Problem Set 1

Name: __________________________

1. When the exchange value of the euro rises in terms of the U.S. dollar, U.S. residents find that European imports are:
   A) cheaper.
   B) more expensive.
   C) oversupplied to the United States.
   D) more heavily taxed by the U.S. government.

2. Foreign exchange market intervention refers to:
   A) actions taken by speculators to increase profits from trading.
   B) actions taken to lower currency trading risks and make the markets safer.
   C) the forgiving of penalties and other punishments for illegal foreign exchange activities.
   D) government purchases or sales of a nation's own currency in international markets to change or stabilize the value of the currency.

3. A derivative is a:
   A) contract derived from a spot market rate.
   B) fixed exchange rate.
   C) flexible exchange rate.
   D) contract derived from an exchange rate.

4. 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?
   A) –12%
   B) –4%
   C) ±0%
   D) –8%
5. If investors can cover themselves in the forward market, they will take advantage of interest rate differentials by:
   A) buying assets (lending) denominated in the high-interest rate currency, and selling assets (borrowing) in the low-interest rate currency.
   B) removing funds from both investments.
   C) turning over their investment portfolio to an expert in one of the two nations.
   D) selling assets denominated in high-interest rate currency and buying assets in the low-interest rate currency.

6. If $E/£$ moves from 2 to 3, this is a percentage change of:
   A) 50%.
   B) 33.3%.
   C) –33.3%.
   D) –50%.

7. Exchange rates exhibit:
   A) steady behavior across the board.
   B) erratic behavior across the board.
   C) very different behavior depending on whether the rates are fixed or floating.
   D) variable behavior (sometimes steady and other times erratic) depending on the business cycle.

8. 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, 2010. In July 2010, when you are arranging the contract, the computers are priced at 500,000 won each. The spot rate in July 2010 is $1 exchanging for 1250 won. In the space provided below write your answers to the following:
   • Calculate the U.S. dollar price (in July 2010) of 1 unit of Korean currency.
   • What is the total price of the computers in dollars?
   • What is the total price of the computers in won?
   • 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?
9. A consequence of the world movement toward financial integration and openness is:
   A) vulnerability and economic decline in many poor nations.
   B) financial interdependence coupled with a tenfold increase in the volume of foreign assets.
   C) a retreat toward safety and heavier regulation of financial flows.
   D) dominance by the United States as being the only destination for investment funds.

10. Which of the following is NOT a major foreign exchange center?
   A) London
   B) New York
   C) Tokyo
   D) Chicago

11. The average of the bilateral rate changes for a nation, weighted by the importance of the trading partner, is known as:
   A) the real exchange rate.
   B) the nominal exchange rate.
   C) the effective exchange rate.
   D) the direct exchange rate.

12. The International Monetary Fund is an example of:
   A) a credit union.
   B) a multinational bank.
   C) an international development organization.
   D) a bond-rating firm.

13. If in January 2007, $1 = 110 yen, and in July 2007 $1 = 90 yen, then a Harley Davidson motorcycle that cost $8000 in January would now cost _______ in Japan in July.
   A) 180,000 yen
   B) 880,000 yen
   C) 720,000 yen
   D) 890,000 yen
14. The article "Wealth of Nations," comments on a study from the 2005 World Development Report published by the World Bank: "In many developing countries, the requirement is not less government but more and better dedicated government." It lists four requirements to achieve this outcome. What are they? Briefly explain each one.

15. Suppose that a loan made in euros has experienced a capital gain. This indicates that:
   A) the dollar appreciated.
   B) the dollar depreciated.
   C) the euro depreciated.
   D) the dollar experienced a capital loss.

16. 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.
   ● How would you advise her?
   ● 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%. 
Use the following to answer questions 17-18:

**Table: Currency Values II: How Much 1 U.S. Dollar Will Buy of Other Currencies in 2007 and 2008**

<table>
<thead>
<tr>
<th>Currency</th>
<th>2007</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1</td>
<td>1.5 euros</td>
<td>1 euro</td>
</tr>
<tr>
<td>$1</td>
<td>2 Brazilian reais</td>
<td>1.5 Brazilian reais</td>
</tr>
<tr>
<td>$1</td>
<td>2 British pounds</td>
<td>3 British pounds</td>
</tr>
<tr>
<td>$1</td>
<td>45 Indian rupees</td>
<td>50 Indian rupees</td>
</tr>
</tbody>
</table>

17. In 2007, how many euros would it take to buy 1 pound?
   A) 0.75
   B) 1.33
   C) 1.5
   D) 3

18. The dollar rose against the rupee by _____.
   A) 111%
   B) 11%
   C) 1%
   D) –1%

19. From uncovered interest parity, we know that when the domestic currency is expected to depreciate, the domestic interest rate should be:
   A) greater than the foreign interest rate.
   B) greater than the foreign exchange rate.
   C) less than the foreign interest rate.
   D) less than the foreign exchange rate.

20. Key elements of the international economy are:
   A) political alliances, capital accumulation, and monopoly power.
   B) many currencies, financial integration, and economic policy choices made in context.
   C) competition, efficiency, and openness.
   D) waste and overuse of natural resources, disregard for the environment, and unfair competition.
21. The difference between the buy at and sell at price is referred to as:
   A) market friction.
   B) transaction cost.
   C) menu cost.
   D) market friction and transaction cost.

22. If we compare the exchange rate between two nations, expressed in the domestic currency with the same rate expressed in units of the foreign currency, it will be obvious that:
   A) they are both equal to 1.
   B) they cancel each other out.
   C) one is always the reciprocal of the other.
   D) they can never coexist.

23. If, in 2000, $1 = 1.5 euro, and in 2007, $1 = 0.9 euro, which of the following statements would be true?
   A) More American tourists will find it cheaper to travel to Europe.
   B) More Europeans will stay home as visits to the United States become more expensive.
   C) Europeans will import fewer products from the United States.
   D) Americans will import fewer products from Europe.

Use the following to answer questions 24-25:

Table: Currency Values I

<table>
<thead>
<tr>
<th>Currency</th>
<th>2007</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1 1.5 euros</td>
<td>$1</td>
<td>1 euro</td>
</tr>
<tr>
<td>$1 2 Brazilian reais</td>
<td>1.5 Brazilian reais</td>
<td></td>
</tr>
<tr>
<td>$1 2 British pounds</td>
<td>3 British pounds</td>
<td></td>
</tr>
<tr>
<td>$1 45 Indian rupees</td>
<td>50 Indian rupees</td>
<td></td>
</tr>
</tbody>
</table>

24. The U.S. dollar depreciated against the euro by ______.
   A) 0.6%
   B) 1%
   C) 40%
   D) 100%
25. The U.S. dollar depreciated against the ________ and the ________.
   A) euro; Indian rupee
   B) Indian rupee; Japanese yen
   C) Mexican peso; Japanese yen
   D) euro; Japanese yen

26. The great divergence refers to:
   A) the widening U.S. trade deficit.
   B) the growing gap between rich and poor workers.
   C) the growing Chinese trade surplus.
   D) the widening U.S. trade deficit, the growing gap between rich and poor workers,
      and the growing Chinese trade surplus.

27. Whenever income is less than expenditure for a period of time, a nation will experience:
   A) a deficit in its current account.
   B) a surplus in its current account.
   C) an increase in GDP since firms' sales will rise.
   D) a rise in national wealth.

28. Some nations such as Ecuador chose dollarization because:
   A) the currency was depreciating so rapidly it became nearly worthless.
   B) Ecuadorians wanted to save dollars for eventual emigration to the U.S.
   C) the Ecuadorian currency was backed by gold, which was confiscated by
      government officials.
   D) All of the answers are correct.

29. The exchange rate between the U.S. dollar and the Chinese yuan:
   A) resulted in a rise in Chinese buying power.
   B) experienced a one-time 15 percent drop after the global financial crisis.
   C) has created a situation in which China is able to get cheap products from the United
      States.
   D) has been unchanged since July, 2005.

30. In June of 2010, the Chinese government:
   A) cracked down on illegal currency trading.
   B) reduced the value of the yuan in terms of the U.S. dollar.
   C) allowed a gradual appreciation in the value of the yuan in terms of the U.S. dollar.
   D) allowed the yuan to fluctuate freely according to the market.
31. Imports from Europe to the United States have risen. This suggests that:
   A) the dollar has depreciated.
   B) the euro has appreciated.
   C) the dollar has appreciated.
   D) the euro has depreciated.

32. When exchange rates are very volatile, with a wide range of variation, the currency is said to be:
   A) in limbo.
   B) in free float.
   C) perfectly flexible.
   D) in sluggish float.

33. If a nation's currency buys fewer units of a foreign currency today than yesterday, we say the value of its currency has:
   A) appreciated.
   B) depreciated.
   C) stagnated.
   D) become inverted.

Use the following to answer questions 34-35:

Table: Exchange Rates across Currencies

<table>
<thead>
<tr>
<th>Country</th>
<th>Price per dollar (January 1, 2006)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>$1.2</td>
</tr>
<tr>
<td>Japan</td>
<td>120 yen</td>
</tr>
<tr>
<td>Mexico</td>
<td>12 pesos</td>
</tr>
<tr>
<td>India</td>
<td>45 rupees</td>
</tr>
</tbody>
</table>

34. If the exchange rate on January 1, 2007, is $1 = 144 yen, then:
   A) the dollar has appreciated 10% against the yen.
   B) the dollar has depreciated 24% against the yen.
   C) the yen has depreciated 12% against the dollar.
   D) the yen has depreciated 20% against the dollar.
35. Based on the information provided, 1 Canadian dollar is equal to _____ Mexican pesos and _____ Indian rupees.
   A) 12; 73.5
   B) 10; 37.5
   C) 12; 37.5
   D) 12; 45

36. A spot contract is:
   A) a promise to purchase a foreign currency in 30 days.
   B) a promise to purchase a foreign currency in 90 days.
   C) a contract for the immediate exchange of currencies.
   D) an agreement to sell currencies at a fixed price indefinitely.

37. What are the differences between a policy, a regime, and an institution?

38. Foreign exchange arbitrage refers to:
   A) the simultaneous purchase and sale of a foreign currency asset in different markets to take advantage of a price differential.
   B) actions taken to lower currency trading risks and make the markets safer.
   C) the forgiving of penalties and other punishments for illegal foreign exchange activities.
   D) government purchases or sales of a nation's own currency in international markets to change or stabilize the value of the currency.

39. Which of the following ratings is most favorable?
   A) BBB+
   B) BBB–
   C) CC
   D) D
Use the following to answer questions 40-41:

**Table: Currency Values III**

<table>
<thead>
<tr>
<th>Currency</th>
<th>2001</th>
<th>2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1</td>
<td>1 euro</td>
<td>.6 euro</td>
</tr>
<tr>
<td>$1</td>
<td>3 Brazilian reais</td>
<td>2 Brazilian reais</td>
</tr>
<tr>
<td>$1</td>
<td>.75 British pounds</td>
<td>.5 British pounds</td>
</tr>
<tr>
<td>$1</td>
<td>40 Indian rupees</td>
<td>30 Indian rupees</td>
</tr>
</tbody>
</table>

40. If there are no arbitrage possibilities, then the pound-real exchange rate in 2001 is:
   A) 600.
   B) 60.
   C) 0.25.
   D) 1.2.

41. If the United States imports trades in equal amounts with all four countries, then the effective exchange rate in 2001 is:
   A) –1.61%.
   B) –16.1%.
   C) –161%.
   D) –1611%.

42. Compared to earlier decades, the prevalence of exchange rate crises during the turn of the century (1997–2002) was:
   A) much less severe compared to the 1970s with its high inflation and high unemployment.
   B) much more severe in rapidly developing economies such as in South America and East Asia.
   C) very typical of modern economic history, indicating a need for international cooperation.
   D) much reduced as a result of the swift and effective response by the International Monetary Fund.
43. 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?
   A) an option
   B) a futures contract
   C) a forward contract
   D) a swap

44. Which of the following situations would not be compatible with the others?
   A) a deficit in the current account
   B) expenditure being greater than income (production) in a nation
   C) a rise in national wealth
   D) new borrowing from the rest of the world

45. In the 12-year period from 1997 to 2009, there were ____ instances of exchange rate crises worldwide.
   A) 3
   B) 10
   C) 16
   D) 24

46. 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?
   A) The dollar will depreciate 4% in 1 year.
   B) The pound will depreciate 9% in 1 year.
   C) The pound will depreciate 5% in 1 year.
   D) The dollar will appreciate 4% in 1 year.

47. Changes in a nation's exchange rates impact:
   A) asset prices (such as equities and bonds).
   B) relative prices of homes and foreign goods.
   C) prices of services (such as insurance or tourism).
   D) All of the above are affected.

48. 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:
   A) covered interest arbitrage.
   B) covered interest parity.
   C) uncovered interest parity.
   D) the forward-spot reversal.
49. External wealth can increase by all of the following except:
A) rises in the value of international assets (capital gains).
B) a decrease in the value of liabilities to international entities.
C) borrowing from international entities.
D) lending to international entities.

50. Suppose $1 = 120 yen in New York, $1 = 2 euros in London, and 1 euro = 75 yen in Tokyo. A speculator with $1 million would get a profit of _____ by engaging in a 3-point arbitrage.
A) $1.20
B) 150,000 yen
C) $250,000
D) $1.25 million

51. From 1992–2007, the volume of currency traded worldwide:
A) slumped due to the world recession.
B) increased approximately 290%.
C) fluctuated wildly due to investor expectations.
D) was concentrated in trades in the developing world.

52. One indicator of international financial openness in advanced countries is that:
A) defaults by borrowers have decreased significantly.
B) cross-border financial transactions in advanced nations have increased tenfold.
C) restrictions on mortgage lending or bank capital requirements have decreased.
D) governments no longer try to control interest rates.

53. What is country risk?
A) the risk that the nation will suffer unemployment and inflation as a result of its economic policies
B) a number of economic indicators reflecting the economic health of the nation that affect the ability of its residents to repay loans
C) the relative risk of political instability, terrorist attacks, and military capability
D) the total of the government's national debt plus private debt owed to international creditors
54. If the dollar-euro exchange rate on June 30, 2010, is $1.225 per euro, then the euro-dollar exchange rate would be:
   A) €2.45 per dollar.
   B) €0.816 per dollar.
   C) €1.225 per dollar.
   D) €1 per dollar.

55. In international finance, hedging indicates:
   A) not being able to make a commitment to buy or sell.
   B) delaying a purchase of foreign exchange hoping the price will fall.
   C) simultaneously buying several currencies to ensure that at least one will rise in value.
   D) 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.

56. Governments affect international financial relationships through their policy regimes. These might include:
   A) economic philosophies like liberalism and Marxism.
   B) laws or regulations affecting investment, reserves, or credit.
   C) larger sets of rules that define a general context to which specific laws or regulations conform.
   D) very broad legal, social, political, and commercial structures that influence economic behavior.

57. What is a currency band?
   A) a limit below which the currency is not allowed to fall
   B) a limit above which the currency is not allowed to rise
   C) a fixed rate regime with some small variation allowed, up or down
   D) a very rigid control of the currency—no variation allowed