# Chapter 14 - Test Bank

###  Multiple-choice questions

[Go to ⇨ Multiple choice questions - Memorandum](#AC14MCQ)

*Answer the following questions by selecting the appropriate answer from the list below.*

**Payment of dividends to a foreign entity will be reflected in which ONE of the following accounts of the balance of payments (BoP)?**

1. Trade account
2. Services account
3. Income account
4. Capital account

**Which ONE of the following statements defines the term “principal brokers”?**

1. Brokers trading as principals for own account so as to act as market makers.
2. Brokers matching deals where settlement takes place between two principals.
3. Brokers matching deals where settlement takes place between principal and broker.
4. Brokers matching deals where settlement takes place between the broker and another broker.

**Which ONE of the following statements is correct with regard to the spot currency quote of EUR/USD = 1,3525/1,3530?**

1. EUR is the base currency and will be bought by a client at 1,3525.
2. EUR is the base currency and will be bought by a client at 1,3530.
3. USD is the base currency and will be bought by a client at 1,3525.
4. USD is the base currency and will be bought by a client at 1,3530.

Which of the following currencies are generally quoted against the USD as an indirect quotation?

1. UK pound sterling (GBP)
2. New Zealand dollar (NZD)
3. Australian dollar (AUD)
4. Japanese yen (JPY)
5. (i) and (iii) only
6. (i), (ii) and (iii) only
7. (i), (ii) and (iv) only
8. (ii), (iii) and (iv) only

**Peter needs to convert ZAR 1 million into USD. He receives the following quotes:**

* **Bank A: USD/ZAR 8,1850/8,1875**
* **Bank B: USD/ZAR 8,1845/8,1880**

**Which bank offers Peter the best deal, and what amount of USD will he receive if he deals with this bank?**

1. Bank A; and Peter will receive USD 122 137,40
2. Bank A; and Peter will receive USD 8 185 000,00
3. Bank B; and Peter will receive USD 122 182,17
4. Bank B; and Peter will receive USD 8 187 500,00

####

**What would the fair value 135-day forward price for the USD/ZAR be, assuming US interest rates at 7 per cent and SA interest rates at 9 per cent (for such maturities)? Assume a current spot rate of USD/ZAR = 7,6740.**

1. 7,3950
2. 7,8432
3. 7,7266
4. 8,1155

**James expects to receive USD 5 million in six months’ time and hopes to hedge himself against the volatility of the USD/ZAR exchange rate. He phones a broker who quotes him 500/550 as the forward points for the transaction. What action should James take, and at what price (i.e. which forward points) to hedge his exposure?**

1. Sell USD 5m forward at 500 points as he is exposed to the ZAR depreciating.
2. Sell USD 5m forward at 500 point as he is exposed to the ZAR appreciating.
3. Buy USD 5m forward at 550 points as he is exposed to the ZAR depreciating.
4. Buy USD 5m forward at 550 points as he is exposed to the ZAR appreciating.

**A local merchant is importing a huge consignment of foreign goods and would like to hedge himself against possible currency fluctuations but is not sure exactly when the foreign currency will be required. Which ONE of the following instruments is most suitable to the importer?**

1. Foreign exchange forward-forward transaction
2. Foreign exchange swap transaction
3. Foreign exchange call option
4. Foreign exchange time option

**Entering into a forward-forward foreign exchange contract will be the most suitable option for a participant who**

1. has entered into a forward contract but wishes to defer the transaction further
2. hopes to take a view on the interest rate differentials between two countries
3. wants to hedge currency risk but without giving up any potential for gain from fluctuations
4. wants to utilise the comparative advantage it has in a specific currency market

**Which ONE of the following represents a characteristic of a foreign exchange futures contract?**

1. No need to post initial margin
2. Ability to create perfect hedges
3. No intention of delivering the currency
4. Flexibility in choosing the expiry date

###  Written questions

[Go to ⇨ Written questions - Memorandum](#AC14WQ)

*Answer the following questions.*

**Explain the role of forex brokers in the foreign exchange market.**

**Explain the concept “pip” and discuss why traders make use of it.**

**Calculate the CAD/USD rate if the USD/CAD is quoted as 1.0272.**

**Calculate the spread in percentage terms of the quotation USD/ZAR 7,8925/7,8989.**

**Define a foreign exchange swap.**

####

**Thabo Express enters into a swap agreement with Fair-Value Bank to exchange USD 1 million for ZAR and to buy USD for ZAR after 60 days. The swap points quoted by Fair-Value Bank are 510/530 at an agreed benchmark rate of USD/ZAR 8,1200.**

**Indicate the cash flows of the transactions at the swap deal date and at 60 days for both parties, as well as the net cash flow for each of them.**

**This implies that Thabo will buy USD 1 million spot at the benchmark rate of R8,12 and then sell it back forward to Fair-Value at their offer rate of 8,1200 + 0,0530 = R8,1730 per USD.**

**List the reasons for the use of the swap market by the central bank of a country.**

**Differentiate between a currency call option and a currency put option.**

####

**Who is responsible for the authorisation of dealer banks to act as market makers in foreign exchange in South Africa?**

**Discuss the consequences of depreciation of the ZAR on imported and exported consumer goods.**

###  Application questions

[Go to ⇨ Application questions - Memorandum](#AC14AQ)

*Read the statements below and indicate whether they are true or false.*

**Susan receives the following market quotes:**

* **USD/ZAR 7,2550/7,2570**
* **USD/CHF 1,2555/1,2575**

**Calculate both the bid and the offer rate for the CHF/ZAR and the ZAR/CHF.**

**The EUR/USD changes from 1,6255 to 1,3215.**

**2.1 Which of the two currencies has appreciated?**

**2.2 Calculate the percentage appreciation/depreciation for the EUR.**

**2.3 Calculate the percentage appreciation/depreciation for the USD.**

**The six-month USD interest rate is set at 8 per cent whilst the six-month ZAR interest rate is set at 6 per cent and the current USD/ZAR spot rate is 8,1850.**

**3.1 Calculate the six-month (181 day) USD/ZAR forward rate.**

**3.2 Calculate the forward points.**

###  True or false questions

[Go to ⇨ True/False questions - Memorandum](#AC14TFQ)

*Read the statements below and indicate whether they are true or false.*

**The market-making banks in the foreign exchange market deal between themselves internationally via the telephone-screen trading system.**

**It is the norm in the foreign exchange market that clients make known the size of their deal to the market maker but not whether they are trading as buyer of seller of the foreign currency they require a quote on.**

**Clients buy the base currency at the market maker’s bid rate, which is normally lower, and sell at their offer rate, which is normally higher.**

**The holder of a call time option has the option but not the obligation to buy the underlying currency at the strike price at any time before or on expiry of the option.**

**An American option bestows the right upon the holder to exercise the option at any time before and on the expiry date of the option.**

###  Choose the correct term

 [Go to ⇨ Choose the correct term - Memorandum](#AC14CTCT)

*Select the correct term to make the statement accurate.*

**Name-give-up brokers and principal brokers act in single/dual capacity in the foreign exchange market.**

**When the USD is, for example, quoted as GPB/USD 1,57595, this is referred to as a direct/indirect quotation.**

**Thinly traded currencies will have a dealer spread smaller/wider than more liquid currencies.**

**In the foreign exchange market, the currency with the lower interest rate always trades at a forward premium/discount.**

**Travel abroad will become more affordable to South Africans if the ZAR appreciates/depreciates meaningfully against the currencies of their destination countries.**

# Chapter 14 - Memorandum

###  Multiple-choice questions

[Go back to ⇦ Multiple choice questions](#C14MCQ)

*Answer the following questions by selecting the appropriate answer from the list below.*

**Payment of dividends to a foreign entity will be reflected in which ONE of the following accounts of the balance of payments (BoP)?**

1. Trade account
2. Services account
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**Which ONE of the following statements defines the term “principal brokers”?**

1. Brokers trading as principals for own account so as to act as market makers.
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**Which ONE of the following statements is correct with regard to the spot currency quote of EUR/USD = 1,3525/1,3530?**

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Which of the following currencies are generally quoted against the USD as an indirect quotation?

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**Peter needs to convert ZAR 1 million into USD. He receives the following quotes:**

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2. 7,8432
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**James expects to receive USD 5 million in six months’ time and hopes to hedge himself against the volatility of the USD/ZAR exchange rate. He phones a broker who quotes him 500/550 as the forward points for the transaction. What action should James take, and at what price (i.e. which forward points) to hedge his exposure?**

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4. Buy USD 5m forward at 550 points as he is exposed to the ZAR appreciating.

**A local merchant is importing a huge consignment of foreign goods and would like to hedge himself against possible currency fluctuations but is not sure exactly when the foreign currency will be required. Which ONE of the following instruments is most suitable to the importer?**

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**Which ONE of the following represents a characteristic of a foreign exchange futures contract?**

1. No need to post initial margin
2. Ability to create perfect hedges
3. No intention of delivering the currency
4. Flexibility in choosing the expiry date

###  Written questions

[Go back to ⇦ Written questions](#C14WQ)

*Answer the following questions.*

**Explain the role of forex brokers in the foreign exchange market.**

**The role of the forex brokers in the foreign exchange market is substantial. The brokers communicate deals/quotes available and, given their market penetration, provide a window into the market.**

**The brokers also offer anonymity to the principals (the banks), meaning that the large deals of banks (which could possibly affect prices) are not communicated to the rest of the market. The brokers only deal with the market-making banks and not with their clients.**

**Explain the concept “pip” and discuss why traders make use of it.**

**“Pip” stands for “percentage in point” and it is the smallest price increment in forex trading. For the ZAR and most other currencies, one pip is equivalent to the fourth decimal place, which is 1/10 000 or 0,0001 of a rand or 1/100th of a cent. However, this four-decimal-places rule does not apply in all currency markets. For example, for the JPY (against the USD), a pip is equivalent to the second decimal place – that is, 1/100 or 0,01 yen.**

**The currency market trades in pips as exchange rates generally change in one-pip movements, enabling participants to estimate profits and losses rapidly.**

**Calculate the CAD/USD rate if the USD/CAD is quoted as 1.0272.**

**CAD/USD 0,9735**

**Calculate the spread in percentage terms of the quotation USD/ZAR 7,8925/7,8989.**

**Spread = (7,8989 – 7,8925)/7,8925**

**= 0,0064/7,8925**

**= 0,0008**

**= 0,08%**

**Define a foreign exchange swap.**

**Foreign exchange swaps are the exchange of two currencies now at a specific exchange rate (which does not have to be the current exchange rate but is usually a rate close to it, i.e. it is a benchmark rate) coupled with an agreement to exchange the two currencies at a specified future date at the specified exchange rate plus or minus the swap points.**

####

**Thabo Express enters into a swap agreement with Fair-Value Bank to exchange USD 1 million for ZAR and to buy USD for ZAR after 60 days. The swap points quoted by Fair-Value Bank are 510/530 at an agreed benchmark rate of USD/ZAR 8,1200.**

**Indicate the cash flows of the transactions at the swap deal date and at 60 days for both parties, as well as the net cash flow for each of them.**

**This implies that Thabo will buy USD 1 million spot at the benchmark rate of R8,12 and then sell it back forward to Fair-Value at their offer rate of 8,1200 + 0,0530 = R8,1730 per USD.**

|  |  |  |
| --- | --- | --- |
|  **Date** | **Fair-Value Bank** | **Thabo Express** |
| **Swap deal date** | **+ USD 1 000 000****– ZAR 8 120 000** | **– USD 1 000 000****+ ZAR 8 120 000** |
| **60 days later** | **– USD 1 000 000****+ ZAR 8 173 000** | **+ USD 1 000 000****– ZAR8 173 000** |
| **Net cash flow** | **+ ZAR 53 000** | **– ZAR 53 000** |

**List the reasons for the use of the swap market by the central bank of a country.**

**Central banks make extensive use of the forex swap market to manage forex reserves, and to affect domestic liquidity in the banking system (money market).**

**Differentiate between a currency call option and a currency put option.**

**A currency call option bestows upon the purchaser the right to buy the underlying currency at the pre-specified price or rate from the writer of the option.**

**A currency put option gives the holder the option to sell the underlying asset at the pre-specified price or rate to the writer.**

####

**Who is responsible for the authorisation of dealer banks to act as market makers in foreign exchange in South Africa?**

**The National Treasury via the Reserve Bank**

**Discuss the consequences of depreciation of the ZAR on imported and exported consumer goods.**

**If the ZAR depreciates against a currency, the cost of South African exported goods to that country will become cheaper, whereas goods imported from that country to South Africa will be more expensive. This will, furthermore, lead to an increase in the volume of exported goods and a decline in imported goods to and from that particular country.**

###  Application questions

[Go back to ⇦ Application questions](#C14AQ)

*Read the statements below and indicate whether they are true or false.*

**Susan receives the following market quotes:**

* **USD/ZAR 7,2550/7,2570**
* **USD/CHF 1,2555/1,2575**

**Calculate both the bid and the offer rate for the CHF/ZAR and the ZAR/CHF.**

**Bid: CHF/ZAR = 7,2550/1,2570 = 5,7717**

**Offer: CHF/ZAR = 7,2570/1,2555 = 5,7802**

**CHF/ZAR 5,7717/5,7802**

**Bid: ZAR/CHF = 1/5,7802 = 0,1730**

**Offer: ZAR/CHF = 1/5,7717 = 0,1733**

**ZAR/CHF 0,1730/0,1733**

**The EUR/USD changes from 1,6255 to 1,3215.**

**2.1 Which of the two currencies has appreciated?**

**2.2 Calculate the percentage appreciation/depreciation for the EUR.**

**2.3 Calculate the percentage appreciation/depreciation for the USD.**

**2.1 The USD has appreciated against the EUR.**

**2.2 (1,3215 – 1,6255)/1,6255 = – 0,304/1,6255 = – 0,1870. Therefore the EUR has depreciated by 18,70 per cent against the USD.**

**2.3** $\left(\frac{1}{1,3215}-\frac{1}{1,6255}\right)÷\frac{1}{1,6255}$** = (0,7567 – 0,6151)/0,6152 = 0,2300. Therefore the**

**USD has appreciated by 23,00 per cent against the EUR.**

**The six-month USD interest rate is set at 8 per cent whilst the six-month ZAR interest rate is set at 6 per cent and the current USD/ZAR spot rate is 8,1850.**

**3.1 Calculate the six-month (181 day) USD/ZAR forward rate.**

**3.2 Calculate the forward points.**

**3.1 Forward rate = 8,1850 ×** $\frac{1+0,06 ×\frac{181}{365}}{1+0,08×\frac{181}{360}}$ **= = 8,1850 ×** $\frac{1,0298}{1,0402} $** = 8,1032**

**3.2 Forward points = Forward rate – spot rate = 8,1032 – 8,1850 = – 0,0818**

###  True or false questions

[Go back to ⇦ True/False questions](#C14TFQ)

*Read the statements below and indicate whether they are true or false.*

**The market-making banks in the foreign exchange market deal between themselves internationally via the telephone-screen trading system.**

**False – the market-making banks in the foreign exchange market deal between themselves internationally on an automated trading system (ATS).**

**It is the norm in the foreign exchange market that clients make known the size of their deal to the market maker but not whether they are trading as buyer of seller of the foreign currency they require a quote on.**

**True**

**Clients buy the base currency at the market maker’s bid rate, which is normally lower, and sell at their offer rate, which is normally higher.**

**False – clients sell the base currency at the dealer’s bid rate, which is normally lower, and buy at their offer rate, which is normally higher.**

**The holder of a call time option has the option but not the obligation to buy the underlying currency at the strike price at any time before or on expiry of the option.**

**False – the holder of a call time option has the obligation to buy the underlying currency at the strike price at any time before or on expiry of the option – that is, it is actually a forward transaction.**

**An American option bestows the right upon the holder to exercise the option at any time before and on the expiry date of the option.**

**True**

###  Choose the correct term

 [Go back to ⇦ Choose the correct term](#C14CTCT)

*Select the correct term to make the statement accurate.*

**Name-give-up brokers and principal brokers act in single/dual capacity in the foreign exchange market.**

**single**

**When the USD is, for example, quoted as GPB/USD 1,57595, this is referred to as a direct/indirect quotation.**

**indirect**

**Thinly traded currencies will have a dealer spread smaller/wider than more liquid currencies.**

**wider**

**In the foreign exchange market, the currency with the lower interest rate always trades at a forward premium/discount.**

**premium**

**Travel abroad will become more affordable to South Africans if the ZAR appreciates/depreciates meaningfully against the currencies of their destination countries.**

**appreciates**