

***International Financial Management, 2e* (Bekaert / Hodrick)
Chapter 2 The Foreign Exchange Market**

2.1 Multiple Choice Easy

1) Which of the following markets is comprises the world's major banks and other financial institutions?

- A) Forex Market
- B) Spot Market
- C) Interbank Market
- D) Money Market

Answer: C

2) When someone in the currency market can buy a currency at a low price and sell it for a higher price, it is known as _____.

- A) arbitrage
- B) the bid-ask spread
- C) hedging
- D) interbank currency market

Answer: A

3) Which one of the following features is not part of the interbank foreign exchange market?

- A) derivative securities such as foreign currency futures and options
- B) trade in swaps and forward contracts
- C) immediate exchanges of monies
- D) non-strategic loans

Answer: D

4) What is the largest financial market in the world measured in dollar-volume trade?

- A) the U.S. stock markets
- B) the currency markets
- C) the forward and swap currency markets
- D) the global market for loanable funds

Answer: B

5) When transactions are conducted on the spot currency markets, _____ business day(s) is(are) allowed for contract settlement.

- A) one
- B) two
- C) five
- D) ten

Answer: B

6) Which one of the following are the main participants in the global currency markets?

- A) commercial banks
- B) insurance companies
- C) hedge funds
- D) private equity funds

Answer: A

7) What do the market makers in the currency markets provide?

- A) insurance against default by the buyers
- B) solvency
- C) stability
- D) liquidity

Answer: D

8) Which one of the following is not a characteristic of a liquid market?

- A) Market makers stand ready to buy and sell currencies.
- B) Foreign exchange dealers make transactions only with dealers.
- C) It becomes easy to match buyers and sellers.
- D) Transaction costs are low.

Answer: B

9) How would economists most often define a perfectly competitive market?

- A) Many firms compete with one another, and the cost of entering the market is low.
- B) Many firms compete with one another, and the cost of entering the market is high.
- C) Firms do not compete with one another, and the cost of entering the market is low.
- D) Firms do not compete with one another, and the cost of entering the market is high.

Answer: A

10) Which one of the following firms dominates the foreign exchange markets?

- A) No one firm dominates.
- B) Deutsche Bank
- C) UBS
- D) Citigroup

Answer: A

11) When an exchange rate is quoted by a dealer in country as the local currency price of one unit of foreign currency, he is quoting the _____.

- A) indirect quote
- B) direct quote
- C) bid quote
- D) ask quote

Answer: B

12) What currency currently serves as the world's primary vehicle currency?

- A) Japanese yen
- B) British pound
- C) U.S. Dollar
- D) European euro

Answer: C

13) The _____ quote refers to the dollar price of a foreign currency.

- A) European
- B) American
- C) Bid
- D) Ask

Answer: B

14) If you were trading currency in the New York currency market, the exchange rate between two currencies not expressed in U.S. dollars would be known as the _____ quote.

- A) direct
- B) indirect
- C) cross-rate
- D) European

Answer: C

15) What is the name of the rate currency traders quote in the interbank market to sell foreign currencies?

- A) bid-ask spread
- B) bid rate
- C) cross rate
- D) ask rate

Answer: D

16) The difference between the ask rate and the bid rate is known as the

- A) arbitrage profit.
- B) dealer's profit.
- C) spread.
- D) bid-ask spread.

Answer: D

17) The fourth decimal place in a dealer's quote in the trade jargon is known as the

- A) pip.
- B) round trip.
- C) spread.
- D) haircut.

Answer: A

18) What is the name of the computer network in which member banks globally send and receive messages pertaining to foreign exchange transactions?

- A) Fed funds
- B) SWIFT
- C) CHIPS
- D) The Automated Clearing House (ACH)

Answer: B

19) When it comes to currency transfers, what is the most important global interbank communications network?

- A) CHIPS
- B) TARGET
- C) SWIFT
- D) RTGS

Answer: C

20) What is the name of the risk that a financial institution may not deliver the currency on one side of a completed currency transaction?

- A) dealer risk
- B) market risk
- C) Herstatt risk
- D) exchange rate risk

Answer: C

21) When it comes to trading global currency, all of the following markets are in the top five EXCEPT:

- A) London.
- B) Singapore.
- C) Tokyo.
- D) Frankfurt.

Answer: C

2.2 Multiple Choice Moderate

1) The cash manager at AmFlex Company needs to buy 1,000,000 British pounds to pay a British supplier. A currency broker quotes him a bid-ask rate of £.4865-.5116/US\$. What will be the dollar cost the 1,000,000 pounds?

- A) \$2,055,499
- B) \$1,954,652
- C) \$486,618
- D) \$511,587

Answer: A

2) The CFO at SmithKlone Company receives a lump sum payment from a foreign vendor of 2,000 euros and intends to convert them to US\$. When she calls her currency broker, the quote given is €.6250-.6667/US\$. What can she expect to realize in US\$ from the broker?

- A) \$3,200
- B) \$3,000
- C) \$1,250
- D) \$1,334

Answer: B

3) The broker at Deutsche Bank quotes bid-ask rates of ¥104.15-30/\$. What would be its direct asking price for yen if the bank's €/ \$ ask rate is .6550?

- A) €0.0061/¥
- B) €0.00628/¥
- C) €159.24/¥
- D) €164.25/¥

Answer: B

4) Eastern Copper Mines of New Zealand has called a broker at Deutsche Bank to ask her opinion about the Japanese yen to New Zealand dollar exchange rate. What would the broker's answer be?

- A) ¥104.30/NZ\$
- B) ¥80.60/NZ\$
- C) ¥75.44/NZ\$
- D) ¥65.57/NZ\$

Answer: D

2.3 Short Answer

1) Describe how an exchange rate is like a market price?

Answer: The direct quote for a currency is the local currency price (numerator) of one unit of foreign currency (denominator).

2) What is most different about the foreign exchange market versus the New York Stock Exchange?

Answer: The interbank foreign exchange market is a very large, diverse, over-the-counter market, not a physical trading place such as the New York Stock Exchange where buyers and sellers gather in a specific geographic location to agree on a price to exchange currencies. Currency traders, who are employees of financial institutions in the major financial cities around the world, deal with each other primarily over the phone or via computer, with written or formal electronic confirmations of transactions occurring only later.

3) What is a spot exchange-rate contract?

Answer: A spot exchange-rate contract is one that trades within forty eight hours. During the first 24 hours, buyers and sellers agree on the terms. The next 24 hours the traders must provide the currency in question and the funds to settle the contract. Due to time zone differences, the second 24 hours is often necessary to complete the transaction.

4) When does delivery occur on a spot contract?

Answer: When currencies in the interbank spot market are traded, certain business conventions are followed. For example, when the trade involves the U.S. dollar, business convention dictates that spot contracts are settled in 2 business days—that is, the payment of one currency and receipt of the other currency occurs in 2 business days. One business day is necessary because of the back-office paperwork involved in any financial transaction. The second day is needed because of the time zone differences around the world.

5) Why are the bid—ask spreads quoted in the interbank spot market? What is their purpose?

Answer: The purpose of the bid-ask spread is to allow traders to profit by buying a currency at a low bid price and selling that currency at a higher ask price. Bid—ask spreads in the spot foreign exchange market are quite small, often a difference of only two or three basis points. A yen—dollar trader might quote a bid price of yen per dollar at which she is willing to buy dollars in exchange for yen of, say, ¥104.30/\$. The trader would then quote a higher ask price at which she is willing to sell dollars for yen, say, at an exchange rate of ¥104.35/\$.

2.4 Essay

1) As a foreign exchange trade at Deutsche Bank, one of your customers would like a yen quote on Australian dollars. The current spot market rates are ¥101.37-85/U.S.\$ and A\$1.2924-44/U.S.\$. What bid and ask yen cross rates would you quote on spot Australian dollars?

Answer: By means of triangular arbitrage, you can calculate the market quotes for the Australian dollar in terms of yen as ¥78.31-81/A\$. These prices can be found by conducting the following trades: For the yen bid price for the Australian dollar, you need to first sell Australian dollars for U.S. dollars and then sell the U.S. dollars for yen. It costs A\$1.2924 to buy one U.S. dollar. With U.S.\$ you can buy ¥101.37. Therefore, $A\$1.2944 = ¥101.37$, or $A\$ = ¥78.31$. This is the yen bid price for one Australian dollar. The yen ask price for the Australian dollar can be found by first selling yen for US\$ and then using the US\$ to buy Australian dollars. Given the quotes above, it costs ¥101.85 to buy one US\$, which can be sold for A\$1.2924. Thus, $A\$1.2924 = ¥101.85$ or $A\$ = ¥78.81$. This is the yen ask price for the Australian dollar.

2) Suppose Lufthansa receives the following indirect quotes in the currency markets of New York. They are €0.92-3/U.S.\$. Given the quotes, there may or may not be arbitrage opportunities if you were a currency trader in Paris. What range of £/€ bid and ask quotes would motivate you to arbitrage the currencies? Explain.

Answer: This may be an opportunity for triangular arbitrage in Paris, and there may be two ways to conduct the trades. In the first way, as a currency trader in Paris, you would convert from euros to U.S. dollars at the ask rate. Once this is accomplished you would convert from dollars to pounds at the bid rate. In the second way you would convert from pounds to dollars at the ask rate, then from dollars to euros at the bid rate. The first quote gives the bid price for the euro in terms of the pound and the second quote yields the ask price. Using the given rates, Lufthansa would end up with the following amounts. From euros to pounds equals $€0.93/\$$ (ask) $\times$ $\$(1/0.63)/\pounds$ (bid) which equals $€1.4762/\pounds$. From pounds to euros equals $\pounds0.64/\$$ (ask) $\times$ $\$(1/0.92/€)$ (bid) which equals $€1.4375/\pounds$. It appears that Lufthansa can buy pounds in New York for $€1.4762/\pounds$, which is the equivalent of selling euros at a rate of $\pounds0.6774/€$. So, if Lufthansa can buy euros in Paris for less than $€1.4762/\pounds$, it can arbitrage profit.