***Financial Markets and Institutions, 7e* (Saunders)**

**Chapter 9 Foreign Exchange Markets**

1) If a foreign currency appreciates, that country's goods and services become relatively more expensive for U.S. buyers.

Answer: TRUE

Difficulty: 2 Medium

Topic: Foreign Exchange Rates and Transactions

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 09-04 Distinguish between a spot foreign exchange transaction and a forward foreign exchange transaction.

Accessibility: Keyboard Navigation

2) A U.S. firm agrees to import textiles from Hong Kong and pay in 90 days. The invoice requires payment in Hong Kong dollars. The U.S. importer could hedge this currency risk by buying the HK dollar forward.

Answer: TRUE

Difficulty: 1 Easy

Topic: Foreign Exchange Rates and Transactions

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 09-05 Calculate return and risk on foreign exchange transactions.

Accessibility: Keyboard Navigation

3) In 1971, the Bretton Woods Agreement established that, for the first time, currency values would be fixed against one another within narrow bands.

Answer: FALSE

Difficulty: 1 Easy

Topic: Background and History of Foreign Exchange Markets

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 09-03 Identify the world's largest foreign exchange markets.

Accessibility: Keyboard Navigation

4) In 1973, the Smithsonian Agreement II eliminated fixed exchange rates for the major economies.

Answer: TRUE

Difficulty: 1 Easy

Topic: Background and History of Foreign Exchange Markets

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 09-03 Identify the world's largest foreign exchange markets.

Accessibility: Keyboard Navigation

5) If you can convert 150 Swiss francs to $90, the exchange rate is 1.67 francs per dollar.

Answer: TRUE

Difficulty: 2 Medium

Topic: Foreign Exchange Rates and Transactions

Bloom's: Understand

AACSB: Reflective Thinking; Analytical Thinking

Learning Goal: 09-04 Distinguish between a spot foreign exchange transaction and a forward foreign exchange transaction.

Accessibility: Keyboard Navigation

6) If the dollar is initially worth 120 yen and then the exchange rate changes so that the dollar is now worth 115 yen, the value of the yen has depreciated.

Answer: FALSE

Difficulty: 2 Medium

Topic: Foreign Exchange Rates and Transactions; Background and History of Foreign Exchange Markets

Bloom's: Understand

AACSB: Reflective Thinking; Analytical Thinking

Learning Goal: 09-05 Calculate return and risk on foreign exchange transactions.; 09-01 Understand what foreign exchange markets and foreign exchange rates are.

Accessibility: Keyboard Navigation

7) If the euro per yen ratio falls, the value of the yen has risen.

Answer: FALSE

Difficulty: 2 Medium

Topic: Foreign Exchange Rates and Transactions

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 09-04 Distinguish between a spot foreign exchange transaction and a forward foreign exchange transaction.

Accessibility: Keyboard Navigation

8) If the United States has inflation of 3 percent and Europe has inflation of 5 percent, the value of the euro should increase, ceteris paribus.

Answer: FALSE

Difficulty: 1 Easy

Topic: Interaction of Interest Rates, Inflation, and Exchange Rates

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 09-07 Identify the relations among interest rates, inflation, and exchange rates.

Accessibility: Keyboard Navigation

9) A U.S. bank has made £12 million worth of loans and £10 million worth of deposits in Britain. The bank would benefit from a drop in the value of the pound against the dollar.

Answer: FALSE

Difficulty: 2 Medium

Topic: Foreign Exchange Rates and Transactions

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 09-05 Calculate return and risk on foreign exchange transactions.

Accessibility: Keyboard Navigation

10) A country with lower interest rates than another country is likely to see its currency appreciate if parity holds.

Answer: TRUE

Difficulty: 2 Medium

Topic: Interaction of Interest Rates, Inflation, and Exchange Rates

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 09-07 Identify the relations among interest rates, inflation, and exchange rates.

Accessibility: Keyboard Navigation

11) During much of the 1800s, developed nations employed what came to be known as the Bretton Woods international monetary system to manage exchange rates.

Answer: FALSE

Difficulty: 1 Easy

Topic: Background and History of Foreign Exchange Markets

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 09-02 Understand the history of and current trends in foreign exchange markets.

Accessibility: Keyboard Navigation

12) New York is the global center of foreign exchange trading with the largest daily volume of currency trading.

Answer: FALSE

Difficulty: 1 Easy

Topic: Background and History of Foreign Exchange Markets

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 09-03 Identify the world's largest foreign exchange markets.

Accessibility: Keyboard Navigation

13) A drop in value of the dollar hurts U.S. importers and helps U.S. exporters, ceteris paribus.

Answer: TRUE

Difficulty: 1 Easy

Topic: Foreign Exchange Rates and Transactions

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 09-04 Distinguish between a spot foreign exchange transaction and a forward foreign exchange transaction.

Accessibility: Keyboard Navigation

14) The dollar's value increased when the Fed cut interest rates in late 2007.

Answer: FALSE

Difficulty: 2 Medium

Topic: Foreign Exchange Rates and Transactions

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 09-04 Distinguish between a spot foreign exchange transaction and a forward foreign exchange transaction.

Accessibility: Keyboard Navigation

15) The ongoing accumulation of foreign currency reserves by foreign monetary authorities contributed to the dollar's drop in 2006.

Answer: FALSE

Difficulty: 1 Easy

Topic: Foreign Exchange Rates and Transactions

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 09-04 Distinguish between a spot foreign exchange transaction and a forward foreign exchange transaction.

Accessibility: Keyboard Navigation

16) Foreign exchange trading in 2016 averaged about \_\_\_\_\_\_\_\_ per day.

A) $101 million

B) $5.09 trillion

C) $101 billion

D) $1.88 trillion

E) $101 trillion

Answer: B

Difficulty: 1 Easy

Topic: Background and History of Foreign Exchange Markets

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 09-03 Identify the world's largest foreign exchange markets.

Accessibility: Keyboard Navigation

17) In 2015, the U.S. imported goods and services worth about \_\_\_\_\_\_\_\_ and exported about \_\_\_\_\_\_\_\_ leading to a current account \_\_\_\_\_\_\_\_.

A) $3.7 trillion; $3.3 trillion; deficit

B) $3.2 trillion; $3.4 trillion; surplus

C) $3.4 trillion; $3.2 trillion; surplus

D) $3.2 trillion; $3.4 trillion; deficit

E) $3.0 trillion; $3.0 trillion; balance

Answer: A

Difficulty: 2 Medium

Topic: Foreign Exchange Rates and Transactions

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 09-04 Distinguish between a spot foreign exchange transaction and a forward foreign exchange transaction.

Accessibility: Keyboard Navigation

18) A U.S. investor has borrowed pounds, converted them to dollars, and invested the dollars in the United States to take advantage of interest rate differentials. To cover the currency risk, the investor should

A) sell pounds forward.

B) buy dollars forward.

C) buy pounds forward.

D) sell pounds spot.

E) None of these choices are correct.

Answer: C

Difficulty: 3 Hard

Topic: Foreign Exchange Rates and Transactions

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 09-05 Calculate return and risk on foreign exchange transactions.

Accessibility: Keyboard Navigation

19) A U.S. bank borrowed dollars, converted them to euros, and invested in euro-denominated CDs to take advantage of interest rate differentials. To cover the currency risk the investor should

A) sell dollars forward.

B) sell euros forward.

C) buy euros forward.

D) sell euros spot.

E) None of these choices are correct.

Answer: B

Difficulty: 3 Hard

Topic: Foreign Exchange Rates and Transactions

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 09-05 Calculate return and risk on foreign exchange transactions.

Accessibility: Keyboard Navigation

20) A U.S. firm has £50 million in assets in Britain that they need to repatriate in six months. They could hedge the exchange rate risk by

A) buying pounds forward.

B) selling pounds forward.

C) borrowing pounds.

D) both selling pounds forward and borrowing pounds.

E) both buying pounds forward and borrowing pounds.

Answer: D

Difficulty: 3 Hard

Topic: Foreign Exchange Rates and Transactions

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 09-05 Calculate return and risk on foreign exchange transactions.

Accessibility: Keyboard Navigation

21) A U.S. firm has borrowed £50 million from a British firm. The borrower will need to convert dollars to pounds to repay the loan when it is due. The U.S. firm could hedge the exchange rate risk by

A) buying pounds forward.

B) selling pounds forward.

C) borrowing pounds.

D) both selling pounds forward and borrowing pounds.

E) both buying pounds forward and borrowing pounds.

Answer: A

Difficulty: 2 Medium

Topic: Foreign Exchange Rates and Transactions

Bloom's: Understand

AACSB: Reflective Thinking; Analytical Thinking

Learning Goal: 09-05 Calculate return and risk on foreign exchange transactions.

Accessibility: Keyboard Navigation

22) A U.S. bank converted $1 million to Swiss francs to make a Swiss franc loan to a valued corporate customer when the exchange rate was 1.2 francs per dollar. The borrower agreed to repay the principal plus 5 percent interest in one year. The borrower repaid Swiss francs at loan maturity and when the loan was repaid the exchange rate was 1.3 francs per dollar. What was the bank's dollar rate of return?

A) 26.00 percent

B) −2.69 percent

C) 7.14 percent

D) −3.08 percent

E) 5.00 percent

Answer: D

Explanation: {[($1 million × SFr 1.2 × 1.05)/SFr 1.3/$]/$1 million} − 1

Difficulty: 3 Hard

Topic: Foreign Exchange Rates and Transactions

Bloom's: Analyze; Apply

AACSB: Reflective Thinking; Analytical Thinking

Learning Goal: 09-05 Calculate return and risk on foreign exchange transactions.

Accessibility: Keyboard Navigation

23) A Swiss bank converted 1 million Swiss francs to euros to make a euro loan to a customer when the exchange rate was 1.85 francs per euro. The borrower agreed to repay the principal plus 3.75 percent interest in one year. The borrower repaid euros at loan maturity and when the loan was repaid the exchange rate was 1.98 francs per euro. What was the bank's franc rate of return?

A) 7.75 percent

B) 11.04 percent

C) 9.94 percent

D) −2.82 percent

E) 5.71 percent

Answer: B

Explanation: {[((SFr1 million × €/SFr 1.85) × 1.0375) × SFr 1.98/€]/SFr1 million} − 1

Difficulty: 3 Hard

Topic: Foreign Exchange Rates and Transactions

Bloom's: Analyze; Apply

AACSB: Reflective Thinking; Analytical Thinking

Learning Goal: 09-05 Calculate return and risk on foreign exchange transactions.

Accessibility: Keyboard Navigation

24) A Japanese investor can earn a 1 percent annual interest rate in Japan or about 3.5 percent per year in the United States. If the spot exchange rate is 101 yen to the dollar, at what one-year forward rate would an investor be indifferent between the U.S. and Japanese investments?

A) ¥100.58

B) ¥98.56

C) ¥101.68

D) ¥97.42

E) ¥103.50

Answer: E

Explanation: (1 + .035) = (1 /101) (1 + .01) (*X*)

*X* = ¥103.5

Difficulty: 3 Hard

Topic: Interaction of Interest Rates, Inflation, and Exchange Rates

Bloom's: Analyze; Apply

AACSB: Reflective Thinking; Analytical Thinking

Learning Goal: 09-07 Identify the relations among interest rates, inflation, and exchange rates.

Accessibility: Keyboard Navigation

25) A European investor can earn a 4.75 percent annual interest rate in Europe or 2.75 percent per year in the United States. If the spot exchange rate is $1.58 per euro, at what one-year forward rate would an investor be indifferent between the U.S. and Japanese investments?

A) $1.5484

B) $1.6108

C) $1.5335

D) $1.5498

E) $1.5977

Answer: D

Explanation: (1.0275/1.0475) × $1.58 = $1.5498

Difficulty: 3 Hard

Topic: Interaction of Interest Rates, Inflation, and Exchange Rates

Bloom's: Analyze; Apply

AACSB: Reflective Thinking; Analytical Thinking

Learning Goal: 09-07 Identify the relations among interest rates, inflation, and exchange rates.

Accessibility: Keyboard Navigation

26) An investor starts with $1 million and converts it to 0.75 million pounds, which is then invested for one year. In a year the investor has 0.7795 million pounds, which she then converts to dollars at an exchange rate of 0.72 pounds per dollar. The U.S. dollar annual rate of return earned was \_\_\_\_\_\_\_\_.

A) 4.97 percent

B) 5.27 percent

C) 6.45 percent

D) 7.69 percent

E) 8.26 percent

Answer: E

Explanation: [(0.7795 million pounds/0.72)/$1 million] − 1 = 8.26%

Difficulty: 2 Medium

Topic: Foreign Exchange Rates and Transactions

Bloom's: Analyze; Apply

AACSB: Analytical Thinking

Learning Goal: 09-05 Calculate return and risk on foreign exchange transactions.

Accessibility: Keyboard Navigation

27) An investor starts with €1 million and converts it to £694,500, which is then invested for one year. In a year the investor has £736,170, which she then converts back to euros at an exchange rate of 0.68 pounds per euro. The annual euro rate of return earned was \_\_\_\_\_\_\_\_.

A) 7.55 percent

B) 6.00 percent

C) 7.45 percent

D) 8.13 percent

E) 8.26 percent

Answer: E

Explanation: [(£736,170/0.68)/€1 million] − 1 = 8.26%

Difficulty: 2 Medium

Topic: Foreign Exchange Rates and Transactions

Bloom's: Analyze; Apply

AACSB: Analytical Thinking

Learning Goal: 09-05 Calculate return and risk on foreign exchange transactions.

Accessibility: Keyboard Navigation

28) Banks' net foreign exposure is equal to

A) net foreign assets.

B) net FX bought.

C) net foreign assets + net FX bought.

D) assets − liabilities.

E) None of these choices are correct.

Answer: C

Difficulty: 2 Medium

Topic: Foreign Exchange Rates and Transactions

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 09-06 Describe the role of financial institutions in foreign exchange transactions.

Accessibility: Keyboard Navigation

29) If a firm has more foreign currency assets than liabilities, and no other foreign currency transactions, it has

A) positive net exposure.

B) negative net exposure.

C) a fully balanced position.

D) zero net exposure.

Answer: A

Difficulty: 2 Medium

Topic: Foreign Exchange Rates and Transactions

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 09-06 Describe the role of financial institutions in foreign exchange transactions.

Accessibility: Keyboard Navigation

30) The levels of foreign currency assets and liabilities at banks have \_\_\_\_\_\_\_\_ in recent years, and the level of foreign currency trading has \_\_\_\_\_\_\_\_.

A) increased; increased

B) decreased; decreased

C) increased; decreased

D) decreased; increased

E) decreased; stayed the same

Answer: A

Difficulty: 2 Medium

Topic: Foreign Exchange Rates and Transactions

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 09-06 Describe the role of financial institutions in foreign exchange transactions.

Accessibility: Keyboard Navigation

31) The agreement that ended the era of fixed exchange rates for the major economies was called the

A) Louvre Accord.

B) Bretton Woods Agreement.

C) Smithsonian Agreement I.

D) Smithsonian Agreement II.

E) Plaza Accord.

Answer: D

Difficulty: 2 Medium

Topic: Background and History of Foreign Exchange Markets

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 09-02 Understand the history of and current trends in foreign exchange markets.

Accessibility: Keyboard Navigation

32) If interest rate parity holds and the annual German nominal interest rate is 3 percent and the U.S. annual nominal rate is 5 percent and real interest rates are 2 percent in both countries, then inflation in Germany is about \_\_\_\_\_\_\_\_ than in the United States.

A) 1 percent higher

B) 2 percent higher

C) 1 percent lower

D) 4 percent lower

E) 2 percent lower

Answer: E

Difficulty: 2 Medium

Topic: Interaction of Interest Rates, Inflation, and Exchange Rates

Bloom's: Analyze; Apply; Evaluate

AACSB: Reflective Thinking; Analytical Thinking

Learning Goal: 09-07 Identify the relations among interest rates, inflation, and exchange rates.

Accessibility: Keyboard Navigation

33) At the beginning of the year the exchange rate between the Brazilian real and the U.S. dollar was 2.2 reals per dollar. Over the year, Brazilian inflation was 12 percent and U.S. inflation was 4 percent. If purchasing power parity holds, at year-end the exchange rate should be *approximately* \_\_\_\_\_\_\_\_ dollars per real.

A) 2.3913

B) 0.4895

C) 2.8498

D) 0.4182

E) 0.3440

Answer: D

Explanation: [(4% − 12%) × (1/2.2)] + (1/2.2) = 0.4182

Difficulty: 2 Medium

Topic: Interaction of Interest Rates, Inflation, and Exchange Rates

Bloom's: Analyze; Apply

AACSB: Reflective Thinking; Analytical Thinking

Learning Goal: 09-07 Identify the relations among interest rates, inflation, and exchange rates.

Accessibility: Keyboard Navigation

34) The spot rate for the Argentine peso is $0.3600 per peso. Over the year, inflation in Argentina is 10 percent and U.S. inflation is 4 percent. If purchasing power parity holds, at year-end the exchange rate should be *approximately* \_\_\_\_\_\_\_\_ dollars per real.

A) 0.2987

B) 0.3614

C) 0.2875

D) 0.3384

E) 0.3015

Answer: D

Explanation: [(4% − 10%) × 0.36] + (0.36) = 0.3384

Difficulty: 3 Hard

Topic: Interaction of Interest Rates, Inflation, and Exchange Rates

Bloom's: Analyze; Apply

AACSB: Reflective Thinking; Analytical Thinking

Learning Goal: 09-07 Identify the relations among interest rates, inflation, and exchange rates.

Accessibility: Keyboard Navigation

35) The largest center for trading in foreign exchange is

A) New York.

B) London.

C) Tokyo.

D) Hong Kong.

E) Geneva.

Answer: B

Difficulty: 1 Easy

Topic: Background and History of Foreign Exchange Markets

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 09-03 Identify the world's largest foreign exchange markets.

Accessibility: Keyboard Navigation

36) A negotiated OTC agreement to exchange currencies at a fixed date in the future but at an exchange rate specified today is a

A) currency swap agreement.

B) forward foreign exchange transaction.

C) currency futures contract.

D) currency options contract.

E) spot foreign exchange transaction.

Answer: B

Difficulty: 1 Easy

Topic: Foreign Exchange Rates and Transactions

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 09-04 Distinguish between a spot foreign exchange transaction and a forward foreign exchange transaction.

Accessibility: Keyboard Navigation

37) Which of the following conditions may lead to a decline in the value of a country's currency?

I. Low interest rates

II. High inflation

III. Large current account deficit

A) I only

B) I and II only

C) II and III only

D) II only

E) III only

Answer: C

Difficulty: 2 Medium

Topic: Interaction of Interest Rates, Inflation, and Exchange Rates

Bloom's: Evaluate

AACSB: Reflective Thinking

Learning Goal: 09-07 Identify the relations among interest rates, inflation, and exchange rates.

Accessibility: Keyboard Navigation

38) The large U.S. current account deficit implies that

A) U.S. interest rates are too high.

B) the value of the dollar is too weak.

C) dollar foreign currency reserves at Asian central banks are too low.

D) the presidential administration desires to improve growth of overseas economies.

E) the United States must rely on foreigners to be willing to invest in the United States.

Answer: E

Difficulty: 2 Medium

Topic: Balance of Payment Accounts

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 09-01 Understand what foreign exchange markets and foreign exchange rates are.

Accessibility: Keyboard Navigation

39) A current account deficit implies that

A) more goods and services are exported than are imported.

B) more goods and services are imported than are exported.

C) there is excessive consumption of foreign financial assets.

D) the value of the dollar will rise.

E) the country is going bankrupt.

Answer: B

Difficulty: 3 Hard

Topic: Balance of Payment Accounts

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 09-01 Understand what foreign exchange markets and foreign exchange rates are.

Accessibility: Keyboard Navigation

40) Which of the following are likely to lead to an appreciation of the U.S. dollar (ceteris paribus)?

I. Higher real U.S. interest rates

II. Lower U.S. inflation

III. Higher nominal U.S. interest rates

A) II and III only

B) I and III only

C) I and II only

D) II only

E) I, II, and III

Answer: C

Difficulty: 2 Medium

Topic: Interaction of Interest Rates, Inflation, and Exchange Rates

Bloom's: Remember; Analyze; Evaluate

AACSB: Reflective Thinking

Learning Goal: 09-07 Identify the relations among interest rates, inflation, and exchange rates.

Accessibility: Keyboard Navigation

41) You can buy or sell the £ spot at $1.98 to the pound. You can buy or sell the pound one-year forward at $2.01 to the pound. If U.S. annual interest rates are 5 percent, what must be the approximate one-year British interest rate if interest rate parity holds?

A) 4.00 percent

B) 5.25 percent

C) 2.75 percent

D) 3.45 percent

E) 5.65 percent

Answer: D

Explanation: Using IRPT formula: 1 + .05 = (1/1.98) (1 + iUK ) × 2.01 and solve for iUK = 3.448%.

Difficulty: 2 Medium

Topic: Interaction of Interest Rates, Inflation, and Exchange Rates

Bloom's: Analyze; Apply

AACSB: Reflective Thinking; Analytical Thinking

Learning Goal: 09-07 Identify the relations among interest rates, inflation, and exchange rates.

Accessibility: Keyboard Navigation

42) You can buy or sell the yen spot at ¥102 to the dollar. You can buy or sell the yen one-year forward at ¥104 to the dollar. If U.S. annual interest rates are 4 percent, what must be the approximate one-year Japanese interest rate if interest rate parity holds?

A) 6.04 percent

B) 3.20 percent

C) 2.75 percent

D) 4.73 percent

E) 6.80 percent

Answer: A

Explanation: Using IRPT: 1 + 0.04 = (1/(1/102)) (1 + iJ ) × 1/104 and solve for iJ = 6.039%.

Difficulty: 3 Hard

Topic: Interaction of Interest Rates, Inflation, and Exchange Rates

Bloom's: Analyze; Apply

AACSB: Reflective Thinking; Analytical Thinking

Learning Goal: 09-07 Identify the relations among interest rates, inflation, and exchange rates.

Accessibility: Keyboard Navigation

43) A U.S. bank has £120 million in loans to corporate customers and has £70 million in deposits it owes to customers with the same maturity. The bank has also sold £20 million pounds forward. The bank's net exposure is

A) £210 million.

B) £30 million.

C) £70 million.

D) £170 million.

E) £190 million.

Answer: B

Difficulty: 2 Medium

Topic: Foreign Exchange Rates and Transactions

Bloom's: Apply

AACSB: Analytical Thinking

Learning Goal: 09-06 Describe the role of financial institutions in foreign exchange transactions.

Accessibility: Keyboard Navigation

44) The \_\_\_\_\_\_\_\_ measures the net flows of imports and exports of goods, services, income payments, and unilateral transfers.

A) current account

B) capital account

C) change in official reserves

D) statistical discrepancy

E) basic balance account

Answer: A

Difficulty: 2 Medium

Topic: Balance of Payment Accounts

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 09-01 Understand what foreign exchange markets and foreign exchange rates are.

Accessibility: Keyboard Navigation

45) The concept underlying purchasing power parity is the

A) Fisher effect.

B) Bretton Woods Agreement.

C) law of one price.

D) Big Mac Index.

E) balance of payments concept.

Answer: C

Difficulty: 1 Easy

Topic: Interaction of Interest Rates, Inflation, and Exchange Rates

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 09-07 Identify the relations among interest rates, inflation, and exchange rates.

Accessibility: Keyboard Navigation

46) The value of the British pound changed from $1.40 to $1.15. We can say that the pound has \_\_\_\_\_\_\_\_ and the dollar has \_\_\_\_\_\_\_\_.

A) depreciated; appreciated

B) appreciated; appreciated

C) appreciated; depreciated

D) depreciated; depreciated

E) None of these choices are correct.

Answer: A

Difficulty: 2 Medium

Topic: Foreign Exchange Rates and Transactions

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 09-04 Distinguish between a spot foreign exchange transaction and a forward foreign exchange transaction.

Accessibility: Keyboard Navigation

47) The value of the British pound changed from $1.23 to $1.32. We can say that the pound has \_\_\_\_\_\_\_\_ and the dollar has \_\_\_\_\_\_\_\_.

A) depreciated; appreciated

B) appreciated; appreciated

C) appreciated; depreciated

D) depreciated; depreciated

E) None of these choices are correct.

Answer: C

Difficulty: 2 Medium

Topic: Foreign Exchange Rates and Transactions

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 09-04 Distinguish between a spot foreign exchange transaction and a forward foreign exchange transaction.

Accessibility: Keyboard Navigation

48) The value of the Euro changed from $1.15 to $1.25. We can say that the dollar has \_\_\_\_\_\_\_\_ and the euro has \_\_\_\_\_\_\_\_.

A) depreciated; appreciated

B) appreciated; appreciated

C) appreciated; depreciated

D) depreciated; depreciated

E) None of these choices are correct.

Answer: A

Difficulty: 2 Medium

Topic: Foreign Exchange Rates and Transactions

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 09-04 Distinguish between a spot foreign exchange transaction and a forward foreign exchange transaction.

Accessibility: Keyboard Navigation

49) The value of the Euro changed from $1.20 to $1.14. We can say that the dollar has \_\_\_\_\_\_\_\_ and the euro has \_\_\_\_\_\_\_\_.

A) depreciated; appreciated

B) appreciated; appreciated

C) appreciated; depreciated

D) depreciated; depreciated

E) None of these choices are correct.

Answer: C

Difficulty: 2 Medium

Topic: Foreign Exchange Rates and Transactions

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 09-04 Distinguish between a spot foreign exchange transaction and a forward foreign exchange transaction.

Accessibility: Keyboard Navigation

50) If the dollar appreciates relative to the Euro then:

A) European cars will become less expensive in the United States.

B) American cars will become less expensive in Europe.

C) the price of cars will not be affected.

D) European cars will become more expensive in the United States.

E) American cars will become less expensive in the United States.

Answer: A

Difficulty: 2 Medium

Topic: Foreign Exchange Rates and Transactions

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 09-04 Distinguish between a spot foreign exchange transaction and a forward foreign exchange transaction.

Accessibility: Keyboard Navigation

51) What are the major purposes of the foreign exchange markets?

Answer: Facilitate

1. international trade and global payments systems.

2. global access to capital.

3. hedging currency risk.

4. speculating on currency values.

Difficulty: 3 Hard

Topic: Foreign Exchange Markets and Risk: Chapter Overview

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 09-01 Understand what foreign exchange markets and foreign exchange rates are.

Accessibility: Keyboard Navigation

52) A U.S. FI has US$200 million worth of one-year loans earning an average rate of return of 6 percent. The FI also has one-year single-payment Canadian dollar loans of C$110 million earning 8 percent. The FI's funding source is $300 million in US$ one-year CDs, on which they are paying 4 percent. Initially the exchange rate is C$1.10 per US$1. The one-year forward rate is C$1.14 per US$1. What is the bank's dollar percent spread if they hedge fully using forwards?

Answer: Hedge by selling C$ forward. The current C$ amount is C$110 million. In one year these loans will be worth $110 million × 1.08 = C$118,800,000. Selling this amount forward, C$118,800,000/C$1.14 will give US$104,210,526. This gives a rate of return of [US$104,210,526/US$100 million] − 1 = 4.211%.

Average rate of return = (2/3 × 6%) + (1/3 × 4.211%) = 5.404%

The cost rate = 4%, so the spread = 5.404% − 4% = 1.404%

Difficulty: 3 Hard

Topic: Foreign Exchange Rates and Transactions

Bloom's: Analyze; Apply

AACSB: Reflective Thinking; Analytical Thinking

Learning Goal: 09-05 Calculate return and risk on foreign exchange transactions.

Accessibility: Keyboard Navigation

53) A British bank has borrowed dollars in the United States, but is now concerned about its currency risk. What alternatives does it have to limit its risk? Be specific.

Answer: The bank could buy dollars (sell pounds) forward for when the loan(s) is(are) due. The bank could also sell the appropriate number of pound futures contracts. Finally, the bank could acquire dollar assets either by lending dollars or by acquiring dollar-denominated real assets (perhaps by branching in the United States).

Difficulty: 2 Medium

Topic: Foreign Exchange Rates and Transactions

Bloom's: Understand; Evaluate; Create

AACSB: Reflective Thinking

Learning Goal: 09-05 Calculate return and risk on foreign exchange transactions.

Accessibility: Keyboard Navigation

54) A bank has committed to deliver yen in six months to a corporate customer. The spot rate is 110 yen to the dollar and the six-month forward rate is 105 yen per dollar. Are there costs to hedging this exposure with the forward market? Explain.

Answer: The bank could hedge by buying the yen forward, but there are costs. At the forward rate, the dollar buys less yen than today. The bank may wish to consider buying the yen today and incurring the financing cost if the net cost is less than the loss from using the forward market. If the bank does not buy the yen forward, the spot may turn out to be greater than 105 or even 110 yen, in which case the yen would cost less than the hedged position.

Difficulty: 3 Hard

Topic: Foreign Exchange Rates and Transactions

Bloom's: Understand; Analyze; Evaluate

AACSB: Reflective Thinking; Analytical Thinking

Learning Goal: 09-05 Calculate return and risk on foreign exchange transactions.

Accessibility: Keyboard Navigation

55) An FI's position in FX markets generally reflects four trading activities. What are they, and which one(s) cause the FI to bear FX risk?

Answer: (1) Buying and selling foreign currencies that allow customers to complete international trade transactions. (2) Buying and selling foreign currencies to allow customers to take positions on foreign real and financial investments. (3) Buying and selling currencies to hedge bank positions arising from (1) and (2). (4) Speculating on currency movements for the bank's own account. (1), (2), and (4) add to the bank's risk.

Difficulty: 2 Medium

Topic: Foreign Exchange Rates and Transactions

Bloom's: Understand; Remember

AACSB: Reflective Thinking

Learning Goal: 09-06 Describe the role of financial institutions in foreign exchange transactions.

Accessibility: Keyboard Navigation

56) Is it reasonable to expect real rates of interest to be identical across countries? Explain. What does this imply about parity?

Answer: Among developed economies, real interest rates are probably similar, but not identical. Real interest rates will differ across countries due to differences in risk (sovereign, exchange, credit, and liquidity risks) and due to differences in taxation, tariffs, capital controls, and so forth. The difference between real interest rates in developed and lesser-developed economies will be quite a bit greater. In these cases, the simple parity conditions may not hold or may have little practical significance.

Difficulty: 3 Hard

Topic: Interaction of Interest Rates, Inflation, and Exchange Rates

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 09-07 Identify the relations among interest rates, inflation, and exchange rates.

Accessibility: Keyboard Navigation

57) What are the major differences between the interbank foreign exchange market and the foreign currency exchanges?

Answer: In the interbank market, the deals are negotiated. The interbank market can operate pretty much around the clock and has no set location. Counterparty credit risk is important in the interbank market and generally no cash changes hands until contract maturity. Spot and forward transactions predominate in this market. The exchanges offer standardized currency futures and options contracts. They offer greater anonymity and liquidity and the exchanges guarantee performance on all contracts so credit risk is not a worry. The exchanges only offer a limited number of contracts on the major currencies and contract terms are not negotiable. Exchanges require gains and losses to be recognized daily. Most futures and options contracts do not result in an actual exchange of currency, whereas most interbank contracts do.

Difficulty: 2 Medium

Topic: Background and History of Foreign Exchange Markets

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 09-01 Understand what foreign exchange markets and foreign exchange rates are.

Accessibility: Keyboard Navigation

58) Why does the size of the U.S. current account deficit put pressure on the value of the dollar to decline? How does the size of the capital account affect that pressure? Explain.

Answer: A current account deficit means that a country is net buying more goods and services from overseas than it is selling to foreigners; or more simply, the country's constituents are spending more than their income. Anyone who spends more than they make must either borrow (from foreigners, in this case), or sell their assets (to foreigners), both of which imply that foreign entities must be willing to supply funds to the United States via capital account inflows. If foreigners become less willing to hold so many dollar assets, the value of the dollar may well decline.

Difficulty: 2 Medium

Topic: Balance of Payment Accounts

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 09-01 Understand what foreign exchange markets and foreign exchange rates are.

Accessibility: Keyboard Navigation

59) A U.S. bank has made £50 million loans in Britain and has £40 million in deposits. The bank's currency trading desk has also contracted to buy £20 million and has short positions of £15 million. What is the bank's net exposure? How could they use forward contracts to hedge the exposure? If the bank has exposures in euros and yen, would you recommend they use the forward hedge? Why or why not?

Answer: Net exposure = (FX assetsi − FX liabilitiesi) + (FX boughti − FX soldi) = (£50 − £40) + (£20 − £15) = £15 million. The bank has positive (or asset) exposure of £15 million. This could be hedged by selling £15 million pounds forward. If the bank has offsetting exposures in other currencies, you may not wish to use the suggested forward hedge because the other exposures may be offsetting, reducing the need to hedge, depending on the correlations of the currencies involved and their relationship to the U.S. dollar.

Difficulty: 3 Hard

Topic: Foreign Exchange Rates and Transactions

Bloom's: Analyze; Evaluate; Create

AACSB: Reflective Thinking; Analytical Thinking

Learning Goal: 09-06 Describe the role of financial institutions in foreign exchange transactions.

Accessibility: Keyboard Navigation

60) Explain how a drop in the value of the dollar could affect the U.S. import and export sectors.

Answer: If the dollar drops in value, imports to the United States become more expensive. If the imports are foreign currency–denominated, U.S. buyers must spend more dollars to buy the same good after the dollar decline. If the imports are dollar-denominated, as most are, it is more complicated. The foreign supplier may raise the dollar price to preserve the amount of foreign currency per sale earned. If this happens, U.S. imports again become more expensive. Likewise, U.S. exports become cheaper for foreign buyers after a dollar decline. The net result should be a decrease in U.S. imports and an increase in U.S. exports. Some economists believe this helps create or keep more jobs in the United States.

Difficulty: 2 Medium

Topic: Foreign Exchange Rates and Transactions

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 09-04 Distinguish between a spot foreign exchange transaction and a forward foreign exchange transaction.

Accessibility: Keyboard Navigation