QUESTION 1

Two companies make handcrafted wooden ducks and rocking horses. Information about each company's weekly production alternatives is as follows:

Company	*Ducks*	*Horses*
Treasure	60	15
Gem	24	12

Production possibilities are linear. The annual market for ducks in the relevant shipping range is saturated at 4,160 ducks. Treasure and Gem enter into a trade agreement. According to the principle of comparative advantage, which company should produce which product and why?

A. Gem should produce horses because it only needs to sacrifice four ducks compared to Treasure's 10 ducks.

B. Treasure should produce ducks because it only needs to sacrifice one-fourth of a horse compared to Gem's one-half of a horse.

C. Treasure should produce horses because it only needs to sacrifice one-half of a horse compared to Gem's one-fourth of a horse.

D. Gem should produce ducks because it only needs to sacrifice two ducks compared to Treasure's four ducks.

Explanation

Choice "B" is correct. Comparative advantage represents the ability of an entity or country to produce a good or service at a lower opportunity cost than another entity or country. Treasure has the option of producing 60 ducks or 15 horses on a weekly basis. The decision to produce ducks only costs Treasure one-fourth of a horse (15 / 60). Gem has the option of producing 24 ducks or 12 horses on a weekly basis. The decision to produce ducks only costs Gem one-half of a horse (12 / 24). From an opportunity cost and comparative advantage perspective, the best decision is for Treasure to produce ducks and Gem to produce horses.

Choice "A" is incorrect. If Gem produces horses, it will sacrifice two ducks (24 / 12) compared to Treasure's four ducks (60 / 15).

Choice "C" is incorrect. In a trade agreement, the comparative advantage lies with Gem producing horses and Treasure producing ducks.

Choice "D" is incorrect. In a trade agreement, the comparative advantage lies with Gem producing horses and Treasure producing ducks.

QUESTION 2

A significant decline in the exchange rate of the U.S. dollar generally will have which of the following effects?

- **A.** It will hurt all U.S. business.
- **B.** It will benefit U.S. importers.
- **C.** It will benefit U.S. exporters.
- **D.** It will make foreign goods cheaper for U.S. consumers.

Explanation

Choice "C" is correct. A decline in the exchange rate of the U.S. dollar will result in U.S. goods being less expensive for purchasers outside of the U.S. The currency for a foreign purchaser will be worth more relative to the U.S. dollar, allowing that purchaser to afford more U.S. goods than before. As a result, this will benefit U.S. exporters, who will be able to sell more of their goods to foreign purchasers.

Choice "A" is incorrect. U.S. businesses who sell goods to foreign purchasers will benefit from the depreciated U.S. dollar, as these purchasers will be able to afford more U.S. goods due to the decline in the exchange rate.

Choice "B" is incorrect. U.S. importers will be hurt by the decline in the exchange rate, as goods denominated in foreign currencies will now be more expensive for a U.S. purchaser. A decline in the exchange rate of the U.S. dollar implies that foreign currencies are now more expensive relative to the dollar.

Choice "D" is incorrect. Foreign goods will now be more expensive to U.S. consumers, as the U.S. dollar will be worth less relative to foreign currencies.

QUESTION 3

A country's currency conversion value has recently changed from 1.5 to the U.S. dollar to 1.7 to the U.S. dollar. Which of the following statements about the country is correct?

A. Its exports are *less* expensive for the United States.

B. Its purchases of the U.S. dollar will cost *less*.

C. Its imports of U.S. goods are more affordable.

D. Its currency has appreciated.

Explanation

Choice "A" is correct. The foreign country's exports will be less expensive for the United States since it will require fewer U.S. dollars to buy the foreign goods. If the conversion factor is 1.5 FCU to the USD, it takes $.666 to purchase one currency unit. When the conversion factor changes to 1.7 FCU to the USD, it takes $.588 to purchase one currency unit. Therefore, with the higher exchange rate the country's exports will be less expensive for the United States.

Choice "B" is incorrect. The currency of the foreign country will be able to buy fewer U.S. dollars per unit as a result of the change in the exchange rate.

Choice "C" is incorrect. Imports of U.S. goods are less affordable. It will now require 1.7 units rather than the old 1.5 units to purchase every dollar of the same U.S. goods.

Choice "D" is incorrect. The currency has depreciated.

QUESTION 4

A massive earthquake and tsunami seriously damaged the productive capabilities of auto manufacturers in Japan. As a result, workers at U.S. parts manufacturing firms dedicated to supplying the Japanese manufacturers are furloughed because the parts produced in the U.S. plants are temporarily unneeded. The negative impact of the Japanese earthquake and tsunami on these U.S. parts manufacturers is best described as:

A. Transaction risk.

B. Global sourcing complications.

C. Economic risk.

D. A shift in the economic balance of power.

Explanation

Choice "B" is correct. Global sourcing is the use of a worldwide supply chain. The reduced production in U.S. factories, as a result of a natural disaster in Japan, is an example of the complications that come from global sourcing.

Choice "A" is incorrect. Transaction risk is the risk that the settlement of a specific transaction in a foreign currency will result in a translation loss.

Choice "C" is incorrect. Economic risk is the general risk that fluctuations in exchange rates could have a negative impact on a company that either consistently sells to foreign customers or consistently buys from foreign vendors.

Choice "D" is incorrect. Shifts in the economic balance of power relate to the shared and changing ability of countries to impact the worldwide economy.

QUESTION 5

Which of the following statements is correct regarding foreign economies?

A. Lower inflation and increased purchasing power increase local demand, as imports are less expensive.

B. High interest rates reflect faster economic growth and increased demand.

C. A strong local currency reduces demand for imported goods and increases demand for exported goods.

D. A weak local currency increases demand for imported goods and reduces demand for exported goods.

Explanation

Choice "A" is correct. Lower inflation leads to increased purchasing power, which will increase local demand and will make imported goods less expensive.

Choice "B" is incorrect. High interest rates (relative to other countries) indicates slower economic growth and demand.

Choice "C" is incorrect. A strong local currency will increase the demand for imported goods and decrease the demand for exported goods.

Choice "D" is incorrect. A weak local currency will reduce the demand for imported goods and increase the demand for exported goods.

QUESTION 6

Which of the following statements is most accurate regarding methods of conducting international business?

A. International joint ventures are set up to maximize the comparative advantages of either one or both of the participating firms.

B. An example of a direct foreign investment (DFI) is a company purchasing five percent of a foreign company's outstanding stock.

C. If a company creates a new software system and offers it to previous foreign customers, it will typically be provided with no fees attached.

D. Importing will be relatively cheap for a country with a depreciating currency that is engaging in international trading.

Explanation

Choice "A" is correct. This is exactly what a joint venture is set up to accomplish...taking advantage of each participating firm's comparative advantages.

Choice "B" is incorrect. Direct foreign investment is better represented by the purchasing (or creation) of a foreign company as a subsidiary company. A purchase of five percent of a company's stock is not really representative of the degree of involvement associated with a DFI.

Choice "C" is incorrect. This is an example of licensing, and it is almost always accompanied by a fee.

Choice "D" is incorrect. Importing will be expensive for a country whose currency is depreciating.

QUESTION 7

Which of the following is/are inherent risk(s) of conducting international business?

I. Exchange rate fluctuation

II. Foreign economies

III. Political risk

A. II and III

B. I only

C. I and III

D. I, II, and III

Explanation

Choice "D" is correct. Exchange rates fluctuating can increase the risk of doing business in other countries. This is related to the fact that interest rates of the countries involved are sometimes unstable.

The state of the economy in a foreign country adds a significant risk of doing business internationally. This would consist of the foreign demand, interest rates of the foreign country, inflation and the exchange rate.

Political risk is also a significant factor in conducting business internationally. The political climate in a foreign country could impact cash flow. Factors of political risk include: barriers to trade, corruption, foreign government's attitude toward other countries, taxes, attitude of consumers to foreign firms, convertibility of foreign currency and war.

Choices "B", "C", and "A" are incorrect based on the above explanation.

QUESTION 8

All of the following represent significant political risks except:

A. The tendency of a local government to try and block foreign firms from operating in its economy.

B. A weak local currency which increases the demand for imported products.

C. The inability to convert a foreign currency into another currency.

D. Barriers to trade established by local governments.

Explanation

Choice "B" is correct. Exchange rates (and variations in rates) do pose a risk to international business operations, but they are not a political risk. In addition, a weak local currency will reduce the demand for imported goods.

Choice "A" is incorrect. A local government making it difficult for foreign firms to operate does represent a political risk.

Choice "C" is incorrect. A foreign currency that cannot be converted into another currency does represent a political risk.

Choice "D" is incorrect. Barriers to trade established by local governments represent a political risk.

QUESTION 9

Global companies that deal with the political and financial risks of conducting business in a particular foreign location face which of the following types of risk?

A. Commodity price risk

B. Interest rate risk

C. Principal risk

D. Country risk

Explanation

Choice "D" is correct. Country risk encompasses the political risk, economic risk, transfer risk, sovereign risk, and exchange rate risk associated with engaging in business with foreign countries.

Choice "A" is incorrect. Commodity price risk relates to market values and future cash inflows that are affected by fluctuations in commodity prices.

Choice "B" is incorrect. Interest rate risk relates to the fluctuation in value of an investment as a result of changes in interest rates.

Choice "C" is incorrect. Principal risk relates to the risk of losing an investment (money).

QUESTION 10

The transfer price set by a parent or subsidiary for goods or services most likely can be used by multinational companies to:

A. Transfer funds from a subsidiary located in a strong-currency country to a subsidiary located in a country with depreciating currency.

B. Transfer as much of the cost as allowable to the country with the lowest overall tax burden.

C. Change the financial statements of the individual subsidiaries.

D. Transfer as much of the cost as allowable to the country with the highest overall tax burden.

Explanation

Choice "D" is correct. Transfer pricing involves setting prices for a product or service when exchanges occur between different units within the same organization. One of the goals of transfer pricing is to minimize the amount of taxes paid by the overall organization. Shifting more costs to the country with the highest tax burden will reduce profitability for the entity in that country, which in turn will reduce taxes owed. Higher profitability in the country with the lower tax burden will minimize the overall taxes paid for the entity. Transfer prices must be set in compliance with applicable tax regulations.

Choice "A" is incorrect. Transfer prices are not set with the goal of transferring funds from a subsidiary with a strong currency to a subsidiary with a depreciating currency.

Choice "B" is incorrect. More costs should be shifted to the country with the highest (not lowest) tax burden.

Choice "C" is incorrect. Transfer prices are not set with the goal of changing the financial statements of the individual subsidiaries.

QUESTION 11

Company A and company B are subsidiaries of company C, a multinational company. A has a fixed corporate tax rate of 15 percent and B pays a 25 percent fixed corporate tax rate. A sells a component to B at a price ranging from $100 to $200 per unit. Which of the following statements is correct regarding the transfer price from A to B?

A. A transfer price of $100 will maximize after-tax profits of A and C.

B. A transfer price of $200 will maximize after-tax profits of A and C.

C. A transfer price of $200 will maximize after-tax profits of B and C.

D. A transfer price of $100 will maximize after-tax profits of B and C.

Explanation

Choice "B" is correct. Transfer pricing is applicable in a situation in which two companies that are owned by the same parent company engage in transactions with each other. Profits are maximized when the company selling the good has a lower tax rate than the company purchasing the good. A, with a tax rate of 15 percent, will pay much less in taxes than B would if B were the seller. So by charging a price of $200, A will only pay taxes at a 15 percent rate, and by paying $200, B will benefit from a tax deduction at the higher rate of 25 percent. C, as the parent company, will benefit the most under this scenario.

Choice "A" is incorrect. $100 will not maximize the profits for A and C.

Choice "C" is incorrect. $200 will maximize the profits for A and C, not B and C.

Choice "D" is incorrect. $100 will not maximize the profits for B and C.

QUESTION 12

NAFTA offers trading partners operating within its boundaries reductions in tariffs on products in exchange for compliance with limits on imported labor and materials used in the manufacture of those products. This practice is also known as a:

- **A.** Foreign trade zone.
- **B.** Value added tax.
- **C.** International rebate.
- **D.** Sourcing requirement.

Explanation

Choice "D" is correct. Sourcing requirements generally refer to content or value added limits on the percentage of labor or materials used in imported products. Compliance with limits may result in tariff reductions.

Choice "A" is incorrect. A foreign trade zone contemplates a physical location in which tariffs are waived on imported products until they leave the zone. Foreign trade zones anticipate delay rather than reductions in tariffs.

Choice "B" is incorrect. A value added tax is an incremental tax, not a reduction in tariffs.

Choice "C" is incorrect. An international rebate is not a tariff reduction practice.

QUESTION 13

Each of the following is an effect from opening markets to foreign investment, *except:*

A. An increase in the correlation of emerging stock markets with world markets.

B. A change in the volatility of emerging stock market returns.

C. A decrease in local firms' cost of capital.

D. A decrease in investment growth rates.

Explanation

Choice "D" is correct. Opening markets to foreign investment is encompassed within globalization, which is the distribution of industrial and service activities across many nations. Investment growth rates will likely increase (rather than decrease) through globalization, as there are more opportunities for investment and growth.

Choice "A" is incorrect. Emerging markets will become more correlated (integrated) with world markets as globalization increases.

Choice "B" is incorrect. Emerging markets on their own tend to be highly volatile, but integration with world markets will help to reduce that volatility.

Choice "C" is incorrect. Local firms will likely see a decrease in their cost of capital because of an increase in growth and demand.