**Chapter 8: Currency of Payment (Managing Transaction Risks)**

TRUE/FALSE

1. If the exporter and the importer agree that a transaction will be in the currency of the exporter’s country, the exporter then bears all the risks of exchange rate fluctuation.

ANS: F DIF: Easy REF: page 278

1. The stated goal of the European Union is to eventually transform the euro to be a challenger to the U.S. dollar in its role as a preferred third-country currency.

ANS: T DIF: Easy REF: page 280

1. The type of exchange rate for a foreign currency for immediate delivery (roughly the price of a foreign currency to be delivered within 48 hours) is called the forward rate.

ANS: F DIF: Easy REF: page 284

1. Some currencies are traded in the futures’ market as “commodities.”

ANS: T DIF: Easy REF: page 286

1. As a theory of exchange rate determination, Purchasing Power Parity is the observation that exchange rates reflect the differences between nominal interest rates in different countries.

ANS: F DIF: Moderate REF: page 293

1. The International Fisher effect is the observation that exchange rates reflect the differences between nominal interest rates in different countries.

ANS: T DIF: Moderate REF: page 294

1. In the long run, technical forecasting of exchange rates is very accurate.

ANS: F DIF: Moderate REF: page 297

1. An options market hedge is, in effect, an insurance policy against unfavorable exchange rate fluctuations.

ANS: T DIF: Easy REF: page 303

1. A characteristic of options hedging is that options are commonly traded for many different currencies.

ANS: F DIF: Moderate REF: page 304

1. If it is agreed that an international exchange will be in the currency of the exporter’s country, then there is no exchange rate fluctuation risk for the importer.

ANS: F DIF: Moderate REF: page 278

1. Although there are many variables affecting the exchange rate of currencies, applications of fundamental forecasting using multiple regression and ANOVA readily overcome the problem of having all these variables.

ANS: F DIF: Moderate REF: page 298

1. Although the Bank for International Settlements originally limited its membership to European Central Banks, the United States Central Bank joined in 1974.

ANS: F DIF: Hard REF: page 305

1. The Ex-Im Bank provides loans to small exporters.

ANS: F DIF: Moderate REF: page 306

1. The principle of Interest Rate Parity is that the forward exchange rate should be expressed as a premium if the foreign country is experiencing higher nominal rates than the domestic country.

ANS: F DIF: Hard REF: page 295

1. Technical forecasting methods are essentially based upon time-series analysis.

ANS: T DIF: Moderate REF: page 297

1. In fundamental forecasting methods, the exchange rate of a specific currency is the dependent variable.

ANS: T DIF: Moderate REF: page 298

1. The Japanese government has been known to keep the value of the yen down in order to boost the Japanese economy through under-valued exports.

ANS: T DIF: Moderate REF: page 299

1. Documents transferred through SWIFT have the same value as original paper documents.

ANS: T DIF: Easy REF: page 306

1. The Ex-Im Bank is the curator of the SDR.

ANS: F DIF: Hard REF: page 305

1. Importers generally prefer quotes that are written in the currency of the exporter’s country.

ANS: F DIF: Moderate REF: page 306

1. For an exporter, there is a strategic advantage in quoting prices in the importer’s currency and reducing the currency fluctuation risk with a forward market hedge or a money market hedge.

ANS: T DIF: Moderate REF: page 306

MULTIPLE CHOICE

1. In valuing a currency, the direct quote is

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| --- | --- | --- | --- |
| a. | the traditional way of expressing the value of a currency like the Canadian dollar. | d. | the value of the domestic currency expressed in units of foreign currency. |
| b. | the value of the foreign currency expressed in units of the domestic currency. | e. | the value of the foreign currency in Special Drawing Rights. |
| c. | the traditional way of expressing the value of a currency like the Japanese yen. |

ANS: B

The direct quote is the value of the foreign currency expressed in units of the domestic currency, while the indirect quote is the value of the *domestic* currency and refers to the traditional way of expressing the value of a currency like the Canadian dollar and the Japanese yen.

DIF: Moderate REF: page 284

2. In the United States, the *Wall Street Journal* publishes the forward rates for some currencies for \_\_\_\_\_ different delivery dates in the future.

|  |  |  |  |
| --- | --- | --- | --- |
| a. | four | d. | twenty |
| b. | six | e. | fifteen |
| c. | twelve |

ANS: A

The *WSJ* publishes the forward rates for four currencies (the British pound, the Japanese yen, the Swiss franc, and the Canadian dollar) for 30, 90, 180 days and one year in the future.

DIF: Hard REF: page 285

3. Countries representing the greatest percentage of world trade all have \_\_\_\_\_ currencies.

|  |  |  |  |
| --- | --- | --- | --- |
| a. | pegged | d. | call |
| b. | volatile | e. | non-convertible |
| c. | floating |

ANS: C

Pegged currencies are used by countries with unstable, volatile currencies, whereas most developed countries have stable currencies for which it is reasonable to expect a predictable exchange rate.

DIF: Moderate REF: page 289

4. As a theory of exchange rate determination, the Fisher effect

|  |  |  |  |
| --- | --- | --- | --- |
| a. | holds that exchange rates are unpredictable and should not be relied upon. | d. | reflects the Big Mac Index. |
| b. | holds that exchange rates should reflect the price differences of each and every product between countries. | e. | holds that a country’s nominal interest rate is comprised of the inflation rate and the real interest rate of money, essentially identical for all countries. |
| c. | links the forward exchange rate of a foreign currency to its spot rate. |

ANS: E

The Fisher effect is the observation that a country's nominal interest rate (what a borrower actually has to pay for a loan) comprises both the inflation rate in that country and the real interest rate that borrowers are paying. Purchasing Power Parity holds that exchange rates should reflect the price differences of each and every product between countries and is reflected in the Big Mac Index. Interest Rate Parity is most closely links the forward exchange rate of a foreign currency to its spot rate.

DIF: Hard REF: page 294

5. Market-based forecasting of exchange rates

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| --- | --- | --- | --- |
| a. | is based on the premise that “the market knows best.” | d. | uses a combination of many sophisticated forecasting tools. |
| b. | attempts to capture the collective knowledge of sophisticated speculators in the future spot rate of a currency. | e. | all answers in this set of responses apply to market-based forecasting. |
| c. | does not take into account potential government interventions. |

ANS: E

All of these options are relevant to market-based forecasting.

DIF: Moderate REF: page 298

6. Companies that will successfully and regularly retain their risk of currency fluctuation are those that

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| --- | --- | --- | --- |
| a. | are very large traders, sophisticated in international finance. | d. | cannot afford major currency fluctuations. |
| b. | are exporters or importers that have large exposure. | e. | trade with countries where currencies fluctuate a lot. |
| c. | are ignorant of the risks. |

ANS: A

Large, sophisticated traders will not assume risks outlined in the answers regarding large exposure, being ignorant of the risks, or being unable to afford major currency fluctuations. Traders who are unfamiliar with the process often ignorantly expose themselves to unwarranted risks of currency fluctuation.

DIF: Moderate REF: page 300

7. A forward market hedge

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| --- | --- | --- | --- |
| a. | allows a bank to protect itself from currency fluctuations. | d. | allows an exporter to purchase currency without risk to pay a receivable. |
| b. | involves selling forward foreign currency yet to be received. | e. | allows a bank to reduce its foreign currency risk by selling currency forward to traders. |
| c. | involves selling forward the currency necessary to cover a foreign payable. |

ANS: B

A forward market hedge consists of selling forward the currency that will eventually be collected from a foreign receivable.

DIF: Moderate REF: page 300

8. In an options market hedge there is the option to sell or purchase certain currencies at a certain exchange rate either on or before a certain date. The agreed-upon exchange rate is called the

|  |  |  |  |
| --- | --- | --- | --- |
| a. | international leverage. | d. | transaction exposure. |
| b. | trade dimension. | e. | strike price |
| c. | leveraging currency. |

ANS: E

The correct answer is strike price.

DIF: Hard REF: page 303

9. SDRs of the International Monetary Fund can be used in international transactions:

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| --- | --- | --- | --- |
| a. | as an artificial currency. | d. | as equivalents to a U.S. dollar |
| b. | as letters of credit. | e. | for money-market hedging purposes |
| c. | instead of open accounts. |

ANS: A

Special Drawing Rights (SDRs) are an artificial currency whose value is determined by the value of a basket of five currencies: the euro, the Japanese yen, the Chinese yuan, the U.S. dollar, and the British pound.

DIF: Moderate REF: page 305

10. The following mathematical expression

Ft + 1(et)  = S(et + 1)

is of what theory of exchange rate determination?

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| --- | --- | --- | --- |
| a. | Interest Rate Parity | d. | Big Mac Index |
| b. | Fisher effect | e. | Forward Rate as a predictor of the spot rate. |
| c. | Purchasing Power Parity |

ANS: E

The correct answer is forward rate as unbiased predictor of spot rate.

DIF: Hard REF: page 296

11. The mathematical representation

(1 + real interest rate) x (1 + inflation rate) = 1 + nominal interest rate

is of what theory of exchange rate determination?

|  |  |  |  |
| --- | --- | --- | --- |
| a. | Fisher effect | d. | Purchasing Power Parity |
| b. | Interest Rate Parity | e. | Forward Rate as a predictor of the spot rate |
| c. | Big Mac index |

ANS: A

Interest Rate Parity and Purchasing Power Parity are alternate theories of exchange rate determination. Multiple regression is a statistical technique, not a theory of exchange rate determination. The Fisher effect determines that a country’s nominal interest rate comprises both the inflation rate in that country and the real interest rate that borrowers are paying.

DIF: Moderate REF: page 294

12. Historical exchange rate data can easily be obtained from

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| --- | --- | --- | --- |
| a. | the Friday *Wall Street Journal*. | d. | the January edition of *Forbes.* |
| b. | the Federal Reserve System. | e. | the weekly edition of the *Financial Times*. |
| c. | the Sunday *New York Times.* |

ANS: B

Historical exchange rate data can be obtained for any currency from the Federal Reserve System, Bank of Canada and the Pacific Exchange Rate Service at the University of British Columbia.

DIF: Moderate REF: page 297

13. International exchange rates began to float

|  |  |  |  |
| --- | --- | --- | --- |
| a. | in 1929. | d. | when the European Union was formed |
| b. | at the end of the gold standard. | e. | when the Federal Reserve was created |
| c. | When the International Monetary Fund was created. |

ANS: B

The gold standard ended in 1971 and exchange rates began to float. Prior to that time, the IMF oversaw the fixed exchange rate system.

DIF: Moderate REF: page 305

14. SWIFT stands for

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| --- | --- | --- | --- |
| a. | Swiss Worldwide International Funding Transactions. | d. | Southwestern International Fund Transferring. |
| b. | Standard Worldwide International Futures Telecom. | e. | Serving-the-World Institutional Financial Transactions. |
| c. | Society for Worldwide Interbank Financial Telecommunications. |

ANS: C

SWIFT is the Society for Worldwide Interbank Financial Telecommunications.

DIF: Moderate REF: page 306

15. The International Bank for Reconstruction

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| --- | --- | --- | --- |
| a. | is called the Bretton Woods Bank. | d. | is the formal name of the Ex-Im Bank |
| b. | was developed to manage Germany’s World War I reparations. | e. | fulfills internationally the same role as the Federal Reserve System plays domestically |
| c. | is also known as the World Bank. |

ANS: C

The International Bank for Reconstruction is known as the World Bank and was founded after the Bretton Woods Conference to help countries rebuild their infrastructures after WWII. The Bank for International Settlements was designed to manage Germany’s World War I reparations.

DIF: Moderate REF: page 306

16. In its absolute form, the exchange rate determination theory of Purchasing Power Parity

|  |  |  |  |
| --- | --- | --- | --- |
| a. | says that exchange rates should reflect the price differences of each and every product between countries. | d. | is rarely noticeable, even for identical products sold worldwide. |
| b. | says that the exchange rate should equalize price differences of similar products between countries. | e. | all answers in this response set are observations that are related to the PPP theory. |
| c. | is impossible to achieve. |

ANS: E

All options relate to Purchasing Power Parity.

DIF: Moderate REF: page 293

17. The risk resulting from possible fluctuations in currency exchange rates is called

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| --- | --- | --- | --- |
| a. | hedging. | d. | floating. |
| b. | transaction exposure. | e. | currency exposure |
| c. | the direct quote. |

ANS: B

Hedging is a *method* for reducing risk, and direct quote and floating are not not risks from possible currency exchange rate fluctuations. Transaction exposure is risk a company is exposed to in an international transaction when it agrees to use a foreign currency, due to possible fluctuations in the currency exchange rates.

DIF: Moderate REF: page 299

18. When a company is engaged in an international transaction and agrees to use a foreign currency to conduct the transaction

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| --- | --- | --- | --- |
| a. | it will use SDRs to mitigate its risks. | d. | it must use a letter of credit |
| b. | it is exposed to a certain amount of risk. | e. | it pays hefty fees to its bank for the privilege |
| c. | it will use the services of the Ex-Im Bank. |

ANS: B

A company is exposed to a certain amount of risk, due to possible fluctuations in the currency exchange rates, in an international transaction when it agrees to use a foreign currency.

DIF: Easy REF: page 299

19. Which of the following companies are exposed to the risk of currency fluctuations?

|  |  |  |  |
| --- | --- | --- | --- |
| a. | firms that do not evaluate international currency transaction risks clearly. | d. | firms that do not hedge their foreign receivables. |
| b. | firms that do not follow a specific policy on currency exchange. | e. | all answers in this response set illustrate companies exposed to the risk of currency fluctuations. |
| c. | firms that have management that is not well-versed in the intricacies of international trade. |

ANS: E

All of these options are applicable.

DIF: Easy REF: page 300

20. One strategy a company can follow to protect itself from currency fluctuations is use of

|  |  |  |  |
| --- | --- | --- | --- |
| a. | a letter of credit. | d. | stock market hedges. |
| b. | risk retention. | e. | bond market hedges. |
| c. | forward market hedges. |

ANS: C

A letter of credit is not relevant, and risk retention is the opposite of protecting oneself from currency fluctuations. Forward market hedges can protect a company from currency fluctuations by selling forward a future receivable in a foreign currency, or purchasing forward the currency necessary to cover a foreign payable. Neither stock market hedges nor bond market hedges exist.

DIF: Moderate REF: page 300

COMPLETION

1. The euro was first created as an artificial \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_.

ANS: currency

DIF: Easy REF: page 280

2. As the *Wall Street Journal* quotes it, the exchange rate is the \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ between the bid and ask rates for exchanges of a value greater than $1,000,000 between banks.

ANS: mid-point

DIF: Moderate REF: page 284

3. The European Monetary System (EMS), which gave rise to the euro, was designed so that the currencies of member countries would have to stay within a few points of each other’s value. This is an example of a floating \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_.

ANS: currency bloc

DIF: Moderate REF: page 291

4. Under the Interest Rate Parity theory of exchange rate determination, the forward exchange rate should be expressed as a \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ if the foreign country is experiencing higher nominal interest rates than the domestic country.

ANS: discount

DIF: Hard REF: page 295

5. The risk a company faces in a transaction that may have fluctuations in foreign currency exchange rates is called transaction \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_.

ANS: exposure

DIF: Easy REF: page 299

6. A money market hedge consists of using the \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ system of the country of the currency in which the receivable or the payable is going to be paid.

ANS: banking

DIF: Easy REF: page 301

7. In the United States, the Federal Reserve System technically fulfills the role of being a \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_.

ANS: central bank

DIF: Hard REF: page 304

8. SDR, an artificial currency, is designed to \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ the U.S. dollar in its role as the international currency.

ANS: supplement

DIF: Moderate REF: page 305

9. One of the functions of a nation’s central bank is that of a check \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_.

ANS: clearinghouse

DIF: Moderate REF: page 305

10. A problem with market-based forecasting is that the “wisdom” of the market may be skewed by \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ who may include people motivated by entirely different motives than the actual purchase and delivery of a currency.

ANS: speculators

DIF: Moderate REF: page 298

1. An exporter writing a quote for a customer located in a developed country can expect that several of his competitors will quote in the \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ currency.

ANS: importer’s

DIF: Moderate REF: page 306

1. If an exporter chooses to quote in his country’s currency, or quotes in the importer’s country currency and hedges with a money market hedge, it is to minimize his \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ risks.

ANS: currency fluctuation, currency

DIF: Moderate REF: page 307