In-class review questions:

*Short-run determinants of Exchange Rates.*

1. Monday trade figures – twice as bad as analysts were generally expecting them to be - reinforced fears that the economy was overheating, with imports outstripping exports and inflationary pressures surging. The government is now expected to raise interest rates almost immediately.
   a. Would you expect imports to outstrip exports in the presence of surging inflation? Explain why or why not.
   b. Why should the government be expected to raise interest rates?

2. Last week’s movement was largely triggered by Bank of Canada concerns about the drop in the Canadian dollar in the face of higher US interest rates. What is the “movement” referred to in this clip? Explain your reasoning.

3. By narrowing the spread between short-term interest rates in Canada and the United States in line with the Canadian dollar forward rate, the Bank of Canada stopped the arbitrage activity that was pushing up the Canadian dollar. Explain the arbitrage activity and how it would work in this case to push up the Canadian dollar.

4. He can’t understand why we would put our money in domestic bonds at 9 percent, when we could get double-A rated New Zealand bonds at 19 percent. Offer an explanation for this.

5. Higher inflation in both Germany and Japan has pushed up their interest rates. What he doesn’t understand is why the US interest rate hasn’t followed suit. He claims that international financial markets are so closely integrated these days that the US interest rate reaction should have been apparent by now. Comment on this observation.