Reading 18

CAPITAL FLOWS AND THE FX MARKET

1. (B) nominal exchange rate.

Explanation

The nominal exchange rate is quite simply the price of one currency relative to another. It is the quote observed in currency markets.

(Module 18.1, LOS 18.a)

2. (C) real exchange rate.

Explanation

A comparison of consumption costs between two markets can, in concert with the foreign exchange rate (also called the nominal exchange rate), be used to calculate the real exchange rate.

(Module 18.1, LOS 18.a)

3. (B) retail market.

Explanation

The retail foreign exchange market refers to transactions by households and relatively small institutions and may be for tourism, cross-border investment, or speculative trading.

(Module 18.1, LOS 18.a)

4. (A) multinational banks that deal in currencies.

Explanation

The sell side of foreign exchange markets is primarily large multinational banks. They are the primary dealers in currencies and originators of forward foreign exchange contracts. Firms and investors that require foreign currencies for transactions or wish to hedge their currency risks comprise the buy side of the foreign exchange market.

(Module 18.1, LOS 18.a)

5. (C) floating exchange rates.

Explanation

When exchange rates are managed within crawling bands, the margin around a target exchange rate increases over time. This technique is sometimes used in a transition from fixed exchange rates to freely floating exchange rates.

(Module 18.2, LOS 18.b)

6. (B) forward exchange rate.

Explanation

A forward exchange rate specifies the amount of two currencies that will be exchanged at a specific point of time in the future. A transaction that uses the spot exchange rate is one that would occur immediately. A real exchange rate is one that has been adjusted for the relative inflation rates in two countries, and could be referring to an exchange rate that prevails at any given time.

(Module 18.1, LOS 18.a)

7. (B) impose capital restrictions.

Explanation

Objectives commonly cited for imposing capital restrictions include reducing the volatility of domestic asset prices, protecting domestic industries, maintaining fixed exchange rates, and keeping domestic interest rates low.

(Module 18.2, LOS 18.c).

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8. (B) Absorption approach.

Explanation

The absorption approach to analysing how to improve a trade deficit suggests that in the absence of excess capacity in the economy, currency devaluation provides only a temporary improvement in a country's trade deficit that will reverse after the decrease in real domestic wealth from the currency depreciation is restored. It also concludes that a long-term improvement in the trade deficit requires either an improvement in the fiscal deficit or an increase in the excess of domestic savings over domestic investment.

(Module 18.2, LOS 18.b)

9. (B) elasticity of demand for imports and exports.

Explanation

The Marshall-Lerner condition is an outcome of the elasticities approach to analysing the balance of trade. It suggests that depreciation or devaluation of a currency is more likely to narrow a country's trade deficit if domestic demand for imports and foreign demand for the country's exports are more elastic. The absorption approach to analysing the balance of trade implies that national

saving must increase relative to domestic investment for a currency devaluation to narrow a trade deficit, which in turn depends on whether the economy is producing at maximum capacity (full employment or potential GDP) when the devaluation occurs.

(Module 18.2, LOS 18.b).

10. (C) are equal to changes in the real exchange rate.

Explanation

The real interest rate = the nominal interest rate × ratio of consumption basket (or index) price levels in both countries. Assuming no price changes, the real exchange rate has remained the same as the nominal interest rate during the period. You can think of the ratio of the consumption basket (or index) price levels in two countries as the bracketed portion of the Fisher relation for two countries. Here is the Fisher relation for two countries:

Here is the ratio of the consumption basket (or index) price levels in two countries:

$$\frac{(1+R_{nominal}A)}{(1+R_{nominal}B)} = \frac{(1+R_{real\ A})[1+E(inflation_A)]}{(1+R_{realB})[1+E(inflation_B)]}$$

Here is the ratio of the consumption basket (or index) price levels in two countries:

$$\frac{[1+E(inflation_A)]}{[1+E(inflation_B)]}$$

If inflation in A is 10% and inflation in B is 0%, the ratio of consumption basket (or index) price levels is 1.1. If inflation in both countries is 0%, the ratio of consumption basket (or index) price levels is 1 and the nominal interest rate = the real interest rate. If the nominal `interest rate = the real interest rate, changes in the nominal exchange rate = changes in the real exchange rate.

(Module 18.1, LOS 18.a)

11. (B) 0.79 BDE/TOL.

Explanation

The real exchange rate is calculated as 0.75 BDE/TOL × 110/105 = 0.79 BDE/TOL.

(Module 18.1, LOS 18.a)

12. (C) insurance companies.

Explanation

Real money accounts are foreign exchange buy-side investors that do not use derivatives. Many mutual funds, pension funds, and insurance companies can

be classified as real money accounts. Hedge funds typically use derivatives. Central banks usually do not act as investors in foreign exchange markets but may intervene in foreign exchange markets to achieve monetary policy objectives.

(Module 18.1, LOS 18.a)

13. (C) Sufficient elasticities of export and import demand.

Explanation

Under the elasticities approach the elasticities of demand for exports and imports are the key to moving a country's balance of payments towards surplus. The absorption approach considers capital flows as well as goods flows. Under this approach, domestic expenditure relative to income must decrease to move the balance of trade towards surplus. Decreasing domestic expenditure relative to income is equivalent to increasing domestic savings, and an increase in savings relative to the current level of domestic investment will also move the balance of payments towards surplus under the absorption approach.

(Module 18.2, LOS 18.b)

14. (B) reduce the volatility of domestic asset prices.

Explanation

Reasons commonly cited by governments for imposing capital restrictions include reducing the volatility of domestic asset prices, maintaining control of exchange rates, keeping domestic interest rates low, and protecting strategic industries from foreign ownership.

(Module 18.2, LOS 18.c)

15. (B) the ratio of the two countries' price levels.

Explanation

The difference between real exchange rates and nominal exchange rates is the relative inflation rates over time between the two countries. Real exchange rate (D/F) = nominal exchange rate (D/F) $\times \frac{CPI_F}{CPI_D}$

(Module 18.1, LOS 18.a)

16. (C) Target zone or conventional fixed peg.

Explanation

With formal dollarization or a monetary union, a country does not have its own currency. With a currency board, conventional fixed peg, target zone, or crawling peg, a country has its own currency and manages its exchange rate with another currency or basket of currencies.

(Module 18.2, LOS 18.b)

17. (C) may fluctuate around the peg rate.

Explanation

In a conventional fixed peg arrangement, a country pegs its currency within a margin of±1% versus another currency or a basket that includes the currencies of its major trading or financial partners. Market-determined exchange rates are a characteristic of an independently floating exchange rate regime.

(Module 18.2, LOS 18.b)

18. (C) target zone.

Explanation

This exchange rate regime is best described as a target zone, or a system of pegged exchange rates within horizontal bands. A target zone allows wider exchange rate fluctuations than a conventional fixed peg arrangement, which typically limits the permitted range to within 1% of the pegged exchange rate. Management of exchange rates within crawling bands allows the percentage deviation from the pegged exchange rate to increase over time.

(Module 18.2, LOS 18.b)

19. (C) EUR has appreciated 2.19% relative to the CNY.

Explanation

The percentage change in the CNY value of one EUR is (8.3378 / 8.1588) – 1 = 0.0219. The EUR has appreciated 2.19% relative to the CNY. This is not the same as CNY depreciating by 2.19% relative to the EUR. The percentage change in the CNY is [(1 / 8.3378) / (1 / 8.1588)] – 1 = –0.0215 = –2.15%.

(Module 18.1, LOS 18.a)

20. (B) J-curve effect.

Explanation

The J-curve refers to a graph of the effect of currency depreciation on the trade balance over time. In the short run, a trade deficit may increase because current import and export contracts may be fixed in foreign currency units over the near term, and only reflect the exchange rate change over time. In the long run, currency depreciation should decrease a trade deficit.

(Module 18.2, LOS 18.b)

21. (B) Long-term investors.

Explanation

Forward contracts are for 30, 90, 180, and 360-day periods and would, therefore, be considered short-term investment choices. Other participants in the forward market are hedgers who use forward contracts to protect the home currency value of foreign currency denominated assets on their balance sheets over the life of the contracts involved.

(Module 18.1, LOS 18.a)

22. (C) depreciation of 9.2%.

Explanation

To correctly calculate the percentage change in AUD relative to GBP, convert the exchange rates so that AUD is the base currency: 1 / 1.4800 = 0.6757 GBP/AUD five years ago and 1 / 1.6300 = 0.6135 GBP/AUD today. The percentage change in the Australian dollar against the British pound is 0.6135 / 0.6757 − 1 = –9.2%.

Note that the GBP has appreciated against the AUD by 1.6300 / 1.4800 − 1 = 10.1% over the same period.

(Module 18.1, LOS 18.a)

23. (B) Appreciated by 5.1%.

Explanation

Because the exchange rates are quoted with the EUR as the base currency, the percentage change is simply 103.00 / 98.00 − 1 = 5.1%. The increase in the quoted JPY/EUR exchange rate means it now requires 5.1% more JPY to purchase one EUR. Thus, the EUR has appreciated by 5.1% against the JPY.

(Module 18.1, LOS 18.a)

24. (C) use derivatives.

Explanation

Leveraged accounts in the foreign exchange market refer to investment accounts that use derivatives.

(Module 18.1, LOS 18.a)

25. (A) appreciated and Canadians will find U.S. goods cheaper.

Explanation

The CAD is now more expensive in terms of USD, and thus it has appreciated. Therefore, each CAD yields more USD than before, and Canadians are able to purchase more U.S. goods with each CAD, making U.S. goods relatively cheaper.

(Module 18.1, LOS 18.a)

26. (A) domestic price level.

Explanation

An increase in the domestic price level, other things equal, will decrease a real exchange rate. Increases in the nominal exchange rate or the foreign price level, other things equal, will increase a real exchange rate.

(Module 18.1, LOS 18.a)

27. (A) Keep domestic interest rates high.

Explanation

A common objective of capital restrictions is to keep domestic interest rates low (not high), by eliminating competition by other countries for investor funds. The other two choices are common objectives of capital restrictions.

(Module 18.2, LOS 18.c)

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