



**THE UNIVERSITY OF THE WEST INDIES
FIVE ISLANDS CAMPUS**

Semester II

Examinations of APRIL/MAY 2023

Course Code: SBF16030
Course Title: International Monetary Economics & Finance
Date of Assessment: April 27, 2023
Time: 9:00 am
Duration: Three (3) Hours

INSTRUCTIONS TO CANDIDATES:

This paper has 2 pages and questions.

YOU ARE REQUIRED TO ANSWER ALL QUESTIONS.

THIS ASSESSMENT IS WORTH 40 % OF YOUR FINAL GRADE.

ASSESSMENT DETAILS FROM INSTRUCTOR(S):

**There are two case studies provided: Managing The Dollar in The 1980s and Voyages Soleil:
Students are required to answer all of the questions on both case studies.**

Managing The Dollar In The 1980s (20 Marks)

1. What does it mean for a currency to be “overvalued”? In late 1984, what evidence was there that the dollar might have been overvalued?
2. How would you explain the dollar’s strength prior to 1985? What economic fundamentals appear to have been at work? What risks and opportunities did this strength present to U.S. business interests?
3. Was the dollar appropriately priced in late 1986? Again, what evidence would you cite in support of your opinion.
4. Is a weak dollar good for the U.S. economy? Why or why not? Why has the US. Trade deficit been slow to respond to the weakened dollar?
5. Why and how do exchange rates influence corporate investment decisions?
Corporate financing decisions

Voyages Soleil (20 Marks)

1. Given the information in the case, how does the future of the Canadian travel industry look over the next six (6) months? Over the next year.
2. Do you expect the value of the Canadian dollar to increase/decrease/remain the same over the next six (6) months? Over the next year.
3. Are your answers to questions 1 and 2 related?
4. As an advisor to Dupuis, what would you suggest that he do regarding the foreign exchange risk associated with this contract?

END OF QUESTION PAPER



Managing the U.S. Dollar in the 1980s

Starting in 1980, the value of the U.S. dollar increased steadily against other currencies and reached record levels by early 1985. An index of the trade-weighted nominal value of the U.S. dollar rose from 100 in 1980 to nearly 170 by late 1984 (see **Exhibit 1**). The same general pattern could be observed in the bilateral exchange rates of the dollar with the four currencies of the other major industrial countries, France, Germany, United Kingdom, and Japan (see **Exhibit 2**).

The strong dollar, coupled with the booming U.S. economy, fueled growth in sales and profitability for many industrial companies around the world. For four years, export sales to the United States increased with widening margins. The effect of the strong dollar on U.S. companies, however, was quite different. It made U.S. exports less competitive in foreign markets, allowed less expensive foreign-made goods to flood U.S. markets, and cost an estimated three million U.S. jobs. The adverse effects were so pronounced that the U.S. Congress gave serious consideration to various trade protection measures proposed by business and labor leaders. Complicating the public debate on this issue was the fact that a wide variety of theories had emerged to explain the dollar's strength.

The 1985 Dollar Debate

The debate on causes of the dollar's rising value, although far from resolved, focused primarily on the impact of relative inflation rates and interest rates on the dollar. Closely linked to these determinants were discussions concerning the balance of trade, the federal government's deficit, monetary growth, real economic growth, and international capital flows.

Briefly, the United States ran an increasingly negative trade balance, current account, and federal government budget deficit since 1980. The U.S. gross national product, however, grew at a slow but healthy rate in 1983 and 1984. Inflation slowed after reaching a peak of 13% in 1980, and interest rates generally declined after peaking in 1980 and 1981. **Exhibit 3** provides statistics on several key economic variables for the United States, France, Germany, Japan, and the United Kingdom.

Traditionally, nations with continuing balance-of-trade, current-account, and budget deficits experience depreciations in the international value of their currencies. It seemed a paradox, therefore, that the United States enjoyed a strong dollar while suffering from expanding deficits of these very same types.

Professor W. Carl Kester and Research Associate Richard P. Melnick prepared this case as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

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Some economists explained the paradox by noting that in the 1980s a happy side effect of the U.S. trade deficit was a substantial capital surplus. Although the federal budget deficit stimulated aggregate demand in the United States, thus increasing demand for imports, it was also the primary stimulant behind the capital inflows needed to finance the trade deficit.

Martin Feldstein, former chairman of the Council of Economic Advisors, and his wife, Kathleen, an economist, also blamed the budget deficit for the strong dollar. However, they viewed the trade deficit primarily as a consequence of that strength:

The current huge trade deficit is not due to any fundamental weakness of American industry or to increases in unfair trade practices of other nations . . . the real trade problem [is] the overvalued dollar.

The major and fundamental change that has occurred during the Reagan years is, of course, the unprecedented increase in the federal budget deficit. The government borrowing to finance this deficit has absorbed more than half of all net savings generated in the United States and has kept real interest rates much higher than abroad. These high interest rates attract investment from abroad and push up demand for the dollar.¹

Allan Meltzer, a professor of political economy and public policy at Carnegie-Mellon University, had a very different view of the role budget deficits played in the dollar's strength:

The effect of large budget deficits is to weaken currencies, not strengthen them. A country with continually large budget deficits eventually will have to pay the bill by raising taxes or printing money and creating more inflation. Both taxes and inflation chase away foreign investors, so either course is poison for the value of the country's currency. The exchange markets recognize this immediately, and the dollar weakens. The dollar is strong despite the budget deficit, not because of it.²

It was Professor Meltzer's opinion that the dollar was strong because of growth in the U.S. economy, particularly in the area of investment spending. This growth, he believed, was stimulated by the lowering of effective tax rates on capital spending and the lowering of inflation, which raised the real value of depreciation write-offs.

Analysts at Morgan Guaranty Trust Company emphasized yet another view on this issue. They believed that "While the large federal deficit may have contributed to a strong dollar in the past, insofar as it has increased real interest rates, continued failure to come to grips with the deficit is likely to erode confidence in the dollar."³

So-called "monetarist" economists tended to discount the importance of budget deficits and focused instead on monetary policy to find an explanation for the dollar's strength. They attributed this strong dollar to the U.S. Federal Reserve's low-inflation monetary policy adopted in the early 1980s. Indeed, some monetarists argued that the dollar would stay high so long as the Fed held monetary growth within reasonable bounds, no matter what happened to the budget deficit.⁴ As the *Wall Street Journal* claimed, "With a given set of outside influences, the value of the dollar in marks depends on how many dollars are created by the Fed and how many marks are created by the Bundesbank, period."⁵

1. Martin and Kathleen Feldstein, "Time to Raise Taxes," *Boston Globe*, October 1, 1985, p. 42.

2. Allan H. Meltzer, "How to Cut the Trade Deficit," *Fortune*, November 25, 1985, p. 177.

3. Morgan Guaranty Trust Company, *World Financial Markets*, August 1985, p. 2.

4. "The 'Cambridge Mafia' and the Friedmanites Debate the Dollar," *Business Week*, September 9, 1985, pp. 22-23.

5. "Only Schizoid Intervention," *Wall Street Journal*, September 23, 1985, p. 30.

The Group of Five (G-5) Agreement

In the midst of this confusion, the Reagan administration initiated a meeting of the finance ministers and central bankers from five major industrial countries (the "Group of Five" or "G-5"): France, Germany, Japan, the United Kingdom, and the United States. The participants met at the Plaza Hotel in New York and announced a three-point program on September 22, 1985, consisting of the following elements:

- A new U.S. commitment to join other nations in lowering the U.S. dollar's value. Although an explicit plan of intervention was only hinted, it was clear that such a commitment would require coordinated bank sales of dollars in foreign exchange markets in return for British pounds, German marks, Japanese yen and French francs;
- Tax cuts and other measures to spur growth in Europe and Japan, and to increase the value of the foreign currencies against the dollar;
- Continued Reagan-administration efforts to reduce U.S. budget deficits and resist protectionist pressures in Congress.

As a rationale for the program, it was stated in the communiqué that "recent shifts in fundamental economic conditions . . . together with policy commitments for the future . . . [had] not been reflected fully in the exchange markets." Nevertheless, it was clear that any attempt to engineer a devaluation of the dollar through market intervention would face serious risks and skepticism.

One such risk was that if this program were too successful it might result in a freefall of the dollar. This could rekindle inflation and raise interest rates. At the other end of the spectrum was the risk that the dollar would not depreciate much at all. This was especially likely if the markets interpreted the program as being merely lip service, or if the Group of Five didn't fulfill their commitments to improve investment and growth prospects in their own countries.

The general skepticism with which the G-5 announcement met was summarized by Ronald Holzer, a vice president and chief foreign-exchange dealer of Harris Trust & Savings Bank, Chicago, who stated:

The past has shown us that whenever the finance ministers from the Big Five get together there's a lot of rhetoric and little action. Any time there's talk of intervention and outside forces in the market, it creates volatility and uncertainty. But in the long term it doesn't have any lasting impact.⁶

The 1987 Dollar Debate

Following the G-5 agreement in September 1985, the dollar depreciated rapidly (see Exhibits 1 and 2). By February 20, 1986, the dollar had dropped 30% against the deutschemark and the yen, exceeding most expectations and prompting Federal Reserve Chairman Paul Volcker to say the dollar had fallen enough. In an October 1986 meeting, Treasury Secretary James Baker and Japanese Finance Minister Kiichi Miyazawa agreed that the dollar should not fall much below 155 yen. However, the Reagan administration, under pressure to decrease the trade deficit, leaked word in

6. "Central Banks' Intervention to Influence Currency Prices is a Game of Skill and Timing Played Amid Uncertainty," *Wall Street Journal*, September 23, 1985, p. 26.

January 1987 that it wanted the dollar to fall further. As the dollar continued to drop, public officials and economists debated what, if anything, could or should be done about the dollar, interest rates, and the trade deficit.

The Administration's Strategy

Nearly everyone in Washington had an opinion about the trade deficit and the dollar's fall. One argument held that the dollar's January 1987 plunge centered around the Reagan administration's effort to avoid protectionist legislation in Congress in the spring. Secretary Baker had masterminded a comprehensive exchange rate, interest rate, and global growth strategy because, "We feel that we are engaged in a life-or-death struggle to preserve the world economy."⁷ His strategy appeared to center on using the weak dollar as leverage to encourage Germany and Japan to stimulate their economies with tax and interest rate cuts. These actions, it was hoped, would support the dollar by creating demand for American exports and making it relatively attractive to invest in the United States. However, Secretary Baker denied that the administration had "talked the dollar down" in January, and noted that, "There's a limit to what you can do. The fact of the matter is, the market will determine what the appropriate level for the dollar is."⁸

Paul Volcker expressed deep concerns about a continued dollar devaluation. He feared that too much downward pressure on the dollar could send it into a free-fall like the decline of 1976 to 1980. "The danger of movements from the present level is that you get a more complete pass-through, I think, into import prices,"⁹ he told the congressional Joint Economic Committee. This outcome might yield increased domestic inflation, capital flight, higher interest rates, and eventually a recession. Chairman Volcker added the further problem that, "Declining currencies do not provide for extra flexibility in the conduct of monetary policy."¹⁰ Instead of driving the dollar down, he recommended that the Administration attack the more fundamental cause of the trade deficit. Specifically, the United States must decrease its federal budget deficit while increasing private investment in new equipment and technology.

Was the Dollar Correctly Valued?

Arguing that the dollar was in fact still *overvalued*, Martin Feldstein, former chairman of the Council of Economic Advisers, wrote, "The only thing that can achieve a sustained reduction of the U.S. trade deficit is a continued substantial decline of the dollar. And that decline is coming."¹¹ Professor Feldstein added that small differences between United States interest rates and Japanese and German interest rates could not prevent the fall of the dollar because investors realized that the dollar's current level was unsustainable.

Ronald I. McKinnon, professor of economics at Stanford University, in contrast, felt the dollar was highly *undervalued*. He explained:

At 200 yen and 2.3 marks by the end of 1985, the dollar was more or less correctly aligned with the currencies of our Japanese and European trading partners in two closely related aspects. First, there was approximate purchasing power parity.

7. *The New York Times*, February 1, 1987. Business section, p. 1.

8. *Wall Street Journal*, January 27, 1987, p. 3.

9. *Wall Street Journal*, February 3, 1987, p. 2.

10. *Wall Street Journal*, January 23, 1987, p. 3.

11. *Wall Street Journal*, November 25, 1986, p. 28.

. . . Second, rates of price inflation (as measured by changes in their respective whole-sale-price indexes in three areas) were virtually the same, and close to zero.¹²

Professor McKinnon said the reason the dollar was undervalued was that the United States followed the "false academic doctrine" that says a devaluation of a currency can by itself reduce that country's trade deficit. Since real interest rates were still too high, he believed, the United States government should reduce its budget deficit instead of pressuring other governments to expand their economies. Once the trade deficit was no longer a problem, Professor McKinnon wrote, the G-7 (the G-5 plus Canada and Italy) should meet to realign exchange rates at purchasing power parity and to coordinate their monetary and fiscal policies.

Martin Feldstein believed that intervention in the markets, as Professor McKinnon proposed, was futile. He wrote:

The decline of the dollar began in March 1985, six months before the Plaza G-5 meeting. Moreover, the dollar's value (relative to a weighted average of other industrial currencies) declined as fast between March and September of 1985 as it has since the meeting. The evidence indicates that the dollar's decline has been caused by private investors responding to economic fundamentals rather than government pronouncements or exchange-market interventions.¹³

The Continuing Trade Deficit

Surrounding the debate about the weak dollar were those who tried to explain why the trade situation had not improved despite the dollar's decline (see **Exhibit 3**). Deborah Allen Olivier, president of the Claremont Economic Institute, said, "The dollar's two year plunge is benefitting American industry very little and very unevenly."¹⁴ A lot of the problem arose because the currencies of several major trading partners such as Canada, Brazil, and South Korea had either been stable or had even fallen against the dollar (see **Exhibit 4**).

Ms. Olivier emphasized the importance of using a broad trade-weighted measure of the dollar when gauging its value. While the Federal Reserve Board said the dollar had depreciated 39% against our 10 major trading partners since early 1985, the Federal Reserve Bank of Dallas said the dollar had decreased only 5% relative to the 131 countries with which the United States traded. Ms. Olivier argued that there were "very few U.S. industries . . . more competitive today than they were 2 years ago." Furthermore, there was "tremendous variation in the amount by which various goods are influenced by currency changes."¹⁵

Others offered different reasons to explain why our trade deficits with Germany and Japan had not decreased. Deputy Secretary of the Treasury Richard Darman accused America's big corporations of being, "bloated, risk-averse, inefficient and unimaginative."¹⁶ The Japanese, it was said, were defending their United States market shares by holding dollar prices constant despite the yen's appreciation. Burk Kalweit, senior economist for the National Association of Machine Tool Builders, so noted that "The Germans aren't selling on price; they're selling on engineering and features."¹⁷

12. *Wall Street Journal*, February 2, 1987, p. 22.

13. *Wall Street Journal*, November 25, 1986, p. 28.

14. *Wall Street Journal*, January 30, 1987, p. 22.

15. *Ibid.*

16. *Wall Street Journal*, January 7, 1987, p. 1.

17. *Ibid.*, p. 18.

A more basic question was asked by Vermont Royster, editor emeritus of *The Wall Street Journal*, who wrote, "One of the things that's always puzzled me is how those who manage our economic affairs think they know what is the 'right' price for a dollar in terms of francs, pounds, yen or whatever. And if they do, why do they keep changing their minds?"¹⁸

Part of the problem, as the *Financial Times* pointed out, was that "There is no scientific way of calculating a 'correct' value for the dollar."¹⁹ Aside from pegging currencies to gold, which would be too confining, Mr. Royster was not sure how to stabilize exchange rates.

Nevertheless, many people had strong feelings about the dollar. French Economics Minister Edouard Balladur called the slide of the dollar, "excessive, unjustified and harmful to the world economy."²⁰ Karl Otto Poehl, president of West Germany's central bank, said, "It's very important that we try to stabilize the current exchange-rate pattern. . . . We are approaching a risky point in the exchange markets . . . [Further devaluation of the dollar] could cause a crisis of confidence in the dollar, and then the whole thing could get out of control."²¹ Meanwhile, Rimmer de Vries, chief international economist at Morgan Guaranty Trust Company said, "The dollar has to decline further, and the earlier the better. It is the only way we can hope for a quick turnaround."²²

The Paris Accord

Clearly, in early 1987, there was very little consensus among experts about whether or not the dollar was correctly priced on foreign exchange markets, and whether or not anything should, or even could, be done about it. Beryl Sprinkel, chairman of the President's Council of Economic Advisers, admitted, "Many of us prefer to have more stable exchange rates than we've had of late." But he added, "We have no objective about what the dollar price should be."²³

This position was ultimately reflected in the Paris Accord that was reached among six major industrial nations (the G-5 plus Canada) on February 22, 1987. The finance ministers of the six nations agreed that they were ready to intervene in the currency markets, if necessary, to stabilize exchange rates at "about their current levels."²⁴ Italy also was party to the meeting, but the Italian minister walked out before the communiqué was signed because he felt the G-5 countries had worked out the major details among themselves the day before. The communiqué released by the six remaining countries said that exchange rates were then "within ranges broadly consistent with underlying economic fundamentals."²⁵ Yet the ministers reiterated that they had not established target or reference zones for the currencies. The basis of the communiqué rested on the pledges by the United States, Germany, and Japan to resolve the trade deficit problem without further devaluing the dollar. Germany would increase the size of its 1988 tax cuts, Japan would propose new measures to stimulate its economy, and the Reagan administration would work to decrease the federal budget deficit. Mr. Baker allowed for the possibility of talking the dollar down further if other nations did not fulfill their promises.

18. *Wall Street Journal*, January 27, 1987, p. 34.

19. *Financial Times*, January 23, 1987, p. 16.

20. *Wall Street Journal*, January 15, 1987, p. 3.

21. *Wall Street Journal*, January 26, 1987, p. 25.

22. *Wall Street Journal*, January 20, 1987, p. 14.

23. *Wall Street Journal*, January 22, 1987, p. 24.

24. *Wall Street Journal*, February 22, 1987, p. 3.

25. *Ibid.*

Discord and Puzzlement

Reactions to the meeting varied. Its mere announcement on February 19 caused the Tokyo stock market to rally to a record level in hope that the Bank of Japan would cut its discount rate to 2.5%. The dollar increased sharply but then fell back when Paul Volcker spoke against target zones. After the meeting, the French Finance Minister, Edouard Balladur, expressed delight with the results and said, "We are not at the end of the road. . . . But we are on the right track."²⁶ Kiichi Miyazawa, the Japanese Finance Minister, said, "I also am very, very happy with the results of the meeting."²⁷ However, the pledges of cooperation were unconvincing to the Italian representative who had walked out, and the Canadian minister who was not much happier. One senior official remarked, "Will the markets be more impressed by the threat of intervention or the size of the imbalances this year in the absence of any new policy moves? That is the real question."²⁸

Despite the Paris Accord, Vermont Royster's earlier words might prove prophetic: "[the] powers-that-be, no matter what they say, are going to keep tinkering with our dollar on the foreign exchange markets while they search for the dollar's 'right' price. . . . But what I don't understand is how they're going to know when they've found that 'right' price. To me it's a puzzlement."²⁹

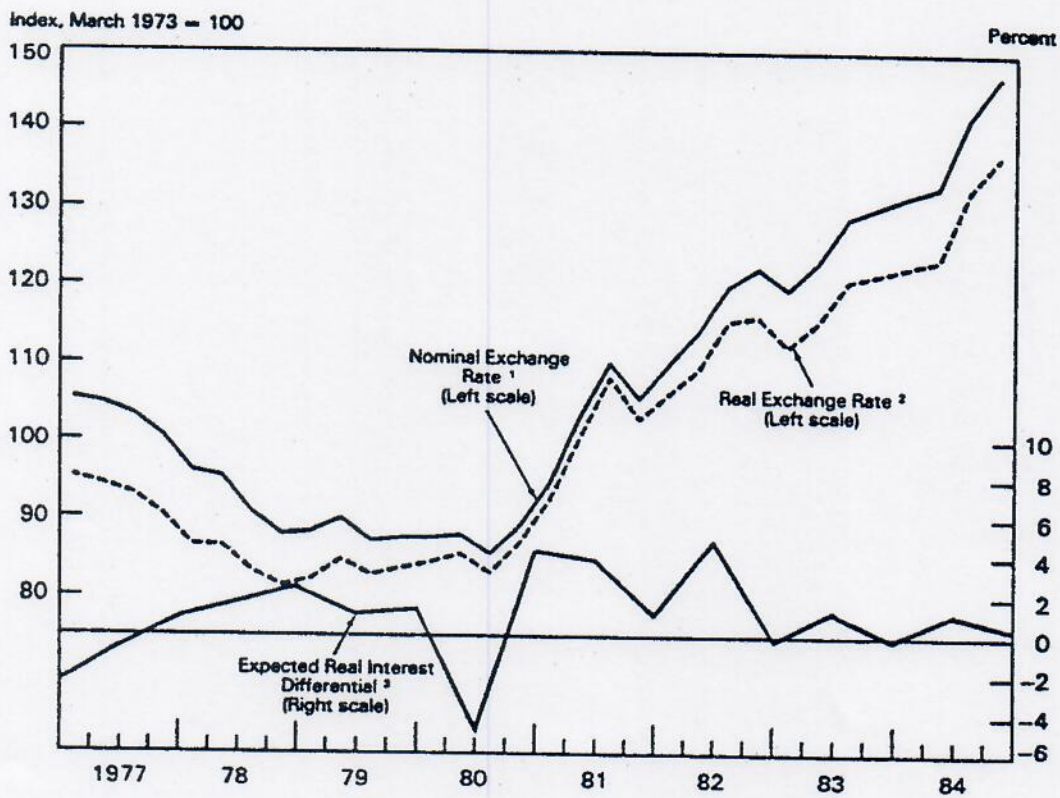
26. *Financial Times*, February 22, 1987, p. 1.

27. *The New York Times*, February 22, 1987, p. D10.

28. *Ibid.*

29. *Wall Street Journal*, January 27, 1987, p. 34.

Exhibit 1 Nominal and Real Exchange Rates and Expected Real Interest Differential



Sources: Board of Governors of the Federal Reserve System and Organization for Economic Cooperation and Development (OECD)

¹ Multilateral trade-weighted dollar.

² Nominal exchange rate adjusted by relative consumer prices.

³ U.S. interest rate (3-month) minus trade-weighted average interest rate (also 3-month) for six industrial countries adjusted by corresponding OECD inflation forecasts.

Exhibit 1 (Continued) Multilateral Trade-weighted Value of the U.S. Dollar (1980 = 100)

Year	Nominal	Real
1975	112.7	110.7
1976	120.8	114.7
1977	118.2	109.8
1978	105.7	99.3
1979	100.8	98.1
1980	100.0	100.0
1981	117.7	118.9
1982	133.4	131.7
1983	143.4	138.3
1984	158.1	151.8

Quarter	Nominal	Real
1983		
I	136.6	132.2
II	140.7	136.0
III	147.3	142.1
IV	149.0	143.2
1984		
I	150.6	144.3
II	151.9	145.4
III	162.1	156.0
IV	168.4	161.2
1985		
I	179.1	170.0
II	170.6	161.6
III	159.3	151.5
IV	146.7	139.5
1986		
I	136.7	129.8
II	130.7	123.2
III	123.9	117.8
IV	122.4	116.4

Exhibit 2 Nominal Bilateral Exchange Rates for the U.S. Dollar
(cents per unit of foreign currency)

Month	French Franc	German Mark	Japanese Yen	United Kingdom Pound
1975	23.354	40.729	.33705	222.16
1976	20.942	39.737	.33741	180.48
1977	20.344	43.079	.37342	174.49
1978	22.218	49.867	.47981	191.84
1979	23.504	54.561	.45834	212.24
1980	23.694	55.089	.44311	232.58
1981	18.489	44.362	.45432	202.43
1982	15.293	41.236	.40284	174.80
1983	13.183	39.235	.42128	151.59
1984	11.474	35.230	.42139	133.56
1983				
I	14.517	41.513	.42436	153.28
II	13.403	40.256	.42109	155.21
III	12.561	37.828	.41252	150.95
IV	12.251	37.344	.42714	146.91
1984				
I	12.060	37.052	.43326	143.50
II	12.004	36.891	.43539	139.58
III	11.160	34.251	.41055	129.65
IV	10.673	32.726	.40635	121.50

Exhibit 2 (Continued) Nominal Bilateral Exchange Rates for the U.S. Dollar
(cents per unit of foreign currency)

Month	French Franc	German Mark	Japanese Yen	United Kingdom Pound
1985:01	10.305	31.540	0.39342	112.71
1985:02	9.908	30.280	0.38391	109.31
1985:03	9.923	30.320	0.38772	112.53
1985:04	10.590	32.314	0.39708	123.77
1985:05	10.545	32.162	0.39725	124.83
1985:06	10.705	32.641	0.40186	128.08
1985:07	11.298	34.384	0.41470	138.07
1985:08	11.720	35.795	0.42112	138.40
1985:09	11.547	35.235	0.42278	136.42
1985:10	12.401	37.813	0.46581	142.15
1985:11	12.643	38.530	0.49003	143.96
1985:12	13.013	39.806	0.49312	144.47
1986:01	13.365	41.010	0.50028	142.44
1986:02	13.971	42.887	0.54098	142.97
1986:03	14.293	43.952	0.55963	146.74
1986:04	13.877	43.991	0.57113	149.85
1986:05	14.091	44.889	0.59869	152.11
1986:06	14.043	44.769	0.59687	150.85
1986:07	14.425	46.475	0.63048	150.71
1986:08	14.878	48.494	0.64859	148.61
1986:09	14.962	48.984	0.64629	146.98
1986:10	15.237	49.865	0.63910	142.64
1986:11	15.104	49.400	0.61406	142.38
1986:12	15.315	50.302	0.61709	143.93
1987:01	16.127	53.775	0.64587	150.54

Exhibit 3 Key Economic Statistics of the Five Major Industrial Countries

	Nominal Interest Rates ¹ (% per Annum)	Premium/Discount (-) on 3-Month Forward Exchange Rate ² (% of Annum)	GROWTH RATES (% PER ANNUM)			Federal Government Deficit (Billions of Local Currency)	BALANCE OF PAYMENTS (\$ MILLIONS)			Overall Balance	
			Real GNP	Money	CPI		MPI	Trade Balance	Current Account		Net Capital Flow
FRANCE											
1980	12.99	5.85	1.1	8.0	13.8	8.8	(13,419)	(4,208)	(8,480)	6,060	
1981	15.66	n.a.	0.3	12.3	13.4	11.0	(9,970)	(4,809)	(8,887)	(4,766)	
1982	15.56	-3.51	1.6	14.8	11.8	11.1	(15,785)	(12,082)	1,239	(3,606)	
1983	13.61	-2.37	0.5	11.2	9.6	11.1	(8,754)	(4,904)	9,396	4,166	
1984	12.41	-2.00	1.8	7.3	7.4	13.3	(4,089)	(14)	5,204	2,786	
GERMANY											
1980	8.50	8.17	1.8	2.4	5.4	7.6	8,970	(16,003)	1,930	(15,650)	
1981	10.38	3.16	(0.1)	0.9	6.3	7.8	16,570	(5,419)	6,830	1,560	
1982	8.95	3.28	(1.0)	3.2	5.3	5.9	25,280	3,135	50	2,920	
1983	7.89	3.94	1.3	10.3	3.3	1.5	22,270	4,170	(6,020)	(1,230)	
1984	7.78	2.92	2.5	3.4	2.4	2.9	22,340	6,074	(10,780)	(1,130)	
JAPAN											
1980	9.22	7.00	4.9	0.8	8.0	17.8	2,130	(10,750)	18,880	5,030	
1981	8.66	6.46	4.0	3.7	4.9	1.4	19,960	4,770	(1,560)	3,640	
1982	8.06	1.87	3.2	7.1	2.6	1.8	18,080	6,850	(16,200)	(4,700)	
1983	7.42	3.70	3.0	3.0	1.8	-2.2	31,460	20,800	(21,320)	1,550	
1984	6.81	1.85	5.8	2.9	2.3	-0.3	44,260	35,000	(36,540)	2,120	
UNITED KINGDOM											
1980	13.79	3.34	(2.6)	4.4	18.0	14.0	3,715	8,690	(7,631)	(1,443)	
1981	14.74	-1.51	(1.3)	10.2	11.9	9.6	7,756	15,070	(15,060)	(825)	
1982	12.88	-0.99	2.3	8.2	8.6	7.7	3,423	8,435	2,228	5,673	
1983	10.81	-0.72	2.5	14.2	4.6	5.4	(1,813)	4,862	(7,659)	(1,247)	
1984	10.69	-1.21	2.0	14.6	5.0	6.2	(5,677)	733	(13,469)	(10,719)	
UNITED STATES											
1980	11.39	n.r.	(0.3)	6.4	13.5	14.1	(25,500)	1,860	(34,830)	(7,890)	
1981	13.72	n.r.	2.5	7.1	10.4	9.1	(27,980)	6,620	(25,750)	(1,250)	
1982	12.92	n.r.	(2.1)	6.6	6.2	2.0	(36,470)	(9,230)	(21,490)	2,030	
1983	11.34	n.r.	3.7	11.2	3.2	1.3	(62,020)	(40,860)	25,190	(4,050)	
1984	12.48	n.r.	6.8	6.9	4.3	2.4	(108,270)	(101,600)	77,030	150	

Source: IMF, International Financial Statistics, 1985

¹ Government Bond Yields (average yields to maturity).² Based on end-of-year quotations for each currency against the U.S. dollar.

Exhibit 3 (Continued) Key Economic Statistics of the Five Major Industrial Countries

	Nominal Interest Rates (% per annum)	Premium/Discount (-) on Three-Month Forward Exchange Rate (% per annum)	GROWTH RATES CPI WPI (% per annum)	BALANCE OF PAYMENTS (\$ MILLIONS)			Overall Balance
				Trade Balance	Current Account	Net Capital Flow	
France							
1985:							
I	12.27	(1.81)	5.6	(2,190)	(1,712)	71	595
II	11.83	(3.16)	7.4	(501)	965	1,519	1,281
III	11.97	(2.80)	3.9	(1,107)	37	80	(184)
IV	11.33	(2.00)	2.5	(734)	1,617	2,167	689
1986:							
I	9.19	(4.84)	0.5	(1,215)	(416)	(519)	80
II	8.65	(0.53)	2.8	(1,010)	1,021	(1,438)	6,706
III	8.51	(2.08)	2.5	(553)	N/A	N/A	N/A
IV	9.89	(5.78)	2.7	N/A	N/A	N/A	N/A
Germany							
1985:							
I	7.44	2.63	4.4	5,070	1,540	(950)	(3,950)
II	7.02	2.28	2.3	6,070	3,001	(160)	1,730
III	6.55	3.60	-1.0	6,970	1,990	(620)	1,870
IV	6.57	6.72	1.3	10,550	7,210	(470)	1,240
1986:							
I	6.21	2.88	0.0	11,480	6,870	9,070	840
II	6.17	2.34	-1.0	12,840	8,230	250	(3,880)
III	6.26	1.51	-2.0	14,850	8,010	4,720	2,100
IV	6.25	1.36	-1.3	N/A	N/A	N/A	N/A
Japan							
1985:							
I	6.97	2.76	0.7	8,930	6,810	(10,350)	150
II	6.53	1.56	3.6	14,190	13,270	(17,040)	950
III	6.36	1.80	0.7	15,080	13,090	(17,810)	(410)
IV	6.10	4.73	1.4	17,790	16,000	(18,060)	(550)
1986:							
I	4.80	2.16	0.3	14,560	12,670	(19,890)	1,180
II	4.83	2.28	1.0	23,910	23,100	(28,990)	5,720
III	4.65	1.24	-2.1	26,590	24,210	(37,760)	7,300
IV	4.66	1.83	0.0	N/A	N/A	N/A	N/A
United Kingdom							
1985:							
I	10.34	3.86	5.1	(2,012)	(765)	(5,914)	1,567
II	10.45	4.56	4.4	(519)	1,342	(2,175)	(2,595)
III	10.15	3.25	1.1	(670)	2,095	(4,847)	(1,700)
IV	10.35	3.64	2.0	916	2,669	(4,206)	(419)
1986:							
I	8.75	3.79	2.8	(2,578)	229	(3,946)	894
II	9.32	2.96	5.4	N/A	N/A	N/A	N/A
III	10.31	4.60	0.3	N/A	N/A	N/A	N/A
IV	10.17	4.52	5.3	N/A	N/A	N/A	N/A
United States							
1985:							
I	11.92	n.r.	2.5	(23,460)	(23,550)	13,450	10,850
II	10.62	n.r.	5.1	(30,350)	(30,380)	14,620	(7,530)
III	10.67	n.r.	2.8	(33,650)	(32,340)	17,840	(2,420)
IV	9.49	n.r.	3.7	(36,980)	(31,480)	25,090	4,720
1986:							
I	7.50	n.r.	0.9	(34,560)	(31,040)	6,750	(2,050)
II	7.79	n.r.	-0.9	(35,930)	(35,500)	20,240	(14,060)
III	7.95	n.r.	3.1	(39,620)	(40,210)	14,920	(15,170)
IV	7.79	n.r.	2.1	N/A	N/A	N/A	N/A

Exhibit 4 The Largest U.S. Bilateral-Trade Deficits

Country	DEFICIT		Change in U.S. Dollar vs. Foreign Currency (9/85-12/86)	Products Exported to U.S.
	1986 Nine Months ^a	1985 Nine Months ^a		
Japan	\$43,871	\$34,659	-34.0%	automobiles and parts, steel, electronics
Canada	18,803	16,474	+0.3	automobiles and parts, lumber, machinery
West Germany	11,415	8,367	-32.0	automobiles and parts, chemicals, machinery
Taiwan	10,716	9,085	-12.0	apparel, electronics, telecommunications gear
South Korea	4,788	2,926	-3.0	textiles, electronics, automobiles, steel
Italy	4,549	3,711	-29.0	apparel, footwear, machinery
Hong Kong	4,303	4,150	-0.2	apparel, electronics, telecommunications gear
Mexico	4,013	4,326	+135.0	automobiles and parts, oil, machinery
Britain	3,534	2,540	-7.0	oil, vehicles, chemicals, machinery
Brazil	2,516	3,622	-109.0	iron, steel, coffee, oil
Switzerland	2,485	1,026	-31.0	chemicals, machinery, pharmaceuticals
France	2,455	2,656	-25.0	automobiles and parts, steel, machinery, wine
Indonesia	1,981	2,898	+47.0	oil, rubber, coffee
Sweden	1,886	1,751	-19.0	automobiles, steel, machinery
Venezuela	1,659	2,025	0.0	oil, metals
Nigeria	1,591	1,568	x	oil
Algeria	1,042	1,473	x	oil
Singapore	1,017	635	-0.9	apparel, electronics, telecommunications gear
South Africa	891	631	-17.0	metals, chemicals
Denmark	712	671	-28.0	furniture, meat
Ecuador	639	886	+34.0	wood, oil, textiles
India	633	602	+8.0	fibers, apparel, oil, misc. manufactured items
Malaysia	512	513	+4.0	rubber, apparel, electrical machinery
Philippines	493	590	+11.0	apparel, electrical products, wood
Angola	438	629	x	oil

Source: *Wall Street Journal*, January 7, 1987

^a In millions.

Note: (x) = No quotes available—insufficiently traded.

VOYAGES SOLEIL: THE HEDGING DECISION

Jonathan Michel prepared this case under the supervision of Professor Stephen Sapp solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

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On March 30, 2002, Jacques Dupuis, president and owner of Voyages Soleil (VS), one of Quebec's leading tour operators in packaged vacations to the Caribbean and South America, sat at his desk in downtown Montreal, pondering what measures he should take to manage his company's upcoming foreign exchange obligations.

On April 1, 2002, Dupuis and his management team must finalize their contracts for hotel rooms for the upcoming fall and winter seasons. Even though the contracts were finalized on April 1, the actual payments were not due until the beginning of the winter season (October 1, 2002). As a consequence, Dupuis needed to determine how to deal with the foreign exchange risk on the US\$60 million in payables for this fall, based on the tour company's expected volume for the coming season.

Industry

Between 1998 and September 11, 2001 (9/11), the Canadian tour operating industry had been flourishing, showing average growth rates above eight per cent. The strength of the Canadian economy was bolstering sales as this industry was very positively correlated with the overall economy (see Exhibit 1). After the terrorist attacks of 9/11 in the United States, the overall economy slowed down somewhat, but the travel industry, which comprises of airlines, hotels, cruise lines, etc., was hit much harder. Specifically, any form of tourism involving air travel was severely affected. Increased security, increased delays at airports and fear of air travel persisted.

Following the events of 9/11, the total number of trips Canadians made to the United States dropped by almost 25 per cent. Although the majority of this drop was believed to be a result of factors related to terrorism, the falling value of the Canadian dollar had been slowing travel to the United States before 9/11. Though VS had seen only a slight decline in business during the winter of 2001-2002, overall trips by Canadians to Florida had fallen by 15 per cent and those to Mexico by 12 per cent in this period.

The decline in business following the events of 9/11 had resulted in two of Quebec's seven tour operators declaring bankruptcy, and the rest were struggling to ensure their survival. Indeed, the volumes for the tour operating industry in Quebec declined by between 30 per cent and 50 per cent. It was mainly the smaller, less well-known firms that had been unable to weather this storm. As a result, the industry climate became one of stringent competition, to service the few who were willing to travel, and risk minimization with regards to product lines and capital expansion. Due to these conditions, all five remaining tour operators were projecting negative earnings for 2002 but were hoping that conditions would improve in the next year, as concerns revolving around the events from 9/11 and the changing nature of air travel started to subside.

Voyages Soleil, Inc.

VS had serviced Quebec travellers since 1975. Since that time, it had established itself as one of Quebec's leading tour operators. The company built strong relationships with its customers over this time, and it became a trusted client of the airlines and hoteliers in its southern markets. VS's strong reputation among customers and suppliers and its leadership position in the market had allowed VS to experience sales growth of roughly 50 per cent from 1997 to 2001. Since 9/11, VS had, however, seen a decline of roughly five per cent, which was much less than experienced by its competitors.

VS provided a wide range of products to its clients. During the winter months, VS offered travel packages that included air travel and a resort stay at the destination of the client's choice. Possible destinations available to VS's clients included: the French Caribbean (Guadeloupe and Martinique), Costa Rica, Cuba, Dominican Republic, Florida, Mexico, Nicaragua and Venezuela. Over the upcoming 2002/2003 winter season, VS had reserved a slightly larger number of rooms than it had reserved last year in over 35 hotels in all eight destinations, with a bill totalling US\$60 million. Although VS had some leftover rooms in the previous year, Dupuis was forecasting a return to the pre-9/11 levels for the upcoming season and therefore did not want to be left short.

Since the majority of VS's clients were from Quebec, the clients paid for these packages in Canadian dollars, but the hotels at these destinations would accept payment in U.S. dollars only. As a consequence, VS faced foreign exchange risk on its packages. Further complicating this situation, VS had to book its space with these resorts in April and pay for them by October of the same year, and it had to determine the prices to charge its clients in April so that the brochures could be printed and ready for its clients to start booking their travel in September. Though clients could start booking their packages as early as September, the majority booked and paid for their packages in October and November. When economic conditions were challenging, clients would wait until December or January to book.

As a consequence of this arrangement, one of the major concerns facing VS was the impact that changes in the Canadian dollar may have on the company's ability to pay its suppliers in October. Exhibit 2 demonstrates how the Canadian dollar has been decreasing in value over the past decade. In particular, since 1998, the Canadian dollar has gone from 0.6940 US\$/Cdn\$ in January 1998 to 0.6298 US\$/Cdn\$ in March 2002, having hit historical lows in February 2002. Because of the low value of the Canadian dollar and the crippling aftermath of 9/11 on the travel industry, Dupuis had to decide what to do with his U.S.-dollar obligations for hotels in the coming year. At the current exchange rate of 0.6298 US\$/Cdn\$, the US\$60 million payable would cost over Cdn\$95 million. If the Canadian dollar were to continue depreciating and reach 0.6000 US\$/Cdn\$, for instance,¹ the payable would then be Cdn\$100 million. Due

¹ In a CIBC World Markets report in October 2000, Jeffrey Rubin writes that while "the timing may be a little premature." He predicted that the Canadian dollar would be heading for 60 cents within the next 12 to 18 months.

to the competitive market, VS needed to price its products aggressively to attract customers yet still provide enough of a mark-up to protect itself from adverse movements in the exchange rates. This had always been an issue for VS, and Dupuis had tended to be risk averse in the face of these uncertainties.

Economic Climate

Since 1998, the S&P/TSX Composite Index for the Canadian equities market has continued to fluctuate and has only recently stabilized following the impact of the events of 9/11 (Exhibit 3). After peaking in July 2001, the Index had decreased in value. The events of 9/11 only strengthened the losses. By the end of 2001, however, the value of the Index appeared to be stabilizing. Despite the slowing of the growth in the equity markets since the early 1990s, Canadian GDP growth remained positive (Exhibit 1). In March of 2002, the growth in GDP was reported to be a positive 2.4 per cent annualized, and expectations for the coming months were for continued positive growth at above three per cent. Interest rates in both Canada and the United States were expected to continue their decreasing trend in an attempt to stimulate the economy after the fall in consumer confidence post-9/11 (see Exhibit 4).

There were several factors affecting the fluctuations in the value of the U.S. dollar. In the short term, a slower-than-expected recovery of the financial markets and high-profile corporate scandals had hurt the U.S. dollar, but these conditions were not expected to persist. In the long term, it was frequently believed that the U.S. dollar would be negatively affected by concerns over the large and growing current account deficit. However, the widening gap of the current account deficit was expected to be offset by productivity increases, the U.S. dollar was expected to remain at its current levels.

Since the Canadian dollar continued to fall in the wake of the events of 9/11 despite the strong Canadian economy, analysts were unclear about the future direction of the Canadian dollar. The standard factors used to help forecast exchange rates were pointing in different directions (see Exhibits 4, 5, 6 and 7). These factors combined with the continuing slide of the Canadian dollar over the previous five years left Dupuis concerned that the Canadian dollar would continue to decline, hurting VS's profitability even more. As a consequence, Dupuis did not know whether he should hedge his US\$60 million payable or wait to see how the value of the Canadian dollar changed between the present time and October 2002, when VS was stipulated, by contract, to pay its hotels for the entire winter season.

Alternatives available to Voyages Soleil

Should the value of the U.S. dollar continue to rise versus the Canadian dollar, the hotel costs would increase significantly, hurting the already diminished margins being faced by VS due to the increasing level of competition in the Canadian travel market. In contrast, should the value of the US\$ begin to decline versus the Canadian dollar, VS would be able to decrease the costs of hotels to its clients or increase margins. There were three alternatives being considered by Dupuis to cope with these risks:

1. Wait and exchange the Canadian dollars in October at the prevailing spot exchange rate at that time.
2. Employ forward contracts for all of the payable, locking in the Canadian dollar price
 - The six-month forward rate at April 1, 2002, for contracts buying up to US\$100 million was 0.6271 US\$/Cdn\$.
3. Borrow Canadian dollars to buy U.S. dollars on April 1, 2002, and invest the U.S. dollars for six months. The loan could then be paid using the Canadian dollars available for the hotel payments.

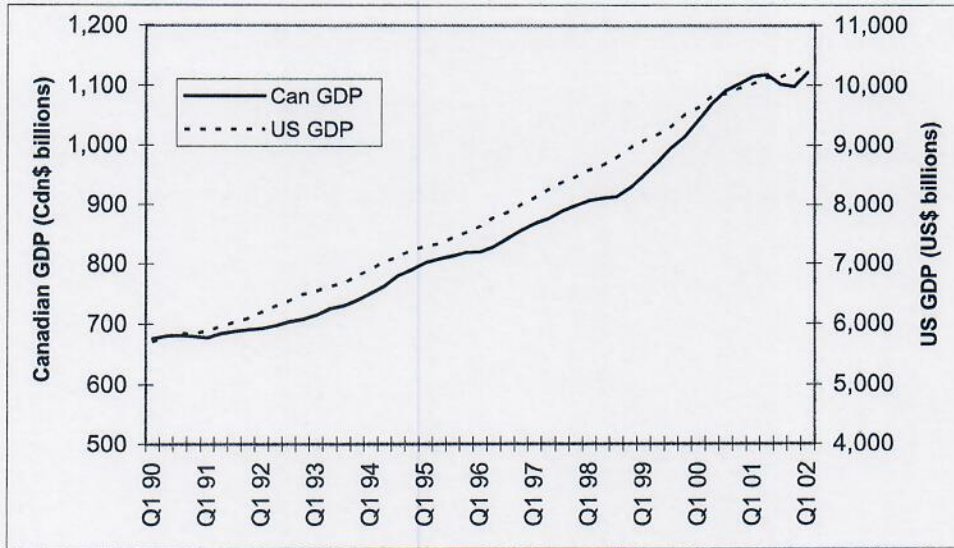
- In late March 2002, the spot exchange rate was 0.6298 US\$/Cdn\$. The Euro-Canadian dollar six-month interest rate for borrowing was 2.70 per cent and depositing was 2.55, while the Euro-U.S. dollar (frequently just called the Eurodollar) six-month interest rate for borrowing was 1.85 per cent and depositing was 1.65 (Note: all of these rates are quoted on an annualized basis).

DECISION

VS's situation was a precarious one. After the events of 9/11, all travel businesses, including VS, were scrounging for profit. Dupuis knew that a bad bet on foreign exchange risk could have a detrimental effect on VS's short-term profitability. However, he knew that any profit made by the company's foreign exchange obligations could be passed onto customers by lowering prices and essentially, swaying the undecided customer to take advantage of lower prices and raise much-needed total volume. This dilemma was further complicated by the uncertainty regarding the future demand for the proposed packages.

Exhibit 1

GROWTH RATE IN THE CANADIAN AND U.S. ECONOMIES
1990 to 2002



Source: Datastream.

Exhibit 2

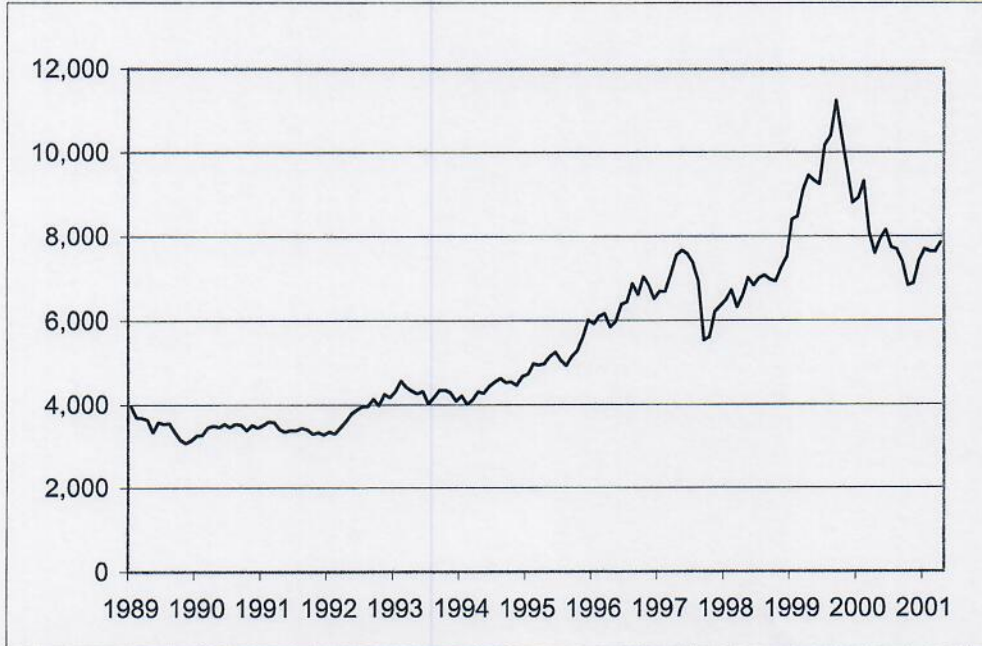
U.S. DOLLAR — CANADIAN DOLLAR EXCHANGE RATE FROM 1990 TO 2002



Source: Datastream.

Exhibit 3

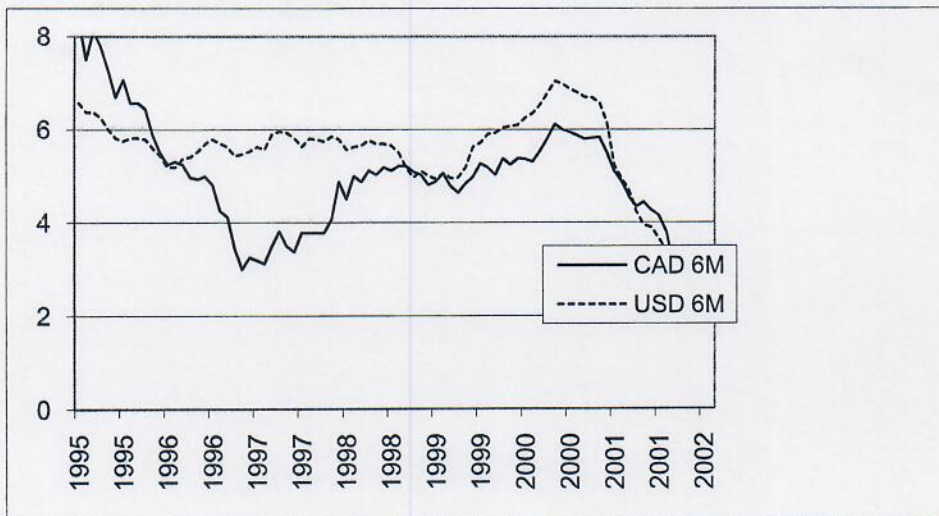
CANADIAN STOCK MARKET INDEX — TSE
1990 to 2002



Source: Datastream.

Exhibit 4

U.S. AND CANADIAN SIX-MONTH INTEREST RATES
1995 to 2002



Source: Datastream.

Exhibit 5

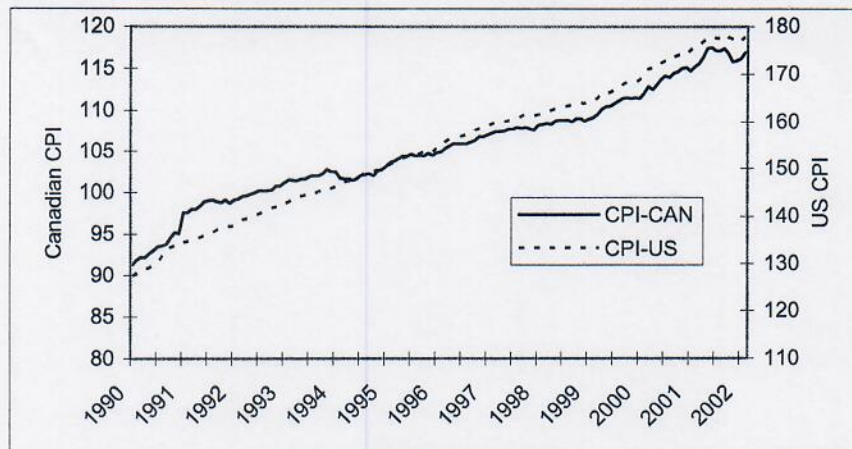
U.S. DOLLAR — CANADIAN DOLLAR SIX-MONTH FORWARD RATES
1990 to 2002



Source: Datastream.

Exhibit 6

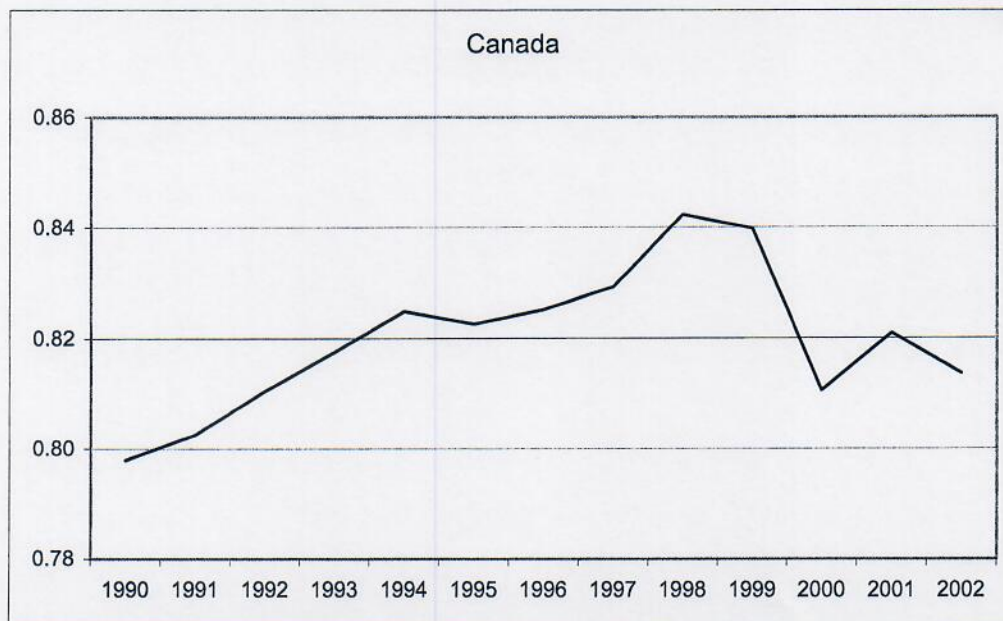
U.S. AND CANADIAN INFLATION RATES



Source: Datastream.

Exhibit 7

US\$ — CDN\$ PPP EXCHANGE RATES



Source: Datastream.