TestBanks Chapter 02(13): Introduction to Exchange Rates and the Foreign Exchange Market

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1 Exchange rates affect:
I. international trade flows.
II. international investment flows.
III. corporate earnings.

- ○ I
- ○ II and III
- ○ I and II
- ◉ I, II, and III

2 The price of a foreign currency expressed in terms of the home currency is called the:

- ◉ exchange rate.
- ○ rate of depreciation.
- ○ dollar–yen ratio.
- ○ opportunity cost.

3 Normally, exchange rates are expressed as:

- ○ the number of units of the currency per one ounce of gold.
- ○ the GDP of one nation as a percentage of the GDP of the other.
- ◉ the price of one unit of foreign currency expressed in terms of the domestic currency.
- ○ ratios of the value of one nation's wealth compared to the other.

4 When interpreting the meaning of an exchange rate, the first step is to always:

- ◉ know exactly what the exchange rate signifies in terms of which currency is the denominator.
- ○ watch for ways the currency might lose value.
- ○ learn about recent behavior of the exchange rate.
- ○ know exactly what the rate is at any moment in time.

5 The notation used in the text for the euro–dollar exchange rate is:

- ○ FX�/$.
- ○ FX$/�.
- ◉ E�/$
- ○ E$/�.

6 Generally, exchange rates are quoted as a single price of a unit of foreign currency rather than a ratio because:

- ○ the ratio of the units of home currency to units of foreign currency is always equal to one.
- ◉ the denominator is always equal to one.
- ○ the price is fixed by the government.
- ○ the rate is adjustable in increments of 25 basis points.

7 The equation $E_{\$/£} = 2$ means that:

- ○ one dollar buys 2 pounds.
- ◉ one dollar buys 1/2 a pound.
- ○ 2 pounds buy one dollar.
- ○ one dollar buys one pound.

8 If the dollar–euro exchange rate on June 30, 2010, is $1.225 per euro, then the euro–dollar exchange rate would be:

- ◯ �2.45 per dollar.
- ◉ �0.816 per dollar.
- ◯ �1.225 per dollar.
- ◯ �1 per dollar.

9 The equation $E_{¥/£}$ = 100 means that:

- ◯ one yen buys 10 pounds.
- ◯ 0.1 yen buys one pound.
- ◉ 10 yen buy one pound.
- ◯ 0.01 yen buys one pound.

10 When we look at exchange rates between two countries, what is the relationship between the exchange rate expressed in units of the domestic currency and the exchange rate expressed in units of the foreign currency?

- ◯ They are both equal to one.
- ◯ They cancel each other out.
- ◉ One is always the reciprocal of the other.
- ◯ They can never coexist.

11 If, in 2000, $1 = 1.5 euros, and in 2007, $1 = 0.9 euros, which of the following statements would be TRUE?

- ◯ More American tourists will find it cheaper to travel to Europe.
- ◯ More Europeans will stay home as visits to the United States become more expensive.
- ◯ Europeans will import fewer products from the United States.
- ◉ Americans will import fewer products from Europe.

12 A dining table costs $3,000 in New York and the same table costs 5,000 euros in Rome. Thus, $1 is equal to:

- ◯ one euro.
- ◯ 2 euros.
- ◉ 1.67 euros.
- ◯ 0.6 euros.

13 **Table: Exchange Rates Across Currencies**

Country	**Price per dollar (January 1, 2006)**
Canada	$1.2
Japan	120 yen
Mexico	12 pesos
India	45 rupees

Reference: Ref 2-1

(Table: Exchange Rates Across Currencies) If the exchange rate on January 1, 2007, is $1 = 144 yen, then:

- ◯ the dollar has appreciated 10% against the yen.
- ◯ the dollar has depreciated 24% against the yen.
- ◯ the yen has depreciated 12% against the dollar.
- ◉ the yen has depreciated 20% against the dollar.

14 **Table: Exchange Rates Across Currencies**

Country	**Price per dollar (January 1, 2006)**
Canada	$1.2
Japan	120 yen
Mexico	12 pesos

India	45 rupees

Reference: Ref 2-1

(Table: Exchange Rates Across Currencies) Based on the information provided, which of the following statements is TRUE?

- one peso = 10 yen.
- one rupee = 10 yen.
- one peso = 3 rupees.
- $1 Canadian = 35 rupees.

15 **Table: Exchange Rates Across Currencies**

Country	**Price per dollar (January 1, 2006)**
Canada	$1.2
Japan	120 yen
Mexico	12 pesos
India	45 rupees

Reference: Ref 2-1

(Table: Exchange Rates Across Currencies) Based on the information provided, one Canadian dollar is equal to ______ Mexican pesos and ______ Indian rupees.

- 12; 73.5
- 10; 37.5
- 12; 37.5
- 12; 45

16 If a nation's currency buys fewer units of a foreign currency today than yesterday, we say the value of its currency has:

- appreciated.
- depreciated.
- stagnated.
- become inverted.

17 If today �1 exchanges for ¥135, and tomorrow �1 exchanges for ¥150, we say the euro has:

- appreciated.
- depreciated.
- stagnated.
- become inverted.

18 When a nation's currency appreciates, it purchases ______ units of a foreign currency and its currency is said to ______.

- fewer; strengthen
- more; strengthen
- fewer; weaken
- more; weaken

19 If one nation's currency strengthens against a foreign currency, the other nation's currency must ______ against the domestic currency.

- strengthen
- equalize
- weaken
- appreciate

20 When the dollar declines in value against a foreign currency, it is called a(n):

- appreciation.
- depreciation.
- inflation.

- ○ deflation.

21 In European terms, when the exchange rate for the U.S. dollar increases:

- ◉ the dollar has appreciated.
- ○ the dollar has depreciated.
- ○ the euro has appreciated.
- ○ the dollar has weakened.

22 Which of the following statements is equivalent to an appreciation of the dollar relative to the euro?

- ○ The dollar buys fewer euros now.
- ◉ The euro buys fewer dollars now.
- ○ The dollar costs less.
- ○ The euro buys more dollars now.

23 When the dollar “cost” of a unit of foreign currency falls, the dollar is ______ against the foreign currency.

- ○ depreciating
- ◉ appreciating
- ○ equalizing
- ○ holding its own

24 If a euro costs $1.25 today, and it costs $1.50 tomorrow, what has happened to the dollar-euro exchange rate?

- ○ Both the dollar and euro have depreciated.
- ○ The dollar has appreciated and the euro has depreciated.
- ◉ The dollar has depreciated and the euro has appreciated.
- ○ Both the dollar and euro have appreciated.

25 It is customary to express changes in the exchange rates of two currencies over time, as:

- ○ the loss of purchasing power of one currency divided by the loss of purchasing power of the other currency.
- ◉ the percentage change expressed as an appreciation or depreciation of one against the other.
- ○ a ratio of the absolute values (without signs).
- ○ a ratio of the price of gold in each nation.

26 In general, the percentage of appreciation of one nation's currency is equal to:

- ○ its rate of growth of real GDP.
- ○ its purchasing power.
- ○ its population growth.
- ◉ the percentage of depreciation of the foreign nation's currency.

27 Slight discrepancies in the rates of appreciation versus depreciation of two currencies are related to:

- ◉ a mathematical quirk that percentage increases are always larger than percentage decreases because, in the first case, the denominator is smaller.
- ○ the imprecise nature of the calculations.
- ○ the lack of reliable information.
- ○ the volatile nature of exchange rates.

28 Changes in exchange rates are usually expressed in percentage terms. The percentage rate of appreciation for one currency will be close to the rate of depreciation for the other nation whenever:

- ◉ the change in the rate is very small.
- ○ the exchange rates are very different in quantitative terms.
- ○ the change in the rate is very large.
- ○ one exchange rate is 50% more than the other one at the time of the

change.

29 If $E_{\$/£}$ moves from 2 to 3, this is a percentage change of:

- (selected) 50%.
- 33.3%.
- −33.3%.
- −50%.

30 If $E_{\$/£}$ increases by 20%, this is consistent with an increase from:

- 4 to 5.
- 4 to 6.
- (selected) 5 to 6.
- 4 to 7.

31 **Table: Currency Values I**

Currency	2007	2008
$1	1.5 euros	one euro
$1	2 Brazilian reais (real)	1.5 Brazilian reais (real)
$1	2 British pounds	3 British pounds
$1	45 Indian rupees	50 Indian rupees

Reference: Ref 2-2

(Table: Currency Values I) The U.S. dollar appreciated against the:

- (selected) British pound and the Indian rupee.
- euro and the Indian rupee.
- euro and the Brazilian real.
- euro and the Indian rupee.

32 **Table: Currency Values I**

Currency	2007	2008
$1	1.5 euros	one euro
$1	2 Brazilian reais (real)	1.5 Brazilian reais (real)
$1	2 British pounds	3 British pounds
$1	45 Indian rupees	50 Indian rupees

Reference: Ref 2-2

(Table: Currency Values I) The U.S. dollar depreciated against the __________ and the _________.

- (selected) euro; Brazilian real
- Indian rupee; Brazilian real
- British pound; euro
- euro; Indian rupee

33 **Table: Currency Values I**

Currency	2007	2008
$1	1.5 euros	one euro
$1	2 Brazilian reais (real)	1.5 Brazilian reais (real)
$1	2 British pounds	3 British pounds
$1	45 Indian rupees	50 Indian rupees

Reference: Ref 2-2

(Table: Currency Values I) The U.S. dollar appreciated against the real by:

- 2.4%.

- (selected) 25%.
- 75%.
- 12.4%.

34 **Table: Currency Values I**

Currency	2007	2008
$1	1.5 euros	one euro
$1	2 Brazilian reais (real)	1.5 Brazilian reais (real)
$1	2 British pounds	3 British pounds
$1	45 Indian rupees	50 Indian rupees

Reference: Ref 2-2

(Table: Currency Values I) The U.S. dollar depreciated against the euro by:

- 0.6%.
- 1%.
- (selected) 33%.
- 100%.

35 **Table: Currency Values II: How Much One U. S. Dollar Will Buy of Other Currencies in 2007 and 2008**

Currency	2007	2008
$1	1.5 euros	one euro
$1	2 Brazilian reais (real)	1.5 Brazilian reais (real)
$1	2 British pounds	3 British pounds
$1	45 Indian rupees	50 Indian rupees

Reference: Ref 2-3

(Table: Currency Values II) The dollar appreciated against which currencies?

- the euro
- the reais (real)
- (selected) the pound and the rupee
- the euro and the pound

36 **Table: Currency Values II: How Much One U. S. Dollar Will Buy of Other Currencies in 2007 and 2008**

Currency	2007	2008
$1	1.5 euros	one euro
$1	2 Brazilian reais (real)	1.5 Brazilian reais (real)
$1	2 British pounds	3 British pounds
$1	45 Indian rupees	50 Indian rupees

Reference: Ref 2-3

(Table: Currency Values II) The dollar depreciated against which currencies?

- the euro
- the real (reais)
- the pound
- (selected) the euro and the real

37 **Table: Currency Values II: How Much One U. S. Dollar Will Buy of Other Currencies in 2007 and 2008**

Currency	2007	2008
$1	1.5 euros	one euro

$1	2 Brazilian reais (real)	1.5 Brazilian reais (real)
$1	2 British pounds	3 British pounds
$1	45 Indian rupees	50 Indian rupees

Reference: Ref 2-3

(Table: Currency Values II) The dollar rose against the rupee by:

- ○ 111%.
- ◉ 11%.
- ○ 1%.
- ○ −1%.

38 **Table: Currency Values II: How Much One U. S. Dollar Will Buy of Other Currencies in 2007 and 2008**

Currency	2007	2008
$1	1.5 euros	one euro
$1	2 Brazilian reais (real)	1.5 Brazilian reais (real)
$1	2 British pounds	3 British pounds
$1	45 Indian rupees	50 Indian rupees

Reference: Ref 2-3

(Table: Currency Values II) The dollar depreciated against the euro by:

- ○ −33%.
- ○ 3%.
- ◉ 33%.
- ○ 50%.

39 **Table: Currency Values II: How Much One U. S. Dollar Will Buy of Other Currencies in 2007 and 2008**

Currency	2007	2008
$1	1.5 euros	one euro
$1	2 Brazilian reais (real)	1.5 Brazilian reais (real)
$1	2 British pounds	3 British pounds
$1	45 Indian rupees	50 Indian rupees

Reference: Ref 2-3

(Table: Currency Values II) In 2007, how many euros would it take to buy one pound?

- ◉ 0.75
- ○ 1.33
- ○ 1.5
- ○ 3

40 **Table: Currency Values II: How Much One U. S. Dollar Will Buy of Other Currencies in 2007 and 2008**

Currency	2007	2008
$1	1.5 euros	one euro
$1	2 Brazilian reais (real)	1.5 Brazilian reais (real)
$1	2 British pounds	3 British pounds
$1	45 Indian rupees	50 Indian rupees

Reference: Ref 2-3

(Table: Currency Values II) Between 2007 and 2008, how did the euro do against the British pound?

- It appreciated.
- It held steady.
- It depreciated.
- Not enough information is provided to know how well the euro did.

41 **Table: Currency Values II: How Much One U. S. Dollar Will Buy of Other Currencies in 2007 and 2008**

Currency	2007	2008
$1	1.5 euros	one euro
$1	2 Brazilian reais (real)	1.5 Brazilian reais (real)
$1	2 British pounds	3 British pounds
$1	45 Indian rupees	50 Indian rupees

Reference: Ref 2-3

(Table: Currency Values II) If you want, *ceteris paribus,* to invest dollars in 2007 and then convert them back into dollars in 2008, which is the best currency to invest in?

- the euro
- the real
- the pound
- the rupee

42 A bilateral exchange rate is an exchange rate:

- that has two sides: maximal and minimal.
- has exhibited both appreciation and depreciation.
- is a hybrid between fixed and floating.
- between two currencies.

43 What is a multilateral exchange rate?

- It is an exchange rate that is measured by using a number of different techniques.
- It is an exchange rate that calculates the overall movement of the rate against more than just one other currency.
- It is an exchange rate that is measured once every 10 years.
- It is a rate that is set by the IMF for many different nations.

44 The average of the bilateral rate changes for a nation, weighted by the importance of the trading partner, is known as the:

- real exchange rate.
- nominal exchange rate.
- effective exchange rate.
- direct exchange rate.

45 To calculate the multilateral effective exchange rate for a nation for each trading partner:

- add the share of trade to the % change in the exchange rate and add the sums.
- divide the share of trade by the % change in the exchange rate and add the dividends.
- subtract the share of trade from the % change in the exchange rate and add the differences.
- multiply the share of trade by the change in the exchange rate and add the products.

46 Your textbook refers to a "basket" of currencies. What is it?

- a random selection of currencies
- currencies that are low-valued and unstable

○ currencies that represent the average increase in value for all currencies
◉ currencies most used by the nation in its trade and other transactions, weighted by their importance

47 We use the effective exchange rate calculation to tell us:

○ the underlying rate of inflation.
○ how international finance affects a nation's exchange rate.
◉ how the overall international purchasing power of a nation has changed.
○ the natural (real) exchange rate taking out the effects of inflation.

48 Suppose 80% of U.S. trade is with England and the rest is with Japan. If the dollar rises by 10% against the pound and rises by 20% against the yen, what is the percentage change in the effective exchange rate of the United States?

○ −16%
◉ −12%
○ −8%
○ −4%

49 Suppose 60% of U.S. trade is with England and the rest is with Japan. If the dollar rises by 20% against the pound but falls by 20% against the yen, what is the percentage change in the effective exchange rate of the United States?

○ −12%
◉ −4%
○ ±0%
○ −8%

50 If the dollar falls by 20% against the euro and rises by 10% against the yen, which of the following values for European and Japanese trade with the United States are consistent with a 10% increase in the effective exchange rate of the United States?

○ Europe: 33%; Japan: 66%
○ Europe: 66%; Japan: 33%
○ Europe: 50%; Japan: 50%
◉ None of these values is consistent with this increase.

51 The U.S. dollar's effective exchange rate since 2002 has steadily weakened. However, it didn't weaken as much against ALL currencies as it did against the currencies of the major developed countries (which include the pound and the euro). This could be because:

○ the U.S. government has a strong dollar policy.
◉ the large trading partners, China and Japan, did not allow their currencies to appreciate greatly against the U.S. dollar.
○ the rate of appreciation is always somewhat greater than the rate of depreciation.
○ the United States does not trade with some nations, so the effective rate is biased.

52 When exchange rates change and prices stay the same:

○ relative prices of traded goods in the two nations are unchanged.
○ the price of foreign goods expressed in the home currency will always rise.
◉ imports get more expensive as the home currency depreciates.
○ the price of foreign goods expressed in the home currency will always fall.

53 The fall in the U.S. dollar has not affected Chinese trade as much as that for other countries because:

○ China has appreciated its currency.

- China has reduced its exports.
- China has depreciated its currency.
- China has pegged its currency to the dollar.

54 Using exchange rates, it is possible to price-compare in different nations. If an iPod costs $90 in the United States and �45 in France, in which nation would you get the better deal when the dollar–euro exchange rate is $2/�?

- The iPod would be cheaper in France.
- The iPod would be cheaper in the United States.
- The iPod would cost the same in both countries.
- From the information provided, it is impossible to answer this question.

55 Using exchange rates, it is possible to price-compare in different nations. If an iPod costs $90 in the United States and �45 in France, in which nation would you get the better deal when the dollar–euro exchange rate is $2.50/�?

- The iPod would be cheaper in France.
- The iPod would be cheaper in the United States.
- The iPod would cost the same in both countries.
- From the information provided, it is impossible to answer this question.

56 A term that categorizes patterns of exchange rate behavior is known as:

- exchange rate regimes.
- exchange rate realms.
- exchange rate principles.
- exchange rate observations.

57 If a government wishes to limit or prohibit fluctuations in exchange rates, it will choose:

- to fix, or peg, the value of its currency to some base currency over a sustained period.
- to allow its currency to rise or fall in price, depending on a variety of supply and demand factors.
- to suspend purchases and sales of its currency.
- to allow the rate to be set by international banks.

58 A flexible or floating exchange rate system is one in which the:

- government closely monitors and controls the value due to the impact on trade flows.
- government makes no attempt to fix it against any base currency.
- government actively tries to achieve fluctuations in the rate.
- government fixes the rate against the currency of its largest trading partner.

59 When exchange rates are limited to small fluctuations, but not totally fixed, economists refer to the situation as:

- essentially fixed.
- essentially floating.
- relatively floating.
- intermediate regimes.

60 Which of the following exchange rate systems is in the right order, from MOST control to LEAST control?

- floating, fixed, managed float
- fixed, floating, managed float
- managed float, floating, fixed
- fixed, managed float, floating

61 When exchange rates are very volatile, with a wide range of variation, the currency is said to be:

- ○ in limbo.
- ◉ in free float.
- ○ perfectly flexible.
- ○ in sluggish float.

62 What is a currency band?

- ○ a limit below which the currency is not allowed to fall
- ○ a limit above which the currency is not allowed to rise
- ◉ a fixed rate regime with some small variation allowed, up or down
- ○ a very rigid control of the currency—no variation allowed

63 A middle-ground exchange rate regime, between fixed and floating, is NOT called:

- ○ a managed float.
- ○ a dirty float.
- ○ limited flexibility.
- ◉ a free float.

64 A large and sudden currency depreciation is widely known as:

- ○ a managed float.
- ○ a crawling peg.
- ◉ an exchange rate or currency crisis.
- ○ a free float.

65 A sudden and pronounced loss of value of one nation's currency against others is known as a:

- ◉ currency crisis.
- ○ forced devaluation.
- ○ thinning of value.
- ○ default.

66 An exchange rate crisis is when:

- ○ the currency is stable.
- ◉ the value of a currency declines dramatically.
- ○ the value of a currency increases dramatically.
- ○ a country fixes the price of its currency.

67 A crawling peg refers to:

- ○ a large and sudden currency depreciation.
- ◉ a fixed exchange rate regime in which the currency is adjusted very frequently to reflect market conditions.
- ○ a managed or dirty float, depending on the business cycle.
- ○ a drag on exchange rate adjustment caused by imperfect markets.

68 Which nation took the bold step of abandoning its own currency and adopting the U.S. dollar?

- ○ China
- ○ India
- ○ Mexico
- ◉ Ecuador

69 Which European nation has kept its own currency and maintains a fixed value against the euro?

- ○ The United Kingdom
- ○ Belgium

- (selected) Denmark
- Russia

70 Since the mid-1990s, the Argentine peso has NOT experienced:

- a one-to-one peg with the U.S. dollar.
- a large devaluation and crisis.
- limited flexibility, after which it was kept in a narrow band with the dollar.
- (selected) a currency union.

71 A nation that allowed its currency to steadily depreciate (crawl) over a six-year period is:

- France.
- Canada.
- the United Kingdom.
- (selected) Colombia.

72 Some nations such as Ecuador chose dollarization because:

- (selected) the currency was depreciating so rapidly it became nearly worthless.
- Ecuadorians wanted to save dollars for eventual emigration to the U.S.
- the Ecuadorian currency was backed by gold, which was confiscated by government officials.
- All of these are reasons why such countries chose dollarization.

73 The International Monetary Fund has classified 192 economies, comparing the:

- value of their currencies.
- percentage of women in the workforce.
- effectiveness of governance and institutions.
- (selected) flexibility of their exchange rate regimes.

74 Across the globe, exchange rate regimes are:

- mostly fixed.
- (selected) a mix of fixed and floating.
- mostly floating.
- hard to pinpoint.

75 A currency board is set up to:

- manage free-floating currencies.
- gradually eliminate currency pegs.
- (selected) give a peg added durability.
- immediately eliminate currency pegs.

76 Some nations use a currency board to manage their currencies. How does this work?

- It is all in the hands of international banks.
- The International Monetary Fund manages the currency.
- (selected) There is a fixed rate regime with a set of strict rules and policy guidelines to keep the currency's value stable.
- The currency is allowed to float, but its fluctuations are reviewed periodically by a board of economists.

77 Eurozone countries:

- have no separate legal tender.
- are pegged to the euro.
- are pegged to the dollar.
- are fixed against a single currency.

78 If a nation abandons its own currency and decides to use another nation's currency as its own circulating currency, this is known as:

- euro-zoning.
- dollarization.
- a managed float.
- a Western regime.

79 Dollarization refers to:

- increased trade with the United States, resulting in a glut of dollars circulating in the domestic economy.
- the fall of the U.S. dollar.
- the dominance of the U.S. dollar in international finance.
- the adoption of any foreign currency as an official currency by nations outside the United States, such as El Salvador and Ecuador.

80 The foreign exchange market refers to:

- a physical place in the heart of New York City's financial district, where traders come to trade other currencies.
- a collection of all purchases and sales of one currency for another, where exchange rates are determined.
- the discount window of the Federal Reserve.
- the commodity futures market.

81 From 1992–2007, the volume of currency traded worldwide:

- slumped due to the world recession.
- increased approximately 290%.
- fluctuated wildly due to investor expectations.
- was concentrated in trades in the developing world.

82 Which of the following correctly ranks the size of the three largest foreign currency trading centers in dollar volume?

- 1-Paris; 2-Miami; 3-London
- 1-New York; 2-Rome; 3-Chicago
- 1-London; 2-New York; 3-Tokyo
- 1-Tokyo; 2-Los Angeles; 3-Paris

83 Which of the following is NOT a major foreign exchange center?

- London
- New York
- Tokyo
- Chicago

84 Foreign exchange is traded:

- weekly on the Internet in special auctions arranged by the Federal Reserve.
- continuously all over the world 24 hours a day and seven days a week.
- only in officially designated trading centers such as London or New York.

- It is traded in none of these ways or venues.

85 The spot market for foreign exchange is(are):

- a market that exists only in one place at one time.
- when a person borrows to speculate in the market.
- (selected) purchases and sales of currencies for immediate delivery.
- the rate of exchange quoted during the next business day.

86 A spot contract is a(n):

- promise to purchase a foreign currency in 30 days.
- promise to purchase a foreign currency in 90 days.
- (selected) contract for the immediate exchange of currencies.
- agreement to sell currencies at a fixed price indefinitely.

87 The overall volume of daily currency trade was ____ in 2007.

- $3.2 billion
- $32 billion
- $320 trillion
- (selected) $320 billion

88 What percent of currency transactions involve a trade in the spot market?

- 30%
- 40%
- 60%
- (selected) 90%

89 A transaction cost associated with spot trading is:

- travel to and from the market.
- shipping costs.
- brokerage commissions.
- (selected) the spread, which is earned mostly by large banks.

90 Spreads in quotations of exchange rates are:

- the geographical dispersion of nations that use the currency.
- a measure of contagion involved in changes in exchange rates.
- (selected) the difference in the price the buyer pays versus the price the seller receives.
- the percentage of interest one pays when borrowing to purchase currencies.

91 Market spreads usually range from _____ on large contracts to _______ on small contracts.

- 3%; 0.5%
- 10%; 2%
- 1%; 2%
- (selected) 0.01%; 5%

92 The difference between the buy at and the sell at price is caused by:

- market friction.
- transaction cost.
- menu cost.
- (selected) market friction and transaction cost.

93 A derivative is a:

- contract derived from a spot market rate.
- fixed exchange rate.
- flexible exchange rate.
- contract between firms for foreign currency.

94 Forwards, swaps, futures, and options are examples of:

- spot market transactions.
- transaction costs.
- market frictions.
- derivatives.

95 The difference between the spot contract and a forward contract is that:

- the former is a flexible price on the currency, and the latter is a fixed price.
- the former is a contract to be settled immediately, and the latter is a contract to be settled at a future agreed-upon date.
- the former is a derivative, and the latter is not a derivative.
- the former has a fixed price but the contract can be settled at a later date, and the latter is a contract to be settled immediately.

96 In which of the following categories would an agreement to trade currencies in pre-set amounts at a certain date in the future be included?

- an option
- a futures contract
- a forward contract
- a swap

97 The forward contract differs from a futures contract in that:

- the forward contract is to be settled immediately.
- the futures contract specifies a fixed amount and arranged date, whereas the forward contract can be for any amount or date.
- the futures contract cannot be traded in a market, whereas the forward contract can be bought in the market.
- forward contracts are standardized, whereas futures contracts are not standardized.

98 Foreign exchange contracts, such as futures, swaps, and options, are collectively known as:

- derivatives.
- deposits.
- spot contracts.
- spreads.

99 The forward market is:

- a market that exists only in one place at one time.
- when a person borrows to speculate in the market.
- purchases and sales of currencies for delivery at a later time—up to a year.
- the rate of exchange quoted during the next business day.

100 In which of the following categories would an agreement to buy or sell a certain quantity of a specified currency at a fixed price at a date 30, 60, 90, 120, or 360 days in the future be included?

- an option
- a futures contract
- a forward contract
- a swap

101 Foreign exchange swaps involve:

- (selected) selling one currency on the spot market and at the same time purchasing it forward.
- trading goods rather than money to improve efficiency.
- delaying payment of a spot contract until the currency is actually delivered.
- a promissory note with repayment in 60 days.

102 A foreign exchange option is:

- the right to engage in buying or selling on the spot market.
- (selected) the right to purchase or sell foreign currency at a specified price on a specified date in the future.
- when the price of foreign currency exceeds the spot rate.
- when a speculator must decide whether to move into the market.

103 In international finance, hedging indicates:

- not being able to make a commitment to buy or sell.
- delaying a purchase of foreign exchange, hoping the price will fall.
- simultaneously buying several currencies to ensure that at least one will rise in value.
- (selected) avoiding risk of loss by offsetting an obligation to buy a foreign currency by locking in a contract to sell it at the same time.

104 When exchange rates are ______, agreeing to wait for one week from today to engage in an international transaction carries ______.

- flexible rather than fixed; less risk
- flexible rather than fixed; the same amount of risk
- (selected) flexible rather than fixed; more risk
- fixed rather than flexible; the same amount of risk

105 In international finance, speculation involves:

- not being able to make a commitment to buy or sell.
- (selected) taking a risk by purchasing (or selling) a foreign currency asset, holding it in anticipation of a rate increase (decrease).
- simultaneously buying several currencies to ensure that at least one will rise in value.
- avoiding risk of loss by offsetting an obligation to buy a foreign currency by locking in a contract to sell it at the same time.

106 In which of the following categories would the sale of foreign currency with a forward repurchase agreement be included?

- an option
- a futures contract
- a forward contract
- (selected) a swap

107 An agreement that gives one party the right to buy or sell from or to another party a specified quantity of currency at a specified price would be included in which of the following transactions?

- (selected) an option
- a futures contract
- a forward contract
- a swap

108 Interbank trading is:

- a monopoly business in the United States.
- (selected) controlled by just 10 banks.

- a state-mandated business.
- a highly competitive market, with hundreds of banks offering services.

109 Why does a government impose controls or restrictions on converting domestic currency to foreign currency (capital controls)?

- The government is trying to stop the rapid decline in value of the domestic currency.
- The government wants to speculate on its own currency
- The government is trying to suppress international trade
- (selected) The government is trying to avoid imposing taxes on citizens.

110 When a government sets limits or puts any restrictions on the international flow of currency or payments, these measures are called:

- forex regulation and restriction.
- (selected) capital controls.
- safeguard measures.
- black-market measures.

111 Why may a "black market" develop in nations in which government has imposed capital controls?

- (selected) All foreign currency purchases and sales are conducted and controlled by the government, and it is illegal to trade privately.
- Traders are trying to avoid the taxes they must pay on each transaction.
- The government makes a huge profit on currency trades that the private sector wants access to.
- None of these explains why a "black market" may develop in these nations.

112 To bypass capital controls, people who need foreign currency sometimes resort to:

- forward foreign exchange markets.
- stock markets.
- (selected) black markets.
- farmers markets.

113 Foreign exchange market intervention refers to:

- actions taken by speculators to increase profits from trading.
- actions taken to lower currency trading risks and make the markets safer.
- the forgiving of penalties and other punishments for illegal foreign exchange activities.
- (selected) government purchases or sales of a nation's own currency in international markets to change or stabilize the value of the currency.

114 To avoid the imposition of capital controls, a government wishing to keep its exchange rate at a certain level, may rely on:

- forbidding all sales or purchases of foreign currency.
- asking the large banks to keep the prices at a certain level.
- asking for loans from the International Monetary Fund (IMF).
- (selected) intervention in the foreign exchange market to raise or lower the exchange rate.

115 To maintain a fixed exchange rate via intervention in the markets, a government should:

- be ready to crack down on illegal traders.
- (selected) be ready to buy the home currency with foreign currency reserves when the home currency's value declines.
- be ready to sell the home currency when the home currency's value declines.

- be ready to borrow funds from international banks when the home currency's value declines.

116 Foreign exchange arbitrage refers to:

- (selected) the simultaneous purchase and sale of a foreign currency asset in different markets to take advantage of a price differential.
- actions taken to lower currency trading risks and make the markets safer.
- the forgiving of penalties and other punishments for illegal foreign exchange activities.
- government purchases or sales of a nation's own currency in international markets to change or stabilize the value of the currency.

117 Capital control is described by all of the following EXCEPT:

- (selected) restricting merchandise trade.
- restricting the trade in foreign exchange.
- channeling the currency trade through the government.
- restricting cross-border financial transactions.

118 *Parallel markets* is another term for:

- government interventions.
- interbank trades.
- (selected) black markets.
- trade in goods and in services.

119 Arbitrage is:

- capital controls.
- interest rate management by the central bank.
- (selected) exploiting profit opportunities in the market resulting from price differences.
- investing in junk bonds or businesses that are not ethical.

120 Whenever there is a difference in the same exchange rate offered in two markets, an arbitrageur would:

- wait for the markets to come to equilibrium.
- (selected) buy in the market where the currency is offered at the cheaper rate, and simultaneously sell the currency where the rates are higher.
- sell the cheaper-rate currency in the home market.
- not consider the trade, since prices would undoubtedly change before it could be executed.

121 Suppose $1 = 10.5 pesos in New York and $1 = 9.6 pesos in Mexico City. If you had $10,000 using arbitrage, your profits would be:

- (selected) $937.50.
- 937 pesos.
- 9,600 pesos.
- $790.

122 If the U.S. interest rate is 4% per year and the U.K. interest rate is 9% per year, then:

- an investor will see no reason to invest in the United Kingdom.
- an investor will borrow money in the United Kingdom and invest it in the United States.
- (selected) an investor can borrow money in the United States and invest it in the United Kingdom and profit.
- an investor will find that the returns are the same in both countries.

123 Arbitrage with two currencies is NOT possible when:

- there is an exchange rate difference in two markets.
- traders are familiar with markets.
- (selected) the exchange rates are in equilibrium, and the same is occurring in all markets.
- the exchange rates are extremely volatile.

124 Suppose $1 = 1.5 euros in London and $1 = 1.2 euros in New York. Which of the following would be the right trade for you to make money?

- You sell 1,000 euros in London and buy euros in New York.
- You sell dollars in New York and buy dollars in London.
- (selected) You sell dollars in London and buy dollars in New York.
- You sell euros in London and buy dollars in New York.

125 Suppose $1 = 120 yen in New York, $1 = 2 euros in London, and one euro = 75 yen in Tokyo. A speculator with $1 million would get a profit of _____ by engaging in a 3-point arbitrage.

- $1.20
- 150,000 yen
- (selected) $250,000
- $1.25 million

126 When it is possible to trade two separate currencies for a common third currency, economists refer to profit opportunities as:

- backward arbitrage.
- speculation.
- (selected) triangular arbitrage.
- forced equilibrium.

127 Approximately how many different national currencies exist in the world today?

- (selected) more than 150
- more than 5,000
- 12
- 535

128 If 1 euro is priced at $1.25 and if 1 euro will also buy 88 Japanese yen (�1 = ¥88), in equilibrium, with no arbitrage opportunities, how much is the cross rate between the yen and the dollar (yen-dollar rate)?

- ¥150/$
- (selected) ¥70.4/$
- ¥20/$
- ¥5/$

129 A vehicle currency is:

- contraband—it is used to smuggle other assets into controlled economies.
- (selected) a widely accepted, tradable currency that serves as a currency to use for buying or selling one's own.
- a currency whose value changes rapidly and erratically.
- a currency used to purchase imports of autos, buses, and other transportation equipment.

130 Suppose the average interest rate on euro bonds is 4%, and the average interest rate on U.S. dollar bonds is 6%. Which should the investor choose?

- neither—bonds have high default rates.
- both—an investor will choose some euro bonds and some U.S. bonds to diversify.
- the euro bond because their economies are usually more stable.
- (selected) It is not possible to answer without information on exchange rates.

131 The forward exchange rate:

- allows investors to be sure of the price at which they can trade forex in the future.
- is the rate at which a trader can purchase currency for immediate delivery.
- is the rate of discount that international banks get when they purchase.
- is the rate that speculators consider if they are looking for bargain prices.

132 If investors can cover themselves in the forward market, they will take advantage of interest rate differentials by:

- buying assets (lending) denominated in the high-interest rate currency, and selling assets (borrowing) in the low-interest rate currency.
- removing funds from both investments.
- turning over their investment portfolio to an expert in one of the two nations.
- selling assets denominated in high-interest rate currency and buying assets in the low-interest rate currency.

133 There can be an opportunity for covered interest arbitrage if:

- the interest rate is low and the exchange rate is high.
- the forward/spot rate difference is either larger or smaller in percentage terms than the difference in the interest rates on two currencies.
- there is a time lag on the settlement of the transactions.
- the interest rate is high and the exchange rate is low.

134 Covered interest parity refers to the situation in which:

- interest rates are the same in both currencies.
- spot and forward rates are the same in both currencies.
- the forward rate between the two currencies is equal to the ratio of their returns times the spot rate between the two currencies.
- there is an opportunity for arbitrage whenever prices are sluggish and sticky.

135 If the future rate equals the spot rate, then in equilibrium:

- the exchange rate must depreciate.
- interest rates should be different.
- the exchange rate will appreciate.
- None of these will occur.

136 Whenever nations remove capital controls on their currencies:

- returns are equalized and arbitrage opportunities disappear.
- there is no opportunity for trade or arbitrage, and differences in returns disappear.
- the government sets the returns on its currency, so traders cannot make profits.
- in those nations, because government has ensured its safety, capital is free to move.

137 Uncovered interest parity refers to:

- borrowing in the low-interest currency and lending in the high-interest currency without covering against a change in the exchange rates.
- foolish actions that usually are not successful.

- activities that are designed to raise or lower interest rates but are risky.
- the practice of depositing all of one's funds in one currency without regarding the pros and cons of such a transaction.

138 Liquidity of an asset refers to:

- its level of risk.
- whether it is held domestically or overseas.
- (x) the ease with which it can be sold.
- its volatility.

139 The situation in which the difference in interest rates between two currencies is equal to the expected change in the spot rate over the same time period is known as:

- covered interest arbitrage.
- covered interest parity.
- (x) uncovered interest parity.
- the forward-spot reversal.

140 As the expected future spot rate moves closer to the spot rate, uncovered interest parity indicates that:

- interest rates should remain constant.
- (x) interest rates should converge.
- interest rates should diverge.
- The answer depends on whether the expected future spot rate is higher or lower than the spot rate.

141 In equilibrium, the expected future spot rate is equal to the:

- current spot rate.
- current interest rate.
- interest rate spread.
- (x) current forward rate.

142 If the U.S. interest rate is 4% per year and the U.K. interest rate is 9% per year, which of the following statements is TRUE?

- The dollar will depreciate 4% in one year.
- The pound will depreciate 9% in one year.
- (x) The pound will appreciate 5% in one year.
- The dollar will appreciate 4% in one year.

143 In equilibrium, if both uncovered and covered interest parity hold, what condition should exist?

- World interest rates will be equal.
- Rates of inflation will equalize.
- (x) The forward rate will equal the expected future spot rate.
- The forward rate will decrease as the spot rate rises.

144 Whenever a nation's currency is expected to depreciate because of various market conditions, the following situation exists regarding its forward rate for another currency:

- there is a forward discount from the spot rate by the rate of depreciation.
- (x) there is a forward premium from the spot rate by the rate of depreciation.
- there is no difference between the spot and forward rates.
- there is no predictable relationship between the spot and forward rates.

145 The expected rate of currency depreciation is equal to the proportional difference between the forward rate and the spot rate. This is known as the:

- forward depreciation.
- backward depreciation.
- (selected) forward premium.
- backward premium.

146 The total rate of return on an international asset is the:

- spot rate plus the forward rate.
- (selected) rate of return on the asset plus or minus the expected capital gain or loss on currency changes.
- rate of return on the asset minus commissions.
- rate of return plus inflation minus taxes.

147 In equilibrium, the interest parity condition requires that:

- all rates of returns will equalize.
- all spot and forward rates will equalize.
- (selected) the home interest rate minus its expected rate of currency depreciation (against the foreign country) will equal the foreign interest rate on similar assets.
- all rates of returns and forward rates will equalize.

148 From uncovered interest parity, we know that when the domestic currency is expected to depreciate, the domestic interest rate should be:

- (selected) greater than the foreign interest rate.
- greater than the foreign exchange rate.
- less than the foreign interest rate.
- less than the foreign exchange rate.

149 From uncovered interest parity, we know that when the domestic interest rate is greater than the foreign one:

- the domestic currency is expected to appreciate.
- (selected) the domestic currency is expected to depreciate.
- the foreign currency is expected to appreciate.
- the foreign currency is expected to depreciate.

150 Explain in your own words the effective exchange rate and why policy makers pay more attention to it than the bilateral exchange rate.

Answer:

The effective exchange rate considers a basket of currencies and weights them by the volume of trade a country has with other countries. By looking at the effective exchange rate, we can get a sense of how competitive the United States is internationally rather than just in comparison to one country.

151 Suppose a country trades with three countries: Brazil (20% of trade), China (45%), and France (35%). Over the last year, the currency of this country has depreciated by 4% against the Brazilian real, appreciated by 3% against the Chinese yuan, and depreciated by 7% against the euro. What has happened to the effective exchange rate of the country?

Answer:

1.9% depreciation. Multiplying the rate of depreciation by the trade weight, we see (20% x 4) + (45% × −3) + (35% × 7) = 1.9.

152 If a pair of shoes in the United States costs $45, and a pair of the exact same shoes is sold in Mexico for 430 pesos while the exchange rate is *E* = $0.1100/pesos, what arbitrage opportunities exist (if any)? Ignoring transactions costs, explain how you would take advantage of this.

Answer:

If you bought 430 pesos to buy the Mexican version of the shoes, it would cost you $47.30. You could buy the shoes in the United States for $45 and sell them in Mexico for more

153 You have studied how nations have adopted a wide variety of exchange rate regimes from freely floating with almost no intervention, to rigid and fixed with complete control by the government. Other nations have chosen different paths, relinquishing some or all control over their currencies. Discuss two such systems and comment on their differences.

Answer:

Some nations have chosen to merge their currencies and use a common currency for all nations in a currency union. Europe is the prime example of a currency union, whereby each nation uses the euro rather than each having its own currency with a variety of exchange rates. Monetary policy in the European Currency Union is managed by a central bank with input from all members of the union. Dollarization is a situation in which a nation adopts a strong currency, such as the U.S. dollar, and uses it as its own currency. It cannot print dollars, but it allows all domestic transactions to take place using the dollar. Dollars are acquired by exporting. The nation then does not have to worry about managing its own currency or interest rates.

154 What are the similarities and differences between a currency union and dollarization?

Answer:

A currency union and dollarization are both forms of a fixed exchange rate regime. While currency unions involve multiple countries cooperating agreeing to adopt a common currency, dollarization is when one country adopts the currency of another but does so unilaterally.

155 Assume your company has a contract to purchase 100,000 computers from a Korean company. The payment is due on receipt of the shipment and must be delivered in Korea on December 31, 2013. In July 2013, when you are arranging the contract, the computers are priced at 500,000 won each. The spot rate in July 2013 is $1 in exchange for 1,250 won.

A) Calculate the U.S. dollar price (in July 2013) of one unit of Korean currency.
B) What is the total price of the computers in dollars?
C) What is the total price of the computers in won?
D) What would you advise your firm to do to avoid a loss on the deal if the Korean won costs 10% more compared to the U.S. dollar when payment is due in December?

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Answer:

A) � � $0.0008
B) � � 100,000 � (500,000/1,250) = $4 million
C) � � 100,000 � 500,000 = won 50 billion
D) � � The advice should be to ?hedge? against the loss of value of the dollar. The firm could buy the won today at the current spot rate and invest it, or buy a forward contract for 120 days to purchase 50 billion won at the prespecified forward rate.

156 Explain two of the four main types of derivatives used in the foreign exchange market, and why they are used.

Answer:

Forward contracts involve buying/selling a specified amount of foreign currency at a specific time in the future at a specified price; they are typically used to hedge. Swaps involve engaging in a spot sale and a forward contract to repurchase foreign currency at a specified price in the future; they are typically used to reduce transaction costs. A futures contract is a standardized contract to buy/sell foreign currency at a set maturity date and can be traded before the maturity date on organized exchanges. Options give the buyer the ability to buy/sell currency at a specified price in the future, but do not require her to follow through. This is typically for speculative purposes.

157 In July 2013, the spot rate is $1 exchanging for 1,250 won. You are convinced that the won will appreciate by the end of the year. How might you profit if your hunch is correct?

Answer:

At this time, you can speculate in the forward market: negotiate a forward contract to buy Korean won at a predetermined price. Then, on December 31, execute the contract (buy the won) and sell it in the spot market for a profit.

158 What role(s) might the government play in the foreign exchange markets? Explain.

Answer:

Governments may try to restrict activity in the foreign exchange market by forcing all activity to go through them or to at least restrict cross-border transactions (impose capital controls), or they may generally let activity occur but then intervene when they want to influence foreign exchange rates.

159 Is it possible to engage in arbitrage under the following scenario? The exchange rate in New York is E = $1.25/euro, and it is E = $1.35/euro in London. Explain how you would do it.

Answer:

The dollar is worth less in London, and the euro is relatively expensive there. If you were to buy euros in New York where they are relatively cheap (it only costs $1.25 to buy a euro in New York, while it costs $1.35 to buy one in London), you could sell them in London for $0.10 profit per Euro sold.

160 Explain how a trader can exploit an arbitrage opportunity using the spot market and the forward market, after discovering a difference in interest rate returns on two currencies.

Answer:

Essentially, the trader would borrow funds in the low-interest currency and deposit those funds in the high-interest currency. For instance, if deposit rates were 4% in the United States and 8% in the United Kingdom, a trader should borrow dollars, purchase pounds, invest the pounds in an 8% U.K. deposit for one year, retrieve the funds, and reconvert to dollars. To avoid exchange rate risk (the risk that the pound would depreciate against the dollar), the trader would cover his or her transaction in the forward market in the following way: at the same time the trader purchases the pounds with the borrowed dollars, she would also negotiate a one-year forward contract to sell those pounds for dollars. As long as the interest earned is greater than the difference between the spot and forward rates, the trader is guaranteed to earn money.

161 Explain the difference between risky and riskless arbitrage.

Answer:

Riskless arbitrage involves taking advantage of interest rate differentials by engaging in a spot transaction today to buy/sell foreign currency, while simultaneously engaging in a sale/purchase of foreign currency for a specific time in the future.

162 Suppose the U.S. dollar interest rate is 5% and the euro interest rate is 6%. Assume no transaction costs, fees, or commissions. In all markets, the spot rate for euros is $1.25. You

believe in one year's time the spot rate for euros will be $1.30. An investor would like to invest $100,000 for one year and is willing to take on risk for a higher return.

A) How would you advise him?

B) What if you are incorrect and the euro rate is lower? Calculate the "break-even" exchange rate; that is, an investment that returns the same as investing $100,000 at 5%.

Answer:

A) The best advice would be to invest in euros by purchasing �80,000 for the $100,000, and purchasing a euro asset returning 6%. At the end of 1 year, the investor should sell the asset for �84,800 and then buy dollars on the spot market. If you are correct and the rate is $1.30, the investment will return $10,240, which is a return of over 10%.

B) To calculate the break-even exchange rate, divide the value after one year from the U.S. investment ($105,000) by the value of the euro investment after one year (�84,800) giving a "break-even" exchange rate of $1.24. If the exchange rate goes below $1.24, the U.S. investment would have earned more.

163 Suppose the U.S. dollar interest rate is 3%, while the interest rate in the United Kingdom is 6%. Your friend thinks he can convert his dollars, invest in the United Kingdom and convert his pounds back into dollars at the end of a year, allowing him to make a lot higher return. Assuming uncovered Interest parity (UIP), explain why he is incorrect.

Answer:

UIP says that the only way that saving in the United Kingdom can be higher than it is in the United States is if the pound is expected to depreciate by 3%. If this is the case, all excess returns are cancelled out by a weakening pound.

164 Suppose interest rates in the United States are 5.5%, while they are 3% in the euro area. Currently the dollar–euro exchange rate is at $2.50 per euro. If UIP holds, what do you expect the exchange rate to be in the future? Round to three decimals.

Answer:

If UIP holds, the dollar is expected to depreciate by 2.5%. Given this, the dollar currently must be trading at 2.5625 dollars per euro.