond presumed by the contract. Usually, the bid bond covers same of the value of the tender. The bid bond is valid from the submitting of the tender until its acceptance.

The contract partners may agree on a part of the contract price to be paid in advance. **Advance payment bond or guarantee** ensures that the buyer recovers the advance payment if the delivery is not accordant with the contractual obligations or if the delivery is not realised.

Performance bond or guarantee compensates the losses for the buyer in the event of non-performance of the performance obligations in the contract. The guarantee is valid from the signing of the contract until the delivery.

The exporter gives a **warranty guarantee** (also known as **maintenance guarantee or retention money bond**) when the delivery or the performance has been effected. The guarantee compensates the losses for the buyer if the exporter fails to reimburse the possible deficiencies or defects within the guarantee period.

Guarantees for Import Trade

A guarantee securing the payment of the purchase price is one of the most common guarantees associated with import trade. When the foreign seller gives the Finnish importer payment time after the delivery, the collateral is usually arranged either as a separate guarantee concerning a single transaction, as an aval, i.e. a guarantee for a bill of exchange accepted by the importer, or as an overdraft facility guarantee limit. **Bank guarantee for a bill of exchange**, also known as **aval**, is an international guarantee term. In Finland, it usually refers to a guarantee specified in the bill of exchange.

Other Types of Guarantee

In addition to the aforementioned forms of guarantee, guarantees can be issued to secure various contractual obligations (for instance exclusive sales, leasing or rent agreement), or to fulfil some obligations to officials provided by the law or orders of the authorities (for instance customs guarantee). There are also many guarantees associated with financing.

Bill of lading guarantee is sometimes needed in import trade, for example, when the products spoil quickly or have high storage costs in customs. If the original bills of lading are not yet at the importer's disposal, the importer can claim the product against the guarantee.

A customs guarantee is needed, for instance, when the importer requests temporary exemption from duty or a position as a charge customer from the customs authorities. A guarantee given for the community's customs procedure is comparable to a customs guarantee. The guarantee is given to Finnish authorities but it covers customs duties and other payments throughout the EU area that the customer has to pay.

A Letter of Credit is a payment term mostly used for long-distance and international commercial transactions.

Letters of credit are indispensable for international transactions since they ensure that payment will be received. Using documentary letters of credit allows the seller to significantly reduce the risk of non-payment for delivered goods, by replacing the risk of the buyer with that of the banks. Letters of credit have become a crucial aspect of **international trade**, due to differing laws in each country and the difficulty of knowing each party personally.

After trade between countries made it impossible to do business by traditional payment methods, Letters of credit make it possible to do business worldwide.

Originally, Letter of Credit was literally a letter written by the buyer's bank to the seller's bank promising that they guarantee to pay the seller in case of the buyer's default.

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Sample Preview of The Chapter

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INTERNATIONAL BUSINESS FINANCE

International Financial System

International Monetary System and Institutions

1

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INTRODUCTION

The international flow of funds can be defined as flow of multiple trade systems into ultra-complex inter relations within the nations. However, the movement of funds across the world faces many restrictions. Thus, multilateral agreements are defined amongst various nations through other international institutions. These institutions are categorized as:

(i) International monetary system;

(ii) Exchange rate system;

(iii) Multilateral institutions regulating international flow of funds.

The gold standard forms the basis of International Monetary System. Others include European Monetary System to promote standard economic policies across the European Union countries. Exchange rate systems may vary between fixed and floating rate practices.

CHAPTER AT A GLANCE

International Monetary System is a set of rules, arrangements, practices and procedures on the basis of which different national currency transactions are made worldwide. Such a system is essential to describe a universal standard of value for the world's currencies. Important features of this system includes

(i) To provide financial support to countries that faces serious financial and economic complexities using funds deposited with the IMF by institution's member countries;

(ii) To limit irregularities in balances of expenses and in the exchange rate systems of member countries which may weaken the development of trade and the flow of capital worldwide.

The International Monetary System adopted before 1914-18 world war was termed as gold standard. This system followed the exchange of gold and sterling in return of an international debt. During this system, the Central Bank of a country could exchange gold with its currency when presented to it. This system offered stability in settlements and automatic adjustment mechanism, which encouraged economic development and peace.

In the year 1944, Bretton Wood's system of monetary management established IMF and World Bank. This encouraged commercial and financial relations among the world's major industrial states. The Bretton Woods system was the first example of a completely negotiated monetary order formed to govern

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monetary relations among independent nation states. Under the Bretton Woods system each country had an obligation to adopt a monetary policy that maintained the exchange rate of its currency at a fixed rate (plus or minus one percent) in terms of gold. Also, under this agreement, US dollar became the standard measurement for new monetary system. However, this system didn't last for long. In the year 1973, to increase uncertainty and misalignment in foreign exchange rate system, the world switched to floating rates.

The IMF created a new international reserve asset known as Special Drawing Right SDR; in 1969 to support the Bretton Woods fixed exchange rate system. The SDR was defined as a basket of 5 currencies; including Deutsch mark, French franc, Japanese yen, pound sterling, and U.S. dollar. Its value is based on a basket of key international currencies.

After the failure of the Bretton Woods system in 1971, most of its member countries formed an agreement in 1972 to establish stable exchange rates by preventing exchange fluctuations. Thus, European Monetary System (EMS) formed by EU countries defined European Currency Unit (ECU). Resultant from a basket of variable amounts of the currencies of the EU nations, the ECU formed the unit of accounting used to determine exchange rates among the national currencies. The most important part of EMS was the Exchange Rate Mechanism (ERM). This meant that the exchange rate of any member nation could not fluctuate more than 2.25 percent from a standard point. This was intended to assist stable trade without the fear that sudden fluctuations in the values of currencies would diminish trade and promote the development of trading barriers between member nations. In 1990, due to reunification of east and West Germany, economic disturbances affected EMS.

At the beginning of 1999, a single currency "euro" was adopted by the same EU members for foreign exchange and electronic payments. With the advent of the euro, the ERM was revised and common economic policy was created amongst the member nations. Lately, in the year 1997, Asian financial crisis had hit the world economy. The crisis started in Thailand. This country had fixed exchange rate against Dollar. This crisis is also referred as IMF crisis.

Development Banks may operate at national regional or international level. They not only provide finance but also help in project development. The World Bank and International Finance Corporation (IFC) operate at international level. During seventies and eighties a tendency was noticed among countries to concentrate on regional cooperation. During this period many development banks were set up at, regional level.

Asian Development Bank: Multinational development finance institution was founded in 1966 by 31 members to promote the social and economic progress of Asian and pacific region. The Bank gives special attention to the needs of the smaller or less-development countries and priority to regional, sub regional and national projects and programmes. The African Development Bank ADB is a regional multilateral development and bank, engaged in promoting the economic development and social progress of its Regional Member Countries (RMCs) in Africa. The Bank was established in 1964.

The European Investment Bank (EIB) offers funds for certain public and private projects in European and other nations associated with the common market. It emphasizes loans to lesser developed regions in Europe and to associated members in Africa. The Inter-American Development Bank (IADB) the oldest and largest regional multilateral development institution was established in December 1959 to help accelerate economic and social development in Latin America and the Caribbea. Atlantic Development Group for Latin America is an international private investment company dedicated to the development in Latin America.

The AFESD is an Arab regional financial institution, having an independent juridsdiction. Its objectives are to assist member countries in eliminating development constraints, increasing absorptive capacity and achieving higher rates of growth; and to foster economic integration and cooperation among member countries. EBRD was established in 1991. It exists to foster the transition towards open market oriented economies and to promote private arid entrepreneurial initiative in the countries of central and Eastern Europe.

CHECK YOUR PROGRESS

Q. 1. What do you understand by International Monetary System?

Ans. A set of rules, practices and procedures by which various national currencies are exchanged for

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trading all over the world constitutes International Monetary System. Such a system identifies a universal standard of exchange rate for the world's currencies. Agreements and consultations amongst various nations participating in other international institutions also play an important role. World Trade Organization (WTO), General agreement on Tariff and Trade (GATT), Organization for Economic Co-operation and Development (OECD) and now European Monetary Union (EMU), the bank of international settlement (BIS) and other international institutions are involved.

In the year 1930, the international economic system collapsed followed by Great depression and fascism. With the advent of second world war and advancing countries, it lead to rise of new economic order to recover the post war affects. And thus, IMF and IBRD are formed which were lately known as World Bank.

The basic purpose of the system is to stabilize exchange rates and supervise the reconstruction of the world's international trade system. Secondly, this system helps in identifying the mode of payment settlement between various countries. And thirdly this system is concerned with the provision of international money reserves.

Since the primary mission of the IMF is to provide financial assistance to countries that experience serious financial and economic difficulties using funds deposited with the IMF from the institution's 185 member countries. Member states with balance of payments problems, which often arise from these difficulties, may request loans to help fill gaps between what countries earn and/or are able to borrow from other official lenders and what countries must spend to operate, including covering the cost of importing basic goods and services.

In return, countries are usually required to launch certain reforms, which have often been dubbed the"Washington Consensus". These reforms are generally required because countries with fixed exchange rate policies can engage in fiscal, monetary, and political practices which may lead to the crisis itself.

Q. 2. What is Gold Standard and Gold Exchange Standard ?

Ans. The first modern international monetary system was the gold standard. The gold standard provided for the free circulation between nations of gold coins of standard specification. Under the system, gold was the only standard of value. The groundwork of the gold standard is that a currency's cost is supported by some weight in gold. Under the gold standard system and based on its gold value, all participating currencies were convertible. Because currencies were convertible in gold, then nations could ship gold among them to adjust their "balance of payments."

In theory, all nations should have an optimal balance of payments of zero, i.e. they should not have either a trade deficit or trade surplus. At the turn of the 20th century, many major trading nations used the gold standard to adjust their monetary supply. However, the processes of the gold standard in reality lead to many issues.

The operation of the gold standard in reality caused many problems. When gold left a nation, the ideal balancing effect would not occur immediately. Instead, recessions and unemployment would often occur. This was because nations with a balance of payments deficit often neglected to take appropriate measures to stimulate economic growth. Instead of altering tax rates or increasing expenditures - measures which should stimulate growth - governments opted to not interfere with their nations' economies. Thus, trade deficits would persist, resulting in chronic recessions and unemployment.

With the eruption of the First World War in the year 1914, the international trading system busted out. Government of respective nations took their currencies off the gold standard and simply ordered the value of their money. Subsequent to the war, few nations tried to re-establish the gold standard system at pre-war rates, but drastic changes in the global economy made such attempts ineffective. This leads to rise of Gold Exchange Standard. Under this new system, currencies would be transferable not in gold but in the leading post-war currencies of the associated nations.

Because the world currencies were still exchangeable for gold, the "gold-exchange" standard became the existing monetary exchange system for several years. However, due to the post war effects and the revival of other economies, many nations could no longer comply to exchange currencies for gold. Hence, gold supply rapidly declined. And only the severity of World War could lead to re-establishments of the economy.

The effect of the gold-exchange system was to make the United States the center for international currency

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exchange. However, due to the inflationary effects of the Vietnam War and the resurgence of other economies, the United States could no longer comply with its obligation to exchange dollars for gold. Its own gold supply was rapidly declining. In 1971, President Richard Nixon removed the dollar from gold, ending the predominance of gold in the international monetary system.

Q. 3. When and where IMF and World Bank were set up?

Ans. The World Bank and International Monetary Fund (IMF) were set up at the Bretton Woods Meetings in the year 1944. This was the result of rigorous work by Lord Keynes and his colleagues in UK along with Mr. Harry Dexter of USA. The representatives of 44 governments met along with the delegates to the conference agreeing on a framework for international economic cooperation and Articles of Agreement of the International Monetary Fund were formed.

The Bank was set up to help rebuild world economy after the war, but soon thereafter twisted its attention to the under developed world to support poor countries into the international economy. The IMF was to help standardize currency exchange rates between nations and supervise the reconstruction of the world's international trade system. IMF focuses on short term aspects of the economic actions of the financial measures. However, World Bank focuses on long term development of the international economy. It mainly serves as an international Development financial institution for the world. World Bank also supports various nations at different levels of development and having different political systems. Thus helps in eliminating the poverty of the developing nations.

The World Bank was originally instituted to aid in the reconstruction of post-war Europe; its current purpose is to assist the economic development of nations by making loans where private capital is not available. Its stated goals are the reduction of poverty in developing countries, the protection of the environment, and the promotion of both private sector and human resource development. The World Bank is currently considered a specialized agency of the United Nations.

Q. 4. Point out the weaknesses of Bretton Woods Agreement.

Ans. The Bretton Woods system of monetary system management created the rules for commercial and financial relations among the world's major developing nations. Until the early 1970s, the Bretton Woods system was effective in maintaining the standard or fixed exchange rates for the leading nations that had created it, especially the United States. Due to this fixed exchange rate, nations experienced balance of payments deficit. This leads to increase in the respective currency in the foreign exchange market. Hence, affects the exchange value of that currency. The Central Banks had to act at this time and failure to which might create financial crisis as it happened in the year 1956- 58. French Franc crisis and problems of British pound were the examples. The currencies of the respective nations were then devalued to correct the payment imbalances. Thus the delayed adjustment of the parities to change in the economic environment of the countries was the weakest point of Bretton Woods Agreement. This led to a lack of trust and strike at the foundations of guesswork.

Another considerable problem was that one national currency had to be an international reserve currency at that time. This made the national monetary and economic policy of the United States liberated from external fiscal pressures, while greatly influencing those external economies. To guarantee international liquidity; USA was enforced to run shortage in their balance of payments, to avoid world inflation. However, in the 1960s they ran a policy that restricted the convertibility of the U.S. dollar to compete the insufficient reserves to meet the currency supply and demand. But other member nations were not ready to accept the high inflation rates and the value of dollar ended up being weak. Hence, the system of Bretton Woods collapsed.

Q. 5. How is the value of SDR calculated?

Ans. In the 1960s the world experienced a substantial economic expansion; especially the warring nations of World War II grew unexpectedly fast. The IMF reacted by issuing Special Drawing Rights (SDRs). The SDR is an international reserve asset, created to supplement the existing official reserves of member countries. SDRs are allocated to member countries in proportion to their IMF quotas. The SDR also serves as the unit of account of the IMF and some other international organizations. Its value is based on a basket of key international currencies.

A country participating in this system needed official reserves-government or Central Bank holdings