International Macroeconomics Review Questions III

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1. Explain why and how the following real factors would be expected to affect the real exchange rate of a country with respect to a foreign country.
   a) Domestic and foreign income growth.
   b) World oil, energy and commodity prices.
   c) The country's terms of trade relative to that of the foreign country.
   d) Government expenditures in the two countries.
   e) Net capital flows into and out of the domestic and foreign economies.

2. What is meant by covered interest parity, the efficient markets condition, and uncovered interest parity? Are these arbitrage conditions?

3. How are domestic real and monetary shocks likely to affect the real exchange rate between the two countries when the nominal exchange rate is alternatively fixed and flexible?

4. Is there any basis for an assumption of purchasing-power-parity? What does the available empirical evidence tell us? Does it make any sense for Canada to fix its nominal exchange rate with respect to the U.S. dollar? Why or why not?

5. What do we mean when we say that a variable is non-stationary? What is the role of drift and trend? Are the real exchange rates of the major countries non-stationary? Explain the Dickey-Fuller and Phillips-Perron tests. What is the observed degree of mean reversion in the case of the major countries?

6. What does it mean to say that stationarity tests have low power?

7. Under what conditions will OLS regression results be spurious?. Explain the role of non-stationarity of the variables. How do we ensure that our results are not spurious?

8. Does covered interest parity hold empirically for the major exchange rates? Does it matter how the data are obtained and presented?

9. What do we mean by the unbiasedness hypothesis? Describe the forward rate and forward premium versions. Are they consistent with the observable evidence?

10. Do forward exchange rates predict the relevand future spot exchange rates? What is the best forcast of next period's spot exchange rate?

11. Explain fully the nature of and basis for overshooting? What factors mitigate it? Is there evidence that overshooting must actually occur?

12. What real factors are important determinants of the real exchange rate of Canada with respect to the United States? What explains the major movements before the year 2002 and what explains them after that year? Are the results consistent with the Balassa-Samuelson hypothesis? Are interest rate differentials significant determinants? If so, Why? How can we rule out the possibility that the regression results are spurious?

13. What real factors are important determinants of the real exchange rate of the United Kingdom with respect to the United States? Are the effects consistent with what you would expect? Are interest rate differentials statistically significant when added to the regression? Can we rule out spurious regression in this case?

14. Outline the factors that are important determinants of the real exchange rate of Japan with respect to the United States and explain whether or not the relationships they suggest are reasonable. Are interest rates statistically significant when added? If so, how would you explain their influence on the real exchange rate? How can we rule out spurious regression?

15. What real factors are important determinants of the real exchange rate of France with respect to the United States before France joined the Euro? Explain why they are important? Are interest rates statistically significant when added? How can we rule out spurious regression?

16. Outline the real factors that are important determinants of the real exchange rate of Germany with respect to the United States and explain why they are important. Are interest differentials significant determants of the real exchange rate? How do you explain the relationship? How can we rule out spurious regression? Why do we restrict the period of the regressions to the years before 1989?

17. Explain in general what we learn by regressing the interest rate differentials on the same real factors we used to explain movements of the real exchange rates of the five countries with respect to the United States? Why would these real factors be correlated with interest rate differentials? Is there any support for the view that the central banks can increase the domestic real exchange rate by raising interest rates and attracting capital from abroad? When we add money shocks to the regression do we find evidence that central banks are setting interest rates by creating anticipated or unanticipated money supply shocks?

18. Have unanticipated monetary shocks had any noticeable effects on the five countries' real exchange rates? Do the observed effects provide any evidence of overshooting? Is there any way that observed overshooting effects were avoided?

19. Outline the Blanchard-Quah-VAR approach to analysing the effects of monetary and real shocks on nominal and real exchange rates. Does the application of that analysis suggest that monetary shocks have had important effects on real, and nominal, exchange rates in the countries examined?

Econometric Exercise

International Monetary Fund Data on the exchange rates of Austalia with respect to the U.S. and U.K. and factors that might determine the respective real exchange rates are presented in the `Excel` file `ausdata.xls` which has descriptions of the series in the top twenty rows. These data are copied, without the descriptions, in the `Gretl` data file `ausdata.gdt`.

Using `Gretl`, investigate the real factors determining the Australian Real exchange rates with respect to the U.S. and U.K. as done in the Advanced Topic material you have read in this course. Which of the two real exchange rates are easiest to predict on the basis of relevant real factors? Do monetary shocks have a bigger effect on one of the exchange rates on the other? If the Australian central bank follows an orderly markets approach, which exchange rate does it smooth?