S.Y.F.M. FOREIGN EXCHANGE MARKET. (MODEL ANSWER PAPER)

QP Code: 00034002 (SEM IV) (75 marks)

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Q.1 A) True or False (any 8) 8mks

True: 1,2,3,4,5.

False: 6,7,8,9,10.

B) Fill ups(any 7) 7mks

1. normalize
2. one year
3. 1975
4. two
5. exchange
6. ask price
7. future contracts
8. direct quotation
9. 1999.
10. indirect terms.

Q.2. A) According to Kindleberger,"foreign exchange market is a market where foreign currencies are bought and sold." (2mks)

charateristics of foreign exchange market: (6mks)

1. superior liquidity
2. strong market trends
3. purchasing power
4. lower trading costs
5. intermediary function
6. electronic market
7. credit provision
8. best transparency.

B) Functions of foreign exchange market: (7mks)

1. transfer of purchasing power

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2. provision of credit
3. minimizing foreign exchange risk.

C) Major participants of foreign exchange market: (8mks)

1. retailers
2. commercial banks
3. foreign exchange brokers
4. central banks
5. investors and speculators
6. authorised dealer
7. market make
8. money changer.

D) Advantages of gold standard system (3.5mks)

Disdvantages of gold standard system (3.5 marks)

Q.3A) Central bank as a participant of Forex Market (8 marks)

B) Difference between FERA and FEMA. (7marks)

1. provision
2. features
3. new terms
4. authorized person
5. RESIDENT
6. punishment
7. quantum of penalty
8. appeal
9. right of assisstance during legal proceedings
10. power of search and seize.

Q.3. c) Locations

3 i) USDINR 60.5060/61.5150.

Locations : America & India.

Direct quote in India.

Indirect quote is INRUSD

$\therefore$ INRUSD (Bid) $= \frac{1}{\text{USDINR (Ask)}} = \frac{1}{61.5150} = 0.0163$
$= \cancel{0.0165}$

INRUSD (Ask) $= \frac{1}{\text{USDINR (Bid)}} = \frac{1}{60.5060}$ 0.0165

Bid = 0.0163 Ask = 0.0165

INRUSD = 0.0163/0.0165

ii) GBPAUD . 1.2050/1.2150.

Locations : Britain & Australia.

Direct quote in Australia

Indirect quote is AUDGBP

AUDGBP (Bid) $= \frac{1}{\text{GBPAUD (Ask)}} = \frac{1}{\cancel{1.1250}\ 1.2150} = \cancel{0.8889}$ 0.8230.

AUDGBP (Ask) $= \frac{1}{\text{GBPAUD (Bid)}} = \frac{1}{1.2050} = 0.8299$

Bid = 0.8230 Ask = 0.8299

$\therefore$ AUDGBP = 0.8230/ 0.8299

Q.3 D. USDINR 65.2350/66.2560

spread = Ask − Bid = 66.2560 − 65.2350

= 1.021.

% spread $= \frac{1.021 \times 100}{65.2350}$

$= 1.5651$

MidRate $= \frac{\text{Bid} + \text{Ask}}{2}$

$= \frac{65.2350 + 66.2560}{2}$

$= 65.7455$

Q.4. C) Arbitrage:

USDINR 65.3250 / 65.5550 – Bank A

USDINR 66.5850 / 66.6580 – Bank B.

Arbitrage gain is there between Bank A – Ask and Bank B, Bid.

Formula = Principal Amount $\times \left(\frac{\text{Identified Bid}}{\text{Identified Ask}}\right) - 1$

$= 10,00,000 \times \left(\frac{66.5850}{65.5550}\right) - 1$

$= 1.0157 - 1$

$= 0.0157$

Arbitrage – $0.0157 \times 10,00,000$

$=$ USD 15,700

D) Forward Rate.

spot USDINR	63.5000	63.8000
+ 1 month Margin (Premium)	.0050	0060
1 month Forward Rate →	63.5050	63.8060
spot USDINR	63.5000	63.8000
– 2 month margin (Discount)	.0756	.0556
2 month Forward Rate	63.4244	63.7444

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Q.4. A) Many countires such as the US and Japan, with floating currencies have attempted, via central bank intervention, to smooth out exchange rate fluctuations. Such a system of managed exchange rates is called as managed float. (8 marks)

Three categories of central bank intervention:

1. short-term: smoothing out daily fluctuations
2. intermediate-term: Leaning against the wind.
3. unofficial pegging.

Advantages and disadvantages can also be considered.

B) Spot contract (7marks)

When a person goes to money changer/bank and buys one currency by paying another currency is an example of spot transaction and the rate quoted by the money changer/bank is the spot rate.

In India, the delivery under a spot transaction can be settled as ready/cash, Tom or spot.

1. Cash
2. Tom
3. Spot.

Q.5.A) Types of foreign exchange risk. (8mks)

1. Transaction risk
2. Economic risk
3. Translation risk
4. Leverage risks
5. Interest rate risk
6. Counterparty risk
7. Country risk

8. Exchange rate risk

B) Techniques of forex risk management (7mks)

1. Forward contracts
2. Futures
3. Options
4. Currency swaps
5. Money market operations

Q5. Short Notes (any three) (5mks each)