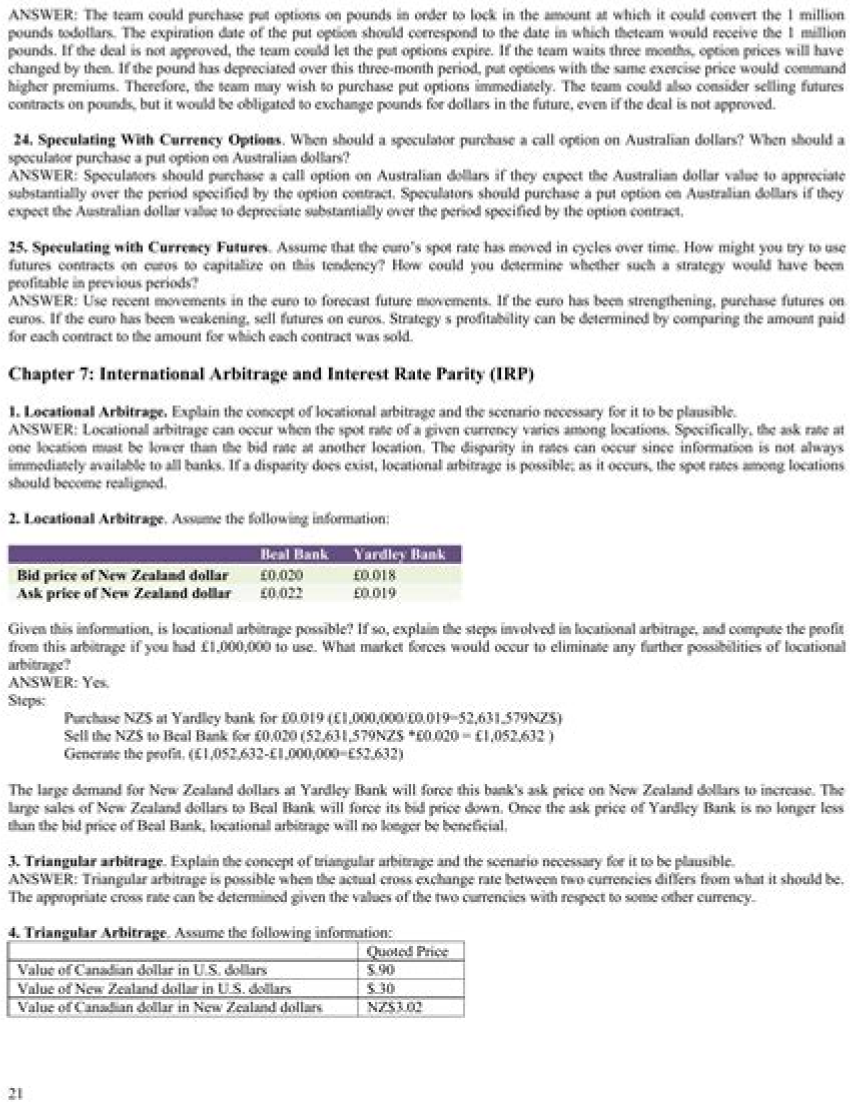
International Financial Management Chapter 5 Solutions


ANSWER: The team could purchase put options on pounds in order to lock in the amount at which it could convert the 1 million pounds todollars. The expiration date of the put option should correspond to the date in which theteam would receive the 1 million pounds. If the deal is not approved, the team could let the put options expire. If the team waits three months, option prices will have changed by then. If the pound has depreciated over this three-month period, put options with the same exercise price would command higher premiums. Therefore, the team may wish to purchase put options immediately. The team could also consider selling futures contracts on pounds, but it would be obligated to exchange pounds for dollars in the future, even if the deal is not approved.

24. Speculating With Currency Options. When should a speculator purchase a call option on Australian dollars? When should a speculator purchase a put option on Australian dollars?
ANSWER: Speculators should purchase a call option on Australian dollars if they expect the Australian dollar value to appreciate substantially over the period specified by the option contract. Speculators should purchase a put option on Australian dollars if they expect the Australian dollar value to depreciate substantially over the period specified by the option contract.

25. Speculating with Currency Futures. Assume that the euro's spot rate has moved in cycles over time. How might you try to use futures contracts on euros to capitalize on this tendency? How could you determine whether such a strategy would have been profitable in previous periods?
ANSWER: Use recent movements in the euro to forecast future movements. If the euro has been strengthening, purchase futures on euros. If the euro has been weakening, sell futures on euros. Strategy s profitability can be determined by comparing the amount paid for each contract to the amount for which each contract was sold.

Chapter 7: International Arbitrage and Interest Rate Parity (IRP)

1. Locational Arbitrage. Explain the concept of locational arbitrage and the scenario necessary for it to be plausible.
ANSWER: Locational arbitrage can occur when the spot rate of a given currency varies among locations. Specifically, the ask rate at one location must be lower than the bid rate at another location. The disparity in rates can occur since information is not always immediately available to all banks. If a disparity does exist, locational arbitrage is possible; as it occurs, the spot rates among locations should become realigned.

2. Locational Arbitrage. Assume the following information:

	Beal Bank	Yardley Bank
Bid price of New Zealand dollar	£0.020	£0.018
Ask price of New Zealand dollar	£0.022	£0.019

Given this information, is locational arbitrage possible? If so, explain the steps involved in locational arbitrage, and compute the profit from this arbitrage if you had £1,000,000 to use. What market forces would occur to eliminate any further possibilities of locational arbitrage?
ANSWER: Yes.
Steps:

Purchase NZ$ at Yardley bank for £0.019 (£1,000,000/£0.019=52,631,579NZ$)
Sell the NZ$ to Beal Bank for £0.020 (52,631,579NZ$ *£0.020 = £1,052,632)
Generate the profit. (£1,052,632-£1,000,000=£52,632)

The large demand for New Zealand dollars at Yardley Bank will force this bank's ask price on New Zealand dollars to increase. The large sales of New Zealand dollars to Beal Bank will force its bid price down. Once the ask price of Yardley Bank is no longer less than the bid price of Beal Bank, locational arbitrage will no longer be beneficial.

3. Triangular arbitrage. Explain the concept of triangular arbitrage and the scenario necessary for it to be plausible.
ANSWER: Triangular arbitrage is possible when the actual cross exchange rate between two currencies differs from what it should be. The appropriate cross rate can be determined given the values of the two currencies with respect to some other currency.

4. Triangular Arbitrage. Assume the following information:

	Quoted Price
Value of Canadian dollar in U.S. dollars	$.90
Value of New Zealand dollar in U.S. dollars	$.30
Value of Canadian dollar in New Zealand dollars	NZ$3.02

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International financial management chapter 5 solutions is a critical topic in the field of finance that delves into the intricacies of managing financial operations in an international context. This chapter typically focuses on the various challenges and solutions faced by multinational corporations (MNCs) when managing their financial resources across different countries. This article explores the key components and solutions presented in Chapter 5 of international financial management, providing insights into exchange rates, risk management strategies, and the impact of international financial markets.

Understanding Exchange Rates

One of the central themes of international financial management is exchange rates, which determine the value of one currency in relation to another. Understanding exchange rates is crucial for MNCs since they influence pricing, competitiveness, and profitability.

Types of Exchange Rates

There are primarily two types of exchange rate systems that countries may adopt:

1. **Fixed Exchange Rates:** These are pegged to another currency or a basket of currencies. This system provides stability but requires significant reserves to maintain the peg.
2. **Floating Exchange Rates:** These rates fluctuate based on market supply and demand. While this system allows for adjustments to economic conditions, it can also result in volatility.

Factors Influencing Exchange Rates

Several factors can affect exchange rates, including:

- **Interest Rates:** Higher interest rates offer lenders a higher return relative to other countries, attracting foreign capital and causing the exchange rate to rise.
- **Inflation Rates:** Countries with lower inflation rates see an appreciation in their currency value, as purchasing power increases relative to other currencies.
- **Political Stability:** Countries that are politically stable attract more foreign investment, leading to stronger currency values.
- **Economic Indicators:** Data such as GDP growth, employment rates, and trade balances can influence investor perception and currency value.

Risk Management in International Finance

Given the uncertainties in the international markets, risk management is a vital aspect of international financial management. MNCs face various types of risks, including currency risk, credit risk, interest rate risk, and political risk.

Types of Risks

1. Currency Risk: This arises from fluctuations in exchange rates between the currency of the MNC's home country and the countries in which it operates.
2. Credit Risk: The risk of loss arising from a borrower’s failure to repay a loan or meet contractual obligations.
3. Interest Rate Risk: This risk pertains to changes in interest rates that can affect the cost of borrowing and investment returns.
4. Political Risk: This includes risks arising from political changes or instability in a country that can affect business operations and profitability.

Risk Management Strategies

To mitigate these risks, MNCs employ various risk management strategies, including:

- **Hedging:** This involves using financial instruments such as options, futures, and swaps to offset potential losses.
- **Diversification:** By spreading investments across different markets and asset classes, MNCs can reduce their exposure to risk.
- **Insurance:** Purchasing insurance policies can provide a safety net against specific risks, particularly political and credit risks.
- **Operational Strategies:** MNCs may adjust their operational structures, such as sourcing materials locally or pricing products in foreign currencies, to minimize exposure to certain risks.

International Financial Markets

The functioning of international financial markets is another essential area covered in Chapter 5. These markets facilitate capital flow across borders and play a significant role in how MNCs raise funds and invest globally.

Key Components of International Financial Markets

1. Foreign Exchange Markets: These are decentralized markets where currencies are traded. They are crucial for MNCs to convert currencies and hedge against currency risk.
2. International Capital Markets: These markets allow MNCs to issue securities and raise capital from international investors. They include the international bond and equity markets.
3. Money Markets: These markets are for short-term borrowing and lending, typically involving maturities of one year or less. They provide liquidity to MNCs for their short-term funding needs.

Challenges in International Financial Markets

MNCs face several challenges when navigating international financial markets:

- Regulatory Differences: Varying regulations across countries can complicate operations and compliance.
- Market Access: MNCs may encounter barriers to entry in certain markets, limiting their ability to raise funds.
- Currency Convertibility: In some countries, currency restrictions can impede the ability to conduct transactions.

Evaluating International Investment Decisions

Chapter 5 also emphasizes the evaluation of international investment decisions, which is crucial for MNCs looking to expand into foreign markets.

Investment Appraisal Techniques

To assess the viability of international investments, MNCs often employ several techniques:

1. **Net Present Value (NPV):** This method assesses the profitability of an investment by calculating the present value of expected cash flows, discounted at an appropriate rate.

2. **Internal Rate of Return (IRR):** The IRR is the discount rate that makes the NPV of an investment zero, providing a quick measure of the investment's potential return.

3. **Payback Period:** This technique measures the time it takes to recover the initial investment from cash flows, helping evaluate liquidity risks.

Considerations in International Investments

When evaluating investments in international markets, MNCs should consider:

- Market Potential: Assessing the growth potential of the market and the demand for products or services.
- Cultural Differences: Understanding cultural nuances can influence marketing strategies and business operations.
- Economic Stability: Evaluating the economic environment of the target country, including inflation rates and economic growth.

Conclusion

In conclusion, the topic of **international financial management chapter 5 solutions** encompasses various critical aspects of managing finances in a global context. By understanding exchange rates, employing risk management strategies, navigating international financial markets, and evaluating investment decisions, MNCs can effectively manage their financial operations and enhance their competitiveness in the global marketplace. As international finance continues to evolve, staying abreast of these concepts and strategies will be essential for financial managers aiming to succeed in an increasingly interconnected world.

Frequently Asked Questions

What are the key concepts covered in Chapter 5 of International Financial Management?

Chapter 5 typically focuses on foreign exchange markets, exchange rate determination, and the impact of exchange rates on international trade and investment.

How do exchange rates affect multinational corporations?

Exchange rates impact the profits and costs of multinational corporations by affecting the value of foreign earnings and the cost of foreign operations.

What are some common methods for managing exchange rate risk?

Common methods include using financial derivatives such as forwards, futures, options, and swaps, as well as operational strategies like pricing adjustments and diversification.

What role do central banks play in the foreign exchange market?

Central banks influence foreign exchange rates through monetary policy, interventions, and by setting interest rates, which can affect capital flows.

How do political risk and economic conditions influence exchange rates?

Political instability and economic conditions can lead to volatility in exchange rates, as investors seek safe havens or react to changes in market sentiment.

What are the implications of exchange rate fluctuations for international capital budgeting?

Exchange rate fluctuations can affect the expected cash flows from foreign investments, requiring adjustments in discount rates and project valuations.

How can firms use hedging strategies to mitigate foreign exchange exposure?

Firms can use hedging strategies, such as forward contracts and currency options, to lock in exchange rates and protect against unfavorable movements.

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