In-class review questions:

Covered and Uncovered Interest Rate Parity. Speculation.

1. 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.
   a. Explain what is the Canadian forward rate, and why is it relevant here.
   b. Explain how the Bank of Canada’s move would reduce the pressure on the Canadian dollar.

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. The Canadian and the US economies are so interrelated that it will be impossible for Canadian interest rates to remain much lower than US rates for an extended period of time.
   Contradict this statement by constructing a scenario in which Canadian rates are persistently lower than US rates.

4. Within the European Monetary Union the concept of _______ parity has been completely superseded by financial arbitrage that has rendered _______ almost identical among its member countries.
   a. Fill in the blanks.
   b. Explain why there may still be some differences in (second blank) across countries that belong to the European Monetary Union.

5. This does not mean there is a massive flow of US funds into Canada because the positive interest rate differentials are mitigated by other factors.
   a. Describe those factors that mitigate the capital inflow to Canada.
   b. Explain how a profit can be made in this situation through non-hedged speculation.