ECON-372 MIDTERM EXAMINATION

Instructions: ALL QUESTIONS ARE EQUALLY WEIGHTED. Choose the one best answer. The exam is closed books, closed notes. All variables are as defined in class. GOOD LUCK!!

MULTIPLE CHOICE Answer all 48 questions.

1. Which of the following is an example of a "flow" variable?
   (a) the spot rate
   (b) the forward rate
   (c) interest rate
   (d) a. and b.
   (e) all of the above
2. Which of the following is an example of a "stock" variable?
   (a) the spot rate
   (b) the forward rate
   (c) interest rate
   (d) a. and b.
   (e) all of the above
3. Speculative activity is likely to occur in the foreign exchange market
   (a) whenever covered interest parity holds.
   (b) whenever uncovered interest parity holds.
   (c) when synthetic cross rates equal direct rates.
   (d) when the current spot rate differs from the forward rate.
   (e) when the expected future spot rate differs from the forward rate.
4. Suppose you buy USD 1000 worth of sterling (GBP) in New York, and sell it in London for Euros (EUR), and sell these EUR for USD 1250 in Frankfurt. This implies,
   (a) Profitability of triangular currency arbitrage.
   (b) An inconsistency in the bilateral exchange rates connecting the three currencies.
   (c) Bilateral exchange rates differ in the three financial centers
   (d) a and b
   (e) all of the above
5. Which of the following predictions of economists were realized with the advent of the general float?
   (a) new financial instruments emerged to facilitate the hedging of foreign exchange risk
   (b) monetary authorities held fewer reserves.
   (c) large trade imbalances proved to be rare occurences.
   (d) real exchange rates proved to be very stable in the long run.
   (e) none of the above

6. One U.S. dollar currently buys very roughly about how many Euros?
   (a) .01
   (b) .1
   (c) 1
   (d) 10
   (e) 100
7. One U.S. dollar currently buys very roughly about how many Japanese yen?
   (a) .01
   (b) .12
   (c) 1.2
   (d) 12
   (e) 120
8. One U.S. dollar currently buys about how many British pounds?
   (a) .06
   (b) .6
   (c) 6
   (d) 60
   (e) 600
9. One U.S. dollar currently buys about how many Canadian dollars?
   (a) .016
   (b) .16
   (c) 1.6
   (d) 16
   (e) 160
10. During the Reagan administration,
    (a) taxes were cut.
    (b) government spending was increased.
    (c) huge government budget deficits were run.
    (d) huge current account deficits were run.
    (e) all of the above.
11. During the Clinton administration,
    (a) inflation skyrocketed.
    (b) the federal budget deficit increased dramatically.
    (c) huge current account deficits were run.
    (d) all of the above.
    (e) none of the above.

12. Which of the following describe Canada in the 1990s?
    (a) the Canadian dollar has appreciated markedly against the U.S. dollar
    (b) the Canadian dollar has depreciated markedly against the U.S. dollar
    (c) the Canadian dollar has undergone a marked real appreciation
    (d) the Canadian dollar has undergone a marked real depreciation
    (e) b. and d.

13. Covered interest rate parity
    (a) is implied by the absence of arbitrage opportunities.
    (b) equates the interest rate differential to the forward rate.
    (c) equates the interest rate differential to expected exchange rate depreciation.
    (d) a. and b.
    (e) all of the above

14. Assuming covered interest parity, if the UK interest rate is higher than the Canadian interest rate on similar assets, then we also see
    (a) a forward discount on Canadian dollars
    (b) a forward premium on Canadian dollars
    (c) lower institutional investors' rating for the UK
    (d) lower demand for investment in Canada
    (e) the number of wealth-holders is smaller in Canada

15. If 2 Australian dollars (AUD) and 80 Algerian Dinars (DZD) are equivalent to x dollars, the cost of AUD in terms of DZD is
    (a) 0.025
    (b) $40x$
    (c) 40
    (d) 82
    (e) not possible to determine from given information.

16. Which of the following are important determinants of the exchange rate under the monetary approach?
    (a) Relative prices.
    (b) Relative money supplies.
    (c) Relative money demands.
    (d) a. and b.
    (e) All of the above.

17. Which of the following characterize the monetary approach to flexible exchange rates?
    (a) Purchasing power parity holds continuously.
    (b) Real income is exogenous.
    (c) Real money demand is determined by real income and the interest rate.
    (d) Money market equilibrium holds continuously.
    (e) All of the above.

18. Arbitrage is the activity of
    (a) buying an item in order to immediately resell it at a profit.
    (b) buying an item in order to immediately resell it at a loss.
    (c) buying an item in order to add it to inventory.
    (d) hedging on open position.
    (e) speculating on future price movements.

19. The three-month interest rate on EUR deposits is 3.1%/year. The three-month interest rate on dollar deposits is 1.5%/year. Suppose the present spot exchange rate is USD/EUR = 0.9. The three-month USD/EUR forward rate must be about
    (a) 0.886
    (b) 0.896
    (c) 0.900
    (d) 0.904
    (e) 0.914

20. The USD/EUR exchange rate has risen. This implies that the
    (a) value of the dollar has fallen in terms of euro.
    (b) value of the euro has risen in terms of dollars.
    (c) value of the dollar has risen in terms of euro.
    (d) value of the euro has fallen in terms of dollars.
    (e) a and b.

21. More than USD 1.5T in foreign exchange transactions take place
    (a) on a daily basis.
    (b) on a weekly basis.
    (c) on a monthly basis.
    (d) on a semi-annual basis.
    (e) on an annual basis.

22. Triangular arbitrage is only profitable when
    (a) spatial arbitrage is also involved.
    (b) spatial arbitrage is not involved.
    (c) a synthetic cross rate yields the same value as the direct exchange rate.
    (d) a synthetic cross rate does not yield the same value as the direct exchange rate.
    (e) none of the above.

23. The effect of transaction costs in foreign exchange markets are reflected in which of the following.
    (a) There is a difference between the price at which one can sell foreign exchange and the price at which one can buy it.
    (b) A tourist pays a larger spread when making a cash transaction at a bank rather than when using a credit card.
    (c) use of a synthetic cross rate involving multiple transactions in an extensively traded currency, instead of a direct exchange rate.
    (d) a. and b.
    (e) all of the above.

24. A forward exchange rate is
   (a) the actual spot rate at a predetermined future date.
   (b) the exchange rate which speculators expect to prevail at a future date.
   (c) the rate at which one contracts today for foreign exchange in the future.
   (d) b and c
   (e) all of the above

25. If the current forward exchange rate F is more than current spot rate S, foreign currency is
   (a) *more* expensive on the forward market than on the spot market.
   (b) as expensive on the forward market as on the spot market.
   (c) *less* expensive on the forward market than on the spot market.
   (d) trading at a forward discount.
   (e) c. and d.

26. If the current spot rate is 1.60 USD/GBP and the one year forward rate is is 2.0 USD/GBP, then the one-year forward discount on dollars is about
   (a) -0.25
   (b) 0.025
   (c) 0.25
   (d) 0.40
   (e) 0.80

27. Mathematical relationships known as "arbitrage conditions" hold almost exactly in foreign exchange markets because
   (a) markets are competitive
   (b) transaction costs are low
   (c) assets are homogenous
   (d) all of the above
   (e) none of the above

28. The monetary approach to flexible exchange rates
   (a) relies on the classical model to explain determination of prices.
   (b) treats the real exchange rate as endogenous.
   (c) assumes that the money market does *not* clear in the short run.
   (d) a and b.
   (e) b and c.

29. Consider the money market equation $H/P = L(i, Y)$. According to the Classical model, when the interest rate goes up,
   (a) Output increases to restore money market equilibrium.
   (b) P falls to restore money market equilibrium.
   (c) H falls to restore money market equilibrium.
   (d) Money demand goes up because people want to take advantage of the higher rate of return.
   (e) Money demand goes down because the opportunity cost of holding real balances increases.

30. Consider the crude monetary approach to exchange rate determination. When the domestic money supply increases,
   (a) the interest rate decreases.
   (b) the foreign money supply rises.
   (c) the domestic currency depreciates
   (d) the domestic currency appreciates
   (e) none of the above
31. Consider the crude monetary approach to exchange rate determination. When *foreign* money demand decreases,
   (a) the domestic currency depreciates
   (b) the domestic currency appreciates
   (c) the foreign nominal money supply rises.
   (d) the domestic interest rate decreases.
   (e) none of the above
32. Consider the crude monetary approach to exchange rate determination. A rise in the domestic interest rate causes
   (a) domestic money demand to fall.
   (b) foreign money demand to fall.
   (c) foreign output to rise.
   (d) domestic output to fall.
   (e) a and c
33. The monetary approach to the determination of flexible exchange rates
   (a) explains the determination of real interest rates.
   (b) explains the determination of real income.
   (c) shows how money influences real outcomes.
   (d) is an application of the simple classical model.
   (e) all of the above
34. Which of the following characterize the crude monetary approach to flexible exchange rates?
   (a) The real exchange rate is constant.
   (b) Real income is exogenous.
   (c) Real money demand is determined by real income and the interest rate.
   (d) Money market equilibrium holds continuously.
   (e) All of the above.
35. Jacob Frenkel's application of the monetary approach to the German hyperinflation
   (a) completely rejected the monetary approach.
   (b) failed to interest the profession despite its startling results.
   (c) showed how a strikingly simple theory may completely mislead the applied economist.
   (d) showed how a strikingly simple theory may have high explanatory power.
   (e) none of the above

36. Jacob Frenkel's application of the monetary approach to the German hyperinflation showed how the spot rate

    (a) was completely unrelated to the money supply.
    (b) was extremely sensitive to the money supply; that is, the money supply elasticity of the spot rate was very large.
    (c) was roughly unit elastic with respect to the money supply.
    (d) was inversely related to the money supply.
    (e) none of the above

37. Which of the following characterize the post-WWI (1921–1923) German economy?

    (a) low inflation but rapid depreciation of the Mark
    (b) high inflation but slow depreciation of the Mark
    (c) low inflation and slow depreciation of the Mark
    (d) high inflation and rapid depreciation of the Mark
    (e) none of the above

38. The effects of transaction costs in foreign exchange markets are reflected in which of the following?

    (a) There is a difference between the price at which one can sell foreign exchange and the price at which one can buy it.
    (b) A tourist pays a larger spread when making a cash transaction at a bank rather than when using a credit card.
    (c) A synthetic cross rate involving multiple transactions in an extensively traded currency is used, instead of a direct exchange rate.
    (d) a. and b.
    (e) all of the above.

39. The broker who intermediates a foreign exchange transaction between two commercial banks receives a fee which is equal to

    (a) the difference between the expected rate and the previously quoted rate.
    (b) a fixed percentage of each transaction.
    (c) the difference between the ask rate and the bid rate in the wholesale market.
    (d) the difference between the ask rate and bid rate quoted by a particular bank.
    (e) the exchange rate.

40. In our small open economy models with fixed exchange rates, a country

    (a) is open to the extent that it trades with other countries.
    (b) cannot influence foreign income.
    (c) cannot influence foreign prices.
    (d) can affect relative price of its export good to its import good by changing the exchange rate or its domestic price level.
    (e) All of the above.

41. Hedging in the forward market
   (a) reduces exchange rate risk.
   (b) involves entering into a contract with a bank under which the parties agree to sell foreign currency for their own currency, with the exchange to take place at a future date, but at a price decided at the time of the contract.
   (c) has meant that the high degree of volatility exhibited by exchange rates since 1973 has not been very costly.
   (d) a and b
   (e) All of the above.

42. If

$$1 + i_{us} < \frac{F}{S}(1 + i_{uk})$$

   (a) A U.S. investor will wish to buy U.K. assets and cover her position.
   (b) A U.K. investor will wish to borrow pounds in order to buy dollar assets.
   (c) A U.K. investor will wish to buy U.S. assets and cover his position.
   (d) A U.S. investor will wish to borrow dollars in order to buy pound assets.
   (e) a. and d.

43. If spatial arbitrage is complete and triangular arbitrage is complete, the market for spot foreign exchange may still offer risk free profits from the simultaneous purchase and sale of
   (a) 2 or more different currencies.
   (b) 3 or more different currencies.
   (c) 4 or more different currencies.
   (d) 5 or more different currencies.
   (e) none of the above

44. If arbitrage is complete, there is no risk premium, and the annualized forward discount is 5% then
   (a) the annualized interest differential is 5% .
   (b) the annualized expected depreciation is 5% .
   (c) the annualized expected appreciation is 5% .
   (d) a. and b.
   (e) a. and c.

45. Which of the following regimes is most susceptible to speculative attack?
   (a) absolutely fixed exchange rate.
   (b) fixed but adjustable exchange rate.
   (c) floating exchange rate.
   (d) a. and b.
   (e) all of the above are equally susceptible.

46. Which of the following periods are characterized by controls upon the flow of capital between developed nations?
    (a) WWI.
    (b) Great Depression.
    (c) WWII.
    (d) a. and c.
    (e) all of the above.

47. Which of the following are true of the excess return on the domestic currency? It is the difference between
    (a) the real rate of return on domestic and foreign currency denominated assets.
    (b) the nominal rate of return on domestic and foreign currency denominated assets.
    (c) the nominal interest differential and the rate of depreciation of the domestic currency.
    (d) a. and b.
    (e) all of the above.

48. Which of the following economists are authors of your article on the German hyperinflation?
    (a) Jeffrey Frankel
    (b) Jacob Frenkel
    (c) Harry Johnson
    (d) Rudiger Dornbusch
    (e) all of the above.

END OF EXAM