Question 1
L2EC-TBX102-1502
LOS: LO-13k
Lesson Reference: Lesson 9: The Impact of Balance of Payment Flows
Difficulty: easy
The Mundell-Fleming model in environments of high capital mobility predicts that expansionary fiscal policy coupled with restrictive monetary policy will *most likely*

- (●) Stronger domestic currency.
- ( ) An ambiguous effect on domestic currency.
- ( ) Weaker domestic currency.

Rationale

This Answer is Correct

When capital mobility is high, the Mundell-Fleming model states that monetary and fiscal policy effects on exchange rates will operate primarily through capital flows. Under the model, both higher interest rates under restrictive monetary policy and higher government borrowing under expansionary fiscal policy should lead to an increase in the value of the domestic currency as investors trade other currencies for the borrower's currency.

Question 2
L1EC-PQ2111-1410
LOS: LOS-2280
Lesson Reference: Lesson 1: Foreign Exchange Market Concepts
Difficulty: medium
A decline in the USD/EUR exchange rate from 1.3425 to 1.3150 *most likely* implies that:

- (●) The USD has appreciated by 2.09%.
- ( ) The EUR has appreciated by 2.05%.
- ( ) The USD has appreciated by 2.05%.

Rationale

This Answer is Correct

A decline in the USD/EUR exchange rate from 1.3425 to 1.3150 implies that the base currency (EUR) has depreciated. The unannualized percentage decrease in the value of EUR relative to USD is calculated as:

$(1.3150/1.3425) - 1 = -2.05\%$

Alternatively, the EUR/USD exchange rate has increased from 0.7449 to 0.7605. The unannualized percentage increase in the value of USD relative to EUR is calculated as:

$(0.7605/0.7449) - 1 = 2.09\%$

Question 3
L2R13TB-0002
LOS: LO-13b
Lesson Reference: Lesson 3: Foreign Exchange Spreads and Arbitrage Constraints on Spot Exchange Rate Quotes
Difficulty: hard

A Russian bank posts RUB/JPY 0.5230 – 0.5232. Related trades posted by other banks include:

	Bid	Offer
JPY/USD	110.33	110.34
RUB/USD	57.7435	57.7525

The triangular arbitrage profit for RUB 100,000 is *closest* to:

- RUB 3.26.
- RUB 23.58.
- RUB 124.35.

Rationale
This Answer is Correct

A triangular arbitrage opportunity exists when the ask price quoted by one market participant is lower than the bid price quoted elsewhere. First determine both the bid and offer sides of the cross-currency quote for RUB/JPY:

	Bid	Offer
JPY/USD	110.33	110.34
RUB/USD	57.7435	57.7525
$\text{RUB/JPY}_{\text{Bid}}$	0.5233	(57.7435 / 110.34)
$\text{RUB/JPY}_{\text{Ask}}$	0.5235	(57.7525/ 110.33)

In this case, there is a triangular arbitrage opportunity because the RUB/JPY *ask* of 0.5232 from the Russian bank is less than the 0.5233 RUB/JPY *bid* from the from the triangular arbitrage. The play here is to first purchase JPY for RUB from the low-ask Russian bank:

$$\frac{100,000\,\text{RUB}}{0.5232\,\text{RUB}\,/\,\text{JPY}} = 191,131.50\,\text{JPY}$$

Next, convert JPY to USD as part of the triangular arbitrage:

$$\frac{191,131.50\,\text{JPY}}{110.34\,\text{JPY}\,/\,\text{USD}} = 1,732.21\,\text{USD}$$

Finally, convert USD to RUB as part of the triangular arbitrage:

$$1,732.21\text{USD} \times 57.7435\,\text{RUB}\,/\text{USD} = 100,023.58$$

Hint: The currency math determines whether you multiply or divide. The lowest outcome determines whether to use bid or ask (i.e., if dividing use the higher ask; if multiplying use the lower bid).

Question 4
R13L10-0001
LOS: LO-13a
Lesson Reference: Lesson 3: Foreign Exchange Spreads and Arbitrage Constraints on Spot Exchange Rate Quotes
Difficulty: medium
Which of the following is *most likely* to indicate an illiquid market for a currency pair?

- Increasing ask prices.
- Decreasing bid prices.
- Increasing dealer spread.

Rationale

This Answer is Correct

Increasing dealer spread is the most likely indication of market illiquidity for a currency pair. Dealers purchase at the lower bid price and sell at the higher ask price. This spread compensates them for the risk of holding a position in the security. When dealers see a lack of liquidity in the market, they may lower both the bid and the ask price to attach liquidity, but will increase their spread to reward themselves for retaining greater risk. Increasing ask prices are more likely an indication of strong demand, which decreasing bid prices indicate a lack of demand. They do not in isolation indicate market liquidity.

Question 5
L2R13TB-ITEMSET-AC007-1512
LOS: LOS-6320
LOS: LOS-6330
Lesson Reference: Lesson 2: Cross Rate Calculations with Bid-Ask Spreads
Difficulty: medium

Use the following information to answer the next three questions:

An investor is preparing to finalize a transaction in a small country, Island X, with limited currency liquidity. Island X has limited international transactions, and currency quotes are only available with respect to "X" and two of its trading partners "Y" and "Z." Both countries Y and Z are active in international markets, and as a result, quotations are available in terms of the investor's home country, "A," in terms of "Y" and "Z" currencies. Assume that the currency names for the countries stated are the same as the country designations. Given the exchange rate quotations provided below, answer the following three questions.

Exchange Rate Quotations

A/Z:	1.50/1.55
Y/A:	50.50/50.75
Y/X:	1.25/1.30

i.
In order to finance an investment in Country Y, the investor must deliver 100,000 units of Y currency. What is the size of this investment in his home currency?

- (●) 1,980.20
- ( ) 1,970.44
- ( ) 1,950.31

Rationale
This Answer is Correct
The investor must deliver 100,000 units of Y currency. Therefore, he must sell A currency to purchase the Y currency. The base currency is the one being valued, so selling A for Y implies the bid side of the Y/A quotation. Setting up the currency unit algebra and then plugging in the numbers is the most consistent means of answering a question like this.

$$\begin{aligned} \text{Y}100,000 = \quad & \text{A} \times \frac{\text{Y}}{\text{A}} = \text{A} \times \frac{\text{Y}50.50}{\text{A}} \\ \text{A} = \quad & \frac{\text{Y}100{,}000}{\text{Y}50.50/\text{A}} = \underline{1,980.1980} \end{aligned}$$

ii.
What is the bid offer on the Y/Z cross exchange rate as implied by the spot rate quotes provided?

- (●) 75.75/78.66
- ( ) 33.67/32.74
- ( ) 1.25/1.55

Rationale
This Answer is Correct

The equation for solving for the cross-rate is A/Z × Y/A. This is equivalent to multiplying the numerator and denominator of the spot rates available to yield Y/Z – remembering that following mathematical principles, A will be eliminated as a factor in the exchange rate calculation as it appears in both the numerator and denominator. However, A is not eliminated in the equation and product due to the variation between the bid and ask price.

$$[(1.5 \times 50.5)/(50.75 \times 1.55)] = 75.75/78.66$$

iii.

Which of the following dealer quotes for the X/A exchange rate would *most likely* create an arbitrage opportunity?

- 40.50/42.75
- 38.85/40.60
- 41.35/43.90

Rationale

This Answer is Correct

The implied cross exchange rate for X/A may be computed based on the rate quotations provided in the vignette. For consistency, always begin with the currency unit algebra and then introduce their values.

$$\frac{X}{A} = \frac{-}{A} \times \frac{X}{-} = \frac{Y}{A} + \frac{Y}{X}$$

Remember to maximize the bid-ask spread. To compute the bid, use the smallest figure for the numerator (the Y/A bid) and the largest number for the denominator (the Y/X ask). The offer will use the largest figure for the numerator and the smallest figure for the denominator.

$$\frac{X}{A} = \frac{Y}{A} + \frac{Y}{X}$$

$$\text{Bid} = \frac{50.50Y/A}{1.30Y/A} = 38.85\,X/A \qquad \text{Offer} = \frac{50.75Y/A}{1.25Y/X} = 40.60X/A$$

An arbitrage opportunity will exist where the dealer's bid is above the implied offer or where the dealer's ask is below the implied bid. Looking at the answer choices, only choice C meets this criterion where the 41.35 bid is above the implied offer of 40.60. In this case, the dealer is overvaluing the A currency. Traders should sell the A currency to the dealer in exchange for X. The riskless profit on the triangular arbitrage would be 0.0185A for each unit of A sold.

Question 6

L2EC-TBB202-1412
LOS: LOS-6380
LOS: LOS-13g
Lesson Reference: Lesson 5: International Parity Relations Part I: Important Concepts, Covered and Uncovered Interest Rate Parity
Difficulty: medium

If all of the key international parity conditions held at all times, which of the following statements is *most likely* to be accurate?

- Investors could earn excess returns on currency movements by holding high interest rate currencies.
- Investors would be unable to earn consistent profits on currency movements.
- Investors could earn excess returns on currency movements by holding low inflation currencies.

Rationale

This Answer is Correct

If all international parity conditions held, then forward rates would accurately predict future spot rates and there would be no way to earn excess returns from forward rate speculation. It would also imply through uncovered interest rate parity that high-interest rate currencies weaken so that returns in different currencies would be the same.

Question 7

L2QM-PQ1227-1410
LOS: LOS-6420
LOS: LOS-6430
LOS: LOS-6440
Lesson Reference: Lesson 10: Monetary and Fiscal Policies
Difficulty: medium

Suppose that the country is currently in a deflationary gap. Given that the exchange rate is fixed and the country has sufficient FX reserves, an increase in money supply will *most likely*:

- Lead to depreciation of the domestic currency.
- Have no net impact on aggregate demand.
- Result in a significant increase in aggregate demand.

Rationale

This Answer is Correct

We work with the Mundell-Fleming model here since there is an output gap in the economy. With fixed exchange rates, an increase in money supply (decrease in interest rates) will exert downward pressure on the currency. However, the central bank will purchase its currency on the FX market to keep the exchange rate at its fixed level. As a result, the monetary base would shrink and domestic credit would dry up, offsetting the desired expansionary affect of the monetary stance.

Question 8
L2QM-PQ1222-1410
LOS: LOS-6370
LOS: LOS-6380
Lesson Reference: Lesson 6: International Parity Relations Part II: Purchasing Power Parity and the Real Exchange Rate
Difficulty: medium

Consider the following statements:

Statement 1: Uncovered interest rate parity is a no-arbitrage condition.

Statement 2: If all international parity conditions hold, the real yield spread across all countries would equal zero.

Which of the following is *most likely*?

- Only Statement 1 is correct.
- Only Statement 2 is correct.
- Both statements are correct.

Rationale

This Answer is Correct

A no-arbitrage condition is a relationship that must hold in an efficient market in order to prevent arbitrage opportunities offering risk-free excess returns. Uncovered interest rate parity links the current spot exchange rate with the expected spot exchange rate through interest rate differentials. This fails to qualify as no-arbitrage condition since the expected spot exchange rate is not tradeable and hence cannot be used in an arbitrage. The only interest rate parity relation that is a no-arbitrage condition is covered interest rate parity, which links the current spot rate with the fair forward rate, both of which can be traded.

Statement 2 is a correct statement.

Question 9
L2R13TB-AC032-1512
LOS: LO-6340
LOS: LO-13e
Lesson Reference: Lesson 4: Forward Markets
Difficulty: medium
A forward discount under assumptions of interest rate parity indicates:

- an expected decrease in the demand for the base currency.
- the interest rate is higher in the base currency relative to the price currency.
- the interest rate is higher in the price currency relative to the base currency.

Rationale

an expected decrease in the demand for the base currency.

Covered interest parity is the one parity condition that must always hold in the "real world" because it is based on arbitrage. It states that the forward price (*F*) is equal to the spot price (*S*) times the ratio of the interest rates in the price and base currencies (*r*).

$$F_{P/B} = S_{p/B}\left(\frac{1+r_P}{1+r_B}\right)$$

Notice that a premium discount (*FP/B* < *SP/B*) will only occur when the price interest rate is lower than the base interest rate (*rP* < *rB*).

Rationale

the interest rate is higher in the base currency relative to the price currency.

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Rationale

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$$F_{P/B} = S_{p/B}\left(\frac{1+r_P}{1+r_B}\right)$$

Notice that a premium discount ($FP/B < SP/B$) will only occur when the price interest rate is lower than the base interest rate ($rP < rB$).

Question 10
L2EC-TBX106-1502
LOS: LOS-6430
Lesson Reference: Lesson 10: Monetary and Fiscal Policies
Difficulty: easy
Opening up an economy to international trade and financial flows is most likely to lead to:

	Investment	Rate of Technological Change
A.	Increase	Decrease
B.	Increase	Increase
C.	Decrease	Decrease

- Row A
- Row B
- Row C

Rationale

This Answer is Correct

When a country opens its borders to international trade and financial flows, investment will not be constrained by domestic savings and countries can import technology. Both factors will most likely therefore increase.

Question 11

L2EC-TB0002-1412

LOS: LOS-6330

Lesson Reference: Lesson 3: Foreign Exchange Spreads and Arbitrage Constraints on Spot Exchange Rate Quotes

Difficulty: medium

A triangular arbitrage will be available in foreign exchange markets when which of the following situations occurs?

- The arbitrageur can sell at a bid that is higher than the fair implied bid.
- The arbitrageur can sell at an offer that is higher than the fair implied bid.
- The arbitrageur can sell at a bid that is higher than the fair implied ask.

Rationale

This Answer is Correct

An arbitrage opportunity will present itself in foreign exchange markets when arbitrageurs can sell at bid prices that are higher than the fair implied ask that can be implied by the quotes in the other two currencies.

An arbitrage will also be possible when the arbitrageur can buy at an ask price that is lower than the fair implied bid.

Question 12
L2R13TB-ITEMSET-AC020-1512
LOS: LO-6420
LOS: LO-6440
LOS: LO-6430
LOS: LO-13k
LOS: LO-13L
Lesson Reference: Lesson 10: Monetary and Fiscal Policies
Difficulty: medium

Use the following information to answer the next 3 questions:

Country A has a high degree of capital mobility and flexible exchange rates. It has issued a significant amount of sovereign debt over the past two years and is expected to continue on its current fiscal trend. While domestic interest rates have risen, Country A's proportion of debt to GDP is currently about average for economies of similar size.

i.
As a short-term effect, the domestic currency has been appreciating with the rise in interest rates, which could *most likely* be explained by the:

- (●) Mundell-Fleming model.
- ( ) portfolio balance approach.
- ( ) Dornbusch model.

Rationale
This Answer is Correct
The Mundell-Fleming model implies that deficit spending would increase domestic interest rates. These higher yields will attract capital flows into the country in the short run, which will cause the currency to appreciate.

Rationale
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Rationale
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The Mundell-Fleming model implies that deficit spending would increase domestic interest rates. These higher yields will attract capital flows into the country in the short run, which will cause the currency to appreciate.

ii.
In the medium term, as its proportion of debt to GDP grows, Country A begins to experience difficulty in financing its deficit. In response, the country's *most likely* policy response is:

- ( ) capital controls.
- ( ) fiscal easing.

monetary easing.

Rationale

This Answer is Incorrect

If the country has effectively run up too much debt, it will be tempted to monetize it through easy money policies, effectively printing money to pay down the debt. Capital controls, which limit investment by foreigners, would not help it sell its debt and, in fact, would make it harder to finance the deficit. Fiscal easing would involve even larger deficits, which is unlikely given the difficulty in financing existing debt.

Rationale

This Answer is Incorrect

If the country has effectively run up too much debt, it will be tempted to monetize it through easy money policies, effectively printing money to pay down the debt. Capital controls, which limit investment by foreigners, would not help it sell its debt and, in fact, would make it harder to finance the deficit. Fiscal easing would involve even larger deficits, which is unlikely given the difficulty in financing existing debt.

Rationale

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iii.

According to the portfolio balance approach, the long-run effect of a sustained series of easy fiscal policies and deficit spending will ultimately be:

- rising interest rates and currency depreciation.
- falling interest rates and currency appreciation.
- rising interest rates and currency appreciation.

Rationale

This Answer is Incorrect

The portfolio balance approach describes a long-run condition where deficit spending and the accumulation of debt causes investors in Country A's sovereign debt to demand higher risk premiums, leading to higher interest rates. However, unlike the short term effects of the Mundell-Fleming model, fear of the central bank monetizing the debt or a reversal of fiscal policy will prompt them to rebalance their portfolios away from Country A's debt, driving down the value of the currency.

Rationale

This Answer is Incorrect

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Question 13
L2QM-PQ1235-1410
LOS: LOS-6450
Lesson Reference: Lesson 11: Exchange Rate Management: Intervention and Controls, Currency Crises and Shorter-Term Forecasting Tools
Difficulty: medium

Consider the following statements:

Statement 1: Capital controls have been more successful in influencing the path taken by currencies of developing countries than currencies of developed countries.

Statement 2: Studies have shown that capital controls have a negligible impact on net capital flows.

Which of the following is *most likely*?

- Only Statement 1 is correct.
- Only Statement 2 is correct.
- Both statements are correct.

Rationale
This Answer is Correct
Both statements are correct.

Question 14
L2R13TB-AC025-1512
LOS: LOS-6400
LOS: LOS-13i
Lesson Reference: Lesson 8: The Carry Trade
Difficulty: medium
Carry trades can be profitable when:

- purchasing power parity holds.
- uncovered interest parity does not hold.
- covered interest rate parity does not hold.

Rationale
purchasing power parity holds.

The carry trade is predicated on uncovered interest rate parity not holding. Uncovered interest rate parity says that the change in the domestic exchange rate will approximately equal the interest rate differential between the foreign and domestic economies.

$$\%\Delta S_{f/d} = r_f - r_d$$

If this held true, the domestic currency would appreciate when the foreign interest rate is above the domestic. The carry trade works because higher domestic interest rates attract foreign capital flows, increasing the demand for the domestic currency, and causing it to appreciate.

Rationale
uncovered interest parity does not hold.

The carry trade is predicated on uncovered interest rate parity not holding. Uncovered interest rate parity says that the change in the domestic exchange rate will approximately equal the interest rate differential between the foreign and domestic economies.

$$\%\Delta S_{f/d} = r_f - r_d$$

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Rationale
covered interest rate parity does not hold.

The carry trade is predicated on uncovered interest rate parity not holding. Uncovered interest rate parity says that the change in the domestic exchange rate will approximately equal the interest rate differential between the foreign and domestic economies.

$$\%\Delta S_{f/d} = r_f - r_d$$

If this held true, the domestic currency would appreciate when the foreign interest rate is above the domestic. The carry trade works because higher domestic interest rates attract foreign capital flows,

increasing the demand for the domestic currency, and causing it to appreciate.

Question 15
L2QM-ITEMSET-PQ1208-1411
LOS: LOS-6350
Lesson Reference: Lesson 4: Forward Markets
Difficulty: medium

Use the following information to answer the questions:

A few months ago, Beta Investments hedged a long exposure to the USD by selling USD 20 million forward against the JPY. The all-in forward price was 89.35 (JPY/USD). Six months prior to the settlement date, Beta Investments wants to mark this forward position to market. The following information is available:

Spot rate (JPY/USD)	88.24/88.31
Six-month points	-13.4/-11.8
Six-month LIBOR (USD)	2.58%
Six-month LIBOR (JPY)	0.42%

i.
The mark-to-market for Beta Investments' forward position is *closest* to:

- JPY 23.07 million.
- JPY 23.11 million.
- JPY 23.15 million.

Rationale

This Answer is Correct

All-in six-month forward rate to buy USD and sell JPY to offset the original contract = 88.31 – 0.118 = 88.192.

Note that the forward points are expressed in "pips," which are the smallest decimal place of the spot quote. Given the spot quote is to two decimal places, the adjustment of –11.8 relates to adjusting the spot by –0.118.

On the settlement date:

Receive USD 20 million × 89.35 JPY/USD = JPY 1,787.00 million

Pay USD 20 million × 88.192 JPY/USD = JPY 1,763.84 million

Net position = JPY 23.16 million

Present value based on JPY LIBOR = 23.16m / {1 + [0.0042 × (180/360)]}

Present value based on JPY LIBOR = JPY 23.11 million

ii.
Given that Beta Investments hedged a long exposure to the JPY by selling JPY 20 million forward against the USD. The all-in forward price was 89.35 (JPY/USD). Six months prior to the settlement date, Beta Investments wants to mark this forward position to market. The mark to market for Beta Investments' forward position is *closest to*:

- –USD 2,748.27
- –USD 2,819.18
- –USD 3,120.21

Rationale

This Answer is Correct

All-in-six-month forward rate to buy JPY and sell USD to offset the original contract is = 88.24 + (–0.134) = 88.106.

On the settlement date:

Receive JPY 20 million / 89.35 JPY/USD = USD 223,838.84

Pay JPY 20 million / 88.106 JPY/USD = USD 226,999.30

Net position = −USD 3,160.46

Present value based on USD LIBOR = −3,160.42 / {1+[0.0258 ×(180/360)]}

Present value based on USD LIBOR = −USD 3,120.21

Question 16
L2QM-PQ1215-1410
LOS: LOS-6360
Lesson Reference: Lesson 7: International Parity Relations Part III: The Fisher Effect and Bringing All Parity Relations Together
Difficulty: medium
Which of the following parity relations assumes that transaction costs and trade impediments are constant over time?

- Absolute purchasing power parity.
- Relative purchasing power parity.
- Uncovered interest rate parity.

Rationale

This Answer is Correct

Absolute purchasing power parity assumes that there are no transaction costs and other trade restrictions. Relative purchasing power parity assumes that these are constant over time.

Question 17
L2QM-PQ1225-1410
LOS: LOS-6410
Lesson Reference: Lesson 9: The Impact of Balance of Payment Flows
Difficulty: medium
Which of the following is *most likely* to have an impact on a currency's exchange rate in the short run?

- Trade flows
- Capital flows
- Inflation differentials

Rationale

This Answer is Correct
Capital flows are the dominant factor in determining exchange rates in the short and medium terms. Trade flows and inflation differentials have an impact in the long run.

Question 18
L2R13TB-ITEMSET-AC016-1512
LOS: LOS-6410
Lesson Reference: Lesson 9: The Impact of Balance of Payment Flows
Difficulty: N/A

Use the following information to answer the next 3 questions:

An analyst is asked to provide his opinion about potential exchange rate movements between Country D and Country E. As a developed economy, D's currency is considered to be a safe haven for investment with low yields. In comparison, Country E is an emerging market with a high-yield currency that is more sensitive to volatility in the global economy. The developed country runs a persistent and substantial current account deficit with the emerging country.

The analyst uses a basic model to forecast the real exchange rate ($q_{D/E}$) between Countries D and E, considering them in isolation to other trading partners around the world. The model uses the long-term average trend in real exchange rates $\bar{q}_{D/E}$ combined with nominal interest rate differentials (r), inflation differentials (π), and risk premium differentials between φ the two countries.

$$q_{D/E} = \bar{q}_{D/E} + (r_E - r_D) - (\pi_E^e - \pi_D^e) - (\varphi_E - \varphi_D)$$

The analyst is interested in the effects of investors' perceptions of risk, capital flows, and interventions by the monetary authorities.

i.
If global economic turmoil reduces investors' appetite for risk, which of the following would *most likely* occur?

- The demand for Country E's currency would increase, increasing $q_{D/E}$.
- The demand for Country D's currency would increase, reducing $q_{D/E}$.
- The demand for Country E's currency would increase, reducing $q_{D/E}$.

Rationale
This Answer is Correct
Economic turmoil would suggest that investors would seek out safe haven investments in Country D and exit positions in Country E. The selling of E's currency and the buying of D's would put downward pressure on the real D/E exchange rate.

Rationale
This Answer is Correct
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Rationale
This Answer is Correct
Economic turmoil would suggest that investors would seek out safe haven investments in Country D and exit positions in Country E. The selling of E's currency and the buying of D's would put downward pressure on the real D/E exchange rate.

ii.

The real exchange rate of the currency of Country E (qD/E) will *most likely* appreciate if the:

- expected inflation level for Country E increases relative to Country D.
- nominal yield on investments in Country E is lower than in Country D.
- risk premium for Country D rises relative to that of Country E.

Rationale

This Answer is Incorrect

Looking at the real exchange rate model, Country E's real exchange rate ($q_{D/E}$) *appreciates* when:

- the average long-run real equilibrium exchange rate ($\bar{q}_{D/E}$) trend value rises;
- the nominal yield spread ($rE - rD$) between the Country E and D increases;
- the inflation spread ($\pi_E - \pi D$) between Country E and D falls; or
- the risk premium difference between Country E and D falls.

Rationale

This Answer is Incorrect

Looking at the real exchange rate model, Country E's real exchange rate ($q_{D/E}$) *appreciates* when:

- the average long-run real equilibrium exchange rate ($\bar{q}_{D/E}$) trend value rises;
- the nominal yield spread ($rE - rD$) between the Country E and D increases;
- the inflation spread ($\pi_E - \pi D$) between Country E and D falls; or
- the risk premium difference between Country E and D falls.

Rationale

This Answer is Incorrect

Looking at the real exchange rate model, Country E's real exchange rate ($q_{D/E}$) *appreciates* when:

- the average long-run real equilibrium exchange rate ($\bar{q}_{D/E}$) trend value rises;
- the nominal yield spread ($rE - rD$) between the Country E and D increases;
- the inflation spread ($\pi_E - \pi D$) between Country E and D falls; or
- the risk premium difference between Country E and D falls.

iii.

If Country E's government encourages an economic environment that promotes price stability, long-run growth, and a more stable financial system, the country's real exchange rate should appreciate primarily through a(n):

- decline in its nominal investment yields.
- increase its risk premium.
- gradual rise in its long-run equilibrium value.

Rationale

This Answer is Incorrect
As investors become convinced that the Country E's government is committed to stable prices, long-run growth, and stable institutions, they will gradually increase the estimated long-run equilibrium value of the currency ($\bar{q}_{D/E}$). This would increase the baseline value of the real exchange rate ($q_{D/E}$).

Rationale

This Answer is Incorrect
As investors become convinced that the Country E's government is committed to stable prices, long-run growth, and stable institutions, they will gradually increase the estimated long-run equilibrium value of the currency ($\bar{q}_{D/E}$). This would increase the baseline value of the real exchange rate ($q_{D/E}$).

Rationale

This Answer is Incorrect
As investors become convinced that the Country E's government is committed to stable prices, long-run growth, and stable institutions, they will gradually increase the estimated long-run equilibrium value of the currency ($\bar{q}_{D/E}$). This would increase the baseline value of the real exchange rate ($q_{D/E}$).

Question 19
L2R13TB-AC026-1512
LOS: LOS-6360
LOS: LOS-13e
Lesson Reference: Lesson 5: International Parity Relations Part I: Important Concepts, Covered and Uncovered Interest Rate Parity
Difficulty: medium
Which of the following would be a limitation to purchasing power parity (PPP) holding?

- (●) Trade barriers.
- ( ) Differences in inflation rates across countries.
- ( ) Differences in growth rates.

Rationale
✔ **Trade barriers.**
PPP assumes that goods and services flow freely between countries. If trade barriers restrict the movement of goods, arbitrageurs would not be able to exploit price imbalances, allowing them to persist.

Rationale
✘ **Differences in inflation rates across countries.**
PPP assumes that goods and services flow freely between countries. If trade barriers restrict the movement of goods, arbitrageurs would not be able to exploit price imbalances, allowing them to persist.

Rationale
✘ **Differences in growth rates.**
PPP assumes that goods and services flow freely between countries. If trade barriers restrict the movement of goods, arbitrageurs would not be able to exploit price imbalances, allowing them to persist.

Question 20
L2EC-TB0004-1412
LOS: LOS-6360
LOS: LOS-13f
Lesson Reference: Lesson 5: International Parity Relations Part I: Important Concepts, Covered and Uncovered Interest Rate Parity
Difficulty: medium

Stella James, CFA, is at a global investment conference and is relaxing between events at the hotel bar. She overhears two other attendees at the conference discussing models used to predict foreign exchange rates. They make the following statements:

> Statement 1: "If uncovered interest parity holds, then the forward rate must be equal to the expected future spot rate."
> Statement 2: "If covered interest parity doesn't hold, then the forward rate and current spot rate can be arbitraged."

How many of the statements are *most likely* to be correct?

- Zero.
- One.
- Two.

Rationale
This Answer is Correct
Both statements are correct interpretations of uncovered and covered interest rate parity relationships.

Question 21

L2EC-TBX103-1502

LOS: LO-13n

Lesson Reference: Lesson 11: Exchange Rate Management: Intervention and Controls, Currency Crises and Shorter-Term Forecasting Tools

Difficulty: easy

An emerging-market country with a fairly-valued currency faces an unwanted surge in capital inflows. If inflation is a concern in the emerging market, which of the following policy responses by the central bank is *most likely* to be appropriate?

- Allow the currency to appreciate.
- Unsterilized intervention.
- Sterilized intervention.

Rationale

This Answer is Correct

Since the currency is not deemed to be undervalued, policymakers will want to intervene to avoid strengthening the currency to overvalued levels and a subsequent potential crash. Hence, the first option is incorrect. The central bank should intervene by loosening monetary policy to lower interest rates and discourage capital flow into the country. Given that inflation is a concern, the central bank should carry out sterilization of the excess liquidity introduced to the market by selling domestic securities to the private sector so that excess liquidity does not stoke inflation.

Question 22
L2R13TB-AC031-1512
LOS: LOS-6330
Lesson Reference: Lesson 2: Cross Rate Calculations with Bid-Ask Spreads
Difficulty: medium

The following table represents midpoint quotations for exchange rates in the format price/base.

Ratio	Spot Rate
BAD/GLD	0.7550
BAD/SLV	0.8700
BAD/PLT	1.3500

The spot SLV/GLD rate is *closest* to:

- 0.8678
- 0.8700
- 1.1523

Rationale

This Answer is Correct

Start with the currency unit algebra to determine whether you should multiply or divide.

$$\frac{\text{SLV}}{\text{GLD}} = \frac{-}{\text{GLD}} \times \frac{\text{SLV}}{-} = \frac{\text{BAD}}{\text{GLD}} + \frac{\text{BAD}}{\text{SLV}}$$

$$= \frac{0.7550\ \text{BAD}\,/\,\text{GLD}}{0.8700\ \text{BAD}\,/\,\text{SLV}} = 0.8678\ \text{SLV}\,/\,\text{GLD}$$

Question 23
L1EC-PQ2110-1410
LOS: LOS-2280
Lesson Reference: Lesson 1: Foreign Exchange Market Concepts
Difficulty: medium
A dealer offers an exchange rate of JPY/USD = 78.95−79.20. This *least likely* implies that:

- The dealer is willing to sell USD for 79.20 yen.
- The dealer is willing to buy JPY for 78.95 dollars.
- The dealer is willing to sell JPY for 0.01267 dollars.

Rationale

This Answer is Correct

The exchange rate quote implies that the dealer is willing to:

- Buy the base currency (USD) for 78.95 yen.
- Sell the base currency (USD) for 79.20 yen.
- Sell the price currency (JPY) for 0.01267 dollars.
- Buy the price currency (JPY) for 0.01263 dollars.

Question 24
L2R13TB-AC028-1512
LOS: LOS-6360
LOS: LOS-13e
Lesson Reference: Lesson 5: International Parity Relations Part I: Important Concepts, Covered and Uncovered Interest Rate Parity
Difficulty: medium
If the real interest rates in Country X and Country Y are equivalent, the variation in nominal rates between the two countries according to the international Fisher effect would be *closest* to:

- (•) their expected inflation differential.
- ( ) the percent change in the exchange rate.
- ( ) the long run average real exchange rate.

Rationale
✓ **their expected inflation differential.**

The Fisher effect simply says that you can break the nominal interest rate into two components, the real interest rate and the expected inflation rate.

$$r = rr + \pi^e$$

The international Fisher effect with real interest rate parity implies that differences in expected inflation rates fully explain nominal interest rate differences.

$$r_f - r_d = \pi_f^e - \pi_d^e$$

Rationale
✗ **the percent change in the exchange rate.**

The Fisher effect simply says that you can break the nominal interest rate into two components, the real interest rate and the expected inflation rate.

$$r = rr + \pi^e$$

The international Fisher effect with real interest rate parity implies that differences in expected inflation rates fully explain nominal interest rate differences.

$$r_f - r_d = \pi_f^e - \pi_d^e$$

Rationale
✗ **the long run average real exchange rate.**

The Fisher effect simply says that you can break the nominal interest rate into two components, the real interest rate and the expected inflation rate.

$$r = rr + \pi^e$$

The international Fisher effect with real interest rate parity implies that differences in expected inflation rates fully explain nominal interest rate differences.

$$r_f - r_d = \pi_f^e - \pi_d^e$$

Question 25

L2QM-PQ1233-1410

LOS: LOS-6450

Lesson Reference: Lesson 11: Exchange Rate Management: Intervention and Controls, Currency Crises and Shorter-Term Forecasting Tools

Difficulty: medium

Which of the following is *least likely* a pull factor resulting in capital flows?

- Better economic management in the domestic economy
- A more flexible exchange rate regime
- Low interest rates in developed countries

Rationale

This Answer is Correct

Developed countries tend to be the primary source of internationally mobile capital. Low interest rates in those economies would encourage funds to be pushed out from those economies into emerging economies.

Question 26

L2R13TB-AC024-1512

LOS: LO-13m

Lesson Reference: Lesson 11: Exchange Rate Management: Intervention and Controls, Currency Crises and Shorter-Term Forecasting Tools

Difficulty: medium

The central bank of Country X initiated monetary easing, while Country Y maintains a neutral monetary policy. The *most likely* result is:

- currency X will appreciate relative to currency Y.
- currency Y will appreciate relative to currency X.
- no distinct impact on relative currency value.

Rationale

This Answer is Correct

Easing typically results in the reduction of interest rates; if rates decline in Country X, investment returns in Country Y may provide a greater return. As a result, ceteris paribus, Country Y's currency will likely appreciate relative to Country X.

Question 27
L2QM-PQ1236-1410
LOS: LOS-6460
Lesson Reference: Lesson 11: Exchange Rate Management: Intervention and Controls, Currency Crises and Shorter-Term Forecasting Tools
Difficulty: medium
Which of the following is *least likely* a warning sign of a currency crisis?

- A sharp rise in nominal private credit growth
- A drastic decline in foreign exchange reserves
- A dramatic deterioration of the trade balance

Rationale

This Answer is Correct
The trade balance displays no significant difference in the pre-crisis period versus relatively tranquil periods.

Question 28
L2R13TB-AC027-1512
LOS: LOS-6320
Lesson Reference: Lesson 3: Foreign Exchange Spreads and Arbitrage Constraints on Spot Exchange Rate Quotes
Difficulty: medium

A dealer is given the following interbank exchange rate quotations using the USD as the base currency.

CAD/USD	1.2104/1.2112
ZAR/USD	11.0642/11.0653

Based on this information, what is the bid offer on ZAR/CAD cross rate implied by the interbank market?

- 0.1094/0.1095.
- 9.1349/9.1419.
- 9.1409/9.1358.

Rationale

This Answer is Correct

It is best to start by doing the currency unit algebra to ascertain whether you should multiply or divide, and then adding the numbers to the equation.

$$\frac{\text{ZAR}}{\text{CAD}} = \frac{\text{ZAR}}{-} \times \frac{-}{\text{CAD}} = \frac{\text{ZAR}}{\text{USD}} + \frac{\text{CAD}}{\text{USD}}$$

Recall that the dealer will demand the largest possible bid ask spread. Starting with the bid, which is the lower of the two quotes, we'll use the smallest numerator and the largest denominator. Similarly, for the ask side, we'll use the largest numerator and the smallest denominator.

$$\text{Bid} = \frac{11.0642\ \text{ZAR}}{\text{USD}} + \frac{1.2112\ \text{CAD}}{\text{USD}} = \frac{11.0642\ \text{ZAR}}{1.2112\ \text{CAD}} = 9.1349\ \text{ZAR}/\text{CAD}$$

$$\text{Offer} = \frac{11.0653\ \text{ZAR}}{\text{USD}} + \frac{1.2104\ \text{CAD}}{\text{USD}} = \frac{111.0653\ \text{ZAR}}{1.2104\ \text{CAD}} = 9.1419\ \text{ZAR}/\text{CAD}$$

Question 29
L2QM-PQ1229-1410
LOS: LOS-6440
Lesson Reference: Lesson 10: Monetary and Fiscal Policies
Difficulty: medium
With floating exchange rates and low capital mobility, an expansionary monetary stance combined with an expansionary fiscal stance will *most likely* result in:

- Appreciation of the domestic currency.
- Depreciation of the domestic currency.
- No clear directional impact on the domestic currency.

Rationale

This Answer is Correct
With low capital mobility, the impact of monetary and fiscal policy on exchange rates comes from trade flows. Expansionary monetary and fiscal policies both lead to a reduction in net exports, causing the domestic currency to depreciate.

Question 30
L1EC-PQ2113-1410
LOS: LOS-2290
Lesson Reference: Lesson 1: Foreign Exchange Market Concepts
Difficulty: medium

A trader is quoted the following exchange rates:

	Spot Rate	Expected Spot Rate in One Year
EUR/USD	0.7186	0.7129
GBP/USD	0.6435	0.6396
USD/JPY	0.0127	0.0125

The spot GBP/EUR cross rate is *closest to*:

- 0.8972
- 2.1624
- 0.8955

Rationale
This Answer is Correct

$GBP/EUR = (EUR/USD)^{-1} \times GBP/USD$

$GBP/EUR = (1/0.7186) \times 0.6435 = 0.8955$

Question 31
L2QM-PQ1230-1410
LOS: LOS-6440
Lesson Reference: Lesson 10: Monetary and Fiscal Policies
Difficulty: medium
According to the Dornbusch model, a decrease in domestic money supply will *most likely* lead to:

- Appreciation in the short run followed by depreciation over time to a level that is still higher than the initial exchange rate.
- Depreciation in the short run followed by further depreciation over time to a level that is substantially lower than the initial exchange rate.
- Depreciation in the short run followed by appreciation over time to a level that is still lower than the initial exchange rate.

Rationale

This Answer is Correct

In the short run, since prices are not flexible, a decrease in domestic money supply translates into a decrease in real money supply. Real interest rates rise, resulting in capital inflows and substantial appreciation of the domestic currency. In fact, the currency overshoots and reaches a level higher than predicted by purchasing power parity.

In the long run, prices are flexible so the currency settles at the value implied by purchasing power parity. Since the currency overshoots in the short run (over appreciates), it depreciates over the long run to a level predicted by purchasing power parity, which is still higher than the initial exchange rate.

Question 32
L2QM-PQ1213-1410
LOS: LOS-6340
LOS: LOS-6360
Lesson Reference: Lesson 5: International Parity Relations Part I: Important Concepts, Covered and Uncovered Interest Rate Parity
Difficulty: medium

Consider the following statements:

Statement 1: If covered interest rate parity holds, a rise in the USD risk-free rate will result in an increase in the forward exchange rate $F_{EUR/USD}$.

Statement 2: If $F_{JPY/GBP}$ is greater than $S_{JPY/GBP}$, the GBP is expected to appreciate going forward.

Which of the following is *most likely*?

- Only Statement 1 is correct.
- Only Statement 2 is correct.
- Both statements are correct.

Rationale

This Answer is Correct

If covered interest rate parity holds, a rise in the USD risk-free rate will result in a **decrease** in the forward exchange rate $F_{EUR/USD}$.

If $F_{JPY/GBP}$ is greater than $S_{JPY/GBP}$, the GBP is trading at a forward premium and is expected to appreciate going forward.

Question 33
L1EC-PQ2112-1410
LOS: LOS-2290
Lesson Reference: Lesson 1: Foreign Exchange Market Concepts
Difficulty: medium

A trader is quoted the following exchange rates:

	Spot Rate	Expected Spot Rate in One Year
USD/EUR	1.3915	1.4028
USD/GBP	1.5540	1.5635
JPY/USD	78.95	80.25

The expected spot JPY/EUR cross rate in one year is *closest to*:

- (•) 112.5747
- ( ) 56.7373
- ( ) 109.8589

Rationale

This Answer is Correct

JPY/EUR = USD/EUR × JPY/USD

JPY/EUR = 1.4028 × 80.25 = 112.5747

Question 34
L2R13TB-AC029-1512
LOS: LOS-6400
LOS: LOS-13i
Lesson Reference: Lesson 8: The Carry Trade
Difficulty: medium
The distribution of carry trade returns *most closely* resembles:

- a normal distribution.
- negatively skewed distribution with fat tails.
- positively skewed distribution.

Rationale
a normal distribution.
The carry trade is profitable during times of stability. However, it can suffer severe losses should volatility or crises erupt. Being prone to strong negative occurrences, the distribution of returns tends to be negatively skewed (drawn toward negative outliers) and experiences more frequent extreme outcomes than the normal distribution would imply.

Rationale
negatively skewed distribution with fat tails.
The carry trade is profitable during times of stability. However, it can suffer severe losses should volatility or crises erupt. Being prone to strong negative occurrences, the distribution of returns tends to be negatively skewed (drawn toward negative outliers) and experiences more frequent extreme outcomes than the normal distribution would imply.

Rationale
positively skewed distribution.
The carry trade is profitable during times of stability. However, it can suffer severe losses should volatility or crises erupt. Being prone to strong negative occurrences, the distribution of returns tends to be negatively skewed (drawn toward negative outliers) and experiences more frequent extreme outcomes than the normal distribution would imply.

Question 35
L2R13TB-AC016-1512
LOS: LO-13l
Lesson Reference: Lesson 10: Monetary and Fiscal Policies
Difficulty: medium
If Country E was in economic turmoil, but Country D was stable, which of the following would *most likely* occur?

- The demand for Country E's currency would increase, increasing $q_{D/E}$.
- The demand for Country D's currency would increase, reducing $q_{D/E}$.
- The demand for Country E's currency would increase, reducing $q_{D/E}$.

Rationale

The demand for Country E's currency would increase, increasing $q_{D/E}$.
Economic turmoil would suggest that investors would seek out safe haven investments in Country D and exit positions in Country E. The selling of E's currency and the buying of D's would put downward pressure on the real D/E exchange rate.

Rationale

The demand for Country D's currency would increase, reducing $q_{D/E}$.
Economic turmoil would suggest that investors would seek out safe haven investments in Country D and exit positions in Country E. The selling of E's currency and the buying of D's would put downward pressure on the real D/E exchange rate.

Rationale

The demand for Country E's currency would increase, reducing $q_{D/E}$.
Economic turmoil would suggest that investors would seek out safe haven investments in Country D and exit positions in Country E. The selling of E's currency and the buying of D's would put downward pressure on the real D/E exchange rate.

Question 36

L2EC-TBB203-1412

LOS: LO-13h

Lesson Reference: Lesson 7: International Parity Relations Part III: The Fisher Effect and Bringing All Parity Relations Together

Difficulty: medium

The mechanism of interest for an analyst focusing on ratio of national debt to GDP would *most likely* be:

- the portfolio balance channel.
- the debt sustainability channel.
- the flow supply-demand channel.

Rationale

This Answer is Correct

The debt sustainability channel looks at national debt to GDP to determine whether a country will be able to continue to service debt or whether the country's currency must depreciate to make the debt affordable. Debt sustainability examines demand for more debt. The portfolio balance channel examines whether debt providers will continue to supply more debt or whether they choose to diversify their portfolio, which will result in depreciation. Portfolio balance examines the supply of more debt. The flow supply-demand channel looks at current account imbalances and whether other countries will continue to purchase goods from them if they have to continue receiving depreciating method of payment.

Question 37
L2EC-TBB201-1412
LOS: LOS-6370
LOS: LOS-13f
LOS: LOS-13e
Lesson Reference: Lesson 5: International Parity Relations Part I: Important Concepts, Covered and Uncovered Interest Rate Parity
Difficulty: hard
Which of the following statements regarding the relations among international parity conditions is *correct*?

- If uncovered interest rate parity and purchasing power parity hold, then real interest rate parity must hold.
- If covered interest rate parity and purchasing power parity hold, then the forward rate is an unbiased predictor of future spot rates.
- If uncovered interest rate parity holds, then the forward rate will not be an unbiased predictor of future spot rates.

Rationale

If uncovered interest rate parity and purchasing power parity hold, then real interest rate parity must hold.
Uncovered interest rate parity states that interest differentials drive future spot rates. Purchasing power parity states that inflation differentials drive spot rates. If both these conditions hold, interest rate differentials must be the same as inflations differentials; hence, the real interest rate in different currencies will be the same. This implies that real interest rate parity must hold.

Rationale

If covered interest rate parity and purchasing power parity hold, then the forward rate is an unbiased predictor of future spot rates.
The second option is incorrect because valid covered interest rate parity implies that the forward rate is driven by interest rate differentials. If interest rate differentials are not purely down to inflation and purchasing power parity holds, then the future spot rate will not be equal to the forward rate.

Rationale

If uncovered interest rate parity holds, then the forward rate will not be an unbiased predictor of future spot rates.
The third option is incorrect since uncovered interest rate parity holding implies that future spot rates are driven by interest rate differentials, as is the forward rate under covered interest rate parity, which always holds since it is a no arbitrage relationship. Hence, if uncovered interest rate parity holds, then the forward rate will be an unbiased predictor of the future spot rate.

Question 38
L2R13TB-ITEMSET-AC004-1512
LOS: LOS-6380
LOS: LOS-13g
Lesson Reference: Lesson 5: International Parity Relations Part I: Important Concepts, Covered and Uncovered Interest Rate Parity
Difficulty: medium

Use the following information to answer the questions:

An analyst collected the following information concerning interest rate and exchange rates.

One Year LIBOR (Today)	Currency Pair	Spot Rate (Today)
GBP 3.00%	GBP/CAD	2.15
CAD 0.75%	CAD/USD	1.05
USD 0.10%	GBP/USD	0.75

i.
If covered interest parity holds, the one year return to the British investor whose currency exposure to the USD is fully hedged is *closest to*:

- 0.10%
- 3.00%
- 2.90%

Rationale
This Answer is Correct
If covered interest rate parity holds, then the return to the British investor with a fully hedged USD exposure would be 3.00%.

ii.
If uncovered interest rate parity holds between today and a year from today, the expected movement in the GBP/USD currency pair is *closest to*:

- 3.00%
- 2.90%
- −2.90%

Rationale
This Answer is Correct
Uncovered interest rate parity implies that the expected change in the spot rate is equivalent to the interest rate differential.

iii.
If uncovered interest rate parity holds, today's expected value for the GBP/USD currency pair one year from now would be *closest to*:

- 0.75
- 1.50
- 0.77

Rationale

This Answer is Correct

The expected spot rate is a function of the current spot rate and the inflation differential:

$$\begin{aligned} S_{PC/BC}(1+r_{PC}) &= E(S_{PC/BC})(1+r_{PC}) \\ E(S_{PC/BC}) &= \frac{S_{PC/BC}(1+r_{PC})}{(1+r_{PC})} \\ &= \frac{0.75(1+0.03)}{1+0.001} = 0.7717 \end{aligned}$$

Question 39
L2QM-PQ1210-1410
LOS: LOS-6400
Lesson Reference: Lesson 8: The Carry Trade
Difficulty: medium

Consider the following information:

Currency	Today's	One-Year LIBOR
JPY	0.15%	
USD	4.25%	

Currency Pair	Spot Rate Today	Spot Rate One-Year Later
JPY/AUD	81.25	80.15
AUD/USD	1.0525	1.0593

The one-year return on a carry trade based on borrowing JPY and investing in one-year USD LIBOR measured in terms of JPY is *closest* to:

- 3.35%.
- 3.50%.
- 4.85%.

Rationale

This Answer is Correct

Current JPY/USD spot rate = 81.25 × 1.0525 = 85.5156

JPY/USD spot exchange rate in one-year = 80.15 × 1.0593 = 84.9029

Return on unhedged USD LIBOR investment in terms of JPY

= [84.9029/85.5156 × (1+0.0425) −1] = 3.50%

Since funding costs equal 0.15%, the net return on the carry trade equals 3.35%.

Question 40

L2EC-TBX104-1502

LOS: LO-13o

Lesson Reference: Lesson 11: Exchange Rate Management: Intervention and Controls, Currency Crises and Shorter-Term Forecasting Tools

Difficulty: easy

Which of the following scenarios is *least likely* to be observed in the buildup to a currency crisis?

- (●) Foreign exchange reserves tend to rise aggressively.
- ( ) Real exchange rates tend to be substantially above the long term mean.
- ( ) Inflation tends to be significantly higher.

Rationale

This Answer is Correct

In the study conducted by the IMF analyzing the behavior of 10 key macroeconomic variables around the time of currency crises in 50 countries over the period 1975–1997, it was found that foreign exchange reserves tended to fall precipitously in the period leading up to a currency crisis.

Question 41
L2R13TB-AC018-1512
LOS: LO-13l
Lesson Reference: Lesson 10: Monetary and Fiscal Policies
Difficulty: medium
If Country E's government encourages an economic environment that promotes price stability, long run growth, and a more stable financial system, the country's real exchange rate should appreciate primarily through a(n):

- decline in its nominal investment yields.
- increase its risk premium.
- gradual rise in its long-run equilibrium value.

Rationale
decline in its nominal investment yields.
As investors become convinced that Country E's government is committed to stable prices, long run growth, and stable institutions, they will gradually increase the estimated long run equilibrium value of the currency $\left(\bar{q}_{D/E}\right)$. This would increase the baseline value of the real exchange rate $\left(q_{D/E}\right)$.

Rationale
increase its risk premium.
As investors become convinced that Country E's government is committed to stable prices, long run growth, and stable institutions, they will gradually increase the estimated long run equilibrium value of the currency $\left(\bar{q}_{D/E}\right)$. This would increase the baseline value of the real exchange rate $\left(q_{D/E}\right)$.

Rationale
gradual rise in its long-run equilibrium value.
As investors become convinced that Country E's government is committed to stable prices, long run growth, and stable institutions, they will gradually increase the estimated long run equilibrium value of the currency $\left(\bar{q}_{D/E}\right)$. This would increase the baseline value of the real exchange rate $\left(q_{D/E}\right)$.

Question 42
L2R13TB-ITEMSET-AC014-1512
LOS: LOS-6400
LOS: LOS-13b
Lesson Reference: Lesson 8: The Carry Trade
Difficulty: medium

Use the following information to answer the next 2 questions:

A dealer enters into a one-year carry trade position using JPY as the funding currency and NZD as the target currency. Relevant market data is provided in the following table.

	JPY	NZD
1-year interest rate	0.10%	3.00%
Currency pairs	JPY/USD	NZD/USD
Spot rate	108.16	1.2775
Spot rate in one year	107.25	1.2545

i.
After one year, the return on the trade measured in JPY would be *closest to*:

- −1.94%.
- +2.10%.
- +3.90%.

Rationale

This Answer is Correct

A successful carry trade assumes uncovered interest rate parity fails to hold. First, calculate the initial and expected cross-currency rates for JPY/NZD:

$$S_0 = 108.16\ JPY/\text{USD} \div 1.2775\ NZD/USD$$
$$= \frac{84.67\ JPY}{\cancel{\text{USD}}} \times \frac{\cancel{\text{USD}}}{1.2775\ NZD} = 84.67\ JPY/NZD$$
$$E(S_t) = \frac{107.25\ JPY}{\cancel{\text{USD}}} \times \frac{\cancel{\text{USD}}}{1.2545\ NZD} = 85.49\ JPY/NZD$$

Because NZD appreciates relative to JPY *and* has a higher interest rate, we want to borrow in JPY at 0.10%, convert the current at the spot rate, invest in NZD at 3.00%, and repay the Japanese loan in depreciated currency (i.e., the future spot exchange rate).

The return will equal the NZD lending rate and the multiplicative effect created by JPY depreciation, less the JPY borrowing rate:

$$r_{CT} = \left[(1 + r_{NZD})\left(\frac{E\left(S_{JPY/NZD,t}\right)}{S_{JPY/NZD,0}}\right) - 1\right] - r_{JPY}$$
$$= \left[(1.03)\left(\frac{85.49}{84.67}\right) - 1\right] - 0.0010 = 0.03898 \text{ or } 3.9\%$$

The investment return measured in JPY is the return on the NZD investment (3.00%), less the cost of JPY funds (0.10%), plus the return on the change in the JPY/NZD exchange rate (85.49/84.67 − 1):

ii.

If uncovered interest rate parity held, the expected return on this trade is *closest to*:

- −1.94%.
- 0.10%.
- 0.00%.

Rationale

This Answer is Correct

If uncovered interest rate parity holds, then the return to the carry trade is zero. This is because uncovered interest rate parity states that high interest rate currencies should depreciate by the interest rate differential over time.

Question 43
L2EC-TBX107-1502
LOS: LOS-6430
Lesson Reference: Lesson 10: Monetary and Fiscal Policies
Difficulty: easy
The endogenous growth model predicts that a more open trade policy will permanently raise the rate of economic growth due for three reasons. One of these reasons is linked to less advanced economies catching up with more advanced countries through knowledge spillovers. This is known as the:

- Selection effect.
- Scale effect.
- Backwardness effect.

Rationale

This Answer is Correct

The selection effect relates to an increase in domestic efficiency brought about by international competition. The scale effect relates to benefiting from economies of scale through having a larger international customer base.

Question 44
L2QM-PQ1216-1410
LOS: LOS-6380
Lesson Reference: Lesson 7: International Parity Relations Part III: The Fisher Effect and Bringing All Parity Relations Together
Difficulty: medium

Consider the following statements:

Statement 1: The real exchange rate $q_{FC/DC}$ equals the ratio of the foreign price level expressed in the domestic currency to the domestic price level.

Statement 2: The real exchange rate $q_{FC/DC}$ is a decreasing function of the domestic price level.

Which of the following is *most likely*?

- Only Statement 1 is correct.
- Only Statement 2 is correct.
- Both statements are incorrect.

Rationale

This Answer is Correct

The real exchange rate $q_{FC/DC}$ equals the ratio of the **domestic** price level expressed in the **foreign** currency to the **foreign** price level. $q_{FC/DC} = S_{FC/DC} \times (P_{DC}/P_{FC})$

The real exchange rate $q_{FC/DC}$ is an **increasing** function of the domestic price level. If the domestic price level rises, domestic income will also increase (assumption), so domestic citizens will be able to purchase more foreign goods.

Question 45

L2EC-TBX105-1502

LOS: LO-13p

Lesson Reference: Lesson 11: Exchange Rate Management: Intervention and Controls, Currency Crises and Shorter-Term Forecasting Tools

Difficulty: easy

A negative risk reversal quote on the USD/GBP exchange rate would *most likely* confirm which of the following trends?

- Decreasing foreign exchange volatility.
- Strengthening GBP.
- Weakening GBP.

Rationale

This Answer is Correct

A negative risk reversal quote indicates that put options on the base currency are more expensive than call options. This indicates that the market is attaching a higher probability to a large depreciation of the base currency.

Question 46
L2QM-PQ1223-1410
LOS: LOS-6400
Lesson Reference: Lesson 8: The Carry Trade
Difficulty: medium

Consider the following statements:

Statement 1: Historically, carry trades have resulted in small gains for investors more frequently than would be expected were carry trade returns normally distributed.

Statement 2: Historically, carry trades have resulted in larger but less frequent losses than implied by the normal distribution.

Which of the following is *most likely*?

- (•) Only Statement 1 is correct.
- ( ) Only Statement 2 is correct.
- ( ) Both statements are correct.

Rationale

This Answer is Correct

Carry trade returns have not followed a normal distribution. The returns distribution has been more peaked, with fatter tails that are negatively skewed.

The negative skew implies more extreme losses.
The fatter tails imply **more frequent** losses.

Question 47
L2R13TB-AC017-1512
LOS: LO-13l
Lesson Reference: Lesson 10: Monetary and Fiscal Policies
Difficulty: medium
The real exchange rate of the currency of Country E (*qD/E*) will *most likely* appreciate if the:

- expected inflation level for Country E increases relative to Country D.
- nominal yield on investments in Country E is lower than in Country D.
- risk premium for Country D rises relative to that of Country E.

Rationale
expected inflation level for Country E increases relative to Country D.
Looking at the real exchange rate model, Country E's real exchange rate ($q_{D/E}$) *appreciates*

- the average long-run real equilibrium exchange ($\left(\bar{q}_{D/E}\right)$ rate trend value rises;
- the nominal yield spread (*rE* – *rD*) between the Country E and D increases;
- the inflation spread ($\pi_E - \pi D$) between Country E and D falls; or
- the risk premium difference between Country E and D falls.

Rationale
nominal yield on investments in Country E is lower than in Country D.
Looking at the real exchange rate model, Country E's real exchange rate ($q_{D/E}$) *appreciates*

- the average long-run real equilibrium exchange ($\left(\bar{q}_{D/E}\right)$ rate trend value rises;
- the nominal yield spread (*rE* – *rD*) between the Country E and D increases;
- the inflation spread ($\pi_E - \pi D$) between Country E and D falls; or
- the risk premium difference between Country E and D falls.

Rationale
risk premium for Country D rises relative to that of Country E.
Looking at the real exchange rate model, Country E's real exchange rate ($q_{D/E}$) *appreciates*

- the average long-run real equilibrium exchange ($\left(\bar{q}_{D/E}\right)$ rate trend value rises;
- the nominal yield spread (*rE* – *rD*) between the Country E and D increases;
- the inflation spread ($\pi_E - \pi D$) between Country E and D falls; or
- the risk premium difference between Country E and D falls.

Question 48
L2R13TB-AC010-1512
LOS: LO-6340
LOS: LO-13c
Lesson Reference: Lesson 4: Forward Markets
Difficulty: medium

The U.S. dollar (USD)—South African rand (ZAR) exchange rate was recently quoted at 11.0472 ZAR/USD. You are interested in a 90-day forward contract on the ZAR/USD. The annualized short-term interest rates in each country are shown in the following table.

Interest Rates

Term	ZAR Rate	USD Rate
30-day	5.00%	0.05%
90-day	5.05	0.07
180-day	5.20	0.10
270-day	5.85	0.16

The forward premium or discount for the ZAR/USD exchange rate is *closest* to:

- −0.0262 ZAR.
- +0.0893 ZAR.
- +0.1375 ZAR.

Rationale

This Answer is Correct

Note that this question does not require calculating a forward premium/discount percentage:

$$F_{\text{ZAR / USD}} = S \times \frac{1+(t/360)(i_{\text{PC}})}{1+(t/360)(i_{\text{BC}})}$$

$$= 11.0472 \times \frac{1+0.25(0.0505)}{1+0.25(0.0007)} = 11.1847$$

$$\text{FP} = F - S = 11.1847 - 11.0472 = 0.1375\,\text{ZAR}$$

Question 49

L2QM-PQ1217-1410

LOS: LOS-6380

Lesson Reference: Lesson 6: International Parity Relations Part II: Purchasing Power Parity and the Real Exchange Rate

Difficulty: medium

Which of the following is *least likely* to serve as a valid framework for assessing the long-run fair value of a currency?

- (•) Absolute purchasing power parity
- ( ) Relative purchasing power parity
- ( ) Uncovered interest rate parity

Rationale

This Answer is Correct

Relative purchasing power parity and uncovered interest rate parity work better in the long run than in the short run. Absolute purchasing power parity tends not to hold because product mixes and consumption baskets differ across countries and there are transaction costs and trade impediments.

Question 50

L2EC-TB0003-1412
LOS: LOS-6360
LOS: LOS-13e
Lesson Reference: Lesson 5: International Parity Relations Part I: Important Concepts, Covered and Uncovered Interest Rate Parity
Difficulty: medium

Which of the following statements *most accurately* describes covered interest parity?

- Covered interest parity is a theory regarding the expected future spot rate of a currency.
- Covered interest rate parity is a no arbitrage relationship regarding the fair forward rate of a currency.
- Covered interest rate parity is a no arbitrage relationship regarding the expected future spot rate of a currency.

Rationale

This Answer is Correct

Covered interest rate parity is a no-arbitrage relationship holding that the fair forward rate of a currency pair is dictated by differences in interest rates.

Question 51
L2R13TB-AC034-1512
LOS: LOS-6370
LOS: LOS-13e
Lesson Reference: Lesson 5: International Parity Relations Part I: Important Concepts, Covered and Uncovered Interest Rate Parity
Difficulty: medium
Which of the following parity conditions is *most likely* to hold in the short run?

- (●) Covered interest rate parity.
- ( ) Real interest rate parity.
- ( ) Uncovered interest rate parity.

Rationale
✔ **Covered interest rate parity.**
Because it is based on arbitrage, only covered interest rate parity is likely to hold in the short run. Empirical studies have shown that real interest rate parity and uncovered interest rate parity do not hold in the short run. If they hold at all, it is likely only in the very long run.

Rationale
✘ **Real interest rate parity.**
Because it is based on arbitrage, only covered interest rate parity is likely to hold in the short run. Empirical studies have shown that real interest rate parity and uncovered interest rate parity do not hold in the short run. If they hold at all, it is likely only in the very long run.

Rationale
✘ **Uncovered interest rate parity.**
Because it is based on arbitrage, only covered interest rate parity is likely to hold in the short run. Empirical studies have shown that real interest rate parity and uncovered interest rate parity do not hold in the short run. If they hold at all, it is likely only in the very long run.

Question 52
L2QM-PQ1219-1410
LOS: LOS-6360
Lesson Reference: Lesson 7: International Parity Relations Part III: The Fisher Effect and Bringing All Parity Relations Together
Difficulty: medium
Which of the following *most likely* asserts that the foreign domestic nominal yield spread is determined by the foreign domestic expected inflation differential?

- Uncovered interest rate parity
- *Ex ante* purchasing power parity
- International Fisher effect

Rationale

This Answer is Correct

The International Fisher effect asserts that the foreign-domestic nominal yield spread is determined by the foreign-domestic expected inflation differential.

International Fisher effect: $(i_{FC} - i_{DC}) = (\pi^e_{FC} - \pi^e_{DC})$

Question 53
L2QM-PQ1218-1410
LOS: LOS-6370
Lesson Reference: Lesson 7: International Parity Relations Part III: The Fisher Effect and Bringing All Parity Relations Together
Difficulty: medium
Which of the following is *least likely* required to hold for real interest rates to converge to the same level across countries?

- (●) Absolute purchasing power parity
- ( ) Uncovered interest rate parity
- ( ) *Ex ante* purchasing power parity

Rationale

This Answer is Correct

Real interest rate parity (the assertion that real interest rates will converge to the same level across countries) requires that both (1) uncovered interest rate parity and (2) *ex ante* purchasing power parity hold.

Question 54
L2R13TB-AC030-1512
LOS: LO-13l
Lesson Reference: Lesson 9: The Impact of Balance of Payment Flows
Difficulty: medium
According to the flow supply/demand channel, a persistent current account deficit in Country X relative to Country Y will *most likely* result in an:

- accumulation of Country Y wealth owned by Country X.
- appreciation in currency value of Country Y relative to Country X.
- increase in Country Y's interest rates relative to Country X.

Rationale
accumulation of Country Y wealth owned by Country X.
The flow supply/demand channel is an approach to exchange rate determination based on the balance of payments. If Country X runs a trade deficit with Country Y (X buys more goods from Y than Y buys from X), it will have to pay for those purchases with Y's currency. The excess demand for Y's currency will put upward pressure on it, causing currency Y to appreciate relative to currency X.

Rationale
appreciation in currency value of Country Y relative to Country X.
The flow supply/demand channel is an approach to exchange rate determination based on the balance of payments. If Country X runs a trade deficit with Country Y (X buys more goods from Y than Y buys from X), it will have to pay for those purchases with Y's currency. The excess demand for Y's currency will put upward pressure on it, causing currency Y to appreciate relative to currency X.

Rationale
increase in Country Y's interest rates relative to Country X.
The flow supply/demand channel is an approach to exchange rate determination based on the balance of payments. If Country X runs a trade deficit with Country Y (X buys more goods from Y than Y buys from X), it will have to pay for those purchases with Y's currency. The excess demand for Y's currency will put upward pressure on it, causing currency Y to appreciate relative to currency X.

Question 55
L2R13TB-ITEMSET-AC001-1512
LOS: LOS-6380
LOS: LOS-13g
Lesson Reference: Lesson 5: International Parity Relations Part I: Important Concepts, Covered and Uncovered Interest Rate Parity
Difficulty: medium

Use the following information to answer the next three questions:

A German asset manager is deciding whether to allocate money between the Euro and the British pound based on the following information:

GBP/EUR spot rate: 0.7840
One-year GBP forward points: 0.50
One-year British risk-free rate: 3.50%
One-year German risk-free rate: 1.75%

i.
Based on uncovered interest rate parity, the expected change in the GBP/EUR is *closest* to a(n):

- (●) increase of 1.75%.
- ( ) decrease of 1.75%.
- ( ) decrease of 3.50%.

Rationale
This Answer is Correct

Uncovered interest rate parity indicates that the change in GBP (the pricing currency) and EUR (the base currency) will be approximated by the interest rate differentials between the countries:

$$\Delta S = ip - iB = 3.50\% - 1.75\% = 1.75\%$$

The base currency will now be worth 1.75% more than before, so it has appreciated by that percentage.

Rationale
This Answer is Correct

Uncovered interest rate parity indicates that the change in GBP (the pricing currency) and EUR (the base currency) will be approximated by the interest rate differentials between the countries:

$$\Delta S = ip - iB = 3.50\% - 1.75\% = 1.75\%$$

The base currency will now be worth 1.75% more than before, so it has appreciated by that percentage.

Rationale
This Answer is Correct

Uncovered interest rate parity indicates that the change in GBP (the pricing currency) and EUR (the base currency) will be approximated by the interest rate differentials between the countries:

$$\Delta S = ip - iB = 3.50\% - 1.75\% = 1.75\%$$

The base currency will now be worth 1.75% more than before, so it has appreciated by that percentage.

ii.

Using forward points to forecast the future GBP/EUR spot rate one year from now assumes that:

- spot rates follow a random walk.
- uncovered interest rate parity does not hold.
- investors are risk neutral.

Rationale

This Answer is Incorrect

Using forward rates to forecast future spot rates assumes uncovered interest rate parity, which is based on investors being risk neutral.

Rationale

This Answer is Incorrect

Using forward rates to forecast future spot rates assumes uncovered interest rate parity, which is based on investors being risk neutral.

Rationale

This Answer is Incorrect

Using forward rates to forecast future spot rates assumes uncovered interest rate parity, which is based on investors being risk neutral.

iii.

If the asset manager completely hedged currency risk associated with a one-year British deposit using a forward rate contract, the one-year holding period return in EUR would be *closest to*:

- 3.50%.
- 1.75%.
- 0.00%.

Rationale

This Answer is Incorrect

A fully-hedged GBP position would provide the same return as the EUR alternative: 1.75%.

Rationale

This Answer is Incorrect

Rationale

This Answer is Incorrect

Question 56

L2EC-TBX101-1502

LOS: LO-13j

Lesson Reference: Lesson 9: The Impact of Balance of Payment Flows

Difficulty: easy

Wayne McCoy, CFA, is an economist attempting to describe the impact of balance of payment flows on the exchange rate of several developed economies. In a particular country, he predicts that a large current account surplus over several years has led to a buildup of foreign holdings in domestic assets that is likely to be reduced in the near future, leading to pressure on the foreign exchange rate of the country. McCoy is describing which of the following mechanisms?

- The flow supply/demand channel.
- The portfolio balance channel.
- The debt sustainability channel.

Rationale

This Answer is Correct

The analyst is describing the portfolio balance channel mechanism when describing the impact of balance of payment flows on the exchange rate. The flow supply/demand channel mechanism states that the current account deficit itself will lead to a weakening of domestic currency, while the debt sustainability channel focuses on the ability of current account deficit nations to service the debts built up from a current account deficit and the weakening impact this will have on their currency.

Question 57

L2R13TB-AC023-1512

LOS: LO-13p

Lesson Reference: Lesson 11: Exchange Rate Management: Intervention and Controls, Currency Crises and Shorter-Term Forecasting Tools

Difficulty: medium

An associate analyst is asked to evaluate currency movements and opts to use technical analysis. He summarizes his findings in a memo to his lead analyst. Which of the following statement would be characterized as *incorrect*?

- Customer order inflows and exchange rates exhibit high short-term correlations.
- Technical analysis is a strong historical predictor of currency movements.
- Technical analysis may be a valuable tool for currency risk management.

Rationale

This Answer is Correct

Although technical analysis is widely used, trend following technical strategies have become less profitable as currency movements have become less dramatic over the last two decades. Trend-following rules have not performed as well in recent history. However, several studies have suggested that technical analysis might be useful in managing downside risk by helping traders avoid extreme contrarian strategies that increased return volatility.

Question 58
L2QM-PQ1220-1410
LOS: LOS-6360
Lesson Reference: Lesson 7: International Parity Relations Part III: The Fisher Effect and Bringing All Parity Relations Together
Difficulty: medium
Which of the following parity relations *most likely* asserts that currencies with lower nominal interest rates will be expected to appreciate in the future?

- Covered interest rate parity
- Uncovered interest rate parity
- International Fisher effect

Rationale

This Answer is Correct

Uncovered interest rate parity asserts that currencies with lower (higher) nominal interest rates will be expected to appreciate (depreciate) in the future.

Covered interest rate parity asserts that currencies with lower (higher) nominal interest rates will trade at a forward premium (discount).

Question 59
L2R13TB-AC033-1512
LOS: LO-13l
Lesson Reference: Lesson 10: Monetary and Fiscal Policies
Difficulty: medium
According to the Mundell-Fleming model under conditions of high capital mobility, which of the following policy mixes will *most likely* result in a strong appreciation in the domestic currency?

- Expansionary monetary policy and restrictive fiscal policy.
- Restrictive monetary policy and restrictive fiscal policy.
- Expansionary fiscal policy and restrictive monetary policy.

Rationale

Expansionary monetary policy and restrictive fiscal policy.
The Mundell-Fleming model views exchange rate determination from the perspective of the effects of interest rates and output growth on capital flows. Foreign capital is attracted to environments with high yields and economic growth. Restrictive monetary policy will drive up interest rates and expansionary fiscal policy will foster growth in GDP. Both of these conditions will draw capital inflows, which put strong upward pressure on the domestic currency value.

Rationale

Restrictive monetary policy and restrictive fiscal policy.
The Mundell-Fleming model views exchange rate determination from the perspective of the effects of interest rates and output growth on capital flows. Foreign capital is attracted to environments with high yields and economic growth. Restrictive monetary policy will drive up interest rates and expansionary fiscal policy will foster growth in GDP. Both of these conditions will draw capital inflows, which put strong upward pressure on the domestic currency value.

Rationale

Expansionary fiscal policy and restrictive monetary policy.
The Mundell-Fleming model views exchange rate determination from the perspective of the effects of interest rates and output growth on capital flows. Foreign capital is attracted to environments with high yields and economic growth. Restrictive monetary policy will drive up interest rates and expansionary fiscal policy will foster growth in GDP. Both of these conditions will draw capital inflows, which put strong upward pressure on the domestic currency value.

Question 60

L2EC-TBB204-1412
LOS: LOS-6400
LOS: LOS-13i
Lesson Reference: Lesson 9: The Impact of Balance of Payment Flows
Difficulty: medium

Which of the following scenarios would *most likely* lead to losses for an investor engaging in an FX carry trade?

- (●) High-interest-rate currencies weaken by more than uncovered interest rate parity predicts.
- ( ) Uncovered interest rate parity holds.
- ( ) High-interest-rate currencies weaken by less than uncovered interest rate parity predicts.

Rationale

This Answer is Correct

The FX carry trade involves depositing in a high-interest-rate currency and borrowing in a low interest rate currency. If uncovered interest rate parity holds, the investor will earn no excess return since the depreciation of the high-interest-rate currency will offset the interest rate differentials. A further weakening of the high-interest-rate currency will cause losses on the carry trade. High-interest-rate currencies weakening by less than uncovered interest rate parity predicts. would give rise to gains on a carry trade.

Question 61

L2R13TB-0002

LOS: LO-13a

Lesson Reference: Lesson 3: Foreign Exchange Spreads and Arbitrage Constraints on Spot Exchange Rate Quotes

Difficulty: medium

The currency quote for US dollars (USD) and Russian rubles (RUB) is 57.5255-57.5349 RUB/USD. The dealer spread for this pair is *closest* to:

- 0.94%.
- 94 pips.
- 1.75%.

Rationale

This Answer is Correct

For a currency pair quoted to four decimal places, a pip equals 0.0001. The dealer spread is: 57.5349 – 57.5255 = 0.0094, so this pair has a spread of 94 pips. The percentage spread is 0.016%, calculated as the number of pips divided by the ask price.

Question 62
L2QM-PQ1211-1410
LOS: LOS-6340
Lesson Reference: Lesson 4: Forward Markets
Difficulty: medium
Which of the following is *least likely* to affect the size of the bid ask spread in the spot FX market?

- The size of the transaction
- The currency pair involved
- The creditworthiness of the counterparty

Rationale

This Answer is Correct
Credit risk does not play an important role in determining the spread quoted to clients in the FX spot market.

Question 63
L2QM-PQ1212-1410
LOS: LOS-6330
LOS: LOS-6340
Lesson Reference: Lesson 4: Forward Markets
Difficulty: medium

Consider the following statements:

Statement 1: If the cross rate bid quoted by a dealer is lower than the implied cross rate ask available in the interbank market, arbitrage is possible.

Statement 2: The greater the uncertainty in the market, the narrower the bid ask spread in the spot FX market.

Which of the following is *most likely*?

- Only Statement 1 is correct.
- Only Statement 2 is correct.
- Both statements are incorrect.

Rationale

This Answer is Correct

If the cross rate bid quoted by a dealer is **higher** than the implied cross rate ask available in the interbank market, arbitrage is possible.

The greater the uncertainty in the market, the **wider** the bid ask spread in the spot FX market.

Question 64

L2R13TB-AC035-1512

LOS: LO-13n

Lesson Reference: Lesson 11: Exchange Rate Management: Intervention and Controls, Currency Crises and Shorter-Term Forecasting Tools

Difficulty: medium

Currency interventions are *least likely* to be effective for:

- emerging countries with significant foreign currency reserves.
- developed countries with large gold reserves.
- emerging countries with undervalued currencies.

Rationale

This Answer is Correct

Developed countries tend to see the ratio of official foreign exchange reserves to the average daily volume of their currencies trading volume to be insignificantly small. Therefore, direct intervention in the currency markets are not considered to be an effective tool for controlling exchange rate movements.