

Economics 356 Section 001

A Few Review Questions

January, 2012

- 1.(a) The markets for foreign exchange are of central importance to international finance. To date, we have referred two classes of foreign exchange markets: (i) spot markets; (ii) forward markets. Distinguish carefully between the two classes.
- (b) Spot markets for foreign exchange can be subject to different forms of exchange rate regimes:
 - (i) fixed (pegged) exchange rates
 - (ii) flexible (freely floating) exchange rates
 - (iii) “managed” floating exchange rates

Discuss the basic nature of each exchange rate regime. Which of the three comes closest to describing the regime currently in place in Canada? Explain.

2. Variations in the exchange rates in the spot markets can have a significant impact on export and import flows. If the economy of the country in question is a very open one (such as Canada), the impact on export/import flows can, in turn, have a significant impact upon the state of the country’s economy. Since the early spring of 2009, the U.S. dollar has depreciated significantly against the Canadian dollar in the Canadian spot market for foreign exchange. After defining what the term “depreciation” means with respect to foreign exchange rates, explain on what grounds could it be argued that this depreciation of the U.S. dollar (with respect to the Canadian dollar) has slowed Canada’s recovery from the Great Recession, which commenced in the autumn of 2008.
3. Suppose, at a particular moment in time, that the price for US dollars in the Toronto inter-bank foreign exchange market is: U.S. \$1.00 = Can. \$1.0250. If the price for Canadian dollars in the New York inter-bank foreign exchange market, at that moment in time, is Can. \$1.00 = U.S. \$0.9756 (1/1.0250), we could say that the foreign exchange rates are “consistent”. After explaining what is meant by “consistency” in this context, describe the forces that would come into play to eliminate any “inconsistency” in the Toronto – New York US dollar-Canadian dollar exchange rates, which might arise. What, if anything, does the question of “consistency” of foreign exchange rates have to do with the Law of One Price? Explain.

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4. Define what is meant by Canada's Balance of International Payments, and then go on to distinguish clearly between Current Account transactions and Capital Account plus Financial Account transactions.

What precisely is the difference between Capital Inflows and Capital Outflows?

Changes in Canada's official foreign exchange reserves (Official Monetary Movements) have been placed by us in a separate category for analytical purposes. These changes, however, really reflect Financial Account transactions.

Move forward to 2013, and suppose that, for the calendar year 2012, Statistics Canada was to record a net decrease in Canada's official foreign exchange reserves of Can. \$20 billion. Would you say that the decrease in official foreign exchange reserves in 2012 constituted: (i) a Capital Inflow; (ii) a Capital Outflow; or (iii) neither? Explain.

5. "The terms Balance of Payments Surplus, and Balance of Payments Deficit have no real meaning if a country is operating under a system flexible (freely floating) exchange rates. It is only, if the country is operating under a system of fixed (pegged) exchange rates, that the terms take on meaning."

Explain why you agree, or disagree, with this statement.

6. In looking back in recent history, there is reason to believe that Can.\$ - US\$ exchange rate (spot) was in long run equilibrium in period $p - 1$. The exchange during that period was, on average, equal to:

$$\begin{aligned} \text{U.S. } \$1.00 &= \text{Can. } \$1.0500 \\ (\text{Can. } \$1.00 &= \text{U.S. } \$0.9524) \end{aligned}$$

From $p - 1$ to p , we observe the following changes in the US and Canadian price indexes, P_{us} and P_c :

Period	P_{us}	P_c
$p - 1$	100	100
p	105	120

What, according to the Relative version of the Purchasing Power Parity (PPP) Theory, should we expect the long run equilibrium exchange rate to be in period p ? Why?

7. Question 6 pertains to the Relative version of the Purchasing Power Parity Theory. There is also an Absolute version of the PPP Theory. Discuss the nature of the Absolute version of the PPP Theory, and explain how it differs from the Relative version.

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With the Absolute version of the PPP Theory in mind, what would it mean, if one were to argue that the US\$ is undervalued in relation to the Canadian \$? If one could argue that the US\$ is undervalued in relation to the Canadian \$, would it follow that the Canadian \$ is therefore overvalued in relation to the US\$? Why?

Is there any evidence, in terms of the Absolute version of the PPP Theory, that the US\$ is, in fact, currently undervalued in relation to the Canadian \$? Explain.

8. There is clear evidence that the true long run equilibrium exchange rate (spot) may deviate from that predicted PPP Theory (Absolute or Relative version). This fact has given rise to the concept of the Real Exchange Rate. After explaining the concept of the Real Exchange Rate, discuss *one* possible reason why the long run equilibrium exchange rate might deviate from that predicted by the PPP Theory.
9. Consider now the determination of the short run equilibrium Canada – US exchange rate, in the spot market.

Let the relevant short term period be one year, (i.e. $p+1$ = one year from now), and let the relevant financial instruments, Canadian and US, be one year term deposits.

Suppose that you were given the following information:

- (a) The current interest rate on Canadian one year term deposits is: 3.00%
- (b) The current interest rate on US one year term deposits is: 2.00%
- (c) Market participants, on both sides of the border, are convinced that, one year from now ($p + 1$), the Canada – US spot rate will be:

$$\begin{aligned} \text{U.S. } \$1.00 &= \text{Can. } \$1.0500 \\ (\text{Can. } \$1.00 &= \text{US } \$0.9524) \end{aligned}$$

What, according to the Interest Parity Theory studied by you, will be the short run equilibrium spot rate in the present, i.e. period p ? (Use the simplified version of the Interest Parity Equation, i.e. the non-purist version.)

What possible explanation can you give for the theory's prediction? Discuss.

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10. Suppose that we commence with short term interest rates in Canada and the US being equal, and suppose that both countries are experiencing a rate of inflation of 0%. Then suppose that, in period p , short term interest rates rise in Canada, while remaining unchanged in the US. There is no change in the inflation rates in the two countries. The expected Can. \$ - US \$ spot rate in period $p + 1$ remains unchanged. Would the US \$, according to the Interest Parity Theory, depreciate or appreciate against the Can. \$ in period p ? Would the theory lead you to believe that the US \$ (against the Can. \$) would depreciate, or appreciate, between period p and $p + 1$? Why?

11. The PPP Theory and the Interest Parity Theory appear, on the surface, to be radically different. After all, one is a long run theory based on Current Account flows, while the other is a short run theory based on Financial Account flows. There is, nonetheless, a key linkage between the PPP Theory and the Interest Parity Theory. Explain the nature of the linkage.

12. In Question 1, you were asked to explain the difference between spot and forward markets for foreign exchange. What, according to the theory studied by you in class, are the forces that can be expected to come into play in determining the equilibrium exchange rates in forward markets (take as an example the Canadian market for US\$ 12 months forward). In what sense, if any, can forward exchange rates, e.g. the exchange rate in the Canadian market for US\$ 12 months forward, be seen as predictions of future exchange rates in the spot market for the relevant currency? Explain.