**International Money System**

1) A company can improve its profits by selling in a country with a strong currency and sourcing from a country with a weak currency.

Answer: TRUE

2) Translating subsidiary earnings from a strong host currency into a weak home currency increases stated earnings in the home currency.

Answer: TRUE

3) The intentional lowering of the value of a currency by a nation's government is called revaluation.

Answer: FALSE

4) Devaluation lowers the price of a country's exports in the global market and increases the price of its imports.

Answer: TRUE

5) Currency devaluation increases consumers' buying power.

Answer: FALSE

6) In order to capture the gains from currency translation, managers prefer exchange rates that are volatile and unpredictable.

Answer: FALSE

7) As the unpredictability of exchange rates increases, so does the cost of insuring against the accompanying risk.

Answer: TRUE

8) Predictable exchange rates increase the need for currency hedging.

Answer: FALSE

9) If the law of one price is applied and upheld, an arbitrage opportunity arises.

Answer: FALSE

10) It is the nature of arbitrage to even out excessive fluctuation by destroying its own profitability.

Answer: TRUE

11) Purchasing power parity does not hold for single products, it is meaningful only when applied to a basket of goods.

Answer: TRUE

12) Inflation is a result of the supply and demand for a currency.

Answer: TRUE

13) Low unemployment rates can lead to higher inflation.

Answer: TRUE

14) Inflation in an economy can be controlled by lowering the interest rates.

Answer: FALSE

15) According to Fisher effect, real interest rate is the sum of the nominal interest rate and the expected rate of inflation over a specific period.

Answer: FALSE

16) Investor confidence in the value of a currency plays an important role in determining its exchange rate.

Answer: TRUE

17) A market is efficient if the prices of financial instruments quickly reflect new public information made available to traders.

Answer: TRUE

18) According to the efficient market view for forecasting exchange rates, forward exchange rates are perfect predictors of future exchange rates.

Answer: TRUE

19) Fundamental analyses used for forecasting exchange rates estimate the timing, magnitude, and direction of future exchange rate changes.

Answer: FALSE

20) Technical analysis employs charts of past trends in currency prices and other factors to forecast exchange rates.

Answer: TRUE

21) The value of a currency expressed in dollars is called its par value.

Answer: FALSE

22) The primary disadvantage of the gold standard was that it increased exchange-rate risk.

Answer: FALSE

23) The Bretton Woods Agreement was an accord among nations to create a new international monetary system based on the value of the U.S. dollar.

Answer: TRUE

24) To provide funding for countries' efforts toward economic development, the Bretton Woods Agreement created the International Bank for Reconstruction and Development.

Answer: TRUE

25) The IMF asset whose value is based on a "weighted basket" of four currencies is called a special drawing right.

Answer: TRUE

26) Today's international monetary system remains in large part a managed float system.

Answer: TRUE

27) A government with a currency board is legally bound to hold an amount of foreign currency that is at least equal to the amount of domestic currency.

Answer: TRUE

28) The European monetary system is still in practice today.

Answer: FALSE

29) When a country's currency is weak, the price of its \_\_\_\_\_\_\_\_.

A) exports and imports on world markets declines

B) exports and imports on world markets increases

C) exports on world markets declines and the price of its imports increases

D) exports on world markets increases and the price of its imports declines

Answer: C

30) A company selling in a country with a strong currency while sourcing from a country with a weak currency \_\_\_\_\_\_\_\_.

A) practices unethical conduct

B) experiences a trade deficit

C) ends up bankrupt

D) improves its profits

Answer: D

31) Which of the following is the intentional lowering of a currency's value by its government?

A) revaluation

B) devaluation

C) currency hedging

D) currency arbitrage

Answer: B

32) Devaluation of a nation's currency \_\_\_\_\_\_\_\_.

A) gives foreign companies in the country an edge over domestic companies

B) leads to a decline in the supply of goods and services

C) increases the price of a country's imports

D) increases consumers' buying power

Answer: C

33) The intentional raising of the value of a currency by a nation's government is called \_\_\_\_\_\_\_\_.

A) revaluation

B) securitization

C) fundamental disequilibrium

D) currency hedging

Answer: A

34) Which of the following lowers the price of a country's exports on world markets and increases the price of its imports?

A) revaluation

B) devaluation

C) currency hedging

D) currency arbitrage

Answer: B

35) Predictable exchange rates reduce the need for \_\_\_\_\_\_\_\_.

A) currency conversion

B) currency swap

C) currency depreciation

D) currency hedging

Answer: D

36) Which of the following stipulates that an identical product must have an identical price in all countries when the price is expressed in a common currency?

A) purchasing power parity

B) the law of one price

C) the comparative advantage theory

D) the efficient market view

Answer: B

37) If a kilogram of coal costs €1.5 in Germany and $1 in the United States, the law of one price calculates the expected exchange rate between the euro and the dollar to be \_\_\_\_\_\_\_\_.

A) €0.67/$

B) €1.5/$

C) $1.67/€

D) $0.12/€

Answer: B

38) When the law of one price is violated, a(n) \_\_\_\_\_\_\_\_ opportunity arises.

A) dumping

B) countertrade

C) arbitrage

D) devaluation

Answer: C

39) A(n) \_\_\_\_\_\_\_\_ opportunity helps in buying a product in one country and selling it in another country where it has a higher value.

A) barter

B) buyback

C) countertrade

D) arbitrage

Answer: D

40) Which of the following talks about the relative ability of two countries' currencies to buy the same "basket" of goods in those two countries?

A) the Fisher effect

B) the law of one price

C) purchasing power parity

D) cross rates

Answer: C

41) Which of the following is true of inflation?

A) It occurs when money is injected into an economy that is experiencing greater output.

B) It is the result of supply and demand for a currency.

C) It increases people's purchasing power.

D) It is not particularly affected by the unemployment in a country.

Answer: B

42) A government buys its own securities on the open market when the \_\_\_\_\_\_\_\_.

A) inflation rate in the country is high

B) inflation rate in the country is low

C) interest rates in the country are high

D) interest rates in the country are low

Answer: A

43) \_\_\_\_\_\_\_\_ is an activity under the monetary policy of a nation.

A) Increasing taxes

B) Lowering taxes

C) Increasing government spending

D) Selling government securities

Answer: D

44) The French government buying its own securities on the open market is part of the \_\_\_\_\_\_\_\_ of France.

A) fiscal policy

B) monetary policy

C) industrial policy

D) investment policy

Answer: B

45) The lowering of taxes in the U.S. by its government is an example of the \_\_\_\_\_\_\_\_.

A) fiscal policy

B) monetary policy

C) social policy

D) foreign affairs policy

Answer: A

46) To cool off an inflationary economy, a government might \_\_\_\_\_\_\_\_.

A) lower interest rates

B) raise interest rates

C) lower foreign exchange rates

D) raise foreign exchange rates

Answer: B

47) The exchange rate at the beginning of a year between the Indian Rupee (R) and the U.S. dollar is R43.125/$. The annual inflation rates in India and in the United States are 19 percent and 3 percent respectively. What would be the new exchange rate at the end of the year?

A) R49.8224/$

B) R37.327/$

C) R0.0267/$

D) $37.327/R

Answer: A

48) The principle that nominal interest rate is the sum of the real interest rate and the expected rate of inflation over a specific period of time is called \_\_\_\_\_\_\_\_.

A) the law of one price

B) purchasing power parity

C) the comparative advantage theory

D) the Fisher effect

Answer: D

49) Which of the following represents the Fisher effect?

A) Cross Rate = Real Interest Rate + Nominal Interest Rate

B) Real Interest Rate = Nominal Interest Rate + Spot Rate

C) Nominal Interest Rate = Real Interest Rate + Inflation Rate

D) Real Interest Rate = Nominal Interest Rate + Unemployment Rate

Answer: C

50) If money were free from all controls when transferred internationally, the real rate of interest would \_\_\_\_\_\_\_\_.

A) be the same in all countries

B) be the same as the inflation rate

C) create arbitrage opportunities across countries

D) create arbitrage opportunities in developed countries

Answer: A

51) The principle that a difference in nominal interest rates supported by two countries' currencies will cause an equal but opposite change in their spot exchange rates is called the \_\_\_\_\_\_\_\_.

A) Guidotti-Greenspan rule

B) international Fisher effect

C) comparative advantage theory

D) efficient market view principle

Answer: B

52) Purchasing power parity is better at predicting \_\_\_\_\_\_\_\_ exchange rates.

A) cross

B) spot

C) short-term

D) long-term

Answer: D

53) Which of the following is a reason for the failure of PPP to predict exchange rates accurately?

A) PPP takes transportation costs into consideration while predicting exchange rates.

B) PPP assumes no barriers to international trade while predicting exchange rates.

C) PPP considers the role of people's confidence and beliefs about a nation's economy in exchange rate predictions.

D) PPP does not take into account the effect of the market forces of demand and supply.

Answer: B

54) According to the efficient market view, future exchange rates are most accurately forecasted by \_\_\_\_\_\_\_\_.

A) forward exchange rates

B) cross rate

C) interbank interest rates

D) buy rate

Answer: A

55) The efficient market view holds that \_\_\_\_\_\_\_\_.

A) companies can search for new pieces of information to improve forecasting

B) forward exchange rates provide the least accurate forecasts of future exchange rates

C) companies must spend time and money collecting and examining information believed to affect future exchange rates

D) prices of financial instruments reflect all publicly available information at any given time

Answer: D

56) The inefficient market view holds that prices of financial instruments \_\_\_\_\_\_\_\_.

A) are dependent on political efficiency

B) are not dependent on political efficiency

C) do not reflect all publicly available information

D) reflect all publicly available information at any given time

Answer: C

57) Which of the following forecasting techniques employs statistical models based on key economic indicators to forecast exchange rates?

A) financial analysis

B) fundamental analysis

C) probability bounds analysis

D) technical analysis

Answer: B

58) Which of the following forecasting techniques employs charts of past trends in currency prices and other factors to forecast exchange rates?

A) financial analysis

B) fundamental analysis

C) value chain analysis

D) technical analysis

Answer: D

59) Which of the following is true of the techniques used for forecasting exchange rates?

A) Very few forecasts are completely accurate because of unexpected events that occur throughout the forecast period.

B) The human element involved in forecasting exchange rates perfect the techniques.

C) Fundamental analysts estimate the timing, magnitude, and direction of future exchange rate changes using charts and models of past data trends.

D) Technical analysts often consider a country's balance-of-payments situation while forecasting exchange rates.

Answer: A

60) The \_\_\_\_\_\_\_\_ is the collection of agreements and institutions that govern exchange rates.

A) Bretton Woods Agreement

B) Plaza Accord

C) international monetary system

D) international bond market

Answer: C

61) In the earliest days of international trade, \_\_\_\_\_\_\_\_ was the internationally accepted currency for payment of goods and services.

A) British pound

B) U.S. dollar

C) silver

D) gold

Answer: D

62) The gold standard is a \_\_\_\_\_\_\_\_ because it secured nations' currencies to the value of gold.

A) floating exchange-rate system

B) fixed exchange-rate system

C) linked exchange rate system

D) free float system

Answer: B

63) \_\_\_\_\_\_\_\_ was the first nation to implement the gold standard in the early 1700s.

A) The United States

B) Britain

C) France

D) Japan

Answer: B

64) The value of a currency expressed in terms of gold is called its \_\_\_\_\_\_\_\_.

A) book value

B) net asset value

C) par value

D) carrying value

Answer: C

65) Under the gold standard, if the U.S. dollar was fixed at $30/oz of gold and Japan was fixed at ¥75/oz of gold, what would be the Yen/dollar exchange rate?

A) ¥2.50/$

B) $2.50/¥

C) ¥0.40/$

D) ¥2250/$

Answer: A

66) The calculation of each currency's par value under the gold standard was based on the concept of \_\_\_\_\_\_\_\_.

A) earnings per share

B) interbank interest rates

C) purchasing power parity

D) inflation rates

Answer: C

67) An exchange rate system in which the exchange rate for converting one currency into another is set by international governmental agreement is called a \_\_\_\_\_\_\_\_ system.

A) floating exchange-rate

B) fixed exchange-rate

C) cross rate

D) spot rate

Answer: B

68) Which of the following was an advantage of the gold standard?

A) It retained trade imbalances.

B) It abolished monetary policies on all countries.

C) It reduced the risk in exchange rates.

D) It increased exchange-rate fluctuations.

Answer: C

69) Which of the following was a disadvantage of using gold as a medium of exchange in international trade?

A) The weight of gold made transporting it expensive.

B) Gold was not in high demand.

C) The gold standard imposed lenient monetary policies on countries that participated in the system.

D) The gold standard increased the risk in exchange rates as it maintained highly flexible exchange rates between currencies.

Answer: A

70) Which of the following created a new international monetary system based on the value of the U.S. dollar?

A) Plaza Accord

B) Bretton Woods Agreement

C) Louvre Accord

D) Jamaica Agreement

Answer: B

71) Which of the following features did Bretton Woods Agreement incorporate in the international monetary system based on the U.S. dollar?

A) floating exchange rates

B) trade imbalance corrections

C) an enforcement mechanism

D) a strict ban on devaluation

Answer: C

72) An economic condition in which a trade deficit causes a permanent negative shift in a country's balance of payments is called \_\_\_\_\_\_\_\_.

A) revaluation

B) statistical discrepancy

C) the Fisher effect

D) fundamental disequilibrium

Answer: D

73) The World Bank was created by the \_\_\_\_\_\_\_\_.

A) Jamaica Agreement

B) Bretton Woods Agreement

C) Smithsonian Agreement

D) Plaza Accord

Answer: B

74) Which of the following was created by the Bretton Woods Agreement to enforce the rules of the international monetary system?

A) International Bank for Reconstruction and Development

B) International Capital Market

C) International Monetary Fund

D) World Bank

Answer: C

75) The \_\_\_\_\_\_\_\_ is an IMF asset whose value is based on a weighted basket of four currencies, including the U.S. dollar, European Union euro, Japanese yen, and British pound.

A) special drawing right

B) gold standard

C) Eurobond

D) currency board

Answer: A

76) The international monetary system created by the Bretton Woods Agreement collapsed because \_\_\_\_\_\_\_\_.

A) of its heavy dependence on the stability of the dollar

B) it was not accepted by a majority of the world's nations

C) it did not have the funds necessary for its functioning

D) it favored only the developed countries and was of no help to struggling nations

Answer: A

77) IMF members formalized the existing system of floating exchange rates as the new international monetary system by drafting the so-called \_\_\_\_\_\_\_\_.

A) Bretton Woods Agreement

B) Smithsonian Agreement

C) Plaza Accord

D) Jamaica Agreement

Answer: D

78) A system in which currencies float against one another, with governments intervening to stabilize their currencies at particular target exchange rates is called a \_\_\_\_\_\_\_\_.

A) managed float system

B) linked exchange rate system

C) free float system

D) fixed exchange-rate system

Answer: A

79) Today's international monetary system is considered to be a \_\_\_\_\_\_\_\_ system.

A) fixed exchange

B) free float

C) managed float

D) linked exchange rate

Answer: C

80) The \_\_\_\_\_\_\_\_ was a 1985 agreement among the G5 nations to act together in forcing down the value of the U.S. dollar.

A) Bretton Woods Agreement

B) Smithsonian Agreement

C) Plaza Accord

D) Louvre Accord

Answer: C

81) The \_\_\_\_\_\_\_\_ was an agreement among the G7 nations that the dollar was appropriately valued and that they would intervene in currency markets to maintain its current market value.

A) Bretton Woods Agreement

B) Smithsonian Agreement

C) Plaza Accord

D) Louvre Accord

Answer: D

82) A \_\_\_\_\_\_\_\_ is a monetary regime that is based on an explicit commitment to exchange domestic currency for a specified foreign currency at a fixed exchange rate.

A) currency option

B) currency board

C) currency speculation

D) currency arbitrage

Answer: B

83) The \_\_\_\_\_\_\_\_ limited the fluctuations of European Union members' currencies within a specified trading range.

A) exchange rate mechanism

B) special drawing right

C) currency board

D) free float system

Answer: A

84) The \_\_\_\_\_\_\_\_ called for large-scale reduction of the debt owed by poorer nations, the exchange of old loans for new low-interest loans, and the making of debt instruments that would be tradable on world financial markets.

A) Brady Plan

B) Louvre Accord

C) Bretton Woods Agreement

D) Smithsonian Agreement

Answer: A

Scenario: Color-Me-Green Inc.

Color-Me-Green Inc., a U.S.-based clothing merchant, has started doing business internationally. Having subsidiaries in several countries, the company must integrate financial information from all its subsidiaries with the U.S. home office at the end of the year.

85) Suppose Country A has a currency called the Pulse (P). At the beginning of the year, the exchange rate between the Pulse and the U.S. dollar was P150/$. The inflation rate in Country A is running at an annual rate of 250 percent ,whereas inflation in the U.S. is running at 2 percent. Which of the following would most likely be the new exchange rate that Color-Me-Green can expect at the end of the year?

A) P525/$

B) P514.70/$

C) P43.71/$

D) $43.71/P

Answer: B

86) In Country B, Color-Me-Green is faced with a tight labor market and a low unemployment rate. This low unemployment rate will most likely result in \_\_\_\_\_\_\_\_.

A) lower interest rates

B) lower wages for workers

C) higher purchasing power

D) higher rate of inflation

Answer: D

87) In an attempt to raise money in Country B, Color-Me-Green was quoted an interest rate of 14 percent by a local bank. This quoted rate is called the \_\_\_\_\_\_\_\_ rate.

A) cross

B) artificial

C) nominal

D) exchange

Answer: C

Scenario: Sam Dearing, Budding International Financier

Sam Dearing is a summer intern in the arbitrage department at a prestigious Wall Street firm. Sam is hoping to be offered a full-time position at the firm after he graduates from college, and therefore, Sam knows that he must demonstrate a strong understanding of how exchange rates work.

88) Sam already knows that the \_\_\_\_\_\_\_\_ tells us how much of one currency we must pay to receive a certain amount of another.

A) exchange rate

B) par value

C) law of one price

D) purchasing power parity theory

Answer: A

89) Sam's mentor at the firm told him that the \_\_\_\_\_\_\_\_ stipulates that an identical product must have an identical price in all countries when the price is expressed in a common currency.

A) exchange price

B) law of one price

C) fixed exchange-rate system

D) floating exchange-rate system

Answer: B

90) Sam has been studying the price of wheat across markets. If a kilogram of wheat costs €1.5 in France and $1 in the United States, the law of one price would tell us \_\_\_\_\_\_\_\_.

A) the expected exchange rate between the euro and the dollar is €1.5/$

B) wheat is over priced in France

C) wheat is under priced in France

D) an arbitrage opportunity exists in the international wheat market

Answer: A

91) Suppose Sam then noticed that the actual euro/dollar exchange rate on currency markets is €1.2/$, and that a kilogram of wheat still costs $1 in the U.S. and €1.5 in France. Sam then knows that \_\_\_\_\_\_\_\_.

A) the expected exchange rate between the euro and the dollar is €1.5/$

B) wheat is priced higher in France

C) wheat is priced lower in France

D) an arbitrage opportunity does not exist in the international wheat market

Answer: B

92) It the actual euro/dollar exchange rate on currency markets is €1.2/$, and a kilogram of wheat still costs $1 in the U.S. and €1.5 in France, Sam also knows that the price of a kilogram of wheat in France is \_\_\_\_\_\_\_\_.

A) $1.25

B) $.80

C) €.80

D) €1.2

Answer: A

93) Sam's mentor is excited about the wheat prices in France and the U.S. because he sees an opportunity to buy wheat in the U.S. and sell it in France, which is known as a(n) \_\_\_\_\_\_\_\_.

A) exchange rate profit

B) arbitrage opportunity

C) violation of purchasing power parity

D) violation of the law of one price

Answer: B

94) Briefly describe how exchange rates influence business activities.

Answer: Movement in a currency's exchange rate affects the activities of both domestic and international companies. For example, exchange rates influence demand for a company's products in the global marketplace. A country with a currency that is weak (valued low relative to other currencies) will see a decline in the price of its exports and an increase in the price of its imports. Lower prices for the country's exports on world markets can give companies the opportunity to take market share away from companies whose products are priced high in comparison.

Furthermore, a company improves profits if it sells its products in a country with a strong currency (one that is valued high relative to other currencies) while sourcing from a country with a weak currency. For example, if a company pays its workers and suppliers in a falling local currency and sells its products in a rising currency, the company benefits by generating revenue in the strong currency while paying expenses in the weak currency. Yet managers must take care not to view this type of price advantage as permanent because doing so can jeopardize a company's long-term competitiveness.

Exchange rates also affect the amount of profit a company earns from its international subsidiaries. The earnings of international subsidiaries are typically integrated into the parent company's financial statements in the home currency. Translating subsidiary earnings from a weak host country currency into a strong home currency reduces the amount of these earnings when stated in the home currency. Likewise, translating earnings into a weak home currency increases stated earnings in the home currency.

95) Explain how exchange rates adjust to inflation.

Answer: An important component of the concept of purchasing power parity is that exchange rates adjust to different rates of inflation in different countries. Such adjustment is necessary to maintain purchasing power parity between nations. Suppose that at the beginning of the year the exchange rate between the Mexican peso and the U.S. dollar is 8 pesos/$ (or $0.125/peso). Also suppose that inflation is pushing consumer prices higher in Mexico at an annual rate of 20 percent, whereas prices are rising just 3 percent per year in the United States. To find the new exchange rate (Ee) at the end of the year, the following formula can be used:

Ee=Eb(1+i1)/(1+i2),

where Eb is the exchange rate at the beginning of the period, i1 is the inflation rate in country 1, and i2 is the inflation rate in country 2. Plugging the numbers for this example into the formula, gives the following value: Ee=8pesos/$[(1+0.20)/(1+0.03)]=9.3pesos/$

Because the numerator of the exchange rate is in pesos, the inflation rate for Mexico must also be placed in the numerator for the ratio of inflation rates. Thus, it can be noticed that the exchange rate adjusts from 8 pesos/$ to 9.3 pesos/$ because of the higher inflation rate in Mexico and the corresponding change in currency values. Higher inflation in Mexico reduces the number of U.S. dollars that a peso will buy and increases the number of pesos that a dollar will buy. In other words, whereas it had cost only 8 pesos to buy a dollar at the beginning of the year, it now costs 9.3 pesos.

For example, companies based in Mexico must pay more in pesos for any supplies bought from the United States. But U.S. companies will pay less, in dollar terms, for supplies bought from Mexico. Also, tourists from the United States would be delighted, as vacationing in Mexico becomes less expensive, but Mexicans will find the cost of visiting the United States more expensive.

This discussion illustrates at least one of the difficulties facing countries with high rates of inflation. Both consumers and companies in countries experiencing rapidly increasing prices see their purchasing power eroded. Developing countries and countries in transition are those most often plagued by rapidly increasing prices.

96) Discuss the role of business confidence and psychology in currency values.

Answer: PPP overlooks the human aspect of exchange rates—the role of people's confidence and beliefs about a nation's economy and the value of its currency. Many countries gauge confidence in their economies by conducting a business confidence survey. The largest survey of its kind in Japan is called the tankan survey. It gauges business confidence four times each year among 10,000 companies.

Investor confidence in the value of a currency plays an important role in determining its exchange rate. Suppose several currency traders believe that the Indian rupee will increase in value. They will buy Indian rupees at the current price, sell them if the value increases, and earn a profit. However, suppose that all traders share the same belief and all follow the same course of action.

The activity of the traders themselves will be sufficient to push the value of the Indian rupee higher. It does not matter why traders believed the price would increase. As long as enough people act on a similar belief regarding the future value of a currency, its value will change accordingly.

That is why nations try to maintain the confidence of investors, businesspeople, and consumers in their economies. Lost confidence causes companies to put off investing in new products and technologies and to delay the hiring of additional employees. Consumers tend to increase their savings and not increase their debts if they have lost confidence in an economy. These kinds of behaviors act to weaken a nation's currency.

97) Why do managers prefer that movements in exchange rates be predictable? How does the Big Mac index help determine whether a currency is overvalued or undervalued, and what are its drawbacks?

Answer: Managers prefer that movements in exchange rates be predictable. Predictable exchange rates reduce the likelihood that companies will be caught off-guard by sudden and unexpected rate changes. They also reduce the need for costly insurance (usually by currency hedging) against possible adverse movements in exchange rates. Rather than purchasing insurance, companies would be better off spending their money on more productive activities, such as developing new products or designing more efficient production methods.

The usefulness of the law of one price is that it helps us determine whether a currency is overvalued or undervalued. Each year, The Economist magazine publishes what it calls its "Big Mac Index" of exchange rates. This index uses the law of one price to determine the exchange rate that should exist between the U.S. dollar and other major currencies. It employs the McDonald's Big Mac as its single product to test the law of one price. The Big Mac is used because each one is fairly identical in quality and content across national markets and almost entirely produced within the nation in which it is sold.

The drawbacks of the Big Mac index reflect the fact that applying the law of one price to a single product is too simplistic a method for estimating exchange rates. Nonetheless, academic studies find that currency values tend to change in the direction suggested by the Big Mac index.

98) Differentiate between efficient and inefficient market views and discuss the implications of the two schools of thought for companies.

Answer: A great deal of debate revolves around the issue of whether markets themselves are efficient or inefficient in forecasting exchange rates. A market is efficient if prices of financial instruments quickly reflect new public information made available to traders. The efficient market view thus holds that prices of financial instruments reflect all publicly available information at any given time. As applied to exchange rates, this means that forward exchange rates are accurate forecasts of future exchange rates.

A forward exchange rate reflects a market's expectations about the future values of two currencies. In an efficient currency market, forward exchange rates reflect all relevant publicly available information at any given time; they are considered the best possible predictors of exchange rates. Proponents of this view hold that there is no other publicly available information that could improve the forecast of exchange rates over that provided by forward rates. To accept this view is to accept that companies do waste time and money collecting and examining information believed to affect future exchange rates. But there is always a certain amount of deviation between forward and actual exchange rates. The fact that forward exchange rates are less than perfect inspires companies to search for more accurate forecasting techniques.

The inefficient market view holds that prices of financial instruments do not reflect all publicly available information. Proponents of this view believe companies can search for new pieces of information to improve forecasting. But the cost of searching for further information must not outweigh the benefits of its discovery.

Naturally, the inefficient market view is more compelling when the existence of private information is considered. Suppose a single currency trader holds privileged information regarding a future change in a nation's economic policy—information that she believes will affect its exchange rate. Because the market is unaware of this information, it is not reflected in forward exchange rates. The trader will no doubt earn a profit by acting on her store of private information.

99) Discuss the challenges involved in forecasting exchange rates.

Answer: The business of forecasting exchange rates is a rapidly growing industry. This trend seems to provide evidence that a growing number of people believe it is possible to improve on the forecasts of exchange rates embodied in forward rates. Difficulties of forecasting remain, however. Despite highly sophisticated statistical techniques in the hands of well-trained analysts, forecasting is not a pure science. Few, if any, forecasts are ever completely accurate because of unexpected events that occur throughout the forecast period.

Beyond the problems associated with the data used by these techniques, failings can be traced to the human element involved in forecasting. For example, people might miscalculate the importance of economic news becoming available to the market, placing too much emphasis on some elements and ignoring others.

100) Explain the impact of added costs, trade barriers, and investor psychology on the ability of purchasing power parity (PPP) to predict exchange rates accurately.

Answer: Purchasing power parity is better at predicting long-term exchange rates (more than 10 years), but accurate forecasts of short-term rates are most beneficial to international managers. Even short-term plans must assume certain things about future economic and political conditions in different countries, including added costs, trade barriers, and investor psychology.

Impact of Added Costs-There are many possible reasons for the failure of PPP to predict exchange rates accurately. For example, PPP assumes no transportation costs. Suppose that the same basket of goods costs $100 in the United States and 950 kroner ($150) in Norway. Seemingly, one could make a profit through arbitrage by purchasing these goods in the United States and selling them in Norway. However, if it costs another $60 to transport the goods to Norway, the total cost of the goods once they arrive in Norway will be $160. Thus no shipment will occur. Because no arbitrage opportunity exists after transportation costs are added, there will be no leveling of prices between the two markets and the price discrepancy will persist. Thus even if PPP predicts that the Norwegian krone is overvalued, the effect of transportation costs will keep the dollar/krone exchange rate from adjusting. In a world in which transportation costs exist, PPP does not always correctly predict shifts in exchange rates.

Impact of Trade Barriers-PPP also assumes no barriers to international trade. However, such barriers certainly do exist. Governments establish trade barriers for many reasons, including helping domestic companies remain competitive and preserving jobs for their citizens. Referring back to the previous example, suppose the Norwegian government imposes a 60 percent tariff on the $100 basket of imported goods or makes its importation illegal. Because no leveling of prices or exchange-rate adjustment will occur, PPP will fail to predict exchange rates accurately.

Impact of Business Confidence and Psychology-Finally, PPP overlooks the human aspect of exchange rates—the role of people's confidence and beliefs about a nation's economy and the value of its currency. Many countries gauge confidence in their economies by conducting a business confidence survey. The largest survey of its kind in Japan is called the tankan survey. It gauges business confidence four times each year among 10,000 companies.

Investor confidence in the value of a currency plays an important role in determining its exchange rate. Suppose several currency traders believe that the Indian rupee will increase in value. They will buy Indian rupees at the current price, sell them if the value increases, and earn a profit. However, suppose that all traders share the same belief and all follow the same course of action.

The activity of the traders themselves will be sufficient to push the value of the Indian rupee higher. It does not matter why traders believed the price would increase. As long as enough people act on a similar belief regarding the future value of a currency, its value will change accordingly.

That is why nations try to maintain the confidence of investors, businesspeople, and consumers in their economies. Lost confidence causes companies to put off investing in new products and technologies and to delay the hiring of additional employees. Consumers tend to increase their savings and not increase their debts if they have lost confidence in an economy. These kinds of behaviors act to weaken a nation's currency.

101) Explain how movement in a currency's exchange rate affects the activities of both domestic and international companies. Discuss how companies can export successfully despite having a strong currency.

Answer: Movement in a currency's exchange rate affects the activities of both domestic and international companies. For example, exchange rates influence demand for a company's products in the global marketplace. A country with a currency that is weak (valued low relative to other currencies) will see a decline in the price of its exports and an increase in the price of its imports. Lower prices for the country's exports on world markets can give companies the opportunity to take market share away from companies whose products are priced high in comparison.

Furthermore, a company improves profits if it sells its products in a country with a strong currency (one that is valued high relative to other currencies) while sourcing from a country with a weak currency. For example, if a company pays its workers and suppliers in a falling local currency and sells its products in a rising currency, the company benefits by generating revenue in the strong currency while paying expenses in the weak currency. Yet managers must take care not to view this type of price advantage as permanent because doing so can jeopardize a company's long-term competitiveness.

A strong and rising currency makes a nation's exports more expensive. Here's how companies can export successfully despite a strong currency.

Prune Operations-Cut costs and boost efficiency by downsizing staff and reworking factories at home to maintain production levels, and pursue customers abroad when export earnings decline.

Adapt Products-Win customer business and loyalty by tailoring products to the needs of global customers and in this way the company may retain its business despite its higher prices.

Source Abroad-Source abroad for raw materials and other inputs to the production process—the supplier will likely earn an extra profit, and the company will get a better deal than is available domestically.

Freeze Prices-A last resort may be to freeze prices of goods in foreign markets—this might boost overall profits if sales improve.

102) Explain the concept of devaluation, and explain the effect devaluation has on the price of a country's imports. Discuss how international companies can adjust to a weak currency.

Answer: The intentional lowering of the value of a currency by the nation's government is called devaluation. The reverse, the intentional raising of its value by the nation's government, is called revaluation. Devaluation lowers the price of a country's exports on world markets and increases the price of its imports because the value of the country's currency is now lower on world markets. Thus, a government might devalue its currency to give its domestic companies an edge over competition from other countries. But devaluation reduces the buying power of consumers in the nation. It can also allow inefficiencies to persist in domestic companies because there is now less pressure to be concerned with production costs. Revaluation has the opposite effects: it increases the price of exports and reduces the price of imports.

A weak and falling currency makes a nation's imports more expensive. Here's how companies can adjust to a weak currency.

Source Domestically-Source domestically for raw materials and components to lower the cost of production inputs, avoid exchange-rate risk, and shorten the supply chain.

Grow at Home-Fight for the business of domestic customers now that imported products of foreign competitors are priced high because of their relatively strong currencies.

Push Exports-Exploit the price advantage that can be obtained from the country's weak currency by expanding the company's reach and depth abroad—people love a good bargain in all countries.

Reduce Expenses-Counteract the rising cost of imported energy by using the latest communication and transportation technologies to reduce air travel, cut utility bills, and slash shipping costs.

103) Briefly describe the gold standard, its advantages, and why it collapsed.

Answer: In the earliest days of international trade, gold was the internationally accepted currency for payment of goods and services. Using gold as a medium of exchange in international trade has several advantages. First, the limited supply of gold made it a commodity in high demand. Second, because gold is highly resistant to corrosion, it can be traded and stored for hundreds of years. Third, because it can be melted into either small coins or large bars, gold is a good medium of exchange for both small and large purchases.

But gold also has its disadvantages. First, the weight of gold made transporting it expensive. Second, when a transport ship sank at sea, the gold sank to the ocean floor and was lost. Thus merchants wanted a new way to make their international payments without the need to haul large amounts of gold around the world. The solution was found in the gold standard—an international monetary system in which nations linked the value of their paper currencies to specific values of gold. Britain was the first nation to implement the gold standard in the early 1700s.

The gold standard required a nation to fix the value (price) of its currency to an ounce of gold. The value of a currency expressed in terms of gold is called its par value. Each nation then guaranteed to convert its paper currency into gold for anyone demanding it at its par value. The calculation of each currency's par value was based on the concept of purchasing power parity. This provision made the purchasing power of gold the same everywhere and maintained the purchasing power of currencies across nations.

All nations fixing their currencies to gold also indirectly linked their currencies to one another. Because the gold standard fixed nations' currencies to the value of gold, it is called a fixed exchange-rate system—one in which the exchange rate for converting one currency into another is fixed by international governmental agreement. This system and the use of par values made calculating exchange rates between any two currencies a very simple matter.

The gold standard was quite successful in its early years of operation. In fact, this early record of success is causing some economists and policy makers to call for its rebirth today. Three main advantages of the gold standard underlie its early success.

First, the gold standard drastically reduces the risk in exchange rates because it maintains highly fixed exchange rates between currencies. Deviations that do arise are much smaller than they would be under a system of freely floating currencies. The more stable exchange rates are, the less companies are affected by actual or potential adverse changes in them. Because the gold standard significantly reduced the risk in exchange rates and, therefore, the risks and costs of trade, international trade grew rapidly following its introduction.

Second, the gold standard imposes strict monetary policies on all countries that participate in the system. Recall that the gold standard requires governments to convert paper currency into gold if demanded by holders of the currency. If all holders of a nation's paper currency decided to trade it for gold, the government must have an equal amount of gold reserves to pay them. That is why a government cannot allow the volume of its paper currency to grow faster than the growth in its reserves of gold. By limiting the growth of a nation’s money supply, the gold standard also was effective in controlling inflation.

Third, the gold standard can help correct a nation’s trade imbalance. The exact opposite occurs in the case of a trade surplus: The inflow of gold supports an increase in the supply of paper currency, which increases demand for, and therefore the cost of, goods and services. Thus exports will fall in reaction to their higher price until trade is once again in balance.

Collapse of the Gold Standard-Nations involved in the First World War needed to finance their enormous war expenses, and they did so by printing more paper currency. This certainly violated the fundamental principle of the gold standard and forced nations to abandon the standard. The aggressive printing of paper currency caused rapid inflation for these nations. When the United States returned to the gold standard in 1934, it adjusted its par value from $20.67/oz of gold to $35.00/oz to reflect the lower value of the dollar that resulted from inflation. Thus the U.S. dollar had undergone devaluation. Yet Britain returned to the gold standard several years earlier at its previous level, which did not reflect the effect inflation had on its currency.

Because the gold standard links currencies to one another, devaluation of one currency in terms of gold affects the exchange rates between currencies. The decision of the United States to devalue its currency and Britain’s decision not to do so lowered the price of U.S. exports on world markets and increased the price of British goods imported into the United States. People quickly lost faith in the gold standard because it was no longer an accurate indicator of a currency’s true value. By 1939, the gold standard was effectively dead.

104) Describe the most important features of the international monetary system created by the Bretton Woods Agreement.

Answer: In 1944, representatives from 44 nations met in the New Hampshire resort town of Bretton Woods to lay the foundation for a new international monetary system. The resulting Bretton Woods Agreement was an accord among nations to create a new international monetary system based on the value of the U.S. dollar. The new system was designed to balance the strict discipline of the gold standard with the flexibility that countries needed to deal with temporary domestic monetary difficulties. Fixed Exchange Rates-The Bretton Woods Agreement incorporated fixed exchange rates by tying the value of the U.S. dollar directly to gold and the value of other currencies to the value of the dollar. The par value of the U.S. dollar was fixed at $35/oz of gold. Other currencies were then given par values against the U.S. dollar instead of gold.

Built-in Flexibility-The new system also incorporated a degree of built-in flexibility. For example, although competitive currency devaluation was ruled out, large devaluation was allowed under the extreme set of circumstances called fundamental disequilibrium which referred to an economic condition in which a trade deficit causes a permanent negative shift in a country's balance of payments. In this situation, a nation can devalue its currency more than 10 percent. Yet devaluation under these circumstances should accurately reflect a permanent economic change for the country in question, not temporary misalignments.

World Bank-To provide funding for countries' efforts toward economic development, the Bretton Woods Agreement created the World Bank—officially called the International Bank for

Reconstruction and Development (IBRD). The immediate purpose of the World Bank was to finance European reconstruction following the Second World War. It later shifted its focus to the general financial needs of developing countries.

International Monetary Fund-The Bretton Woods Agreement established the International Monetary Fund (IMF) as the agency to regulate the fixed exchange rates and enforce the rules of the international monetary system. At the time of its formation, the IMF had just 29 members, but today it consists of 185 countries.

105) Explain the differences between a monetary policy and a fiscal policy, and discuss why the IMF was established.

Answer: Because of the damaging effects of inflation, governments try to manage the supply of and demand for their currencies. They do this through the use of two types of policies designed to influence a nation's money supply. Monetary policy refers to activities that directly affect a nation's interest rates or money supply. Selling government securities reduces a nation's money supply because investors pay money to the government's treasury to acquire the securities. Conversely, when the government buys its own securities on the open market, cash is infused into the economy and the money supply increases.

Fiscal policy involves using taxes and government spending to influence the money supply indirectly. For example, to reduce the amount of money in the hands of consumers, governments increase taxes—people are forced to pay money to the government coffers. Conversely, lowering taxes increases the amount of money in the hands of consumers. Governments can also step up their own spending activities to increase the amount of money circulating in the economy or cut

government spending to reduce it.

The Bretton Woods Agreement established the International Monetary Fund (IMF) as the agency to regulate the fixed exchange rates and enforce the rules of the international monetary system. At the time of its formation, the IMF had just 29 members—today 185 countries belong. Included among the main purposes of the IMF are:

•Promoting international monetary cooperation.

•Facilitating expansion and balanced growth of international trade.

•Promoting exchange stability, maintaining orderly exchange arrangements, and avoiding competitive exchange devaluation.

•Making the resources of the fund temporarily available to members.

•Shortening the duration and lessening the degree of disequilibrium in the international balance of payments of member nations.

106) Compare and contrast the two main techniques for forecasting exchange rates.

Answer: Fundamental analysis uses statistical models based on fundamental economic indicators to forecast exchange rates. These models are often quite complex, with many variations reflecting different possible economic conditions. These models include economic variables such as inflation, interest rates, money supply, tax rates, and government spending. Such analyses also often consider a country's balance-of-payments situation and its tendency to intervene in markets to influence the value of its currency.

Another method of forecasting exchange rates is technical analysis—a technique that uses charts of past trends in currency prices and other factors to forecast exchange rates. Using highly statistical models and charts of past data trends, analysts examine conditions that prevailed during changes in exchange rates, and they try to estimate the timing, magnitude, and direction of future changes. Many forecasters combine the techniques of both fundamental and technical analyses to arrive at potentially more accurate forecasts.

107) Explain how a pegged exchange-rate system works. Why would a country choose to follow this system?

Answer: Pegged exchange-rate arrangements "peg" a country's currency to a more stable and widely used currency in international trade. Countries then allow the exchange rate to fluctuate within a specified margin (usually 1 percent) around a central rate.

Many small countries peg their currencies to the U.S. dollar, European Union euro, the special drawing right (SDR) of the IMF, or other individual currency. Belonging to this first category are the Bahamas, El Salvador, Iran, Malaysia, Netherlands Antilles, and Saudi Arabia. Other nations peg their currencies to groups, or "baskets," of currencies. For example, Bangladesh and Burundi tie their currencies (the taka and Burundi franc, respectively) to those of their major trading partners. Other members of this second group are Botswana, Fiji, Kuwait, Latvia, Malta, and Morocco.