Exchange Rates

Multiple Choice Questions

1) A firm that buys foreign exchange in order to take advantage of higher foreign interest rates is
   A)speculating.
   B)demonstrating purchasing power parity.
   C)engaging in interest rate arbitrage.
   D)responding to fluctuations in the business cycle.
   E)ignoring the nominal rate of exchange.

2) Suppose the euro is subject to a floating exchange rate system and that $E$ is the number of dollars per unit of
   foreign exchange. If $E$ increases, then the dollar
   A)depreciates.
   B)appreciates.
   C)is devalued.
   D)is revalued.
   E)Both A and C.

3) When an individual or firm in a particular country requests that a bank sell foreign exchange, the bank will
   probably
   A)call a foreign bank and arrange a purchase.
   B)call the central bank and arrange a purchase.
   C)call another bank customer with foreign exchange holdings.
   D)call another domestic bank and arrange a purchase.
   E)call a foreign exchange broker and arrange a purchase.

4) In order to protect against foreign exchange risk, firms can use
   A)the spot market for foreign exchange.
   B)interest rate arbitrage.
   C)purchasing power parity.
   D)the forward market for foreign exchange.
   E)the J-curve.

5) Covered interest arbitrage involves both
   A)the purchase of a foreign asset and a forward contract in the market for foreign exchange.
   B)the purchase of a domestic asset and a spot contract in the market for foreign exchange.
   C)the sale of a foreign asset and the purchase of a forward contract in the market for foreign exchange.
   D)the sale of domestic stocks and the purchase of foreign bonds.
   E)None of the above.
6) All else equal and under a system of floating exchange rates, if a country enters a period of exceptionally strong growth,
   A) the pressure on its currency is to revalue.
   B) the pressure on its currency is to devalue.
   C) the pressure on its currency is to depreciate.
   D) the pressure on its currency is to appreciate.
   E) Both A and D.

7) All else equal, if Euro Area raises its interest rates,
   A) the dollar depreciates.
   B) the U.S. demand for euros increases.
   C) the Euro Area supply of euros increases.
   D) Both A and B.
   E) Both A and C.

8) An Austrian firm that buys foreign exchange because its managers expect the euro to depreciate is
   A) increasing the supply of foreign exchange.
   B) increasing the demand for foreign exchange.
   C) speculating.
   D) Both A and B.
   E) Both B and C.

9) Suppose the exchange rates between the United States and Euro Area are in long-run equilibrium as defined by the idea of purchasing power parity. If the law of one price holds perfectly, then differences between U.S. and Euro Area rates of inflation would
   A) have no effect on nominal exchange rates.
   B) be completely offset by changes in the real exchange rate.
   C) be completely offset by changes in the nominal exchange rate.
   D) violate the conditions for the law of one price.
   E) lead to a change in the real purchasing power of each country's currency when it is converted to the other country's currency.

10) Under a gold standard, countries should
    A) keep the supply of their domestic money constant.
    B) keep the supply of their domestic money fixed in proportion to their gold holdings.
    C) keep the supply of foreign exchange less than their domestic money supply.
    D) restrict the demand for foreign goods.
    E) outlaw speculation.

11) Under a fixed exchange standard, if the domestic demand for foreign exchange increases
    A) the central monetary authority must meet the demand out of its reserves.
    B) the central monetary authority must increase the supply of domestic money.
    C) the fixed exchange standard will breakdown.
    D) inflation will increase.
    E) the domestic currency must be depreciated.
12) The Bretton Woods exchange rate system was an example of a
   A) target zone.
   B) managed float.
   C) pure gold standard.
   D) modified gold standard.
   E) floating exchange rate system

13) The biggest disadvantage of a fixed exchange rate is the
   A) increased probability of high inflation.
   B) tradeoff between supporting the exchange rate and adjusting the trade balance.
   C) tradeoff between supporting the exchange rate and maintaining full employment.
   D) increased probability of a trade deficit.
   E) tradeoff between supporting the exchange rate and maintaining a balanced budget.

14) The effect of a depreciation of the domestic currency on the trade balance is likely to
   A) increase it in the short and long runs.
   B) decrease it in the short run and increase it in the long run.
   C) decrease it in the short and long runs.
   D) increase it in the short run and decrease it in the long run.
   E) have little or no effect.

15) Which of the following institutions is the most important participant in foreign currency markets?
   A) A retail customer
   B) A commercial bank
   C) A foreign exchange broker
   D) A central bank
   E) None of the above.

16) An increase in the U.S. demand for the euro
   A) causes a rise in the dollar exchange rate.
   B) causes the euro to appreciate.
   C) causes the dollar to depreciate.
   D) causes Euro Area goods to be relatively more expensive.
   E) All of the above.

17) Which of the following would NOT be a cause for an increased American demand for the euros?
   A) The United States having lower interest rates than the Euro Area
   B) Increased American demand for Euro Area goods
   C) The expectation by speculators that the value of the euro is edging up
   D) More economic expansion in the United States
   E) None of the above.
18) Which of the following is NOT one of the determinants of the gains of adopting a single currency?
   A) A well-synchronized business cycle involving all member countries
   B) The possibility of factors of production to freely move across borders
   C) The willingness and ability of member countries to design policies to address regional imbalances that may develop
   D) Widening the common market by allowing other countries to join
   E) None of the above.

True/False Questions

19) A weak euro leads to a higher volume of Euro Area imports.

20) If Europeans increasingly lose confidence in their domestic financial markets and move their assets to other countries, the euro will depreciate.

21) Imports tend to fall whenever a nation’s currency appreciates because foreign products become more expensive to domestic consumers.

22) The spot rate is the rate at which foreign currencies will be exchanged a specified number of days in the future.

23) A currency market option obligates the owner to make a trade at a specified exchange rate a fixed number of days in the future.

24) A country that experiences higher real interest rates than other countries would expect its currency to depreciate.

25) If more European and Japanese firms want to build factories and expand their offshore investments in the United States, the supply of U.S. dollars on foreign exchange markets will increase as a result of this investment activity.

26) If Joko contracts to buy Euro Area office equipment in euros and her domestic currency depreciates against the euro between the time the contract is signed and the bill is paid, she will wind up paying less for the equipment because she stayed in the spot market.
27) If Euro Area consumers increase their demand for foreign products and foreign travel, the euro would tend to depreciate as more euros are supplied to foreign exchange markets.

28) If Euro Area productivity is higher than its trading partners, as time passes we would expect the euro to appreciate.

29) If the Japanese central bank sells yen and buys euros, the euro will appreciate.

30) When Jeneva went to Costa Rica in July 2003, a euro was worth 400 colones. Today a euro is worth 440 colones, meaning that the euro has depreciated against the colone.

31) If the Costa Rican colone is expected to depreciate in the future, it will temporarily appreciate as people move to take advantage based on this expectation.

32) Speculation would involve using forward contracts and options to reduce the exchange rate risk on future foreign exchange transactions

**Essay Type Questions**

33) Define and distinguish spot, forward and swap transactions. What is each likely to be used for.

34) Distinguish the forward rate from the future spot rate and from the expected future spot rate.

35) What is the expected relation between international interest differences and the forward premium or discount on the currency?

36) What is the difference between the terms of trade and the real exchange rate?

37) Distinguish between covered and uncovered interest arbitrage.

38) What is the interest rate parity condition?