

# STUDY SESSION

# 4

## Economics for Valuation

**T**his study session begins with fundamental foreign exchange concept and theories of exchange rate determination. As a means to understanding exchange rate risk exposures, discussion centers on theoretical long-term equilibrium values. International parity conditions and the carry trade are described. Both direct (capital controls, foreign exchange intervention) and indirect (monetary, fiscal policy) exchange rate influencers are considered. A discussion of long-term growth and its relationship to investment returns follows. The three theories of growth (classical, neoclassical, endogenous) are presented. The session concludes with an overview of regulation, including the types, roles played by regulation, and advantages and disadvantages of having regulation in place.

### READING ASSIGNMENTS

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| <b>Reading 13</b> | Currency Exchange Rates: Understanding Equilibrium Value<br>by Michael R. Rosenberg and William A. Barker, CFA |
| <b>Reading 14</b> | Economic Growth and the Investment Decision<br>by Paul Kutasovic, PhD, CFA                                     |
| <b>Reading 15</b> | Economics of Regulation<br>by Chester S. Spatt, PhD  |

**LEARNING OUTCOMES****READING 13. CURRENCY EXCHANGE RATES: UNDERSTANDING EQUILIBRIUM VALUE**

The candidate should be able to:

- a** calculate and interpret the bid–offer spread on a spot or forward currency quotation and describe the factors that affect the bid–offer spread;
- b** identify a triangular arbitrage opportunity and calculate its profit, given the bid–offer quotations for three currencies;
- c** distinguish between spot and forward rates and calculate the forward premium/discount for a given currency;
- d** calculate the mark-to-market value of a forward contract;
- e** explain international parity conditions (covered and uncovered interest rate parity, forward rate parity, purchasing power parity, and the international Fisher effect);
- f** describe relations among the international parity conditions;
- g** evaluate the use of the current spot rate, the forward rate, purchasing power parity, and uncovered interest parity to forecast future spot exchange rates;
- h** explain approaches to assessing the long-run fair value of an exchange rate;
- i** describe the carry trade and its relation to uncovered interest rate parity and calculate the profit from a carry trade;
- j** explain how flows in the balance of payment accounts affect currency exchange rates;
- k** explain the potential effects of monetary and fiscal policy on exchange rates;
- l** describe objectives of central bank or government intervention and capital controls and describe the effectiveness of intervention and capital controls;
- m** describe warning signs of a currency crisis.

**READING 14. ECONOMIC GROWTH AND THE INVESTMENT DECISION**

The candidate should be able to:

- a** compare factors favoring and limiting economic growth in developed and developing economies;
- b** describe the relation between the long-run rate of stock market appreciation and the sustainable growth rate of the economy;
- c** explain why potential GDP and its growth rate matter for equity and fixed income investors;
- d** distinguish between capital deepening investment and technological progress and explain how each affects economic growth and labor productivity;
- e** forecast potential GDP based on growth accounting relations;
- f** explain how natural resources affect economic growth and evaluate the argument that limited availability of natural resources constrains economic growth;
- g** explain how demographics, immigration, and labor force participation affect the rate and sustainability of economic growth;

- h** explain how investment in physical capital, human capital, and technological development affects economic growth;
- i** compare classical growth theory, neoclassical growth theory, and endogenous growth theory;
- j** explain and evaluate convergence hypotheses;
- k** describe the economic rationale for governments to provide incentives to private investment in technology and knowledge;
- l** describe the expected impact of removing trade barriers on capital investment and profits, employment and wages, and growth in the economies involved.

## READING 15. ECONOMICS OF REGULATION

The candidate should be able to:

- a** describe classifications of regulations and regulators;
- b** describe uses of self-regulation in financial markets;
- c** describe the economic rationale for regulatory intervention;
- d** describe regulatory interdependencies and their effects;
- e** describe tools of regulatory intervention in markets;
- f** explain purposes in regulating commerce and financial markets;
- g** describe anticompetitive behaviors targeted by antitrust laws globally and evaluate the antitrust risk associated with a given business strategy;
- h** describe benefits and costs of regulation;
- i** evaluate how a specific regulation affects an industry, company, or security.