**International Financial Markets**

**Homework 2**

**Tutorial**

**Forward Currency Market and Interest Rates**

Following are 20 questions, each worth five points. Indicate the answers you think most correct.

**The Forward Currency Market and International Financial Arbitrage**

1) Foreign exchange is best defined as the risk that

A) the value of an obligation will change because of a change in foreign exchange risk.

B) the value of an asset will become trapped by an inability to exchange foreign currencies.

C) a foreign government may be overthrown freezing any assets held in that country.

D) a foreign currency market might collapse.

2) The process of offsetting risk that a multinational firm faces is known as

A) domesticating

B) uncovering.

C) hedging.

D) exposure.

3) One method of hedging that eliminates foreign exchange risk is by ensuring the future delivery of a foreign currency is called

A) a spot contract

B). a forward contract.

C) an option.

D) standing order.

4) If the dollars-per-euro spot rate is 0.7750 and the 3 month forward rate is 0.7800, what is the amount of the standard forward discount or premium?

A) 7.69%

B) 2.56%

C) 2.58%

D) 7.74%

5) If the supply of loanable funds increases, what is the result for the equilibrium of the loanable funds market?

A) ) A shortage of loanable funds would push interest rates up and decrease the equilibrium quantity of loanable funds.

B) A surplus of loanable funds would push interest rates up and decrease the equilibrium quantity of loanable funds.

C) A shortage of loanable funds would push interest rates down and increase the equilibrium quantity of loanable funds.

D) A surplus of loanable funds would push interest rates down and increase the equilibrium quantity of loanable funds.

6) What would the foreign interest rate need to be to achieve interest rate parity if the domestic interest rate is 5%, the forward rate is 1.48 and the spot rate is 1.5?

A) 6%

B) 8%

C) 7%

D) 2%

7) Suppose an individual firm is comparing two investments, a one year bond from a U.S. firm paying 4% or a one year bond from a German firm which is paying 6%. The current dollars-per-euro rate is 0.75, and the expected rate in one year is 0.72. If the expected rate is correct, which investment will receive the higher return?

A) The U.S. Bond

B) The German Bond

C) They will have the same return.

D) This cannot be determined from the information given.

8) If covered interest parity holds then

A) international interest rates should be equal

B) the difference between two countries' interest rates should roughly equal the forward discount or premium between their currencies.

C) firm should be able to identify opportunities for arbitrage in investments.

D) forward rates should equal spot rates.

9) Suppose an individual firm is comparing two investments, a one year bond from a U.S. firm paying 4% or a one year bond from a German firm which is paying 6%. The current dollars-per-euro rate is 0.75, and the expected rate in one year is 0.78. If the expected rate is correct, which investment will yields a covered interest arbitrage opportunity?

A) The U.S. Bond

B) The German Bond

C) They will have the same return

D) This cannot be determined from the information given.

10) The difference between the covered and uncovered interest parity conditions is

A) whether or not the investment return rates are guaranteed.

B) how far out the expected spot rates are given.

C) whether or not the foreign interest rate is known.

D) whether or not the future exchange value is secured with a hedge.

11) Which of the following is a carry trade strategy?

A) Borrow currency with a low interest rate, convert it into a currency with a higher interest rate and lend it out.

B) Buy currencies that have a forward discount and sell currencies at a forward premium.

C) Sell currencies that have a forward discount and buy currencies at a forward premium.

D) both A and B

**Interest Yields, Interest Rate Risk and Derivative Securities**

1) Which of the following is a correct description of Libor?

A) an average interest rate from sixteen large banks are paying to borrow funds from other large banks.

B) an interest rate calculated by the British Banker's Association every day at 11 a.m. London time

C) an interest rate tied to corporate and mortgage loan contracts valuing roughly $400 trillion

D) all of the above

2) The risk of variations in the market value of a financial instrument due to changes in interest rates is minimized when the instrument is a

A). zero-coupon bond.

B) fixed term to mature bond.

C) perpetuity

D) Libor-based financial instrument.

3) Which of the following theories does not help to explain the why the yield curve follows its traditional shape?

A) the Segmented Markets theory

B) the Rational Expectations theory

C) the Preferred Habitat theory

D) All of these help to explain the yield curve's shape.

4) Which of the theories explaining the yield curve can explain the slope of the yield curve but cannot explain why it is traditionally upward sloping?

A) the Segmented Markets theory

B) the Expectations theory

C) the Preferred Habitat theory

D) Uncovered Interest Rate parity

5) Which of the following theories includes both the concept of imperfect substitutability of financial instruments of varying terms as well as allowing for a preference for shorter-term instruments?

A) the Segmented Markets theory

B) the Expectations theory

C) the Preferred Habitat theory

D) Uncovered Interest Rate parity

6) Real interest rate parity implies that

A) real rates of return will be equal when expected inflation rates converge.

B) real rates of return on similar financial instruments in two different nations should be equal.

C) uncovered interest rate parity will never hold.

D) absolute purchasing power parity holds.

7) A derivative security is

A) an instrument whose value is derived from the returns on another financial instrument or market.

B) a security based on currency markets.

C) a security with very little risk.

D) a financial tool which eliminates risk.

8) When do derivatives increase overall risk?

A) when investors use them to gamble against market trends

B) when firm try to use them to create a perfect hedge

C) when banks use them to cover possible foreign exchange exposure

D) Derivatives always increase overall risk.

9) An agreement to deliver a standardized amount of a commodity at a specified date is called

A) a forward contract.

B) a futures contract.

C) an option.

D) a swap.