End-Sem Question Bank - 2

1) Questions that will carry 2 marks each

A) Distinguish between spot and forward exchange rates.

Answer:

The main difference between forward rate and spot rate in foreign exchange is their timing. The spot rate is the current market price for immediate currency exchange, while the forward rate is an agreed-upon price for exchanging currencies at a future date.

B) Describe in brief the functions of World Bank, The international Monetary Fund, and World Trade Organisation.

Answer:

The World Bank's role is to reduce poverty by lending money to the governments of its poorer members to improve their economies and to improve the standard of living of their people. The Bank is also one of the world's largest research centres in development.

The IMF's three main roles are economic surveillance, lending, and capacity development.

he overall objective of the WTO is to help its members use trade as a means to raise living standards, create jobs and improve people's lives. The WTO operates the global system of trade rules and helps developing countries build their trade capacity.

C) Distinguish between comparative advantage and absolute advantage.

Answer:

Where absolute advantage refers to the ability of an entity (a country) to produce a greater quantity of a product or service, comparative

advantage refers to the ability to produce goods and services at a lower opportunity cost compared to the competition.

D) Compare gross domestic product and gross national product.

Answer:

Gross domestic product (GDP) is the value of the finished domestic goods and services produced within a nation's borders. On the other hand, gross national product (GNP) is the value of all finished goods and services produced by a country's citizens, both domestically and abroad.

E) What are the main components of Balance of Payments?

Answer:

The major components of the balance of payments are the

- current account balance, which largely reflects trade in goods and services.
- capital account balance, which mainly consists of capital transfers and net sales of non-produced, non-financial assets.
- financial account, which measures net capital flows based on sales and purchases of domestic and foreign financial assets.

F) What do you understand by trade restrictions and capital restrictions?

Answer:

Capital restrictions are defined as controls placed on foreigners' ability to own domestic assets and/or domestic residents' ability to own foreign assets. In contrast to trade restrictions, which limit the openness of goods markets, capital restrictions limit the openness of financial markets.

G) Define Money. What are the basic functions of money?

Answer:

Money is any item or medium of exchange that symbolizes perceived value. As a result, it is accepted by people for the payment of goods and services, as well as the repayment of loans. Economies rely on money to facilitate transactions and to power financial growth.

Money serves four basic functions:

- it is a unit of account
- it's a store of value
- it is a medium of exchange and finally,
- it is a standard of deferred payment.

H) What is the Fisher's theory of money demand?

Answer:

Fisher's Quantity Theory of Money-The Transactions Approach: The quantity of money affects the price level and value of money. Price level changes directly and value of money changes inversely in the same proportion as the change in supply of money, other things remaining the same.

2) Questions that will carry 5 Marks

A) How do decisions by consumers, firms, and governments influence the balance of payments?

Answers:

Low private savings and/or high investment tend to produce a current account deficit that must be financed by net capital imports; high private savings and/or low investment, however, produce a current account surplus, balanced by net capital exports.

All else the same, a government deficit produces a current account deficit and a government surplus lead to a current account surplus.

All else the same, a sustained current account deficit contributes to a rise in the risk premium for financial assets of the deficit country. Current account surplus countries tend to enjoy lower risk premiums than current account deficit countries.

B) Compare Monetary and Fiscal policies

Answer:

Monetary policy refers to central bank activities that are directed toward influencing the quantity of money and credit in an economy. By contrast, **fiscal policy** refers to the government's decisions about taxation and spending. Both monetary and fiscal policies are used to regulate economic activity over time. They can be used to accelerate growth when an economy starts to slow or to moderate growth and activity when an economy starts to overheat. In addition, fiscal policy can be used to redistribute income and wealth.

The overarching goal of both monetary and fiscal policy is normally the creation of an economic environment where growth is stable and positive and inflation is stable and low. Crucially, the aim is therefore to steer the underlying economy so that it does not experience economic booms that may be followed by extended periods of low or negative growth and high levels of unemployment. In such a stable economic environment, householders can feel secure in their consumption and saving decisions, while corporations can concentrate on their investment decisions, on making their regular coupon payments to their bond holders and on making profits for their shareholders.

C) What are the IS – LM Model?

Answer:

The IS-LM model, which stands for "investment-saving" (IS) and "liquidity preference-money supply" (LM), is a Keynesian macroeconomic model that shows how the market for economic goods interacts with the loanable funds market, or money market. It is represented as a graph in which the IS and LM curves intersect to show the short-run equilibrium between interest rates and output.

The IS curve depicts the set of all levels of interest rates and output (GDP) at which total investment (I) equals total saving (S). At lower interest rates, investment is higher, which translates into more total output (GDP), so the IS curve slopes downward and to the right.

The LM curve depicts the set of all levels of income (GDP) and interest rates at which money supply equals money (liquidity) demand. The LM curve slopes upward because higher levels of income (GDP) induce increased demand to hold money balances for transactions, which requires a higher interest rate to keep money supply and liquidity demand in equilibrium.

3)Questions that will carry 5 marks each

A) *(a)* What is meant by a saving leakage? (*b*) Will output expand or contract when (1) saving is greater than investment? (2) spending is greater than output?

Answer:

(a) When individuals do not consume their entire income, they are not purchasing the entire output they helped create. That is, there is a saving leakage. Investment must fill the void created by saving if output is to be maintained.

(*b*) (1) Output contracts since saving leakages are not replaced by an equal amount of investment injections. (2) Output expands since planned spending exceeds output.

B) What is Covered Interest Arbitrage?

Answer:

Covered interest arbitrage is a strategy in which an investor uses a forward contract to hedge against exchange rate risk. Covered interest rate arbitrage is the practice of using favourable interest rate differentials to invest in a higher-yielding currency, and hedging the exchange risk through a forward currency contract.

Covered interest arbitrage is only possible if the cost of hedging the exchange risk is less than the additional return generated by investing in a higher-yielding currency—hence, the word *arbitrage.*

C) What is the difference between a flexible exchange rate environment and a fixed exchange rate environment?

Answer:

A shift of the supply and/or demand for foreign exchange changes the exchange rate in a flexible exchange rate environment. When the exchange rate is fixed, the central banks of the two countries agree to intervene in the foreign exchange market to maintain the agreed to exchange rate. Thus, a supply and/or demand shift in the foreign exchange market may create a surplus or shortage of foreign exchange. The central banks eliminate the surplus or shortage by buying or selling foreign exchange.

4)<u>Questions that will carry 10 marks each</u>

A) Distinguish between nominal and real exchange rates

Answer:

Nominal exchange rates are the rates at which you can exchange one currency for another. For example, if the nominal exchange rate between the British pound and the US dollar is 1.3, this means you can

exchange 1 pound for 1.3 dollars. Nominal exchange rates are the rates you see quoted in the foreign exchange market and are used in most international financial transactions.

On the other hand, real exchange rates take into account the relative purchasing power of the two currencies. They adjust the nominal exchange rate for differences in price levels or inflation rates between the two countries. This is important because inflation can erode the value of money over time. If prices are rising faster in one country than another, the real value of its currency will fall, even if the nominal exchange rate remains unchanged.

Understanding the difference between nominal and real exchange rates is crucial for international trade and investment. Nominal rates tell you how much of one currency you can get for another, but real rates tell you how much you can actually buy with that currency in another country. If the real exchange rate is high, it means your currency has a lot of purchasing power abroad, which can make foreign goods and investments seem cheap. Conversely, if the real exchange rate is low, foreign goods and investments can seem expensive.

B) What is the relationship between the spot rate, the forward rate and the interest rate in foreign and domestic countries

Answer:

The interest rate difference between two countries affects the spot and forward rates. Using a single period analogy, an investor who has funds to invest in treasury securities, has two alternatives:

- Invest at the domestic risk-free rate (i_d).
- Invest at the foreign risk-free rate (i_f).

If the investor takes the former option, the fund held at the end of the period would be $(1 + i_d)$. Alternatively, the investor could convert the domestic currency to be invested in a foreign currency using the spot

rate $S_{f/d}$. It is important to note that (f/d) is the currency quoting convention that expresses the number of foreign units per single domestic unit.

At the end of the investment period, the investor would old $S_{f/d}(1 + i_f)$ units of foreign currency. Then, the funds would have to be converted back into the domestic currency using the initial forward rate. Note that the two investment alternatives are risk-free because they are invested in risk-free assets.

Since these investment alternatives are equal, considering the risk characteristics, the returns must also be equal. As such, we have the following relationship:

$$1 + i_d = S_{f/d}(1 + i_f)\left(\frac{1}{F_{f/d}}\right)$$

Note that $^1/_{F_{f/d}}$ is the number of units of domestic currency for each unit of foreign sold forward.

The relationship above can be rearranged to get the formula for a forward rate as:

$$F_{f/d} = S_{f/d}\left(\frac{1 + i_f}{1 + i_d}\right)$$

This formula shows the relationship among the spot rate, the forward rate, and the interest rate in foreign and domestic countries.