

Assignment 3 – Answer Key
(Maximum Points: 100)

Multiple-Choice Questions

Each question is worth 3 points. Explanation is not required.

1. The most commonly traded currency in the foreign exchange market is the
 - (a) British pound.
 - (b) Japanese yen.
 - (c) Chinese yuan.
 - (d) U.S. dollar.**

2. The euro is now the official currency of all of the following countries except
 - (a) France.
 - (b) Slovenia.
 - (c) Great Britain.**
 - (d) Spain.

3. A balance of trade deficit occurs when a country
 - (a) exports more goods than it imports.
 - (b) buys more goods from the rest of the world than it sells.**
 - (c) buys more stocks and bonds from the rest of the world than it sells.
 - (d) both (b) and (c).

4. Which of the following transactions is a debit in the current account?
 - (a) export of merchandise
 - (b) export of services
 - (c) gift to foreigners**
 - (d) foreign bond purchase

5. _____ is necessary to "balance" the BOP statement.
 - (a) Reserve inflow
 - (b) Statistical discrepancy**
 - (c) Debit transaction
 - (d) Credit transaction

6. In the BOP, travel and tourism are included in the category of
 - (a) unilateral transfers.
 - (b) financial account.
 - (c) merchandise account.
 - (d) services account.**

7. Interest earned on foreign holdings of U.S. federal, state and local government debt are recorded in the
 - (a) services account.
 - (b) merchandise account.
 - (c) transfers account.**
 - (d) financial account.

8. A current account surplus implies that
(a) the country is a net lender with the rest of the world.
(b) the country is running a net capital account surplus.
(c) foreign investment in domestic securities is at very low levels.
(d) All of the above.
9. Security purchases in the United States by foreigners is
(a) a credit item in the current account.
(b) a debit item in the financial account.
(c) a credit item in the financial account.
(d) a debit item in the current account.
10. Merchandise exports minus imports equal the
(a) basic balance.
(b) liquidity balance.
(c) official settlements balance.
(d) balance of trade.
11. The payment of a dividend by an American company to a foreign stockholder represents
(a) a debit in the U.S. financial account.
(b) a credit in the U.S. current account.
(c) a credit in the U.S. official reserve account.
(d) a debit in the U.S. current account.
12. According to the National Income Accounting Identity, the current account (surplus) is equal to
(a) S-I
(b) $C+I+G+X$
(c) $I+X$
(d) $T-G$
13. If the bank is selling euros for \$0.89, then what is the implied euro price of the dollar?
(a) 2.0
(b) 1.999
(c) 2.323
(d) 1.123
14. Suppose in London $\text{£}/\text{\$} = 0.5$ while in New York $\text{£}/\text{SF} = 0.2$. The corresponding cross rate (SF/\$) is
(a) 2.5.
(b) 0.1.
(c) 0.4.
(d) 0.3.
15. Riskless transactions to take advantage of profit opportunities due to a price differential or a yield differential in excess of transaction costs are called
(a) differential actions.
(b) cash transactions.
(c) arbitrage.
(d) forward transactions.
16. The difference between bid (buying) rates and ask (selling) rates is called the
(a) profit.
(b) arbitrage.
(c) spread.
(d) forward transaction.

17. The size of the spread that a dealer will quote for a foreign exchange transaction will vary depending on
- the degree of market volatility at the time.
 - the degree of risk associated with a particular currency.
 - the size of the market for the currency being traded.
 - All of above.**
18. The euro is said to be selling at a _____ if the spot dollar price is \$1.18 and the nine-month forward rate is \$1.16
- forward discount**
 - forward premium
 - forward spread
 - none of the above
19. A _____ is a transaction in which both a spot transaction and a forward transaction are agreed upon simultaneously.
- arbitrage
 - call
 - swap**
 - put

The Balance of Payments

20. (10) **Chapter 12, Question 2, part c) and d):** Classify the following transactions in the **Mexican balance of payments.**

c) (5) A US tourist travels to Mazatlan, Mexico and spends Ps10,000 on hotels and tequila while on vacation. He pays with a check drawn on a Phoenix, Arizona bank.

(Remember: the Mexican balance of payments)

- **The tourist expenditures are a service export, a credit to the Mexican current account (in services sub-account)**
- **The check is an increase in Mexican-owned assets overseas → a debit in the Mexican financial account.**

d) (5) Senor de la Madrid in Mexico City receives Ps80,000 in interest from a deposit in a Houston, Texas bank. He deposits the Ps80,000 in Bank of America in San Francisco.

(Remember: the Mexican balance of payments)

- **The interest is a payment on investment income, a credit to the Mexican current account (in the income sub-account).**
- **The deposit in the US is an increase in Mexican-owned assets overseas → a debit in the Mexican financial account.**

21. (8) Use the information in the following table on Switzerland's 1998 international transactions to answer the questions below (amounts are millions of U.S. dollars):

<u>Balance of Payments Account</u>	<u>Amount</u>
Merchandise imports	\$92,871
Merchandise exports	\$93,859
Services imports	\$15,406
Services exports	\$26,683
Investment income receipts	\$43,720
Investment income payments	\$27,702
Unilateral transfers	-\$ 3,736

a) (4) What is the current account balance?

\$24,547 (surplus)

b) (4) Did Switzerland become a larger international net creditor during 1998?

Yes, a current account surplus means a financial account deficit so Switzerland was a net lender to the rest of the world during this period.

The Foreign-Exchange Market

22. (4) **Chapter 13, Question 8:** The U.S. dollar price of a Swedish krona changes from \$.1572 to \$.1730.

a) (2) Has the dollar depreciated or appreciated against the krona?

dollar has depreciated.

b) (2) Has the krona appreciated or depreciated against the dollar?

krona has appreciated.

23. (10) **Chapter 13, Question 3:** Suppose £1=\$2.411 in New York, \$1 = €1.050 in Paris, and £1 = €2.50 in London.

a) (6) If you begin by holding £1, how could you profit from these exchange rates? (Please report your answer with 3 decimal digits e.g. 0.001)

Take £1 to New York and exchange it for \$2.411; take those \$2.411 to Paris and exchange it at \$1 = €1.050 for €2.532; take these to London and exchange it for £ (2.532/2.50) = £1.013.

b) (4) Ignoring transaction costs, what is your arbitrage profit per pound initially traded?

You can gain £0.013 per pound initially traded.

24. (11) Show a graph of the exchange rate between the currency of your country of study against the U.S. dollar. If it is not available, you can show the exchange rate of any country of your choice against the U.S. dollar. Please follow the following instructions.

Instructions:

- Go to <http://www.x-rates.com/>
- On the right hand side, there is a list of currencies.
- Click on the name of the currency you want to report.
- Click on the value on the upper right hand corner of the table to see the graph of the exchange rate between the U.S. dollar against that currency for the last 120 days.
- Right hand click on the graph. Select Copy Image and then paste onto your assignment.

An example of the graph of the exchange rate between the [Turkish Lira](#) and the U.S. Dollar (TL/\$) is shown below.

