

Econ 3607A

Problem set 2

Ans 1: Dividend discount model: The Theory that the fundamental value of a stock equals the PV of expected future dividend payments.

$$P_{today} = \frac{D_{today}(1 + g)}{(i - g)}$$

How well the economy does depend upon the expected growth of dividends g . so when the investors are optimistic about the future they will expect the dividend to grow at a faster rate which increases the price they are willing to pay for stock. This leads to more investment and thus more economic growth. As in the formula as well if g grows P will grow as well.

Ans 2:

- a) Law of one price: two identical goods should sell for the same price regardless of location.

Strengths:

- Explains the behavior of the exchange rates over long periods (10 to 20 years)
- Explains/works on the concept of arbitrage.
- Makes comparison of same good easy in different markets
- Leads to the important concept of Purchasing power parity

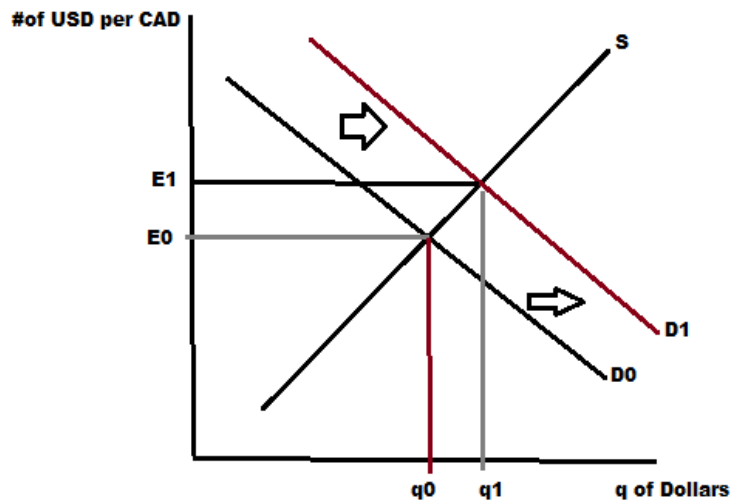
Weaknesses:

- Ignores transportation costs
- Ignores Tariff imposed by the countries
- Different specifications of goods
- Nature of services e.g. price of a haircut in India VS price of that haircut in Canada
- Different Taxation policies in different countries

- Third country intervention in exchange rates.

Ans 2:

- b) If bank of Canada increases interest rates the real yield of a Canadian bonds rises relative to the yield on Foreign Bonds leading to a rise in demand for CAD as these bonds will be more appealing investment for foreigners. A rise in desire to purchase Canadian bonds shifts CAD demand outwards to the right. (see graph)



- c) Riskiness of foreign investment if the risk related to the European investment falls/rises Canadians will want to invest more/less and thus would shift the supply of CAD right/left in terms of USD due to the cross-exchange rates.

d) .

	CAD	USD	£	€
CAD	...	1.31	1.63	1.42
USD	0.76	...	1.25	1.08*
£	0.61	0.80	...	0.86
€	0.70	0.92	1.15	...

1.08*: 1 EURO IS WORTH 1.08 USD OR YOU CAN BUY 1.08 USD FROM 1 EURO.