Self Test Exercise

1. *Define and clearly explain each of the for your better understanding*
   - *Absolute purchasing power parity*
   - *Appreciation*
   - *Balance of payments approach*
   - *Covered interest arbitrage*
   - *Demand for foreign exchange*
   - *Depreciation*
   - *Destabilizing speculation*
   - *Effective exchange rate*
   - *Equilibrium exchange rate*
   - *Exchange arbitrage*
   - *Foreign exchange market*
   - *Foreign exchange risk*
   - *Forward rate*
   - *Forward transaction*
   - *Hedging*
   - *Monetary approach*
   - *Money demand*
   - *Money supply*
   - *Nominal effective rate*
   - *Real effective exchange rate*
   - *Relative purchasing power parity*
   - *Spot rate*
   - *Spot transaction*
   - *Stabilizing speculation*
   - *Supply of foreign exchange*
   - *Swap transaction*
   - *Uncovered interest arbitrage*
2. *Discuss the impact of a decrease in the demand for foreign exchange on the equilibrium exchange rate.*
3. *Given the following: The exchange rate between the dollar (US) and the euro is 0.82 whereas the exchange rate between the dollar and the pound (British) is 0.55. Calculate the exchange rate between the euro and the British pound.*
4. *The price index in Ethiopia in 2000 was 100. This will rise to 240 in 2010. The general price level of Canada slightly increases from 100 to 110 between the years 2000 and 2010. If the exchange rate that existed in the year 2000 between the Canadian dollar and the birr was 2.1, estimate the exchange rate of 2010.*
5. *Define speculation and differentiate between the two types of speculation.*
6. What is meant by the foreign-exchange market?Where is it located?
7. What is meant by the forward market? How does it differ from the spot market?
8. The supply and demand for foreign exchange are considered to be derived schedules. Explain how it is.

9. Explain why exchange-rate quotations stated indifferent financial centers tend to be consistentwith one another.
10. Who are the participants in the forward-exchange market? What advantages does this market afford these participants?
11. What explains the relationship between the spot rate and the forward rate?
12. What is the strategy of speculating in the forward market? In what other ways can one speculate on exchange-rate changes?
13. Distinguish between stabilizing speculation and destabilizing speculation.
14. If the exchange rate changes from $1.70 =£1 to $1.68 =£1, what does this mean for the dollar? For the pound? What if the exchange rate changes from $1.70 =£1 to $1.72 =£1?
15. What is the effect of a balance-of-payments surplus on a country's domestic money supply? How does this effect occur? How can it be offset or canceled by the central bank of the payments-surplus country?
16. If interest rates in Japan rise relative to those prevailing in the United States, would you expect a steady flow of capital into Japan? Why, or why not?
17. Real output and incomes rise in Country A. How and why would a Keynesian analysis of the likely effect of that event on the balance of payments of Country A differ from that of a monetarist?
18. Suppose the dollar/franc exchange rate equals $0.50 per franc. According to the purchasing power-parity theory, what will happen to the dollar's exchange value under each of the following circumstances?
    a. The U.S. price level increases by 10 percent, and the price level in Switzerland stays constant.
    b. The U.S. price level increases by 10 percent, and the price level in Switzerland increases by 20 percent.
    c. The U.S. price level decreases by 10 percent, and the price level in Switzerland increases by 5 percent.
    d. The U.S. price level decreases by 10 percent, and the price level in Switzerland decreases by 15 percent.
19. In a monetarist model of the balance of payments, assuming a fixed exchange rate and starting from equilibrium in all markets, how would Country A's balance of payments react to each of the following events:

a. The central bank of Country A increases its domestic assets sufficiently to increase the stock of base money in the banking system by 10 percent.
b. Central banks in the rest of the world increase their domestic assets sufficiently to increase the stock of base money in the banking system of the rest of the world by 10 percent.
c. Because of a drought, GNP in the rest of the world declines by 10 percent.

20. Why has the goods and services balance sometimes shown a surplus while the merchandise trade balance shows a deficit?
21. From a functional view point, a nation's balance of payments can be grouped into several categories. What are these categories?
22. Why are international investors especially concerned about the real interest rate as opposed to the nominal rate?
23. If a currency becomes overvalued in the foreign exchange market, what will be the likely impact on the home country's trade balance? What if the home currency becomes undervalued?
24. Explain why you agree or disagree with each of the following statements:

a. ''A nation's currency will depreciate if its inflation rate is less than that of its trading partners.''
b. ''A nation whose interest rate falls more rapidly than that of other nations can expect the exchange value of its currency to depreciate.''
c. ''A nation that experiences higher growth rates in productivity than its trading partners can expect the exchange value of its currency to appreciate.''